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Interpretive Letter

Division of Credit Unions Interpretive Letter I-15-04

DATE: December 29, 2015

TO: All Washington State-Chartered Credit Unions

FROM: Linda Jekel, Director
Division of Credit Unions

RE: Complying with GAAP in Relation to MBLs and Reserving for ALLL

This Interpretive Letter clarifies the requirements for Washington State-chartered credit unions when complying with generally accepted accounting principles ("GAAP") in relation to member business loans ("MBL") and reserving for their allowance for loan and lease losses ("ALLL") account.

We looked at the legislative and rulemaking history of the following laws:

- the Washington Credit Union Act ("WCUA"),
- the Washington Administrative Code ("WAC"),
- the Federal Credit Union Act ("FCUA"), and
- the Rules of the National Credit Union Administration ("NCUA") ["NCUA Rules"].

In order to clarify the governing federal and state requirements, we also looked at certain NCUA Interpretive Rulings and Policy Statements ("IRPS") and certain Accounting Standards Codifications ("ASC").

1.0 Summary Interpretation[i]

State Credit Unions of *$10 million or more in assets* are generally required to file quarterly reports with the NCUA ["5300 Call Reports"] that are in conformity with GAAP. However, all State Credit Unions, *regardless of asset size*, are required to fund their ALLL account according to GAAP, consistent with and to the extent that the FCUA and NCUA Rules preempt the WCUA and the WAC.

The Division of Credit Unions' existing WAC Rules, which relate to (1) the classification of MBLs to reserve for potential losses[ii] and (2) directing how much a State Credit Union must reserve for losses on a classified MBL[iii], are *preempted* by the FCUA, NCUA Rules, and the NCUA's 2002 IRPS[iv] and 2006 Accounting Bulletin[v], to the extent they are in conflict. All State Credit Unions engaging in MBLs must follow the NCUA's 2002 IRPS and 2006 Accounting Bulletin with respect to classifying MBLs and reserving for potential MBL losses in the ALLL account.

2.0 Legislative & Rulemaking History – Federal & State

Relevant Federal & State Legislation and Rulemaking.

In 1997, the Washington State Legislature first enacted a GAAP requirement for State Credit Unions, and later amended the WCUA in 2001 to clarify that State Credit Unions will comply with GAAP as required by federal law or rule of the Director [of Credit Unions].[vi]

One year later, in 1998, the United States Congress enacted the Credit Union Membership Access Act ("CUMAA").[vii] Among CUMAA's many provisions, Section 201 of CUMAA[viii] requires all federally-insured credit unions with assets of $10 million or more to follow GAAP for all reports or statements required to be filed with the NCUA.[ix] Effectively, this provision of CUMAA preempts any state law or rule, including the WCUA and the WAC, which may be in conflict with it.[x]

In the same year as the Washington State Legislature's enactment of the 2001 Statute, the Division of Credit Unions also adopted a rule, effective June 1, 2001 ("2001 State Rule"), requiring State Credit Unions to reserve for MBLs based on whether they are categorized as substandard, doubtful, or loss, and setting a + or - 10%, 50%, and 100% minimum reserve requirements, respectively, for these categories of business loans.[xi] While the requirements of the 2001 State Rule are currently ***not*** in conformity with GAAP, they were at the time of their adoption.[xii] Indeed, the 2001 State Rule was identical to the NCUA Rules in existence at that time ("2001 Federal Rule").[xiii]

In 2002, the NCUA adopted an IRPS ("2002 IRPS") providing guidance for FISCUs on the design and implementation of ALLL methodologies and supporting documentation practices consistent with GAAP.[xiv]

Then, in 2003, the NCUA repealed its 2001 Federal Rule,[xv] stating that the 2002 IRPS[xvi] "supersedes the current regulatory provisions."[xvii]

3.0 Relevant Accounting Standards and Classification System

3.1 To be consistent with GAAP, State Credit Unions should incorporate key concepts and requirements in their ALLL account funding practices, included in the following:

- The ALLL supervisory guidance contained in the NCUA's 2006 Accounting Bulletin, including the Questions and Answers on Accounting for Loan and Lease Losses,
- The 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses, adopted by NCUA and all other federal banking regulators,[xviii]
- NCUA's 2002 IRPS 02-3 titled Allowance for Loan and Lease Losses Methodology and Documentation for Federally Insured Credit Unions, and
- The Accounting Standards Codification ("ASC") 450[xix] and ASC 310.[xx]

State Credit Unions should ensure that controls are in place to consistently determine the ALLL account balance at a level that is appropriate and determined in accordance with GAAP. An appropriate ALLL account balance will cover estimated credit losses on individually evaluated loans that are determined to be impaired[xxi] as well as the estimated credit losses inherent in the remainder of the State Credit Union's loan and lease portfolio. [xxii]

3.2 Required Loan Classification or Credit Grading System. State credit unions with a material amount of MBLs are expected to adopt and implement a commercial loan rating system. Materiality for this purpose is defined as those credit unions that have the lesser of either over five percent in aggregate MBLs to totals assets or over $25 million in total MBLs. The Division of Credit Unions (DCU) provided guidance on implementing a commercial loan rating system in Bulletin B-07-06, dated May 1, 2007.

4.0 Conclusion

All State Credit Unions, *regardless of asset size*, are required to fund their ALLL accounts according to GAAP, consistent with federal deposit insurance requirements in the Federal Credit Union Act and NCUA Rules. As a result, the specific reserving requirements in WAC 208-460-120 are preempted by the Federal Credit Union Act's requirement to comply with GAAP.

In addition to compliance with GAAP, State Credit Unions with a material amount of MBLs (i.e. the lesser of either over five percent in aggregate MBLs to totals assets or over $25 million in total MBLs) are expected to implement an industry standard commercial loan rating system as described in the DCU Bulletin B-07-06. Examiners will expect when a State Credit Union classifies its MBLs in its risk rating system using pass, substandard, doubtful, and loss, along with other ratings, it will not use the reserve percentages in WAC 208-460-120, but will instead determine the reserve amount based on GAAP.

If you have any questions regarding this Interpretive Letter, please contact Linda K. Jekel, Director of Credit Unions, at linda.jekel@dfi.wa.gov, or (360) 902-8778.

[i] This interpretation is made with reference to the FCUA, NCUA Rules, NCUA Policy Statements, the WCUA and the WAC, as set forth in more detail in Section 2.0 of this Interpretive Letter
[ii] WAC 208-460-110
[iii] WAC 208-460-120
[iv] NCUA Interpretive Rulings and Policy Statement (IRPS) 02-3 Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions
[v] NCUA Accounting Bulletin 06-01 on key concepts and requirements in GAAP and existing ALLL supervisory guidance
[vi] WCUA, at RCW 31.12.569 (1997 c 397 §50)["1997 Statute"]
[vii] P.L. 105-219, effective August 7, 1998
[viii] CUMAA, at 12 U.S.C. §1782 (a)(6)(C)(i)
[ix] See NCUA Letter to Credit Unions, 98-CU-16, dated August 7, 1998, summarizing the provisions of CUMMA
[x] See, for example, *United States v. Gary Locke*, 529 U.S. 89, 108-109, 120 S.Ct. 1135, 1148 (2000), which in relation to the respective shoreline management laws of the federal government and Washington State, the U.S. Supreme Court, while noting in passing that the seminal financial preemption case of *McCullough v. Maryland*, 4 Wheat. 316, 17 U.S. 316 (1819), for the proposition that federal and state regulation of financial institutions are often exercised in concurrence with each other, declared: (1) That an assumption of non-preemption of state law is not triggered when a State regulates in an area where there has been a history of significant federal presence; and (2) that "conflict preemption" of state law occurs "when compliance with both state and federal law is impossible, or when the state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objective of Congress.'" [Citation omitted.]
[xi] 2001 State Rule: WAC 208-460-110 and WAC 208-46-120
[xii] WAC 208-460-110 and WAC 208-460-120
[xiii] NCUA Rules, at 12 CFR §§723.14 and 723.15
[xiv] 2002 IRPS: Interpretive Ruling and Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions, No. 02-3 (IRPS 02-3), 67 FR 37445, 37449, dated May 29, 2002
[xv] NCUA Rules, at 12 CFR §§723.14 and 723.15
[xvi] See Footnote 19 above
[xvii] 68 FR 16450, 16453, dated April 4, 2003 [Proposed Rule]; see also Final Rule repealing 12 CFR §§723.14 and 723.15 at 68 FR 56537, 56552, dated October 1, 2003
[xviii] Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (the Fed), the Federal Deposit Insurance Corporation (FDIC), and the former Office of Thrift Supervision (OTS)
[xix] Formerly FAS 5
[xx] Formerly FAS 114
[xxi] ASC 310
[xxii] ASC 450