NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA

DATE: **January 2003** **LETTER NO.:** **03-CU-01**

TO: **Federally Insured Credit Unions**

SUBJ: **Loan Charge-off Guidance**

ENCL: **Enclosure A: Guidance on On-going Quality Control Procedures**

Dear Manager and Board of Directors:

In June 2002, we issued NCUA Letter to Credit Unions No. 02-CU-09, Allowance for Loan and Lease Losses (ALLL), along with the Interpretive Ruling and Policy Statement (IRPS) No. 02-3, Allowance for Loan and Lease Losses Methodologies and Documentation for Credit Unions. This IRPS clarifies our expectations regarding methodologies and documentation support for the ALLL. An essential part of a credit union's ALLL methodology is a comprehensive, disciplined, timely, and consistently applied charge-off policy for uncollectible loans. This letter is intended to provide guidance on the systematic charge off of uncollectible loans.

For financial reporting purposes, including regulatory reporting, credit unions must determine the provision for loan and lease losses and the ALLL in accordance with generally accepted accounting principles (GAAP). GAAP requires a credit union to maintain written documentation to support the amount of the ALLL and the provision for loan and lease losses reported in the financial statements. The IRPS does not change existing accounting guidance in or modify the documentation requirements of GAAP. It is intended to supplement, not replace, current guidance.

The IRPS does not address or change current guidance regarding loan charge offs. The board of directors should appropriately tailor a charge-off policy to the size and complexity of the credit union's operation. The charge-off policy should reflect current judgments about the credit quality of the loan portfolio.

The board of directors may adopt a policy that delegates to the manager the authority to charge off loans. The board should approve the extent of the delegation (i.e., the dollar amount and loan type), reflect the approval in board minutes, and note the parameters in the written loan charge-off policy. The policy should address any areas where the manager is specifically prohibited from charging off loans, e.g., when the charge off may constitute a conflict of interest, such as loans to family members.

Management should report loans charged off under the delegated authority to the board at the next regularly scheduled board of directors meeting. NCUA recommends the board ratify all delegated charge offs. The manager should refer loans not meeting the established criteria in the charge-off policy to the board for their consideration. The board should periodically review management and staff compliance with the charge-off policy.

When the board deems the loan a loss, they must charge off the loan to the ALLL account in compliance with full and fair disclosure requirements of Part 702 of NCUA Rules and Regulations. The credit union's charge-off policy should address loans presenting a high probability of loss. Examples include the following:

- A non-performing loan more than six months past due without a payment of at least 75 percent of a regular monthly installment within the last 90 days. In cases of non-performing loans, transfers from shares and proceeds from the sale of collateral generally do not constitute "payments";

- A delinquent loan in the hands of an attorney or collection agency, unless there are extenuating circumstances to indicate the credit union will collect the loan;

- A "skip" where the credit union has had no contact for 90 days;

- An estimated loan loss, where the credit union has repossessed, but not yet sold, collateral on hand. The credit union may transfer the loan balance into the Collateral in Process of Liquidation account and should charge off any outstanding loan balance in excess of the value of the property, less the cost to sell;

- An estimated loan loss, where the credit union has foreclosed on, but has not yet sold the property securing the real estate loan at the fair value of the property. The credit union should transfer the loan balance into the Other Real Estate Owned (OREO) account and should charge off any loan balance in excess of the value of the property, less the cost to sell;

- A loan in bankruptcy, within 60 days of receipt of notification of filing from the bankruptcy court, unless the credit union can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. However, in

Chapters 11 and 13 bankruptcy proceedings, if the court lowers the amount that the borrower must pay, the credit union should immediately charge off that portion of the debt discharged by the court.

- A fraudulent loan, no later than 90 days of discovery or when the loss is determined, whichever is shorter;

- A loan of a deceased person when the loss is determined;

- A loan, where a deficiency balance remains after the sale of repossessed collateral and where the credit union has received no payment and has no apparent course of action; and

- A loan deemed uncollectible, where additional collection efforts are non-productive regardless of the number of months delinquent.

The examples above are intended to provide guidance to the credit union for developing a charge-off policy and do not constitute a complete list of loans the board should consider for charge off.

Credit unions should keep in mind that their ALLL methodology should provide an ALLL sufficient to cover necessary charge offs. If the ALLL account balance is insufficient to cover loans identified for charge off, management may need to re-evaluate the ALLL funding methodology.

In addition to a charge-off policy, credit unions should also implement a quality control process by which they review the loan portfolio, or components of the loan portfolio, to determine if existing or potential risk factors exist that, if left unattended, could adversely affect the overall quality of the loan portfolio. Credit risk occurs when the borrower cannot repay according to the terms of the loan. Management's responsibility includes identifying and monitoring credit risk and delinquency, as well as charged-off loans, on an ongoing basis. Adequate funding of the ALLL and/or low delinquency and loan loss ratios do not necessarily mean the credit union properly mitigates its credit risk.

The credit union's quality control process may include preparing lists to monitor and track delinquent loans, other problem credits (including past due leases and accounts receivable), and special mention loans. The preparation and maintenance of these reports vary among credit unions and largely depend on the credit union's resources and sophistication. Tracking the loans on these lists enables management to assess the performance of the loan portfolio and act to mitigate risk therein through necessary changes in policies and/or procedures. The quality control process also serves as a tool to assist the credit union in identifying loans for charge off on a timely basis.

As part of on-going quality control, management may want to consider developing a "watch list" for reviewing and tracking loans that meet certain criteria to ensure that policies and underwriting, especially for new programs and systems, are safe and sound. Enclosure A, Guidance on On-going Quality Control Procedures, contains information on developing watch lists, which credit unions may find beneficial[1].

The examination process includes procedures for determining whether the credit union has a reasonable and timely method of charging off loans. A sound charge-off policy and documentation of an effective quality control procedure helps demonstrate management's commitment to identify, monitor, measure and control the risk in the loan portfolio. Further, establishment of a charge-off policy is an essential part of a credit union's ALLL methodology. Finally, proper implementation of a charge-off policy can avoid an intentional or unintentional misstatement of the credit union's net worth position.

Credit unions are encouraged to contact their NCUA Regional Office or State Supervisory Authority if they have questions regarding this guidance.

Sincerely,

/S/

Dennis Dollar
Chairman

Enclosure

[1] The NCUA Examiner's Guide Chapter 10 – Part 2, Credit Risk, Delinquency, and Charge Offs provides additional information on sound quality control procedures. The Examiner's Guide may be accessed using the Internet at www.ncua.gov in the Reference Information section.