

The Technical Guide

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Interpretive Ruling and Policy Statement #02-3 (IRPS) regarding “Allowance for Loan and Lease Losses”

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General

On May 16th 2002, the National Credit Union Administration (NCUA) Board unanimously approved the adoption of a final Interpretive Ruling and Policy Statement #02-3 (IRPS) regarding “Allowance for Loan and Lease Losses” (ALLL) for Federally-insured credit unions. The IRPS is intended to provide guidance and clarify NCUA’s expectations regarding methodologies and supporting documentation practices for the ALLL, the amount required to be set aside by a credit union based on its estimate of probable loan and lease portfolio losses.

IRPS #02-3 provides guidance on the design and implementation of ALLL methodologies and supporting documentation practices. The guidance recognizes that credit unions should adopt methodologies and documentation practices that are appropriate for their size and complexity. The IRPS emphasizes the NCUA’s long-standing position that credit unions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, generally accepted accounting principles (GAAP), and applicable supervisory guidance. It also states that a credit union’s ALLL methodology must be a thorough, disciplined, and consistently applied process that incorporates management’s current judgments about the credit quality of the loan portfolio.

Management is responsible for establishing and documenting the methodology, while 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 and to approve sound policies appropriately tailored to the size and complexity of the credit union and its loan portfolio. These controls and policies should assist in the effective application of Management’s ALLL methodology.

This methodology should conform to GAAP. Under GAAP, Statement of Financial Accounting Standards No. 5, “Accounting for Contingencies” (SFAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be

reasonably estimated. SFAS 5 supports the use of a historical loan loss ratio applied to performing loans in order to estimate potential future loan losses.

Statement of Financial Accounting Standards No. 114, “Accounting by Creditors for Impairment of a Loan” (SFAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans. Specifically, SFAS 114 applies to loans that are identified for evaluation on an individual basis. 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. SFAS 14 requires reserves for both delinquent and non-delinquent loans when circumstances point towards a loan loss.

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 each period, either upward or downward, for differences between the results of Management’s estimated required reserves and the balance of the ALLL account. Increases in the ALLL account should not be based merely on budgeted amounts, but rather the results of Management’s analysis.

In developing the method that is right for your Credit Union, considerations should be given to the complexity of the Credit Union’s loan portfolio. Does the loan portfolio have various loan types and different degrees of determined risk? Does the loan portfolio contain large balance commercial loans? Are there pools of loans that have been segregated from other loans due to an inherit risk factor? Should a single loan loss experience ratio be used or should different loan loss ratios be developed for different loan pools. How should delinquent loans be graded for estimating potential loan losses? How many years of past losses should be used in calculating your loan loss experience rates? Are there certain unquantifiable loss reserves that are justifiable? To develop a methodology that is right for you these matters will have to be addressed.

Once a methodology is determined, approved, and implemented, it will have to be reviewed by someone outside the application of that methodology to ensure the method is consistently applied.

Effective Date

The NCUA ruling made Interpretive Ruling and Policy Statement #02-3 effective immediately.

If you have any questions or need further information regarding IRPS #02-3, call us at (800) 288-0293 or e-mail us at info@nearman.com.