



Applying the New Disclosure Requirements for Loans and the Allowance for Loan Loss

Overview

Credit Unions who receive opinion audits are required to provide additional disclosures in the footnotes to their financial statements beginning with their December 31, 2011 financial statements. The intent of the new requirements are to provide the financial statement users with greater transparency about the credit union's allowance for loan loss and the credit quality of its loan portfolio by providing greater details relative to the following:

- The nature of the credit risk inherent in the loan portfolio.
- How the credit union analyzes and assesses risk in arriving at the allowance for loan losses.
- The changes and reasons for those changes in the allowance for loan loss account.

The information included herein is intended to help you sort through the detail. The requirements were put in place by the Financial Accounting Standards Board through ASU No. 2010-20 and have become a part of ASC 310.

Disclosures

The new disclosures require certain information to be provided on a "disaggregated" basis. This essentially means breaking it down by category the credit union uses, internally, to compute its required allowance for loan loss balance. If the Credit Union uses the following sample categories in computing its historical loss percentages, the disclosure information below is required to be provided for each category. All of the sample footnotes included assumes the following loss categories are tracked.

- Unsecured
- Credit Card
- Auto-New
- Auto-Used
- Mortgage
- Other

The disclosure information for each of the categories is as follows:

1. A summary of the annual activity in the allowance for loan loss for the year.
2. The amount of loans outstanding.
3. The nonaccrual status.
4. Loans impaired.

The above information should not be too difficult to assemble as most of it can be obtained from the historical loss worksheets maintained by the credit union.

In addition, the following information is required disclosure about the loan portfolio:

1. Loan class balance by "credit quality indicator". Credit Quality indicators include consumer credit scores, credit ratings, internal loan grades, loan to value ratios, collateral, collection experience and other internal metrics. My experience has been that most credit union's use "credit quality indicators" at the time the loan is made but do not necessarily track data on an ongoing basis that would provide any meaningful information to a financial statement user. Consequently, unless your credit union specifically tracks credit quality data, my recommendation would be to disclose that the credit union does not use credit quality indicators on an ongoing basis as a tool in evaluating the adequacy of the allowance for loan loss account.
2. Delinquency by class (generally equivalent to categories used for the determination of the historical losses as noted above)
3. The extent of troubled debt restructurings (TDR) by class and their impact on the allowance for loan loss balance.
4. The amount of TDRs during the last twelve months that defaulted and their impact on the allowance for loan loss.
5. Significant purchases of and sales of loans during the year.

The credit union must also describe by portfolio segment, its accounting policies and methodology used to estimate its allowance for loan losses, including any changes made during the year.

I have included sample footnote disclosures that I would generally recommend for credit unions to meet the new reporting and disclosure standards. The disclosures included reflect what would be recommended for inclusion in the "Summary of Significant Accounting Policies" note as well as those in the "Loans to Members" note.

Prior to year end, we suggest that you review your system and data accumulation information to assure that you are able to assemble the information required to be include in the financial statement footnotes as included below.

If you have any questions, please feel free to contact me.

Gary D. Condit
Director, Assurance & Business Advisory Services
gcondit@gbq.com
614.947.5272

SAMPLE OF LOAN SECTION OF "SUMMARY OF SIGNIFICANT POLICIES" FOOTNOTELoans to Members and Allowance for Loan Losses

The Credit Union grants mortgage and consumer loans to members. Loans receivable are stated at unpaid principal balances, less an allowance for loan losses and net deferred loan origination fees and discounts. Interest on loans is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding.

The accrual of interest on loans is discontinued at the time the loan is 180 days delinquent unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on non-accrual or charged-off at an earlier date if management believes, after considering economic conditions, business conditions, and collection efforts, that collection of principal or interest is considered doubtful. All interest accrued but not collected for loans that are placed on non-accrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses reflects management's judgment of probable loan losses inherent in the portfolio at the balance sheet date. The Credit Union uses a disciplined process and methodology to establish the allowance for loan losses each quarter. To determine the total allowance for loan losses, management estimates the reserves needed for each segment of the portfolio, including loans analyzed individually and loans analyzed on a pooled basis. The allowance for loan losses consists of amounts applicable to: (i) the auto secured portfolio; (ii) the real estate portfolio; (iii) the consumer portfolio and (iv) the unsecured and credit card portfolio.

To determine the balance of the allowance account, loans are pooled by portfolio segment and losses are modeled using historical experience and quantitative and other mathematical techniques over the loss emergence period. Management exercises significant judgment in determining the estimation method that fits the credit risk characteristics of each portfolio segment. The Credit Union uses both internally-developed and vendor-supplied models in this process. Management must use judgment in establishing additional input metrics for the modeling processes. The models and assumptions used to determine the allowance are independently validated and reviewed to ensure

that their theoretical foundation, assumptions, data integrity, computational processes, reporting practices, and end-user controls are appropriate and properly documented.

The establishment of the allowance for loan losses relies on a consistent process that requires management review and judgment and responds to changes in economic conditions, member behavior, and collateral value, among other influences. From time to time, events or economic factors may affect the loan portfolio, causing management to provide additional amounts to or release balances from the allowance for loan losses. The Credit Union's allowance for loan losses is sensitive to risk ratings assigned to individually evaluated loans and economic assumptions and delinquency trends driving statistically modeled reserves. Individual loan risk ratings are evaluated based on each situation by experienced senior credit officers.

Management monitors differences between estimated and actual incurred loan losses. This monitoring process includes periodic assessments by senior management of loan portfolios and the models used to estimate incurred losses in those portfolios. Additions to the allowance for loan losses are made by charges to the provision for loan losses. Credit exposures deemed to be uncollectible are charged against the allowance for loan losses. Recoveries of previously charged off amounts are credited to the allowance for loan losses.

Loan Charge-Offs

For consumer loans, the Credit Union generally fully or partially charges down to the fair value of collateral securing the asset when:

- management judges the asset to be uncollectible;
- repayment is deemed to be protracted beyond reasonable time frames;
- the asset has been classified as a loss by either the Credit Union's internal loan review process or external examiners;
- the member has filed bankruptcy and the loss becomes evident from a lack of assets

SAMPLE "LOANS TO MEMBERS" FOOTNOTE

The loans to members at June 30, 2011 and 2010 consist of the following:

	<u>2011</u>	<u>2010</u>
Unsecured	\$ 5,000,000	\$ 4,000,000
Credit card	10,000,000	9,000,000
Auto – New	76,000,000	75,000,000
Auto – Used	25,000,000	24,000,000
Mortgage	40,000,000	39,000,000
Other	<u>2,000,000</u>	<u>1,000,000</u>
Total	158,000,000	152,000,000
Less: allowance for loan losses	<u>(3,000,000)</u>	<u>(2,000,000)</u>
Loans, net	<u>\$ 155,000,000</u>	<u>\$ 150,000,000</u>

The interest rates on the loans range from 2.25% to 18.00% at December 31, 2011.

The activity in allowance for loan loss account for the year ended at June 30, 2011 consisted of the following (in 000's):

	Unsec	Credit	Auto New	Auto Used	Mort	Other	Total
Beginning balance	\$ 50	\$ 300	\$ 800	\$ 750	\$ 75	\$ 25	\$2,000
Provision charged to operations	30	200	400	300	100	70	1,100
Loans charged off	(30)	(30)	(90)	(90)	(80)	(30)	(350)
Recoveries	<u>10</u>	<u>50</u>	<u>75</u>	<u>75</u>	<u>20</u>	<u>20</u>	<u>250</u>
Ending balance	<u>\$ 60</u>	<u>\$ 520</u>	<u>\$1,185</u>	<u>\$1,035</u>	<u>\$ 115</u>	<u>\$ 85</u>	<u>\$3,000</u>

Impaired Loans - The Credit Union considers a loan to be impaired when, based on current information and events, the Credit Union determines that the Credit Union will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. Determination of impairment is treated the same across all classes of loans. When the Credit Union identifies a loan as impaired, the Credit Union measures the impairment based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole (remaining) source of repayment for the loan is the operation or liquidation of the collateral. In these cases, the Credit Union uses the current fair value of the collateral, less selling costs when foreclosure is probable, instead of discounted cash flows. If the Credit Union determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), the Credit Union recognizes impairment through an allowance estimate or a charge-off to the allowance. The credit union determines impairment based on a 60 day default period and all loans classified as TDRs.

When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal, under the cost recovery method. When the ultimate collectability of the total principal of an impaired loan is not in doubt and the loan is on nonaccrual status, contractual interest is credited to interest income when received, under the cash basis method.

The following table includes the recorded investment and unpaid principal balances for impaired financing receivables with the associated allowance amount, if applicable. The Credit Union determined the specific allowance based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the remaining source of repayment for the loan is the operation or liquidation of the collateral. In those cases, the current fair value of the collateral, less selling costs was used to determine the specific allowance recorded.

When the ultimate collectability of the total principal of an impaired loan is not in doubt and the loan is on nonaccrual status, contractual interest is credited to interest income when received, under the cash basis method.

Other credit related information as of December 31, 2011 by class, dollar amounts (in 000s):

	Unsec	Credit	Auto New	Auto Used	Mort	Other	Total
Historical Loss %	1.7%	2.2%	0.5%	1.1%	0.2%	0.5%	1.8%
Delinquency over 60 day - Total	\$ 200	\$ 300	\$ 250	\$ 350	\$ 600	\$ 50	\$1,750
Delinquent 60-90 days	\$ 180	\$ 225	\$ 200	\$ 300	\$ 250	\$ 50	\$1,205
Delinquent 90-180 days	\$ 20	\$ 50	\$ 30	\$ 25	\$ 300	\$ -	\$ 425
Delinquent over 180	\$ -	\$ 25	\$ 20	\$ 25	\$ 50	\$ -	\$ 120
Impaired restructured loan balances	\$ -	\$ -	\$ -	\$ -	\$ 200	\$ -	\$ 200
Specific reserves on restructured loans included in overall allowance	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Restructured loans in default	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Loans in non-accrual status	\$ -	\$ 25	\$ 20	\$ 25	\$ 50	\$ -	\$ 120

The overall credit quality of the loan portfolio is monitored by management based on current loan performance, historical losses and delinquency status.

The Credit Union does not accrue interest on loans more than 180 days delinquent. If interest on these loans had been accrued, such income would have been \$18,000 for the year ended December 31, 2011.