



**State of Wisconsin**  
*Department of Financial Institutions*

Jim Doyle, **Governor**

Lorrie Keating Heinemann, **Secretary**

April 25, 2008

**LETTER CU 1-08**  
**ALLOWANCE FOR LOAN AND LEASE LOSSES**

**TO ALL CREDIT UNIONS:**

*This letter replaces Letter CU 4-00 regarding the Allowance for Loan and Lease Losses (ALLL) account.*

In May 2002, the National Credit Union Administration (NCUA) Board issued Interpretive Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions* (NCUA's 2002 IRPS). It was designed to assist credit unions in establishing a sound process for determining an appropriate ALLL and documenting that process in accordance with generally accepted accounting principles (GAAP).

In March 2004, the NCUA along with the banking agencies issued an *Update on Accounting for Loan and Lease Losses*. This guidance provided reminders of longstanding supervisory guidance as well as a listing of the existing allowance guidance that credit unions should continue to apply.

In December 2006, NCUA Accounting Bulletin No. 06-01 was issued to distribute an *Interagency Policy Statement on the Allowance for Loan and Lease Losses* and *Questions and Answers on Accounting for Loan and Lease Losses*. The policy statement reiterated key concepts and requirements included in GAAP and existing ALLL supervisory guidance.

All of these NCUA documents remain in effect. This letter summarizes the key points and expectations of credit unions to maintain the ALLL in accordance with the credit union's stated policies and procedures, GAAP and ALLL supervisory guidance.

**Definition**

The ALLL is a credit union's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement. The ALLL is reported as an asset valuation account.

The responsibility for the ALLL oversight is shared between the board of directors, management and supervisory committee. Boards of directors are responsible for ensuring that controls are in place to consistently determine the ALLL in accordance with their stated policies and procedures, GAAP and



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ALLL supervisory guidance. Sound policies should be tailored to the size and complexity of the credit union. Policies should be reviewed annually. Management is responsible for implementing suitable policies and procedures and determining the amounts of the ALLL and provisions for loan and lease losses. Management must communicate the ALLL process to all applicable personnel. The supervisory committee must ensure that the methodology is appropriate and is periodically validated and, if needed, revised. In addition, the committee should oversee and monitor the internal controls over the ALLL determination process.

### **Common Elements of an ALLL Methodology**

An ALLL methodology is a system that is designed and implemented to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process. Management is expected to perform a detailed ALLL analysis quarterly.

The ALLL methodology is influenced by credit union specific factors such as: credit union size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures and management information systems. However, while credit unions may use different methods, certain common elements should be included in the ALLL methodology:

- ❖ A detailed analysis of the loan portfolio, performed on a regular basis;
- ❖ Consider all loans (whether on an individual or group basis);
- ❖ Identify large balance, non-homogeneous loans to be evaluated for impairment under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- ❖ Consider all known relevant internal and external factors that may affect loan collectibility;
- ❖ Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- ❖ Consider the particular risks inherent in different kinds of lending;
- ❖ Consider current collateral values (less costs to sell), where applicable;
- ❖ Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
- ❖ Be based on current and reliable data;
- ❖ Be well documented with clear explanations of the supporting analyses and rationale; and
- ❖ Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in a credit union's best estimate of the ALLL. Accordingly, credit unions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.

An essential part of a credit union's ALLL methodology is a comprehensive, disciplined, timely and consistently applied charge-off policy. NCUA Letter to Credit Unions No. 03-CU-01, *Loan Charge-Off Guidance*, provides guidance on the systematic charge off of uncollectible loans. The board of directors should appropriately tailor a charge-off policy to the size and complexity of the credit union's operation.

Finally, in conjunction with the ALLL process, management should consider the effect of foreclosed and/or repossessed assets and Overdraft Protection programs (also known as “bounce protection”, “courtesy pay”, “overdraft privilege”, etc.). Credit union policies and procedures should incorporate how an overdraft program and/or foreclosed and repossessed assets affect the methodology and analysis of the ALLL account.

### **Documentation and Validation**

Credit unions should maintain written supporting documentation for:

1. Policies and procedures over the systems and controls that maintain an appropriate ALLL and the ALLL methodology;
2. Loan grading system or process;
3. Summary or consolidation of the ALLL balance;
4. Validation of the ALLL methodology; and
5. Periodic adjustments to the ALLL process.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, the board of directors 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 who is independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

Management should support the validation process with workpapers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The board of directors should review the findings and acknowledge its review in the board minutes. If the methodology is changed based on the findings of the validation process, documentation to support the changes should be maintained.

### **Summary**

While the guidance applies to all credit unions, regardless of size, it recognizes operational and managerial standards that are appropriate for a credit union’s size, nature and scope of its activities. Credit unions with less than \$10 million in assets may still follow the directives in Wisconsin Letter CU 04-00.

The board of directors bears the responsibility for ensuring their credit union has controls in place to consistently maintain the ALLL in accordance with policies and procedures, generally accepted accounting principles and supervisory guidance.

### **Resources**

- ❖ NCUA Interpretive Ruling and Policy Statement, #02-3
- ❖ NCUA Accounting Bulletin No. 04-1
- ❖ NCUA Accounting Bulletin No. 06-01
- ❖ NCUA Supervisory Committee Guide, Chapter 11
- ❖ The Office of Credit Unions (608) 261-9543