DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

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Implementing IRPS 02-3 in Washington State

As we discussed in Bulletin B-02-13, National Credit Union Administration's (NCUA) new interpretative ruling may require many credit unions to change the way they handle the allowance for loan and lease losses (ALLL). This Bulletin discusses key issues and explains how the Division of Credit Unions (DCU) intends to implement the changes in upcoming exams.

Under IRPS 02-3, "boards of directors of federally-insured credit unions are responsible for ensuring that their credit union has controls in place to consistently determine the ALLL in accordance with the credit union's stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance."

DCU understands this implementation may require some time to accomplish. However, we anticipate most credit unions examined after January 1, 2003 will have adopted appropriate ALLL and charge-off policies and have the process of documenting and monitoring the policy well underway. Given the complexity of this process, we also understand there may be some discussion with the examiner during the first examination or two to resolve questions specific to individual credit unions. Even in this transition period, however, credit unions are expected to appropriately fund an ALLL that reflects known risks in a loan portfolio.

Policies and Procedures

Adequate policies and procedures adapted to the unique situations of individual credit unions, and approved by the board of directors, are key elements for compliance with IRPS 02-3. Policies should:

1. Define the roles and responsibilities of the credit union's departments and personnel (including lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and other, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
2. Set forth the credit union's accounting policies for recognizing loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
3. Describe the description of the credit union's systematic methodology for determining its ALLL, which should be consistent with the credit union's other accounting policies;
4. Establish a system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance;
5. Describe documentation requirements;
6. Establish the validation process and person responsible for validating the ALLL methodology.

Charge-off Policy
It will be essential that credit unions have clear, reasonable, and consistently applied policies regarding charged off loans. DCU will be using the "uniform charge-off policy" adopted by FFIEC in 1999, and modified in 2000, as the starting point for an adequate charge-off policy. That "uniform charge-off policy" is available at http://www.fdic.gov/news/news/financial/2000/fil0040.html

In brief, the "uniform charge-off policy" states that open-end credit is charged off at 180 days delinquency and closed-end credit at 120 days delinquency. The policy also provides guidance regarding loans affected by bankruptcy, fraud, and death. It establishes guidelines for re-aging, extending, deferring or rewriting past due accounts.

It is important that qualifying loans be charged off in a timely manner. RCW 31.12.255 outlines the options for approval of loans to be charged off. In many instances the board of directors may be reviewing the charged-off loans after the actual accounting entry has occurred. Each credit union may wish to review its bylaws to ensure the bylaws allow adequate flexibility for charge off of loans in a timely manner.

A number of credit unions appear to believe that once a loan has been charged off, the credit union must discontinue all further collection efforts. That position is not correct. The decision to discontinue the collection effort is a management decision that is separate and distinct from the decision to charge off a loan.

Methodology

The methodology adopted by a credit union should be specific to that individual credit union. It should consider credit union size, loan portfolio characteristics, computer system capabilities, and management resources. Each credit union is encouraged to segregate its loan portfolio into various pools having common characteristics as distinct as is economically feasible. DCU recognizes there are trade-offs between information gained by analyzing many smaller pools of loans and the cost of managing that information. Each credit union should make a reasonable business decision about the number of loan pools to use in analyzing its ALLL. The categories on the loan-rate sheet for the credit union might be a reasonable starting point but other factors may also be considered.

The methodology adopted should be consistently applied but may be subject to modification as the credit union offers new loan products, adjusts underwriting criteria, encounters economic changes to the field of membership, or other relevant factors change. Such changing circumstances must be adequately documented and explained.

The review of ALLL adequacy should be performed at least quarterly, prior to quarter end. It should include all loans, consider collateral values (less costs to sell), be based upon current and reliable data, and be performed by well-trained personnel.

An internal control system for the ALLL estimation process should:

1. include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
2. reasonably ensure the credit union's financial statements are prepared in accordance with GAAP and ALLL supervisory guidance; and
3. include a well-defined loan review process.

Documentation

Each credit union will be expected to maintain appropriate written documentation regarding its ALLL analysis and surrounding issues. At a minimum, that documentation should include but not necessarily be limited to adequate:

1. Policies and procedures covering

   a. the systems and controls for maintaining an appropriate ALLL
   b. the overall ALLL methodology
   c. periodic re-evaluation of loan pools and loss history as well as any member business loans (MBL) loan grading systems
2. Summary or consolidation of the ALLL balance
3. Validation of the ALLL methodology, and
4. Explanations and justifications of periodic adjustments to the ALLL process

Validation of the Process
The board of each credit union will be responsible for arranging or providing an independent review of the ALLL methodology and its application in the credit union. This review must be documented with adequate work-papers. The board of directors will need to review the findings and document that review in the meeting minutes. When a CPA performs that validation, it must be clearly covered in the engagement letter. If an internal auditor performs this function, the persons involved in the validation process should not have other responsibility for the ALLL process.

Other Issues
<u>Member Business Loans</u>
The AICPA pronouncements do not establish dollar limits on the loans to be considered under FAS 114. Some literature has used the example of a $10 million loan as one that would be handled under FAS 114 rather than as part of a pool under FAS 5. That example should not be taken to imply all loans under $10 million must be handled as part of a pool under FAS 5.

Until they are changed, WAC 208-460-110 and 208-460-120 provide specific guidance for handling of MBLs. When a credit union has a limited number of MBLs, they will have the option to develop a pool for MBL plus any specific FAS 114 classification or to individually classify all of that limited number of MBLs.

<u>ALLL for New Product Lines</u>
When a credit union introduces new loan products, the credit union should identify appropriate industry or peer loss experience to be used as the basis for the credit union’s loss estimate until a suitable history within the credit union has been developed.

Handling of an Over-funded ALLL

The handling of an over-funded ALLL will depend upon circumstances at an individual credit union and the guidance given by its outside CPA firm. However, in general, DCU anticipates the over-funding will be handled in one or more of the following ways:

- for non material amounts, discontinued any new provision expense until the ALLL works its way down to an appropriate level,
- a credit back to the provision expense in the current period, or
- with CPA concurrence, a one time credit adjustment affecting undivided earnings of prior periods.

Any credit union that believes it has an over-funded ALLL and takes action to reduce it will be expected to have in place the necessary policies, methodology, and documentation outlined in IRPS 02-3. As with other issues, the examiner evaluation of earnings will be based upon the "core earnings," prior to any one-time events that may benefit earnings for a single year.

Materiality

Accountants often define a material amount as the amount that makes it probable that the judgment of a reasonable person would have been changed. Clearly DCU is most interest in materiality as measured against two standards, earnings and net worth. The Securities and Exchange Commission suggests that a 5 percent change in earnings per share would be considered material. DCU will use the 5 percent of net earnings as the general test of material amounts in reviewing ALLL adequacy.

The net-worth to total assets ratio is the determinant for a number of actions under Prompt Corrective Action (PCA). Any adjustment that would have pushed a credit union below 7% net-worth or any of the other trigger points under PCA would be considered material. On the other hand, the higher a credit union's net-worth ratio is above the 7%, the greater will be the tolerance for "immaterial" adjustments.

Examiner Judgment

Throughout the review of ALLL, examiner judgment will continue to be an important factor. DCU reserves the right for examiners to exercise their judgment to determine the significance of particular issues with regard to the ALLL.

Additional Information

DCU has scheduled two opportunities for credit unions to discuss the ALLL with our staff. The meetings are scheduled as follows:

- Tuesday, October 22, 2002 at 1:00 p.m. in Spokane, at Numerica Credit Union, 4217 E. Main (lower level of administration building)

- Wednesday, October 23, 2002 at 1:00 p.m. in Federal Way, at the Washington Credit Union League, 33320 - 9th Avenue So.

Please RSVP to Tina Philippsen at the Division by phone (360) 902-8718 or e-mail tphilippsen@dfi.wa.gov by October 18, 2002. Indicate which session and the number of people from your credit union who plan to attend. In addition, you may contact Jane Johnson (360) 902-0508 or Mike Delimont at (360) 902-8790 with questions about handling of the ALLL.