NCUA LETTER TO CREDIT UNIONS

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TO THE BOARD OF DIRECTORS OF THE FEDERALLY INSURED CREDIT UNION ADDRESSED

This letter provides interim guidance for establishing and maintaining the allowance for loan losses (ALL), one of the most important items affecting credit unions. The ALL should result in a fair presentation of financial statements in conformity with generally accepted accounting principles (GAAP) and meet regulatory requirements for full and fair disclosure. It affects profitability, reserves, and CAMEL ratios, and can be an area of disagreement during an examination. Because of the importance of this issue, the National Credit Union Administration (NCUA) and its examiners and credit unions and their managers must have a clear and consistent policy to follow. NCUA has been working with the credit union trade associations, the American Institute of Certified Public Accountants (AICPA), and selected credit unions to develop a definitive Accounting Bulletin in this area and it will be issued soon. This guidance should be used in the meantime.

GAAP requires that the ALL represent an estimate of loan losses in the entire loan portfolio accordance with Statement of Financial Accounting Standard No. 5, Accounting for Contingencies. The AICPA recently issued an exposure draft of a proposed audit and accounting guide that provides additional guidance in this area. Those credit unions currently receiving "opinion audits" performed by independent, certified public accountants should already be providing for probable losses on the entire loan portfolio - For these institutions, this letter should provide information only. The methodology and loss estimate will be reviewed during each examination.

Recognizing that in practice greater emphasis is being put on the ALL representing inherent losses in the entire portfolio, NCUA has been reviewing the guidance issued in NCUA's Accounting Manual to compute the ALL. Historically, financial institutions, including credit unions, have established an ALL based strictly on nonperforming or delinquent loans. NCUA's Accounting Manual outlines two different methods for establishing the ALL. The first method, "the experience method," uses the credit union's historical loss ratio and applies it to total loans outstanding to arrive at the level of the ALL. The second method, "the adjustment method," involves an individual review of delinquent loans. This is the method used most often by credit unions and has historically been used by examiners to determine the adequacy of the ALL.

Although both the experience and adjustment methods are useful in establishing an ALL, both methods have shortcomings. The experience method may not reflect current economic conditions. The adjustment method may not deal with probable losses in the current portfolio. Both methods have served NCUA and credit unions well for many years, but are being revised to be more reflective of GAAP requirements.

Credit union management is responsible for the timely and periodic determination of an adequate and reasonable ALL, and must use a reasonable method for estimating losses in the loan portfolio. NCUA examiners will check the adequacy of the ALL by using the following test as a guideline:

Establish and maintain an ALL which represents the total estimated probable losses in the entire loan portfolio based on all relevant conditions. The ALL account should approximate the total of the following two steps. While this method may produce results that approximate an acceptable ALL under GAAP, it tends to be conservative and care must be taken in interpreting the results.

(1) Review each delinquent or nonperforming loan and selected large loans and determine the amounts that are losses or doubtful of collection. Refinancing and extension agreements without an adequate payment history would be considered nonperforming. Add the anticipated loss amount for each loan.

(2) Compute the credit union 5-year average loss ratio. Determine whether this is a reasonable ratio to apply to the balance of the loan portfolio in light of current economic conditions and unusually high or low charge-offs in prior periods. Multiply this ratio by total loans outstanding less loans that have been individually reviewed per step (1). For those credit unions which maintain sufficient detail, computing a loss ratio for each loan category (i.e., auto, real estate, business, etc.) would be appropriate.

(Note: Examiners will be instructed to use their judgment. The analysis and estimate of probable losses in the ALL, especially in step (2), should be tempered by economic realities, i.e., it may be appropriate to shorten the historical time period during periods of significant economic expansion or contraction to more accurately reflect loss experience in the current economic climate. Recent real estate problems in the Southwest and New England do prove that real estate values can plummet. Also, the loss ratio may be adjusted up or down based on the asset quality cycle (i.e., stable, declining or improving).)

The results of steps (1) and (2) above should be compared to the ALL account balance and the balance should be adjusted if it is materially inaccurate. Note: If the credit union does not currently use step (2) above, the initial set-up entry for the step (2) portion of the ALL adjustment may be made to the beginning balance of undivided earnings. Subsequent entries must flow through the income statement. (If you receive an opinion audit, please consult with your CPA as to the appropriate entries.)

Credit unions should review the adequacy of the ALL at least quarterly or at the end of each regular share account dividend period, or more often as required. It is also critical that credit union management practice the timely charge-off of "loss loans". Charge-off policies must clearly identify charge-off criteria. Monthly board minutes should reflect the discussion and recognition of identified loan losses.

Additional guidance can be found in the appropriate section of the Accounting Manual and the AICPA's Audit and Accounting Guide, "Audits of Credit Unions" (the AICPA is currently revising the guide, and expects to expose the revised guide for public comment in November, 1991). In the meantime, if you have any problems or questions, please call your examiner, your CPA, your NCUA regional office, or your state regulator. Examiners will be reviewing this area carefully during examinations and are prepared to assist you. In the end, we all have the same goal: healthy credit unions.

For the National Credit Union Administration Board,

Roger W. Jepsen
Chairman