

Chapter 11

ALLOWANCE FOR LOAN AND LEASE LOSSES

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Chapter 11

ALLOWANCE FOR LOAN AND LEASE LOSSES

Examination Objectives

- Determine if management has a sound methodology, with supporting documentation, for estimating the amount of probable existing losses in its loan and lease portfolio
- Assess the overall adequacy of the Allowance for Loan and Lease Losses (ALLL)
- Ensure management understands the purpose of the ALLL

Associated Risks

- Compliance risk – Includes the risk that the credit union does not present ALLL in compliance with the laws and regulations.
- Transaction risk – Includes the risk that internal controls do not sufficiently deter or detect errors, omissions or material misstatements.
- Reputation risk – Includes the risk that management did not meet its fiduciary duty to properly reserve for probable existing losses, resulting in poor publicity or administrative action.

Overview

The boards of directors of federally-insured credit unions bear responsibility for ensuring their credit unions have controls in place to consistently maintain the ALLL in accordance with the credit union's stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance. They should instruct management to develop and maintain appropriate, systematic, and consistently applied procedures to determine the amounts of the ALLL and provisions for loan losses.

The ALLL provides an estimate of probable but unconfirmed losses in the loan portfolio as of the financial statement date; it is not a reserve for future anticipated losses. GAAP has as a primary objective for the ALLL to ensure a credit union recognizes and measures loan impairment in the period the impairment occurs and in the amount of that impairment. This applies to all credit unions, regardless of size.

If the credit union obtains a certified public accountant (CPA) opinion audit, examiners can place reliance on the CPA's review of the ALLL. The Supervisory Committee chapter contains additional guidance.

Definitions

Following are definitions used in this chapter:

- **ALLL:** A contra asset account established and maintained by periodic charges to operating expense to provide a credit union's best estimate of the probable amount of loans it will be unable to collect based on current information and events and the amount of the loss can be reasonably estimated.
- **Homogenous:** Of the same kind or nature; having similar parts or elements.
- **Impairment of loans:** A loan is impaired when it is probable that a creditor (credit union) will be unable to collect all amounts due, including principal and interest, according to the contractual terms and schedules of the loan agreement.
- **Layering:** The inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.
- **Loan Segmentation:** Presentation of information about certain parts of a loan portfolio, in contrast to information about the entire loan portfolio.
- **Migration Analysis:** A method to determine the adequacy of valuation allowances by tracking movements (or migration) of a classified asset to a worse classification in order to estimate a loss percentage likely to be incurred from different categories of assets within the current portfolio.
- **Probable:** Higher level of likelihood than "more likely than not."
- **Non-homogenous:** Not of the same kind or nature.

Documenting the ALLL

The examiner should ensure the credit union has appropriate documentation to support the ALLL process and reported amounts. The credit union should document the relationships between the results of the credit union's detailed review of the loan portfolio, the amount of the ALLL, and the provision for loan and lease losses reported in each period. Examiners should review the supporting documentation over the following decisions, strategies, and processes:

- Policies and procedures over the systems and controls that maintain an appropriate ALLL, and over the ALLL methodology;
- Loan grading system or process (if applicable);
- Summary or consolidation of the ALLL components;
- Validation of the ALLL methodology; and
- Periodic adjustments to the ALLL process.

Analysis of ALLL

The following sections of this chapter provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, this chapter addresses:

- Application of GAAP,
- Policies and procedures,
- Methodology,
- Summarizing components and consolidating the loss estimates forming the amount required in the ALLL, and
- Validating the ALLL methodology.

Application of GAAP

GAAP-recorded ALLL quantifies a credit union's best estimate of the probable uncollectible amount of loans and leases based on current information and events. Estimating the amount of the ALLL involves management judgment and is inevitably imprecise.

Two GAAP rules primarily govern valuation of the ALLL. One covers large balance non-homogeneous loans (FAS 114), usually business and agriculture loans. The other rule deals with groups of homogeneous pools of loans (FAS 5) such as credit card, residential mortgage and consumer installment loans. The following further details those rules:

- Business and agricultural loans. GAAP provides guidance on the acceptable methods for measuring impairment for larger-balance loans individually evaluated. Specifically, GAAP states that if impairment of such a loan exists, a credit union should measure impairment based on the following:
 - The present value of expected future principal and interest cash flows discounted at the loan's effective interest rate;

- A loan's observable market price; or
- The fair value of collateral, if applicable.

When developing the estimate of expected future cash flows for a loan, a credit union should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors.

- Credit Card, Residential Mortgage, and Consumer Installment Loans. Credit unions collectively evaluate large pools of smaller-balance homogeneous loans for impairment rather than evaluating these pools on an individual basis. The pools may include individually evaluated loans (business and agricultural above) that the credit union does not consider individually impaired.

According to GAAP, a credit union should increase the ALLL when it has incurred a probable loss and it can reasonably estimate the amount. A credit union may determine that the amount of loss falls within a range and may record its best estimate within the range of loan losses.

Examiners should ensure credit unions do not layer their loan loss allowances. Layering occurs when the credit union inappropriately records in the ALLL more than one amount for the same probable loan loss. It can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or in a pool, and then includes the loan in another pool, which receives an additional ALLL amount.

Policies and Procedures

The ALLL process requires a wide range of policies, procedures, and control systems. Credit unions should tailor their policies to the size and complexity of the credit union and its loan portfolio.

The effectiveness of a credit union's ALLL methodology requires written policies and procedures that, at a minimum, should address the following:

- The roles and responsibilities of the credit union's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, board of directors,

and others, as applicable) who determine, or review the ALLL they will report in the financial statements;

- The credit union's accounting policies for loans and loan losses, including the policies for charge-offs, recoveries, and estimating the fair value of collateral (if any);
- The description of the credit union's methodology, which should maintain consistency with the credit union's accounting policies for determining its ALLL; and
- The system of internal controls used to ensure that the ALLL process adheres to GAAP and supervisory guidance.

An internal control system for the ALLL estimation process should:

- Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- Reasonably ensure that the credit union's financial statements (including regulatory reports) follow GAAP and ALLL supervisory guidance;
- Include a well-defined loan review process containing:
 - An effective, consistently-applied loan grading system that accurately, and in a timely manner, identifies differing risk characteristics and loan quality problems, and prompts appropriate corrective actions;
 - Internal controls that ensure consideration of all relevant loan review information in estimating losses. This includes maintaining appropriate reports and details of reviews performed, and identifying personnel involved; and
 - Clear, formal communication and coordination between the board of directors, management, and others involved in the ALLL determination or review (e.g., written policies and

procedures, management reports, audit programs, and committee minutes.)

Methodology

An ALLL methodology is a system designed and implemented by the credit union to reasonably estimate loan and lease losses as of the financial statement date. ALLL methodologies should incorporate management's current judgment about the loan portfolio's credit quality through a disciplined and consistently applied process.

A credit union's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan procedures, field of membership, and management information systems influence its ALLL methodology. While credit unions may use different methods, certain common elements should exist in any ALLL methodology. Generally, a credit union's methodology should:

- Include a regularly performed analysis of the loan portfolio detailing delinquency, loan losses, extensions, etc., by loan type and/or category;
- Consider all loans (whether on an individual or pool basis);
- Identify loans for impairment evaluation on an individual basis under FAS 114 and segment the remainder of the portfolio into pools of loans with similar risk characteristics for evaluation and analysis under FAS 5 (discussion of FAS 114 and FAS 5 occurs later in this chapter);
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Apply factors affecting collectibility consistently (but modify for new factors);
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;

- Require performance of analyses, estimates, reviews, and other ALLL methodology functions by well-trained personnel;
- Base methodology on current and reliable data;
- Require thorough documentation with clear explanations of the supporting analyses and rationale; and
- Include a systematic and logical method to summarize the balances determined under the various methodologies and ensure the credit union follows GAAP when recording the ALLL balance.

A properly designed and implemented methodology should provide a credit union's best estimate of the ALLL balance. Each dividend period, credit unions should make necessary adjustments to the ALLL account.

**Documenting
ALLL
Methodology**

A credit union's written policies and procedures should describe the primary elements of its ALLL methodology, including portfolio segmentation and impairment measurement. Effective policies and procedures should describe the methodology:

- For segmenting the portfolio:
 - The credit union's segmentation process (i.e., by loan type, industry, credit scoring, etc.),
 - The loan grading system used to segment the portfolio, if applicable, including:
 - i. Definitions of each loan grade,
 - ii. Reconciliation of the credit union's internal loan grades to examiners' concerns, and
 - iii. Delineation of responsibilities for the loan grading system.
- For determining and measuring impairment for business and agriculture loans (FAS 114):

- The methods used to identify loans for individual analysis;
- The methods by which the credit union determines and measures the amount of impairment for individually reviewed impaired loans, including:
 - i. Procedures describing available impairment measurement techniques, and
 - ii. Steps performed to determine which technique most appropriately fits a given situation.
- The methods used to determine whether and how the credit union should pool business and agriculture loans deemed individually evaluated, but not individually impaired, with other loans that share common characteristics for impairment evaluation under pools (FAS 5.)
- For determining and measuring impairment for groups of consumer and mortgage loans (FAS 5):
 - Criteria for pooling loans with similar characteristics to evaluate them for collectibility (such as loan type, past-due status, and risk);
 - Criteria for determining loss rates (e.g., historical loss rates adjusted for environmental factors or migration analysis) and time frames to evaluate loss experience; and
 - Descriptions of qualitative factors (e.g., industry, geographical, economic and political factors) that may affect loss rates or other loss measurements.

The credit union may integrate supporting documents for the ALLL in its credit files, loan review reports or worksheets, board of directors and committee meeting minutes, computer reports, or other appropriate documents and files.

Management should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date.

Management's current judgments about the credit quality of the loan portfolio should determine the amounts of the ALLL and provisions for loan and lease losses and should include the following:

- The board should review and approve the ALLL and provision for loan and lease losses reported each period;
- The board should periodically validate and, when necessary, revise the methodology to ensure it remains appropriate for the credit union;
- The supervisory committee should oversee and monitor the internal controls over the ALLL determination process;
- The officials should adjust the allowance for loan and lease losses through current earnings in accordance with GAAP; and
- The officials should understand that they must meet the full and fair disclosure requirements in §702.402 of *NCUA Rules and Regulations* before distributing dividends.

Allowance for Individual Impairment of Large Balance, Non-Homogeneous Loans (FAS 114)

In applying its ALLL methodology for business and agriculture loans, the credit union begins with its normal loan review procedures to identify whether impairment of a loan exists. The credit union must document its method for identifying and analyzing impaired loans and must retain that documentation. The analysis must include the determination of which of the following measurement methods it used:

- Present value of expected future cash flows, including:
 - The amount and timing of cash flows,
 - The effective interest rate used to discount the cash flows, and
 - The basis for determining cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- Fair value of collateral less costs to sell, including:
 - Criteria for determining fair value, including the use of appraisals, valuation assumptions, and calculations,
 - Supporting rationale for any adjustments to appraised values,
 - Determination of costs to sell, if applicable, and
 - Appraisal quality, and the expertise and independence of the appraiser.

- Observable market price:
 - The amount, source, and date of the observable market price of the loan.

Examiners should understand that fully collateralized loans may require no ALLL.

Documenting an ALLL for Individually Impaired Large Balance Non-Homogeneous Loans (e.g., Business and Agricultural)

Comprehensive worksheet for the impairment measurement process

A small credit union uses a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Illustration 11-A

Allowance for Small Balance Homogeneous Pools of Loans (FAS 5)

When evaluating loans on a pool basis under GAAP, management should segment the loan portfolio by identifying risk characteristics common to various pools of loans. Credit unions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Credit unions typically segment their portfolios as follows:

- Credit unions involved in less complex activities and offering a narrow range of loan products often segment the portfolio into broad loan categories.
- Credit unions offering a more diverse and complex mix of loan products may segment the portfolio into major loan types but typically maintain more detailed information. This allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment.

Changes in economic and other business conditions often require credit unions to modify their business strategies. This may result in

adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses.

Regardless of the segmentation method used, a credit union should maintain written documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

Credit unions use a variety of documents to support the segmentation of their portfolios, including:

- Loan trial balances by categories and types of loans;
- Management reports about the mix of loans in the portfolio;
- Delinquency and non-accrual reports; and
- A summary presentation of the results of an internal or external loan grading review.

Credit unions may find reports generated to assess the profitability of a loan product line useful in identifying areas in which to further segment the portfolio.

Documenting Segmentation Practices

Documenting a refinement in a segmentation method.

A credit union with a significant portfolio of consumer loans performed a review of its ALLL methodology. The credit union had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge offs) for the past two years to the estimated loss rates. During this process, the credit union decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans.) This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Illustration 11-B

Estimating Loss on Pools of Loans

After segmenting the portfolio and using a systematic and consistently applied approach to select the most appropriate loss measurement methods, a credit union should estimate the required ALLL for each segment (pool.) For those segments that require an ALLL, the credit

New

union should estimate the loan and lease losses, each dividend period, based on its ongoing loan review process and loan performance analysis.

One method of estimating loan and lease losses for pools of loans is by applying loss rates to the pools' aggregate loan balances. Such loss rates typically reflect historical loan loss experience for each pool of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time.

If a credit union does not have loss experience of its own, it may reference the loss experience of other credit unions. To do so, it must demonstrate similarity between the attributes of the loans in its portfolio to those of the loans included in the portfolio of the credit union providing the loss experience.

Documenting the Loss Measurement Method

Comprehensive loss analysis in a small credit union

A small credit union determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge offs and recoveries in determining the loss rate. The credit union also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The credit union maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

A credit union develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on business real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The credit union generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The credit union maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Illustration 11-C

Credit unions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which they incurred the losses. If credit unions use a range of

loss, they should maintain documentation to support the identified range and the rationale used for determining the best estimate within the range of loan losses.

Before employing a loss measurement method, a credit union should evaluate and modify, as needed, the method's assumptions to ensure consistency of the resulting loss estimate with GAAP. Credit unions can demonstrate consistency with GAAP by documenting the evaluation, the conclusions regarding the appropriateness of the loss measurement method or other loss estimation tool, and the support for adjustments to the method or its results.

In developing loss measurements, credit unions should consider the impact of current environmental factors and document which factors they used in the analysis and how those factors affect the loss measurements. Credit unions should consider the following factors when developing loss measurements:

- Levels of and trends in delinquencies and impaired loans;
- Levels of and trends in charge-offs and recoveries;
- Trends in volume and terms of loans;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- Experience, ability, and depth of lending management and other relevant staff;
- National and local economic trends and conditions;
- Industry conditions; and
- Effects of changes in credit concentrations.

Adjustments of loss measurements for environmental factors require that the credit union maintain sufficient, objective evidence to support the amount of the adjustment. The documentation must relate the need for the adjustment to current information, events, circumstances, and conditions.

**Summarizing
Components
and
Consolidating
the Amount
of the ALLL**

Management should prepare a summary document supporting the amount of ALLL it reports on the credit union's financial statements. This will verify that the ALLL is fairly presented in accordance with GAAP and is auditable. The credit union board should review and approve this summary. Common elements in such summaries include:

- An estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other pools of loans collectively evaluated for impairment);
- The aggregate probable loss estimated using the credit union's methodology;
- A summary of the current ALLL balance;
- The amount, if any, of the necessary ALLL adjustment; and
- Detailed sub-schedules of loss estimates that reconcile to the summary schedule, if so warranted by the level of detail supporting the ALLL analysis.

Generally, a credit union's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. However, instances may exist whereby individuals or committees that review the ALLL methodology and allowance balance identify needed adjustments to provide a better estimate of loan losses. These changes may result from information not known at the time of the initial loss estimate.

Management should (1) document the nature of any adjustments and the underlying rationale for making the changes, (2) ensure these adjustments remain consistent with GAAP, and (3) make certain the adjustments receive the review and approval of appropriate personnel. They should provide this documentation to those making the final determination of the ALLL amount. The summary should give each subsequent reviewer an understanding of the support behind the adjustments.

**Validating
ALLL
Methodology**

A valid ALLL methodology accurately estimates the amount of loss contained in the portfolio. Thus, the credit union's methodology should include procedures that adjust loss estimation methods to

reduce differences between estimated losses and actual subsequent charge offs, as necessary.

To verify the validity of the ALLL methodology and its conformance with GAAP and necessary supervisory guidance, the board should establish internal control policies, appropriate for the size of the credit union and the type and complexity of its loan products. These policies should include procedures for a review, by a party independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, credit unions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether deficiencies exist in their overall methodology or loan grading process. Validation procedures include the following:

- A review of trends in loan volume, delinquencies, restructurings, and concentrations;
- A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- A review, on a test basis by a party independent of the ALLL estimation process, of source documents and underlying assumptions to determine that the established methodology results in reasonable loss estimates; and
- An evaluation of the appraisal process of the underlying collateral, by periodically comparing the appraised value to the actual sales price on selected properties sold.

**Supporting
Documentation
for the Validation
Process**

Usually, management supports the validation process with the working papers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The credit union's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the officials change the methodology based upon the findings of the validation process, they should maintain documentation that describes and supports the changes.

When a Document of Resolution is Required

If required, a Document of Resolution (DOR) should focus on the methodology (deficiencies noted, improvements needed) rather than a specific dollar amount of over- or under-statement in the ALLL. However, if the examiners detect a material misstatement, they should require an appropriate dollar amount of funding.

Workpapers and References

- Workpapers
 - ALLL
 - Loan Analysis
 - Query Report Loans Impaired
 - Allowance for Loan and Lease Losses Classification
 - Allowance Summary
- References
 - *NCUA Rules and Regulations*
 - § 702.402 -- Full and Fair Disclosure

ALL FACTS, QUESTIONS, and ANSWERS - APPENDIX 11A

Measuring and Documenting Impairment Under FAS 114

Facts: Approximately one-third of Credit Union A's business loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Credit Union A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Credit Union A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the business loans reviewed under FAS 114 that are individually impaired, how should Credit Union A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Credit Union A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Credit Union A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its business loans for the past five years.

Credit Union A should maintain written documentation to support its measurement of loan impairment under FAS 114. If Credit Union A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions. When Credit Union A uses the fair value of collateral to measure impairment,

Credit Union A should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Credit Union A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

**Measuring
Impairment
for a
Collateral
Dependent
Loan Under
FAS 114**

Facts: Credit Union B has a \$750,000 loan outstanding to Member X that is secured by real estate, which Credit Union B, according to their current policy, individually evaluates under FAS 114 due to the loan's size. Member X is delinquent under the terms of the loan agreement. Accordingly, Credit Union B determines that its loan to Member X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Credit Union B measures impairment of the loan based on the fair value of the collateral. Credit Union B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$900,000.

Credit Union B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, personnel at Credit Union B adjust the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral. After adjusting the collateral valuation assumptions, the loan review department determines that the current estimated fair value of the collateral, less costs to sell, is \$575,000. Considering the loan balance is \$750,000, Credit Union B concludes that the loan is impaired by \$175,000 and records an ALLL adjustment of \$175,000.

Question: What type of documentation should Credit Union B maintain to support its ALLL adjustment of \$175,000 for the loan to Member X?

Interpretive Response: Credit Union B should document that it measured impairment of the loan to Member X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$575,000. This documentation should include the credit union's rationale and basis for the \$575,000 valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Credit Union B arrived at the valuation of \$575,000 by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$900,000 eighteen months ago to \$575,000 in the current period.

**Fully
Collateralized
Loans Under
FAS 114**

Facts: Credit Union C has \$500,000 in business loans that are fully collateralized by purchased business equipment. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to fully secure each loan. The member borrowers have physical control of the collateral. Credit Union C perfected its security interest in the collateral when the funds were originally distributed. On an annual basis, Credit Union C determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. Semiannually, or more frequently as needed, Credit Union C physically inspects the equipment. If there are any collateral deficiencies, Credit Union C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Credit Union C has historically not incurred any material losses on these loans. Credit Union C believes these loans are fully collateralized and therefore does not maintain any ALLL reserve for these loans.

Question: What documentation does Credit Union C maintain to adequately support its determination that no allowance is needed for this group of loans?

Interpretive Response: Credit Union C's management summary of the ALLL includes documentation indicating that, in accordance with the credit union's ALLL policy, the collateral protection on these loans has been verified by the credit union, no probable loss has been incurred, and no ALLL is necessary. Documentation in Credit Union C's loan files includes the two independent market quotes obtained annually for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Credit Union C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Credit Union C's policy requires the following factors to be considered and the credit union's findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral;
- Recency and reliability of the appraisal or other valuation;
- Recency of the credit union or other third party inspection of the collateral;
- Historical losses on similar loans;
- Confidence in the credit union's lien or security position including appropriate:
 - Type of security perfection (e.g., physical possession of collateral or secured filing);
 - Filing of security perfection (i.e., correct documents and with the appropriate officials), and
 - Relationship to other liens.
- Documentation indicating adequate and up to date insurance is in effect for the secured collateral.
- Other factors as appropriate for the loan type.

**Adjusting
Loss Rates
Under FAS 5**

Facts: Credit Union D's field of membership (lending area) includes a metropolitan area that is financially dependent upon the profitability of a number of sponsor manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these sponsor manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the sponsor

manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the sponsor manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Credit Union D has yet to confirm an increase in its loss experience as a result of these events, management knows that the credit union lends to a significant number of member's for business and individual purposes whose repayment ability depends upon the long-term viability of the sponsor manufacturing businesses. Credit Union D's management has identified particular segments of its business and consumer member bases that include member borrowers highly dependent upon sales or salary from the sponsor manufacturing businesses. Credit Union D's management performs an analysis of the affected portfolio segments to adjust its loss rates used to determine the ALLL. In this particular case, Credit Union D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How should Credit Union D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Credit Union D should document its identification of the particular segments of its business and consumer loan portfolio for which it is probable that the sponsor manufacturing business' financial downturn may result in loan losses. In addition, Credit Union D should support adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Credit Union D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data, and notes from discussions with individual member borrowers. Because in this case Credit Union D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Credit Union D creates a summary of the amount and rationale for the adjustment factor, which

management presents to the supervisory committee and board for their review and approval prior to the issuance of the financial statements.

**Estimating
Losses under
FAS 5 for
Loans First
Reviewed but
Not
Considered
Impaired
Under FAS
114**

Facts: Credit Union E has outstanding loans of \$875,000 to Member Y and \$725,000 to Member Z, both of which are paying as agreed upon in the loan documents. The credit union's ALLL policy specifies that all loans greater than \$700,000 must be individually reviewed for impairment under FAS 114. Member Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Member Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the credit union's loan grading system. Despite its concern, management believes Member Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Credit Union E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Member Y has risk characteristics similar to the loans included in Segment 1 and the loan to Member Z has risk characteristics similar to the loans included in Segment 2.

In its determination of the ALLL under FAS 5, Credit Union E includes its loans to Member Y and Member Z in the groups of loans with similar characteristics (i.e., Segment 1 for Member Y's loan and Segment 2 for Member Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the credit union's probable loan losses in these segments.

Question: How does Credit Union E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: As part of Credit Union E's effective ALLL methodology, it documents the decision to include its loans to Member Y and Member Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Credit Union E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The credit union also maintains copies of the economic and other reports that provided source data.

**Consolidating
the Loss
Estimates –
Documenting
the Reported
ALLL**

Facts: Credit Union F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Credit Union F's documentation practices related to its ALLL balance appropriate?

Interpretive Response: No. A credit union must maintain supporting documentation for the ALLL amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For credit unions subject to external audit, this documentation should also be made available to the supervisory committee and its independent accountants. If changes frequently occur during management or committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the credit union uses.