DCU BULLETIN

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ALLL In A Challenging Economy

Calculating an appropriate amount for the Allowance for Loan and Lease Losses (ALLL) has never been a precise process. However, in these times of high unemployment, exceptional delinquencies, and unprecedented loan losses it becomes even more critical. The accounting profession has adopted several statements (FAS 5, 15, and 114) that should guide the process. This bulletin will summarize those statements and outline what our examiners will expect to find when they evaluate the ALLL process in your credit union. It will remain the responsibility of the Board of Directors to ensure the ALLL is adequately funded at all times so capital and earnings are not overstated. Each credit union is responsible to have an independent validation of the ALLL annually. A significant underfunding of the ALLL may have an adverse effect on the "Management" and "Asset Quality" ratings in CAMEL.

In these challenging times, an adequately funded ALLL will include an amount calculated under guidance from FAS 5, focusing on the homogeneous loan pools. It is very likely there should also be a segment of the ALLL funded through estimates using FAS 114 guidance that focuses on "impaired loans." (See FAS 15 and FAS 114, paragraph 8 and 9 for the definition of "impaired," attached as Appendix A.) Both the FAS 5 and 114 segments will have a number of specific elements that should be considered.

FAS 5 - Homogeneous Pools Segment

All loans made by a credit union are subject to analysis for possible loss under FAS 5 homogeneous pools **<u>except</u>** if:

a. The loan has become "impaired"

   NOTE: All "troubled debt restructured" (TDR) loans are a subset of "impaired" loans and would require evaluation. Depending on circumstances, it is possible that a delinquent loan is also impaired. In selected circumstances a loan may be impaired before it becomes delinquent.

b. The loan is a member business loan (MBL) classified substandard, doubtful or loss (see WAC 208-460-110 and 120)

The remaining loans in the FAS 5 pool are then multiplied by a “historic loss factor” and the resulting amount is multiplied by an “environmental factor” to arrive at the amount required in this portion of the ALLL. The loans of the FAS 5 segment may be subdivided into various pools or types of loans with similar characteristics.

FAS 5 portion = loans in pool(s) X historic loss factor X environmental factor

The **“historic loss factor”** is typically derived by examining records of the dollar losses attributed to the particular pool or type of loans. The dollar losses are then divided by the actual balance in that pool of loans for that month end to arrive at a loss factor for the month. This process typically continues month by month to determine the rolling historical loss factor.

The question as to the appropriate number of months to include in the average in arriving at the “historic loss factor” often comes up. The answer will depend on what is happening with the losses in that pool of loans. If losses are mounting month by month, a shorter number of months will be appropriate. In the current environment, many credit unions are using a rolling 12 month average of losses. However, there are credit unions using a three month average. Any period longer than 12 months should be justified by very stable monthly loan losses over the period.

The **“environmental factor”** or **“qualitative and environmental factor”** is a further reflection of the current economic environment. Factors such as (but not limited to) rising loan delinquencies and charge-offs, increasing unemployment in the credit union’s field of membership, or declining asset values on the pool loan type suggest the credit union should apply some factor to increase the balance of the FAS 5 portion of the ALLL to further reflect the eroding economy. A simple example might be, if delinquencies have increased from a historic 1.5% to 2.0% (a 33% increase) an environmental factor of 1.33 might be justified. Another example might be a pool of home equity lines of credit (HELOCs) that have an average current combined loan to value of 110%. In this case, an additional environmental factor of 10% of the now unsecured portion of HELOCs might be appropriate. This analysis may be a good deal more complex. The conditions used to justify the “environmental factor” should be documented for evaluation by CPAs and examiners. Those conditions should be supported by objective economic data from the credit union’s market.

FAS 114 – Impaired Loan Segment

The FAS 114 segment of the ALLL will be determined by analysis of all “impaired” loans using valuation guidance in paragraphs 12-16 of FAS 114. In summary, this will mean that an estimate of the value of each impaired loan under current conditions will be made. Any book value amount above the value of the estimate will have a specific reserve established in the FAS 114 portion of the ALLL. While troubled debt restructure status and others factors may apply, it is reasonable to review all loans more than 60 days delinquent for impairment.

FAS 114 paragraphs 12-16 provide for three approaches to arriving at a current value for the loans as follows:

1. Present value of future cash flows discounted at the loan's effective interest rate

   or if the loan is collateral dependent

2. Observable market value
3. Fair value of collateral

When these options are used, the value may change from period to period requiring adjustments to be made to the reserve each period. The loans evaluated under the present value of future cash flows approach must also include a reasonable factor that provides for the estimated re-default rate on modified loans.

After evaluation for possible reserving under FAS 114, any loan <u>not</u> requiring a specific reserve is reserved using the FAS 5 pool "historic loss factor."

Troubled Debt Restructuring

In the current economy credit unions have encountered many circumstances that suggest restructuring of a loan is appropriate. FAS 15, paragraph 2 reads as follows:

> "*A restructuring of a debt constitutes a troubled debt restructuring for purpose of this Statement if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider…*"

This is the guidance examiners will expect credit unions to use in determining if a restructured loan is considered troubled debt. We recognize there may be circumstances unrelated to the borrower's financial difficulties that may exempt the credit from consideration as troubled debt. One example would be a December skip a payment program offered by some credit unions to their entire membership. Those that qualify for the skip a payment program are typically loans in good standing and would not be considered troubled debt since there would be no "debtor financial difficulties."

Timely Charge-Off

Clearly for the ALLL methodology to work, credit unions will need to charge off loans in a timely manner. Failure to do so will under report the "historic loss factor" as well as the ALLL. It will be essential that credit unions have clear, reasonable, and consistently applied policies regarding charged off loans. Division of Credit Union examiners 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 also 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 charging 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. Any collections made after the loan has been charged-off should be recognized as a "recovery." One clue to timely charging off of loans is the amount of recovery. A credit union without any loan loss recoveries may not be charging off loans appropriately.

Some credit unions have decided to reserve 100% for selected loans rather than charging them off in order to facilitate computer tracking of the loan. This can be an acceptable approach if the reserved amount is included in the "historic loss" balance in calculating the historic loss factor for the FAS 5 pool.

Conclusion

Examiners will expect credit unions to follow the accounting literature as they evaluate loans and make provision for the ALLL. An ALLL that is under provisioned will mean that earnings and capital are both overstated. Such a condition will not be acceptable and will likely require exam adjustments, corrections to the credit union books, and 5300 report corrections to properly comply with the accounting guidance and regulatory requirements.

In the experience of our examiners, perhaps the most important result of the careful analysis of emerging credit losses has been the adjustments to the credit underwriting criteria used by the credit union. Those adjustments have allowed the credit union to mitigate or control future losses more effectively.

If you have questions about the handling of the ALLL, you may contact Mike Delimont at (360) 902-8790.

APPENDIX A

FAS 114, Recognition of Impairment

Paragraph 8
"A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As used in this Statement and in Statement 5, as amended, *all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to the contractual terms of a loan. A creditor should apply its normal loan review procedures in making that judgment. An insignificant delay or insignificant shortfall in amount does not require application of this Statement. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding."

Paragraph 9
"Usually, a loan whose terms are modified in a troubled debt restructuring already will have been identified as impaired because the condition specified in paragraph 8 will have existed before a formal restructuring. However, if a loan is excluded from the scope of this Statement under paragraph 6(a), a creditor may not have accrued for the loan in accordance with this Statement before the loan was restructured. The creditor shall apply the provision of this Statement to that loan when it is restructured."