

*Affected public:* Individuals or households, business or other for-profit, not-for-profit institutions, Federal, state, local or tribal government.

*Estimated number of respondents:* 22,728.

*Estimated time per response:* 8 minutes.

*Frequency of response:* On occasion.

*Estimated total annual burden hours:* 3,030 hours.

*Abstract:* The information collection is prescribed by 36 CFR 1254.6. The collection is an application for a research card. Respondents are individuals who wish to use original archival records in a NARA facility. NARA uses the information to screen individuals, to identify which types of records they should use, and to allow further contact.

2. *Title:* Order Forms for Genealogical Research in the National Archives.

*OMB number:* 3095-0027.

*Agency form numbers:* NATF Forms 81, 82, 83, 84, 85, and 86.

*Type of review:* Regular.

*Affected public:* Individuals or households.

*Estimated number of respondents:* 97,600.

*Estimated time per response:* 10 minutes.

*Frequency of response:* On occasion.

*Estimated total annual burden hours:* 16,267 (rounded up).

*Abstract:* Submission of requests on a form is necessary to handle in a timely fashion the volume of requests received for these records (approximately 12,000 per year for the NATF 81, approximately 600 per year for the NATF 82, approximately 1,000 per year for the NATF 83, approximately 6,000 per year for the NATF 84, approximately 46,000 per year for the NATF 85, and approximately 32,000 per year for the NATF 86) and the need to obtain specific information from the researcher to search for the records sought. The form will be printed on carbonless paper as a multi-part form to allow the researcher to retain a copy of his request and NARA to respond to the researcher on the results of the search or to bill for copies if the researcher wishes to order the copies. As a convenience, the form will allow researchers to provide credit card information to authorize billing and expedited mailing of the copies.

Dated: October 22, 2001.

**L. Reynolds Cahoon,**

*Assistant Archivist for Human Resources and Information Services.*

[FR Doc. 01-26936 Filed 10-25-01; 8:45 am]

**BILLING CODE 7515-01-U**

## **NATIONAL CREDIT UNION ADMINISTRATION**

### **Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions**

**AGENCY:** National Credit Union Administration.

**ACTION:** Notice of Proposed Interpretive Ruling and Policy Statement (IRPS) 01-3, with request for comments.

**SUMMARY:** The National Credit Union Administration (NCUA) is proposing to adopt an Interpretive Ruling and Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions (the proposed IRPS). The federal banking agencies recently issued a final policy statement intended to clarify the banking agencies' expectations regarding methodologies and documentation support for the ALLL. The Securities and Exchange Commission (SEC) issued parallel guidance in a Staff Bulletin. Likewise, it is necessary for the NCUA to issue analogous guidelines for federally-insured credit unions in order clarify the NCUA's expectations regarding methodologies and documentation support for the ALLL. This proposed IRPS is intended to provide the necessary parallel guidance for federally-insured credit unions.

The proposed IRPS 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.

**DATES:** NCUA welcomes comments on the proposed IRPS. Comments must be received on or before January 24, 2002.

**ADDRESSES:** Send comments to Becky Baker, Secretary to the NCUA Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428. You may also fax comments to (703) 837-2823, or e-mail comments to [regcomments@ncua.gov](mailto:regcomments@ncua.gov). Please send comments by one method only.

#### **FOR FURTHER INFORMATION CONTACT:**

Karen Kelbly, Program Officer, Office of Examination and Insurance, at the above address or telephone (703) 518-6389.

#### **SUPPLEMENTARY INFORMATION:**

##### **I. Keypoints**

- Credit union management is responsible for establishing an

appropriate ALLL and documenting their methodology.

- Credit union methodologies should conform to generally accepted accounting principles (GAAP).

- Credit unions with lending portfolios comprised of homogeneous pools of consumer loans (such as credit card and automobile loans) and mortgage loans will find methodology and documentation requirements discussed herein to be less burdensome than those for credit unions with lending portfolios comprised of larger-balance, non-homogeneous loans. Simply put, credit unions must review all loans (by groups as appropriate) for relevant internal and external factors, loss history, collateral values, and methods to ensure they are applied consistently when estimating probable existing losses but, when appropriate, modify loss estimates for new factors affecting collectibility.

- The FAS 5 discussions throughout this document will be most relevant to the majority of credit unions.

- Independent review of management's methodology and documentation practices by the supervisory committee, internal or external auditors is emphasized.

- Illustrations are provided that may be useful to a credit union in enhancing their own ALLL estimation methodology and documentation practices.

##### **II. Background**

On March 10, 1999, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (the Agencies) issued a joint letter to financial institutions on the allowance for loan and lease losses (the Joint Letter). In the Joint Letter, the Agencies agreed to establish a Joint Working Group to study ALLL issues and to assist financial institutions by providing them with improved guidance on this topic. The Agencies agreed that the Joint Working Group would develop and issue parallel guidance for two key areas regarding the ALLL:

- Appropriate methodologies and supporting documentation, and
- Enhanced disclosures.

As a result, the banking agencies issued a final Policy Statement providing guidance to banks and savings institutions relating to methodologies and supporting documentation for the ALLL. The Securities and Exchange Commission staff has issued parallel guidance on this topic for public companies in Staff

Accounting Bulletin No. 102.<sup>1</sup> This proposed IRPS is intended to provide parallel guidance for federally-insured credit unions.

This proposed IRPS clarifies the NCUA's 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 a credit union maintain written documentation to support the amounts of the ALLL and the provision for loan and lease losses reported in the financial statements.

The proposal does not change existing accounting guidance in, or modify the documentation requirements of, GAAP. It is intended to supplement, not replace, current guidance. The proposed IRPS does not address or change current guidance regarding loan charge-offs; therefore, credit unions should continue to follow existing regulatory guidance that addresses the timing of charge-offs.

The guidance in this proposed IRPS recognizes that credit unions should adopt methodologies and documentation practices that are appropriate for their size and complexity. For credit unions with fewer and less complex loan products, the amount of supporting documentation for the ALLL may be less exhaustive than for credit unions with more complex loan products or portfolios.

Recognizing that a primary mission of the NCUA is to support a safe and sound credit union system, examiners will continue to evaluate the overall adequacy of the ALLL, including the adequacy of supporting documentation, to ensure that it is appropriate. While the proposed IRPS generally does not provide guidance to examiners in conducting safety and soundness examinations, examiners may take exception to credit union practices that fail to document and maintain an adequate ALLL in accordance with this IRPS, and other NCUA guidance. In such cases, credit union management may be cited for engaging in unsafe and unsound practices and may be subject to further supervisory action.

### III. The Proposed IRPS

Four of the FFIEC agencies including the Board of Governors of the Federal

<sup>1</sup> In addition, the American Institute of Certified Public Accountants (AICPA) is developing guidance on the accounting for loan losses and the techniques for measuring probable incurred losses in a loan portfolio.

Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) sought public comment on a proposed policy statement on ALLL Methodologies and Documentation for Banks and Savings Institutions on September 7, 2000 (65 FR 54268). The proposal indicated that the purpose of the policy statement was to provide financial institutions with enhanced guidance on appropriate ALLL methodologies and documentation practices. This IRPS proposes parallel guidance for federally-insured credit unions. The following is a summary of the proposal:

The proposed IRPS explains that 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. It also 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, GAAP, and applicable supervisory guidance.

The proposed IRPS describes significant aspects of ALLL methodologies and documentation practices. Specifically, the proposal provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the credit union and its loan portfolio. The proposed IRPS 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.

The proposal also discusses the methodology and documentation needed to support ALLL estimates prepared in accordance with GAAP, which requires loss estimates based upon reviews of individual loans and groups of loans. The proposal states that after determining the allowance on individually reviewed loans and groups of loans, management should consolidate those loss estimates and summarize the amount to be reported in the financial statements for the ALLL. To verify that the ALLL methodology is effective and conforms to GAAP and supervisory guidance, the supervisory committee, the internal or external auditors or some other designated party who is independent from the ALLL estimation process should review the methodology and its application in a manner appropriate to the size and complexity of the credit union.

The proposal includes illustrations of implementation practices that credit unions may find useful for enhancing their own ALLL practices; a summary of applicable GAAP guidance; an appendix that provides examples of certain key aspects of ALLL guidance; and a bibliographical list of relevant GAAP guidance, joint interagency statements, and other literature on ALLL issues.

### IV. Regulatory Procedures

#### *Regulatory Flexibility Act*

The Regulatory Flexibility Act requires that NCUA prepare an analysis describing any significant economic impact agency rulemaking may have on a substantial number of small credit unions. 5 U.S.C. 601 et seq. For purposes of this analysis, NCUA considers credit unions under \$1 million in assets as small credit unions.

Credit unions over \$10 million in assets must follow GAAP in the call reports they file with the NCUA Board. All other credit unions must comply with GAAP in relation to the ALLL in order to meet regulatory requirements of full and fair disclosure. This proposed IRPS describes simplified ALLL requirements for the less complex loan activities that small credit unions engage in. For example, small credit unions may satisfy their ALLL responsibilities with consolidated documentation, the use of standardized checklists and worksheets, and simplified loan categorizations and segmentation. Accordingly, the NCUA has determined and certifies that this proposed IRPS will not have a significant economic impact on a substantial number of small credit unions beyond what is already required of them.

#### *Paperwork Reduction Act*

NCUA has determined that this proposed IRPS does not increase paperwork requirements under the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35) and regulations of the Office of Management and Budget.

#### *Executive Order 13132*

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order.

This proposed IRPS applies to all credit unions, but does not have substantial direct effect on the states, on the relationship between the national

government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this proposed IRPS does not constitute a policy that has federalism implications for purposes of the executive order.

By the National Credit Union Administration Board, on October 18, 2001.

**Becky Baker,**

*Secretary of the Board.*

**Authority:** 12 U.S.C. 1782a; 12 CFR 702.402.

### **Proposed Interpretive Ruling and Policy Statement No. 01-3**

#### *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions (IRPS 01-3)*

Boards of directors of federally-insured credit unions are responsible for ensuring that their credit unions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the credit union's stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.<sup>2</sup> To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and the underlying controls, the board of directors should assure themselves that the policies specifically address the credit union's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions 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

<sup>2</sup> A bibliography is attached that lists applicable ALLL GAAP guidance, interagency policy statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See "Application of GAAP" section for additional information on applying GAAP to determine the ALLL.

date. The amounts to be reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the credit union, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the supervisory or audit committee<sup>3</sup> should oversee and monitor the internal controls over the ALLL determination process.<sup>4</sup>

The NCUA has a long-standing examination policy that calls for examiners to review a credit union's lending and loan review functions and recommend improvements, if needed. Agency guidance assists a credit union in estimating and establishing a sufficient ALLL supported by adequate documentation. Additionally, guidance requires operational and managerial standards that are appropriate for a credit union's size and the nature and scope of its activities.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.<sup>5</sup> This IRPS describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is

<sup>3</sup> All credit unions should establish a supervisory or audit committee.

<sup>4</sup> Credit union supervisory or audit committees and their auditors should refer to Statement on Auditing Standards No. 61, Communication With Audit Committees (as amended by Statement on Auditing Standards No. 90, Audit Committee Communications), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties, that have a significant impact on the accounting information included in the financial statements.

<sup>5</sup> The documentation guidance within this IRPS is predominantly based upon the GAAP guidance from Financial Accounting Standards Board Statement Numbers 5 and 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio (which includes the Viewpoints Article—an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); and Chapter 6—Allowance for Loan Losses, the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, Audits of Credit Unions 2000 edition (AICPA Audit Guide).

generally an unsafe and unsound credit union practice.<sup>6</sup>

This guidance applies equally to all credit unions, regardless of the size. However, credit unions with less complex lending activities and products may find it more efficient to combine a number of procedures (*e.g.*, information gathering, documentation, and internal approval processes) while continuing to ensure the credit union has a consistent and appropriate methodology. Thus, much of the supporting documentation required for a credit union with more complex products or portfolios may be combined into fewer supporting documents in a credit union with less complex products or portfolios. For example, simplified documentation can include spreadsheets, check lists, and other summary documents that many credit unions currently use. Illustrations B and D provide specific examples of how less complex credit unions may determine and document portions of their loan loss allowance.

#### *Documentation Standards*

Appropriate written supporting documentation facilitates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. A credit union should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.

At a minimum, credit unions should maintain written supporting documentation for the following decisions, strategies, and processes:

1. Policies and procedures:
  - a. Over the systems and controls that maintain an appropriate ALLL, and
  - b. Over 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.

The following sections of this IRPS provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, this IRPS provides documentation guidance on:

1. Application of GAAP,

<sup>6</sup> Failure to maintain adequate supporting documentation does not relieve a credit union of its obligation to record an appropriate ALLL.

2. Policies and Procedures,
3. Methodology,
4. ALLL Under FASB Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114),
5. ALLL Under FASB Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FAS 5),
6. Consolidating the Loss Estimates, and
7. Validating the ALLL Methodology.

#### *Application of GAAP*

An ALLL recorded pursuant to GAAP 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.<sup>7</sup> A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, a credit union may determine that the amount of loss falls

within a range. A credit union should record its best estimate within the range of loan losses.<sup>8</sup>

Under GAAP, Statement of Financial Accounting Standards No. 5, Accounting for Contingencies (FAS 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. Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.<sup>9</sup> Specifically, FAS 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.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent.

When developing the estimate of expected future cash flows for a loan, a credit union should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The Illustration A provides an example of a credit union estimating a loan's impairment when the loan has been partially charged-off.<sup>10</sup>

### **ILLUSTRATION A**

#### **INTERACTION OF FAS 114 WITH AN ADVERSELY CLASSIFIED LOAN, PARTIAL CHARGE-OFF, AND THE OVERALL ALLL**

A credit union determined that a collateral dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the credit union established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the credit union classified as "Loss," the portion of the recorded investment deemed to be the confirmed loss, and classified the remaining recorded investment as "Substandard." For this loan, the amount classified "Loss" was less than the impairment amount (as determined under FAS 114). The credit union charged off the "Loss" portion of the loan. After the charge-off, the portion of the ALLL related to this "Substandard" loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the credit union's overall ALLL.

<sup>7</sup> This section provides guidance on the ALLL and does not address allowances for credit losses for off-balance sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Credit unions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, Audits of Credit Unions, 2000 edition (AICPA Audit Guide). Additionally, this section does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial

Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125 (FAS 140).

<sup>8</sup> Refer to FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss, and Emerging Issues Task Force Topic No. D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio (EITF Topic D-80).

<sup>9</sup> Emerging Issues Taskforce (EITF) Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other. The AICPA is currently developing a

Statement of Position (SOP) that will provide more specific guidance on accounting for loan losses.

<sup>10</sup> The referenced "gray box" illustrations are presented to assist credit unions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all credit unions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of ALLL Questions and Answers (Q&As) are included in Appendix A of this paper.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.<sup>11</sup> Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired.

Credit unions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an addition ALLL amount.<sup>12</sup>

While different credit unions may use different methods, there are certain common elements that should be included in any loan loss allowance methodology. Generally, a credit union's methodology should:<sup>13</sup>

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 for impairment on an individual basis 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;
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;

<sup>11</sup> In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

<sup>12</sup> According to the Federal Financial Institutions Examination Council's Federal Register Notice, Implementation Issues Arising from FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan, published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

<sup>13</sup> Refer to paragraph 6.04–6.10 of the AICPA Audit Guide.

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 systematic determination process and the unadjusted ALLL balance in the general ledger.<sup>14</sup>

#### *Policies and Procedures*

Credit unions use a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the credit union and its loan portfolio.

In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to:

(1) The roles and responsibilities of the credit union's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;

(2) The credit union's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;

(3) The description of the credit union's systematic methodology, which should be consistent with the credit union's accounting policies for determining its ALLL;<sup>15</sup> and

(4) The system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

<sup>14</sup> For informational purposes, credit unions may want to refer to the guidance on materiality provided in SEC Staff Accounting Bulletin No. 99, Materiality.

<sup>15</sup> Further explanation is presented in the Methodology section that appears below.

An internal control system for the ALLL estimation process should:

(1) Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;

(2) Reasonably ensure that the credit union's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance; and

(3) Include a well-defined loan review process containing:

(a) An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;

(b) Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and

(c) Clear formal communication and coordination between a credit union's credit administration function, financial reporting group, management, board of directors, and others who are involved in the ALLL determination process or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

#### *Methodology*

An ALLL methodology is a system that a credit union designs and implements 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.

A credit union's ALLL methodology is influenced by credit union-specific factors, such as a credit union's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, there are certain common elements a credit union should incorporate in its ALLL methodology. A summary of common elements was provided in Application of GAAP section of this IRPS.<sup>16</sup>

#### *Documentation of ALLL Methodology in Written Policies and Procedures*

A credit union's written policies and procedures should describe the primary

<sup>16</sup> Also, refer to paragraph 6.04–6.10 of the AICPA Audit Guide, 2000 edition.

elements of the credit union's ALLL methodology, including portfolio segmentation and impairment measurement. In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures should describe the methodology:

(1) For segmenting the portfolio:

(a) How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),

(b) When a loan grading system is used to segment the portfolio:

(i) The definitions of each loan grade,

(ii) A reconciliation of the internal loan grades to supervisory loan grades, and

(iii) The delineation of responsibilities for the loan grading system.

(2) For determining and measuring impairment under FAS 114:

(a) The methods used to identify loans to be analyzed individually;

(b) For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:

(i) Procedures describing the impairment measurement techniques available and

(ii) Steps performed to determine which technique is most appropriate in a given situation.

(c) The methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.

(3) For determining and measuring impairment under FAS 5:

(a) How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);

(b) How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and

(c) Descriptions of qualitative factors (e.g., industry, geographical, economic and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in a credit union's credit files, loan review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

#### *ALLL Under FAS 114*

A credit union's ALLL methodology related to FAS 114 loans begins with the use of its normal loan review procedures to identify whether a loan is impaired as defined by the accounting standard. Credit unions should document:

(1) The method and process for identifying loans to be evaluated under FAS 114 and

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

Once a credit union has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

(1) When using the present value of expected future cash flows method:

(a) The amount and timing of cash flows,

(b) The effective interest rate used to discount the cash flows, and

(c) The basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.

(2) When using the fair value of collateral method:

(a) How fair value was determined, including the use of appraisals, valuation assumptions, and calculations,

(b) The supporting rationale for adjustments to appraised values, if any,

(c) The determination of costs to sell, if applicable, and

(d) Appraisal quality, and the expertise and independence of the appraiser.

(3) When using the observable market price of a loan method:

(a) The amount, source, and date of the observable market price.

Illustration B describes a practice used by a small credit union to document its FAS 114 measurement of impairment using a comprehensive worksheet. Q&A #1 and #2 in Appendix A provide examples of applying and documenting impairment measurement methods under FAS 114.

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Q&A #3 in Appendix A presents an example of a credit union whose loan portfolio includes fully collateralized loans and describes the documentation maintained by that credit union to support its conclusion that no ALLL was needed for those loans.

## **ILLUSTRATION B**

### **DOCUMENTING AN ALLL UNDER FAS 114**

#### *Comprehensive worksheet for the impairment measurement process*

A small credit union uses a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

*ALLL Under FAS 5*

## Segmenting the Portfolio

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. Credit unions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. 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 in only 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.

As economic and other business conditions change, credit unions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration C presents an example in which a credit union refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

Credit unions use a variety of documents to support the segmentation of their portfolios.

## ILLUSTRATION C

### DOCUMENTING SEGMENTING PRACTICES

#### *Documenting a refinement in a segmentation method*

A credit union with a significant portfolio of consumer loans performed a review of its ALLL methodology. The credit union had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the credit union decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Some of these documents include:

- Loan trial balances by categories and types of loans,
- Management reports about the mix of loans in the portfolio,
- Delinquency and nonaccrual reports, and
- A summary presentation of the results of an internal or external loan grading review.

Reports generated to assess the profitability of a loan product line may be useful in identifying areas in which to further segment the portfolio.

#### Estimating Loss on Groups of Loans

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,<sup>17</sup> the credit union should estimate the loan and lease losses, on at least a

quarterly basis, 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. Regardless of the method used to measure losses, a credit union should demonstrate and document that the loss measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.<sup>18</sup>

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. 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 defined period of time. If a credit union does not have loss experience of its own, it may be appropriate to reference the loss experience of other credit unions, provided that the credit union demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the credit union providing the loss experience.<sup>19</sup> Credit unions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, credit unions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan

<sup>17</sup> An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending credit union.

<sup>18</sup> Refer to paragraph 8(b) of FAS 5. Also, the AICPA is currently developing a Statement of Position that will provide more specific guidance on accounting for loan losses.

<sup>19</sup> Refer to paragraph 23 of FAS 5.

losses. An example of how a small credit union performs a comprehensive

historical loss analysis is provided as the first item in Illustration D.

## ILLUSTRATION D DOCUMENTING THE SETTING LOSS RATES

### *Comprehensive loss analysis in a small credit union*

A small credit union determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The credit union also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The credit union maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

### *Adjustment of loss rates for changes in local economic conditions*

A credit union develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on business real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The credit union generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The credit union maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Before employing a loss estimation model, a credit union should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, credit unions that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, credit unions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affect the loss measurements. Factors that should be considered in developing loss measurements include the following:<sup>20</sup>

- (1) Levels of and trends in delinquencies and impaired loans;
- (2) Levels of and trends in charge-offs and recoveries;
- (3) Trends in volume and terms of loans;
- (4) Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;

(5) Experience, ability, and depth of lending management and other relevant staff;

(6) National and local economic trends and conditions;

(7) Industry conditions; and

(8) Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, the credit union should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in Illustration D provides an example of how a credit union adjusts its business real estate historical loss rates for changes in local economic conditions. Q&A #4 in Appendix A provides an example of maintaining supporting documentation for adjustments to portfolio segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Q&A #5 in Appendix A describes one credit union's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

### *Consolidating the Loss Estimates*

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include:

(1) An estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);

(2) The aggregate probable loss estimated using the credit union's methodology;

(3) A summary of the current ALLL balance;

(4) The amount, if any, by which the ALLL is to be adjusted;<sup>21</sup> and

(5) Depending on the level of detail that supports the ALLL analysis, detailed sub-schedules of loss estimates that reconcile to the summary schedule.

Illustration E describes how a credit union documents its estimated ALLL by

<sup>21</sup> Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

<sup>20</sup> Refer to paragraph 6.08 in the AICPA Audit Guide.

adding comprehensive explanations to its summary schedule.

## ILLUSTRATION E SUMMARIZING LOSS ESTIMATES

### *Descriptive comments added to the consolidated ALLL summary schedule*

To simplify the supporting documentation process and to eliminate redundancy, a credit union adds detailed supporting information to its summary schedule. For example, this credit union's board of directors receives, within the body of the ALLL summary schedule, a brief description of the credit union's policy for selecting loans for evaluation under FAS 114. Additionally, the credit union identifies which FAS 114 impairment measurement method was used for each individually reviewed impaired loan. Other items on the schedule include brief descriptions of loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Generally, a credit union's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Q&A #6 in Appendix A addresses the documentation of the final amount of the ALLL.

#### *Validating the ALLL Methodology*

A credit union's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the credit union's methodology should include procedures that adjust loss estimation methods to

reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, a credit union's 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.

In practice, credit unions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

(1) A review of trends in loan volume, delinquencies, restructurings, and concentrations.

(2) A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.

(3) A review by a party that is independent of the ALLL estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.

(4) An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised

value to the actual sales price on selected properties sold.

#### Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The credit union's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

#### Appendix A—ALLL Questions and Answers

##### *Introduction*

The Questions and Answers (Q&As) presented in this appendix serve several purposes, including (1) to illustrate the NCUA's views, as set forth in this IRPS, about the types of decisions, determinations, and processes a credit union should document with respect to its ALLL methodology and amounts; and (2) to illustrate the types of ALLL documentation and processes a credit union might prepare, retain, or use in a particular set of circumstances. The level and types of documentation described in the Q&As should be considered neither the minimum acceptable level of documentation nor an all-inclusive list. Credit unions are expected to apply the guidance in this IRPS to their individual facts, circumstances, and situations. If a credit union's fact pattern differs from the fact patterns incorporated in the following Q&As, the credit union may decide to prepare and maintain different

types of documentation than did the credit unions depicted in these Q&As.

**Q&A #1—ALLL Under FAS 114—Measuring and Documenting Impairment**

**Facts:** Approximately one-third of Credit Union A's business loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Credit Union A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Credit Union A determines that certain of the loans are impaired as defined by FAS 114.

**Question:** For the business loans reviewed under FAS 114 that are individually impaired, how should Credit Union A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

**Interpretive Response:** For those loans that are reviewed individually under FAS 114 and considered individually impaired, Credit Union A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Credit Union A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its business loans for the past five years.

Credit Union A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If Credit Union A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors<sup>1</sup> and other information reflecting past events and current conditions. When Credit Union A uses the fair value of collateral to measure impairment, Credit Union A should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Credit Union A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

<sup>1</sup> Question #16 in Exhibit D-80A of EITF Topic D-80 and attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

**Q&A #2—ALLL Under FAS 114—Measuring Impairment for a Collateral Dependent Loan**

**Facts:** Credit Union B has a \$750,000 loan outstanding to Member X that is secured by real estate, which Credit Union B individually evaluates under FAS 114 due to the loan's size. Member X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Credit Union B determines that its loan to Member X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Credit Union B measures impairment of the loan based on the fair value of the collateral. Credit Union B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$900,000.

Credit Union B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Credit Union B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.<sup>2</sup> After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$575,000. Given that the recorded investment in the loan is \$750,000, Credit Union B concludes that the loan is impaired by \$175,000 and records an allowance for loan losses of \$175,000.

**Question:** What type of documentation should Credit Union B maintain to support its determination of the allowance for loan losses of \$175,000 for the loan to Member X?

**Interpretive Response:** Credit Union B should document that it measured impairment of the loan to Member X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$575,000. This documentation should include the credit union's rationale and basis for the \$575,000 valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable.

Because Credit Union B arrived at the valuation of \$575,000 by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$900,000 eighteen months ago to \$575,000 in the current period.<sup>3</sup>

<sup>2</sup> When reviewing collateral dependent loans, Credit Union B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

<sup>3</sup> In accordance with the FFIEC's **Federal Register** Notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 FR 7966, February 10, 1995), impaired, collateral-

**Q&A #3—ALLL Under FAS 114—Fully Collateralized Loans**

**Facts:** Credit Union C has \$500,000 in business loans that are fully collateralized by purchased business equipment. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to fully secure each loan. The member borrowers have physical control of the collateral. Credit Union C perfected its security interest in the collateral when the funds were originally distributed. On an annual basis, Credit Union C determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. Semiannually or more frequently as needed, the Credit Union C's credit administration function physically inspects the equipment. If there are any collateral deficiencies, Credit Union C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Credit Union C has historically not incurred any material losses on these loans. Credit Union C believes these loans are fully-collateralized and therefore does not maintain any ALLL balance for these loans.

**Question:** What documentation does Credit Union C maintain to adequately support its determination that no allowance is needed for this group of loans?

**Interpretive Response:** Credit Union C's management summary of the ALLL includes documentation indicating that, in accordance with the credit union's ALLL policy, the collateral protection on these loans has been verified by the credit union, no probable loss has been incurred, and no ALLL is necessary. Documentation in Credit Union C's loan files includes the two independent market quotes obtained annually for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Credit Union C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Credit Union C's policy requires the following factors to be considered and the credit union's findings concerning these factors to be fully documented:

1. Volatility of the market value of the collateral;
2. Recency and reliability of the appraisal or other valuation;
3. Recency of the credit union or other third party inspection of the collateral;
4. Historical losses on similar loans;
5. Confidence in the credit union's lien or security position including appropriate:
  - a. Type of security perfection (e.g., physical possession of collateral or secured filing);
  - b. Filing of security perfection (i.e., correct documents and with the appropriate officials), and
  - c. Relationship to other liens.
6. Other factors as appropriate for the loan type

dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

*Q&A #4—ALLL Under FAS 5—Adjusting Loss Rates*

*Facts:* Credit Union D's field of membership (lending area) includes a metropolitan area that is financially dependent upon the profitability of a number of sponsor manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these sponsor manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the sponsor manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the sponsor manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Credit Union D has yet to confirm an increase in its loss experience as a result of these events, management knows that the credit union lends to a significant number of member's for business and individual purposes whose repayment ability depends upon the long-term viability of the sponsor manufacturing businesses. Credit Union D's management has identified particular segments of its business and consumer member bases that include member borrowers highly dependent upon sales or salary from the sponsor manufacturing businesses. Credit Union D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Credit Union D has experienced similar business and lending conditions in the past that it can compare to current conditions.

*Question:* How should Credit Union D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

*Interpretive Response:* Credit Union D should document its identification of the particular segments of its business and consumer loan portfolio for which it is probable that the sponsor manufacturing business' financial downturn has resulted in loan losses. In addition, Credit Union D should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Credit Union D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data, and notes from discussions with individual member borrowers.

Because in this case Credit Union D has had similar situations in the past, its supporting documentation also includes an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Credit Union D creates a summary of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for

their review and approval prior to the issuance of the financial statements.

*Q&A #5—ALLL Under FAS 5—Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired*

*Facts:* Credit Union E has outstanding loans of \$875,000 to Member Y and \$725,000 to Member Z, both of which are paying as agreed upon in the loan documents. The credit union's ALLL policy specifies that all loans greater than \$700,000 must be individually reviewed for impairment under FAS 114. Member Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Member Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the credit union's loan grading system. Despite its concern, management believes Member Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Credit Union E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Member Y has risk characteristics similar to the loans included in Segment 1 and the loan to Member Z has risk characteristics similar to the loans included in Segment 2.<sup>4</sup>

In its determination of the ALLL under FAS 5, Credit Union E includes its loans to Member Y and Member Z in the groups of loans with similar characteristics (i.e., Segment 1 for Member Y's loan and Segment 2 for Member Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the credit union's probable loan losses in these segments.

*Question:* How does Credit Union E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

*Interpretive Response:* As part of Credit Union E's effective ALLL methodology, it documents the decision to include its loans to Member Y and Member Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Credit Union E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The credit union also maintains

<sup>4</sup> These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

copies of the economic and other reports that provided source data.

*Q&A #6—Consolidating the Loss Estimates—Documenting the Reported ALLL*

*Facts:* Credit Union F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

*Question:* Are Credit Union F's documentation practices related to the balance of its loan loss allowance appropriate?

*Interpretive Response:* No. A credit union must maintain supporting documentation for the loan loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For credit unions subject to external audit, this documentation should also be made available to the supervisory committee and its independent accountants. If changes frequently occur during management or committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the credit union uses.

**Bibliography***GAAP and Auditing Guidance*

- American Institute of Certified Public Accountants' Audit and Accounting Guide, Audits of Credit Unions, 2000 edition
- Auditing Standards Board Statement on Auditing Standards No. 61, Communication With Audit Committees (AICPA, Professional Standards, vol. 1, AU sec. 380)
- Emerging Issues Task Force Topic No. D-80, Application of FASB Statements No. 5

and No. 114 to a Loan Portfolio (EITF Topic D-80 and attachments), discussed on May 19-20, 1999

Financial Accounting Standards Board Interpretation No. 14, Reasonable Estimation of the Amount of a Loss (An Interpretation of FASB Statement No. 5)

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, Accounting for Contingencies

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of A Loan (An Amendment of FASB Statements No. 5 and 15)

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 118, Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures (An Amendment of FASB Statement No. 114)

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125

#### Regulatory Guidance

Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL), December 21, 1993

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## NUCLEAR REGULATORY COMMISSION

[Docket Nos. 50-321 and 50-366]

### Southern Nuclear Operating Company, Inc. et al.; Notice of Consideration of Issuance of Amendments to Facility Operating License, Proposed No Significant Hazards Consideration Determination, and Opportunity for a Hearing

The U.S. Nuclear Regulatory Commission (the Commission) is considering issuance of amendments to Facility Operating License Nos. DPR-57 and NFP-5 issued to Southern Nuclear Operating Company, Inc. et al., (the licensee) for operation of the Edwin I. Hatch Nuclear Plant, Units 1 and 2, located in Appling County, Georgia.

The proposed amendments would revise the Technical Specifications to allow the main control room boundary to be opened intermittently under administrative controls and to allow 24 hours to restore the main control room

boundary to Operable status before requiring the plant to perform an orderly shutdown.

Before issuance of the proposed license amendments, the Commission will have made findings required by the Atomic Energy Act of 1954, as amended (the Act) and the Commission's regulations.

The Commission has made a proposed determination that the amendment request involves no significant hazards consideration. Under the Commission's regulations in 10 CFR 50.92, this means that operation of the facility in accordance with the proposed amendments would not (1) involve a significant increase in the probability or consequences of an accident previously evaluated; or (2) create the possibility of a new or different kind of accident from any accident previously evaluated; or (3) involve a significant reduction in a margin of safety. As required by 10 CFR 50.91(a), the licensee has provided its analysis of the issue of no significant hazards consideration, which is presented below:

1. The proposed changes do not involve a significant increase in the probability or consequences of an accident previously evaluated.

The proposed changes involve the Main Control Room Environmental (MCREC) system which provides a radiologically controlled environment from which the plant can be operated following a design basis accident (DBA). Therefore, the MCREC system is not assumed to be the initiator of any analyzed accident. The proposed changes allow the main control room boundary to be opened intermittently under administrative control, and allow 24 hours to restore the main control room boundary to Operable status before requiring the plant to perform an orderly shutdown. The 24 hour Completion Time is reasonable based on the low probability of a DBA occurring during this time period and SNC's commitment to implement, via administrative controls, appropriate compensatory measures consistent with the intent of 10 CFR 50, Appendix A, General Design Criteria (GDC) 19. These compensatory measures minimize the consequences of an open main control room boundary and assure that MCREC system can continue to perform its function. As such, these changes will not affect the function or operation of any other systems, structures, or components.

2. The proposed changes do not create the possibility of a new or different kind of accident from any accident previously evaluated.

The proposed changes allow the main control room boundary to be opened intermittently under administrative control, and allow 24 hours to restore the main control room boundary to Operable status before requiring the plant to perform an orderly shutdown. The 24 hour Completion Time is reasonable based on the low probability of a DBA occurring during this

time period and SNC's commitment to implement, via administrative controls, appropriate compensatory measures consistent with the intent of 10 CFR 50, Appendix A, GDC 19. These compensatory measures minimize the consequences of an open main control room boundary and assure that the MCREC system can continue to perform its function. As such, these changes will not affect the function or operation of any other systems, structures, or components.

3. The proposed changes do not involve a significant reduction in a margin of safety.

The proposed changes allow the main control room boundary to be opened intermittently under administrative control, and allow 24 hours to restore the main control room boundary to Operable status before requiring the plant to perform an orderly shutdown. The 24 hour Completion Time is reasonable based on the low probability of a DBA occurring during this time period and SNC's commitment to implement, via administrative controls, appropriate compensatory measures consistent with the intent of 10 CFR 50, Appendix A, GDC 19. These compensatory measures minimize the consequences of an open main control room boundary and assure that the MCREC system can continue to perform its function such that compliance with GDC 19 is maintained.

The NRC staff has reviewed the licensee's analysis and, based on this review, it appears that the three standards of 10 CFR 50.92(c) are satisfied. Therefore, the NRC staff proposes to determine that the amendment request involves no significant hazards consideration.

The Commission is seeking public comments on this proposed determination. Any comments received within 30 days after the date of publication of this notice will be considered in making any final determination.

Normally, the Commission will not issue the amendments until the expiration of the 30-day notice period. However, should circumstances change during the notice period such that failure to act in a timely way would result, for example, in derating or shutdown of the facility, the Commission may issue the license amendments before the expiration of the 30-day notice period, provided that its final determination is that the amendments involve no significant hazards consideration. The final determination will consider all public and State comments received. Should the Commission take this action, it will publish in the **Federal Register** a notice of issuance and provide for opportunity for a hearing after issuance. The Commission expects that the need to take this action will occur very infrequently.

Written comments may be submitted by mail to the Chief, Rules and