State of Wisconsin

Department of Financial Institutions

Tommy G. Thompson, **Governor** John F. Kundert, **Secretary**

November 10, 2000

LETTER CU 4-00
ALLOWANCE FOR LOAN & LEASE LOSSES (ALLL) ACCOUNT

TO ALL CREDIT UNIONS:

General Letter CU 5-91 documented the accounting requirements for the Allowance for Loan Loss account. That letter was sent to all Wisconsin state-chartered credit unions in response to National Credit Union Administration Letter 126. This letter serves to update General Letter CU 5-91. Although many of the original comments are still pertinent, many industry changes have also taken place that have required revision of the original letter.

In September 1999, the Allowance for Loan Loss account was renamed the Allowance for Loan & Lease Losses (ALLL) account. The name change was required per Generally Accepted Accounting Principles (GAAP). The ALLL account is intended to be the current estimate of the potential losses existing in the entire loan and lease portfolio. To comply with GAAP, and to meet the regulatory requirements for full and fair disclosure, calculation of the ALLL must still include two distinct components:

1. ***Individual classification***: An identification of known and potential losses from an analysis of the delinquent and current loan and lease lists.

2. ***Inherent loan loss classification***: An estimation of the historical loss potential which exists within the current and fully performing portion of the portfolio. Within any loan portfolio, there are losses that are not now apparent, but which long time experience would indicate will surface in the future.

Following is the method of analysis that should be used in determining each component of the ALLL.

Individual Classification Method

Management must continue to evaluate the delinquent and classified loans individually for potential losses. The *Classified Loans* schedule used in the examination report provides the detail explaining how the examiners classify individual loans.

Examiners typically use the following guidelines for evaluating loan portfolios. Loans over 12 months delinquent and without a payment for 6 months are discounted 100% and classified as a loss. Loans over 12 months, not classified as a loss, are generally discounted at 75% unless the collateral value or payment history supports a lesser discount. Loans over 6 months delinquent, not already classified, are generally discounted 50%. Loans in the 2-6 month delinquent category may be discounted anywhere from 10-50% depending on the collateral and the payment history.

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After discussing individual loan classifications with management, the examiners may also increase or decrease any loan account, change any classification, or classify additional loans as necessary. Other loans may be individually discounted for a variety of reasons. These discounts are reviewed with collection personnel and management prior to the close of the examination. The potential loss for each loan identified by this analysis is then added to arrive at the total of the individually classified loans.

The Inherent Loan Loss Classification

The second component of the ALLL calculation is based on the 5-year average loss ratio of your credit union. The examination schedule *Allowance for Loan and Lease Losses Summary* provides detail on this calculation. The ratio must be updated at the beginning of every year to include the previous year's data.

In some cases, adjustments to this ratio may be appropriate based on a number of subjective factors. For example, economic conditions unique to your credit union may have resulted in unusual charge-offs within the 5-year period. Or, factors relating to sponsor employment practices, labor disputes, plant closings, or other local economic circumstances may necessitate upward or downward adjustments in this component of the ALLL. If after calculating your 5-year average loss ratio, you feel it does not fairly represent your credit union's loss experience, a variance in the calculation may be allowed. You should document why you feel the standard calculation is not appropriate and be prepared to justify an alternative calculation.

The total of the individual and inherent loss calculations will then be the accounting balance required in the ALLL. Adjustments must flow through the Provision for Loan Loss expense account. If during an examination, it is determined that the ALLL account is underfunded, the examiner will require management to make a journal entry to fund the account. If it is determined that the account is overfunded, no entry will be required as long as the overage is reasonable and supported.

Below are other guidelines that should be considered:

- The Board of Directors of each credit union is responsible for ensuring that controls are in place to determine the appropriate level of the ALLL. This analysis must be conducted, at a minimum, on a quarterly basis. Monthly monitoring and adjustments, however, will more accurately represent the financial statements and true value of the loan portfolio.

- ALLL processes must be thorough, disciplined, and consistently applied and must incorporate management's current judgments about the credit quality of the loan portfolio.

- Credit unions must maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, generally accepted accounting principles, and applicable supervisory guidance.

- Policies and procedures should be appropriately tailored to the size and complexity of the credit union and its loan portfolio.

- The timely charge-off of loan losses is a key factor in funding and maintaining the ALLL account. A charge-off policy, adopted by the Board of Directors, must provide the "triggering" guidelines which ensure that non-performing assets are charged off in a timely manner.

Finally, the ALLL account previously was considered as a reserve account and was included in the calculation of the Capital/Assets ratio. Beginning December 31, 2000, all credit unions will now calculate their Net Worth via the NCUA 5300 Call Report. Please note that the ALLL account is not included in this calculation.

More information pertaining to this topic can be obtained from this office, a public accounting firm, and in the AICPA audit guide “Audits of Credit Unions”.

Sincerely,

Ginger Larson

Ginger Larson
Director
OFFICE OF CREDIT UNIONS

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