# Bulletin CU-02-2

TO: ALL TENNESSEE STATE CHARTERED CREDIT UNIONS
SUBJECT: INTERPRETIVE RULING AND POLICY STATEMENT (IRPS) 02-03
DATE: September 23, 2002

The National Credit Union Administration recently released Interpretive Ruling and Policy Statement (IRPS) 02-03. The guidance provides information for the design and implementation of allowance methodology and supporting documentation, policies, and procedures. Primary tenets to this statement are the following:

All credit unions must comply with generally accepted accounting principles (GAAP) in relation to the Allowance for Loan and Lease Losses (ALLL). Management is responsible for establishing an appropriate ALLL All loans must be reviewed when estimating the allowance account adequacy. This does not mean an individual loan review of every loan in the portfolio. Most credit unions will perform the review by segmenting the portfolio into various types of loans (for example, new auto, used auto, unsecured, and real estate), and then analyzing the segments. The process must be periodically reviewed and validated by an independent third party (supervisory committee, internal auditor, external auditor, etc.) The policy does not change or address guidance regarding charge-offs.

After full implementation of GAAP and the IRPS, examiners will consider it an unsafe and unsound practice if a credit union fails to maintain, analyze, and support an adequate ALLL. Credit unions with fewer and less complex loan products will require less documentation than institutions with larger, more complex loan portfolios.

Examiners will evaluate both the overall adequacy of the ALLL account and the adequacy of the supporting documentation.

Ultimate responsibility for compliance rests with the Board. Accordingly, it is the Board's responsibility to develop and implement suitable policies and procedures that address the credit union's unique goals, systems, risks, personnel, and other resources. Likewise, it is the Board's responsibility to ensure that the ALLL methodology is thorough, documented, and applied consistently.

A cornerstone of GAAP and the IRPS is periodic validation by an independent third party. Accordingly, the supervisory committee, internal or external auditor, or another designated party independent of the ALLL estimation process must review the methodology and application of policies and procedures at least annually. Appropriate written documentation builds discipline and consistency into the ALLL determination process. It improves the process by ensuring that all relevant factors are considered in the analysis. At a minimum, the following documentation must be maintained.

Policies and procedures over the ALLL methodology and over the systems and controls that maintain an adequate ALLL; (See Sample Policy)
Loan valuation system or process;

Summary of the ALLL balance;
Validation of the ALLL methodology; and
Periodic adjustments to the ALLL process.

As discussed above, part of the process includes reviewing all loans and then estimating the loss in the portfolio to determine an acceptable allowance balance. For most credit unions, the ALLL valuation will be based on standards derived from Statement of Financial Accounting Standards No. 5 (FAS 5). Per FAS 5 guidelines, homogenous loans (i.e., loans with similar characteristics) can be pooled and then reviewed as a pool. As part of the policy governing maintenance of the ALLL, credit unions should define the criteria for pooling loans with similar characteristics (such as loan types, past due status, and risk). For the small, less complex institutions, determining an appropriate ALLL may be as simple as segmenting the loan portfolio into secured consumer loans, unsecured consumer loans, and real estate loans. After loans are segmented, the credit union would then calculate a historical average of loan losses for each type of loan. Larger, more complex institutions might consider pooling loans by grade (A, B, C, or D paper) for each type of loan granted. These two methods are illustrations only and should not be considered as the only appropriate methods of segmenting a loan portfolio. After segmenting the portfolio, the average loss ratio is generally based on a twelve-month rolling average for each segment of the portfolio. A longer historical period can be used if adequately justified. Reserve adequacy would then be determined by multiplying the loss ratios (adjusted for any known and documented factors) by the amount of loans outstanding in each category and adding up the totals. (See Sample of Loan Portfolio Segmentation)

The Department expects all credit unions to comply with IRPS 02-03. Preferred timeframes for implementing IRPS 02-03 are detailed below. Should you have any questions regarding implementation of GAAP accounting for the ALLL, first contact your certified public accountant.

| Date | Goal |
|---|---|
| November 2002 | Develop an Allowance for Loan and Lease Losses (ALLL) Policy to incorporate the new ALLL methodology. |
| December 2002 | Develop documentation of loan portfolio segments for the purpose of determining the adequacy of the Allowance for Loan and Lease Losses under the new methodology. |
| December 2002 | Develop documentation of loan loss estimates for each segment, for the purpose of determining the adequacy of the Allowance for Loan and Lease Losses under the new methodology. |
| March 2003 | Implement the new ALLL methodology by the end of the first quarter of 2003, with an adjustment to the ALLL account if necessary. |
| December 2003 | Validate the new ALLL methodology developed. |

Should you have additional questions, feel free to contact the department. Your primary contact will be the supervising examiner for your section of the state. Contact information is listed below.

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|---|---|---|
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