## I. PURPOSE

The Allowance for Loan Loss and Lease Losses Account (ALLL) should provide a best estimate of the probable amount of loan or lease account the institution will have difficulty collecting. The ALLL should be reviewed to ensure compliance with state and federal regulations and that the account is adequately funded. Methodology for determining the required balance in the account must be consistently applied and regularly reviewed.

## II. PRIMARY REFERENCES / RELATED REGULATIONS

1. Michigan Credit Union Act:
   - **a.** Section 342(3)(i): Adopting policies
   - **b.** Section 342(4)(g): Establishing internal controls
   - **c.** Section 382: Fiscal year; accounting principles
   - **d.** Section 386: Establishment and maintenance of reserves
2. Accounting Standards Codification (ASC):
   - **a.** ASC 450-20: Loss Contingencies
   - **b.** ASC 310-10: Receivables
3. FFIEC Interagency Policy Statement on the Allowance for Loan and Lease Losses
4. FFIEC Uniform Retail Credit Classification and Account Management Policy
5. Office of Credit Unions (OCU) Letter 2010-CU-01

## III. MINIMUM PROCEDURES

1. **Documentation Standards**:
   Examiners must ensure appropriate supporting documentation exists for the ALLL and Provision for Loan and Lease Loss (PLLL). At minimum, documentation should include:
   - **a.** Board approved policies and procedures;
   - **b.** Loan grading system or process;
   - **c.** Summary or consolidation of the ALLL balance;
   - **d.** Validation of the ALLL methodology; and
   - **e.** Periodic adjustments to the ALLL process.
2. **Policies and Procedures:**
   - **a.** Review policies and procedures to ensure they are sufficient; policies must correspond with the complexity of the institution and the loan portfolio. At minimum, policies should address the following:
     - **i.** The roles and responsibilities of the departments and personnel (including the lending function, credit review,

financial reporting, internal audit, senior management, Board of Directors, and others, as applicable) who determine, or review the ALLL;

**ii.** The accounting policies for loans and loan losses, including the policies for charge-offs, recoveries, and estimating the fair value of collateral (if any). Policies must require loans, or portions of loans, to be promptly charged off when available information confirms them to be uncollectable;

**iii.** The description of the methodology, which should maintain consistency with the accounting policies for determining its ALLL; and

**iv.** The system of internal controls used to ensure the ALLL process adheres to GAAP and supervisory guidance.

**b.** Policies and procedures should detail the methodology used to determine the ALLL, including the following, at minimum:

**i.** Segmenting the portfolio, including how the segmentation process is performed (i.e., by loan type, industry, risk rating, etc.)

**ii.** The methods used to identify loans to be analyzed individually under ASC 310-10, including how individual impairments are determined and measured.

**1.** Procedures for determining impairment techniques should be documented (i.e., present value of future cash flows, fair value of collateral less cost to sell, or the loan's observable market price).

**2.** Documented procedures should address steps performed to determine which technique is most appropriate in a given situation.

**iii.** The methods used for determining impairment under ASC 450-20 (FAS 5).

**1.** How loans with similar risk characteristics are grouped together.

**2.** How loss rates are determined, and factors considered when establishing appropriate time frames over which to evaluate loss experience.

**3.** Description of qualitative factors (e.g., industry, geographical, economic and/or political factors) which may affect loss rates or other loss measurements. Qualitative factors must be supported in writing.

- **c.** Ensure policies and/or procedures document a system of internal controls which should, at minimum:
  - **i.** Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
  - **ii.** Ensure adequate data capture and reporting systems exist to support and document information necessary for determining an appropriate ALLL;
  - **iii.** Reasonably ensure the financial statements (including regulatory reports) comply with GAAP and ALLL supervisory guidance;
  - **iv.** Include a well-defined loan review process containing:
    - **1.** An effective, consistently-applied loan grading system that accurately, and timely, identifies differing risk characteristics and loan quality problems, and prompts appropriate corrective actions;
    - **2.** Internal controls that ensure consideration of all relevant loan review information in estimating losses. This includes maintaining appropriate reports and details of reviews performed, and identifying personnel involved; and
    - **3.** Clear, formal communication and coordination between the Board of Directors, management, and others involved in the ALLL determination or review (e.g., written policies and procedures, management reports, audit programs, and committee minutes.)
  - **v.** The ALLL methodology is periodically and independently validated.
- **d.** The ALLL policies must be reviewed and approved by the Board of Directors annually.

**3. Methodology:**

- **a.** An adequate determination of loan losses must include both an individual appraisal of specifically identified loans and an estimate of losses inherent in the remaining loan portfolio based upon historical loan loss and environmental experience.
  - **i.** When measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with ASC 450-20 (FAS 5), a widely used method is based on each loan segments' historical net charge-off rate adjusted for the effects of the qualitative or environmental factors (as applicable).

ii. When determining the ASC 310-10 (FAS 114) component of the ALLL for an individually impaired loan, an institution should consider estimated costs to sell the loan's collateral, if any, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the institution bases its measure of loan impairment on the present value of expected future cash flows discounted at the loan's effective interest rate, the estimates of these cash flows should be the best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the estimate of expected future cash flows.

**b.** The ALLL analysis must reflect appropriate consideration of the institution's credit risk management systems. This interaction may be simplistic relative to homogeneous retail credit pools and rely primarily on delinquency status and loan-to-value (See OCU Letter 2010-CU-01), or may require more robust, individual credit analysis in the case of non-homogeneous pools, such as commercial loan portfolios.

**c.** An appropriate credit risk management system, and relatedly the ALLL, should always include recognition of individually impaired loans. Factors to consider when determining collectability include delinquency status, the borrower's documented capacity to service the debt and the liquidation value of collateral securing the loan.

**d.** Someone other than the responsible loan officer should perform the appraisal of individual loans. In situations where internal controls are not sufficient, the institution should ensure an appropriate, regularly scheduled independent loan review.

**e.** The experience component of the methodology should be based upon a historical average net loss ratio that management can support with appropriate documentation and independently reviewed as part of the financial audit. Newly initiated loan programs, without historical perspective, must include a reasonable estimate of predicted losses until appropriate statistics become available.

**f.** The ALLL calculation must comply with GAAP and be supported in writing as part of the audit process. Relatedly, the audit should include appropriate review of internal controls over the modification of due dates, loan-to-value data and other information used in the ALLL methodology.

   g. As prescribed by GAAP, all amounts recovered from charged-off loans shall be placed in the ALLL account until the amount charged off has been replenished.

4. **Reconciling Activity in the ALLL Account:**
   The examiner must reconcile all ALLL account activity occurring between examination dates. Each account transaction from the previous examination date to the current examination's effective date may be scheduled on the Allowance for Loan Losses worksheet within the AIRES Exam.xls file. The worksheet will detail the following:
   a. Adjustments to fund the ALLL account, made through the Provision for Loan Losses Expense account (not the Required Reserves).
   b. Monthly summary of loans charged off between examinations. The examiner should review the monthly board reports to verify that amounts charged off agree with the members' account balances approved for charge off. Charges to the ALLL account should be approved by the Board of Directors.
   c. Monthly summary of recoveries from previously charged off loans received between examinations.
   d. Complete detail of any other miscellaneous debits or credits to this account not mentioned above. These types of entries should be rare; satisfactory explanation should be obtained for any such entries.
   e. The ALLL should never have a debit balance.
   f. Subsidiary records should be maintained which show detail of each of the charged off loans and any subsequent recoveries.

5. **Determine Adequacy of the ALLL Account:**
   a. Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances, this may include a quantitative analysis (e.g., using ratio analysis) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.
   b. Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.

c. Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.

## IV. CURRENT EXPECTED CREDIT LOSS (CECL) MODEL

The Financial Accounting Standards Board (FASB) issued the final guidance on the Current Expected Credit Loss (CECL) model in June 2016 which will be effective beginning for fiscal years after December 15, 2020. CECL is the new accounting model for the recognition and measurement of credit losses for loans and debt securities. CECL will require significant changes to the data credit unions maintain and analyze.

1. **Difference between current accounting standards and CECL:**
   - **a.** Current credit loss accounting standards are referred to as “incurred loss” accounting, meaning something probably happened which caused impairment to the loan. For practical purposes, that impairment is normally measured in pools of loans and is primarily based on historic annualized charge-off ratios.
   - **b.** In contrast, CECL has an “expected loss” notion. An event does not have to have occurred but can be expected in the future. Further, the historical data that CECL relies upon is not annual loss rates but is on life of loan or life of portfolio loss rates.
   - **c.** Individual loan impairments will still be evaluated and measured under CECL.
2. **Preparing for CECL:**
   - **a.** Examiners should begin educating themselves on CECL and encouraging institutions to as well.
   - **b.** Examiners should communicate preparing for CECL with institutions; institutions will need to assess their governance and risk management frameworks, credit models, data requirements, accounting and operational policies and procedures, processes, controls and information technology systems to plan for successful implementation of CECL requirements.
   - **c.** CECL will require more complete and detailed data. Institutions should be proactively assembling a comprehensive inventory of the data which will be needed to prepare for CECL compliance deadlines.

**d.** When discussing the new accounting standard and its implementation with their external auditors, institutions and their Supervisory Committees should be mindful of applicable auditor independence requirements.

**e.** Management must also begin planning for the potential impact of the new accounting standard on capital.