



BULLETIN

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Issued to: State-Chartered Credit Unions

Subject: Risk-Focused Examinations and Allowance for Loan and Lease Losses **Date Issued: January 15, 2003**

Risk-Focused Examinations

As most of you are aware, the National Credit Union Administration (NCUA) implemented a risk-focused examination program during the last quarter of 2002. This program focuses on seven areas of concern: credit risk, interest rate risk, liquidity risk, transaction risk, compliance risk, strategic risk, and reputation risk. In order for the NCUA to accept our examination reports in lieu of conducting its own independent or concurrent examinations, the Division's examiners will formally review these areas of concern. However, state-chartered credit unions should not expect to see any major difference in the examination process or the resulting Report of Examination. At this point in the economic cycle, the Division does not believe it is prudent to curtail the scope of credit union examinations. However, the Division is committed to continually monitoring its examination process in order to ensure maximum efficiency and effectiveness. Further, the Division will continue with its long-standing risk-focused approach to examination cycles and will not adopt the NCUA's Risk-Based Examination Scheduling Policy.

Allowance for Loan and Lease Losses (ALLL)

State-chartered credit unions should follow Interpretive Ruling and Policy Statement (IRPS) No. 02-3 issued by the NCUA in May 2002 on *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions*. The IRPS clarifies expectations regarding methodologies and documentation support for the ALLL. For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with generally accepted accounting principles (GAAP). GAAP requires that loss estimates be based upon reviews of individual loans and groups of loans and that documentation be maintained to support the amounts of the ALLL and the provision for loan and lease losses reported in the financial statements, as outlined in Statements of Financial Accounting Standards (FAS) 5 and 114. The vast majority of credit unions will have loans within the scope of FAS 5 (smaller balance, homogenous pools of consumer loans). Large-balance, nonhomogeneous loans (predominantly business and agricultural loans) are addressed in FAS 114.

The guidance in the IRPS recognizes that credit unions should adopt methodologies and documentation practices that are appropriate for their size and complexity. Credit unions with fewer and less complex/diverse loan products will need less exhaustive supporting documentation for the ALLL than credit unions with more complex/diverse loan products or portfolios. The board of directors of each credit union is responsible for ensuring that adequate policies, procedures and controls are in place to determine the appropriate level of the ALLL. A credit union's methodology must be a thorough, disciplined, and consistently applied process that incorporates management's current judgments about the credit quality of the loan portfolio. The supervisory committee, the internal or external auditors, or some other designated party who is independent from the ALLL estimation process should periodically review the methodology.

Division examiners will continue to evaluate the overall adequacy of the ALLL, including the adequacy of supporting documentation, to ensure that it is appropriate. Examiners may take exception to credit union practices that fail to document and maintain an adequate ALLL.

The determination of the amounts of the ALLL and provision for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date.

Generally, a credit union's methodology should:

1. Include a detailed analysis of the loan portfolio, performed on a regular basis;
2. Consider all loans (whether on an individual or group basis);
3. Identify loans to be evaluated on an individual basis and segment the remainder of the portfolio into groups of loans with similar risk characteristics (credit card, residential mortgage, and consumer installment loans, for example) for evaluation and analysis;
4. Consider all known relevant internal and external factors that may affect loan collectibility;
5. Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
6. Consider the particular risks inherent in different kinds of lending;
7. Consider current collateral values (less costs to sell), where applicable;
8. Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
9. Be based on current and reliable data;
10. Be well documented with clear explanations of the supporting analyses and rationale; and
11. 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 analysis and the ALLL account balance.

In order for the credit union's ALLL methodology to be effective, sound written policies and procedures for systems and controls to maintain an appropriate ALLL, that are appropriately tailored to the size and complexity of the credit union, should be established. The credit union's written policies and procedures should describe the methodology for:

1. Segmenting the portfolio into groups of loans with similar characteristics for loss evaluation (i.e. by loan type, industry, risk rates, credit scores, past due status, etc.);
2. How loss rates and appropriate time frames are established to evaluate loss experience on the loan pools; and
3. Identifying loans to be analyzed individually (under FAS 114 or otherwise) and how the estimated loss amount is determined.

A credit union's methodology related to FAS 114 loans (predominantly large business or agricultural loans) begins with the use of its normal loan review procedures to identify whether a loan is impaired (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). Credit unions should document:

1. The method and process for identifying individual loans to be evaluated under FAS 114, and

2. The analysis that resulted in an impairment decision for each loan and the impairment measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less the costs to sell, or the loan's observable market price).

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL.

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Smaller credit unions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate only in small credit unions offering a narrow range of loan products. Larger credit unions typically offer a more diverse and complex mix of loan products. Such credit unions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, a credit union should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

Based on the segmentation of the portfolio, a credit union should estimate the FAS 5 portion of the ALLL. For those segments that require an ALLL, the credit union should estimate the loan and lease losses on at least a quarterly basis (preferably monthly, especially if dividends are paid monthly), based upon its ongoing loan review process and analysis of loan performance. The credit union should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation.

One method of estimating loan losses for groups of loans is through the application of loss rates (charge offs less recoveries) to each group's aggregate loan balance. Such loss rates typically reflect historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a definite period of time. Credit unions should maintain supporting documentation for the technique used to develop the loss rate, including the period of time over which the losses were incurred.

Here are some examples of how a credit union might perform a comprehensive historical consumer loan analysis and break the portfolio down into various pools for more refined loss estimates than computed under prior methodologies:

1. The analysis is conducted by type of loan (secured, unsecured, and real estate pools, for example), and considers charge-offs and recoveries within each type in determining the loss rate for that pool.
2. The credit union segments the portfolio by loan grade (A, B, C, or D paper, for example), and considers charge-offs and recoveries within each grade in determining the loss rate for that pool.
3. Use a combination of 1. and 2. above to develop even smaller pools for measurement (secured, grade A and secured, grade B, and secured, grade C, etc., for example).
4. The credit union determines the average loss ratios for the pools based on loss rates (net charge offs) over a three, four, or five-year historical period, and the period selected is used consistently thereafter.
5. If necessary, develop and assign a judgmental or empirical factor to adjust the historical loss ratios for management's assessment of present financial conditions and trends (such as adverse changes in the local economy, rising unemployment, increasing bankruptcy trends, etc.).
6. Delinquent loans more than sixty days past due might be pooled by number of days past due, or by collateral type, and each pool is classified with a specific loss percentage (25%, 50%, 75%, or 100%, for example) that reflects past collection experience. (Alternatively, management may determine it is more appropriate to continue classifying individual delinquent loans in a manner similar to past practice.)

7. All loss estimates for the pools (and individual loans, as applicable) are summed together and the total is compared to the existing ALLL balance in the financial statements. Upward or downward adjustments are booked accordingly in a timely manner.
8. Management maintains adequate supporting documentation for all steps and processes used in determining the ALLL estimate and applies the policies/procedures consistently from period to period to ensure full and fair disclosure.

For additional information, refer to Interpretive Ruling and Policy Statement (IRPS) No. 02-3 issued by the NCUA in May 2002 on *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions*. The IRPS can be found on the NCUA's website www.ncua.gov under Reference Information, Interpretive Rulings and Policy Statements.

While it may take some time to gather historical data on groups of loans in order to determine loss rates, the Division will expect each credit union to be working toward compliance. Please contact your assigned Division examiner for additional guidance, if needed.