7400. ALLOWANCE FOR LOAN LOSS POLICY

Revised: December 2018
Ratified: April 2019

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General Policy

Basic Philosophy

The Allowance for Loan Loss policy of Resource One Credit Union (the "Credit Union") is designed to insure that the Allowance for Loan Loss Account (the "Allowance") is adequately funded to absorb estimated losses inherent to the loan portfolio. The loan portfolio should be measured and reported at its net collectible amounts through the use of the Allowance Account.

Definition

The Allowance for loan loss is an accounting estimate (accrual) of credit losses inherent in the credit union's loan portfolio that have been incurred at the date of the Statement of Financial Condition. The allowance is an estimate. It requires substantial judgment and is in most cases not simply a routine numerical calculation.

Responsibility

Credit Union's Chief Financial Officer, Chief of Lending and Member Solutions/Collections Manager (the "Management") are responsible for the timely and periodic determination of the amount of allowance required.

Methodology

Management is responsible for establishing and documenting the methodology used in determining the adequacy of the Allowance. They should maintain and support the Allowance with documentation that is consistent with stated policies, generally accepted accounting principles (GAAP), and applicable supervisory guidance. The methodology must be thorough, disciplined, and consistently applied to insure that the process incorporates management's current judgments about the credit quality of the current loan portfolio. Periodically, management should insure that the credit union's methodology continues to accurately predicts the embedded risk residing in the current loan portfolio

Measurement and Reporting

The Allowance for Loan Loss is designed to insure that the Allowance for Loan Loss Account 719-100 (the "Allowance") is adequately funded to absorb estimated losses inherent to the loan portfolio. The credit union's loan portfolio should be analyzed, measured and reported at its net collectible value (Fair Value) through the use of the Allowance Account. The Allowance for loan loss is an accounting estimate (accrual) reflecting embedded losses currently existing in the credit union's loan portfolio.

1. **Exclusion:** The following types of loans should be removed from the total loans used to calculate the current accounting period's required allowance:

   a. Loans 100% insured through 3rd party mortgage insurance providers.
   b. Share secured loans where share deposits are deposited and held at the credit union.

Pronoucements and Guidance

The methodology used to determine the allowance for loan loss should be based on Generally Accepted Account Principles (GAAP) and current regulatory pronouncements. More specifically, the Financial Accounting Standards Board (FASB) FASB 5 – Accounting for Contingencies, FASB 114 – Asset impairment, Commission Rule 91.718(b), and The Texas Credit Union Department's January 31, 2001 regulatory publication entitled "Guidance on Allowance for Loan and Lease Losses" should serve as a foundation when developing the credit union's allowance valuation methodology.

Loan Segmentation

During changes in the economic environment, certain loan types of loans may out-perform others types. In general, during period economic downturns, net charge-off ratios for unsecured loans are much higher than those of real estate loans. Therefore, to accurately measure historical payment performance of the loan portfolio is divided into multiple of unique segments. Each segment should contain similar credit risk, terms, and collateral. The credit union uses the following segments below to calculate the allowance for loan loss:

a. Secured Non-Mortgage (autos, other vehicles, and other loans not collateralized by real estate).

b. Secured - Mortgage (real estate, home improvement, home equity, and other loans collateralized by real estate).

c. Unsecured Loans (signature, credit cards, LOCs, and all other unsecured loans).

d. Indirect Auto Loans (Includes both new & used).

e. Indirect Real Estate (1-4 family, 2nd liens, Home Equity, Home Improvements, etc.).

f. Loans Acquired through Merger, or specific loan participation purchased.

g. Commercial Loans (MBLs shall be individually classified using Commercial Loan Department's monthly "Watch-List").

h. Larger non-homogenous loans (should be individually classified when possible.)

When possible, each loan segment shall be categorized into six (6) additional categories based on Risk Paper Grades: A, B, C, D, E, or Unassigned:

Historical Loss Ratio:
The historical loan loss ratio will be calculated using a rolling 12-month rolling average of the credit union's monthly weighted average net charge-off ratio for each loan portfolio segment. The historical loss ratio should be calculated for each of the six loan segments and paper grade.

For new loan segments, the actual number of months may be used for any loan segment having less than 12 months of history.

Loans Classified at Estimated Fair Market Value:
The following types of loans should be valued at the estimated sales price less estimated cost of selling the asset (fair value):

a. Loans in Process of Liquidation – Repossessed assets that have fulfilled the legal ownership requirements needed to sell the collateral (usually a 10-14 day waiting period after repossession). If the outstanding loan balance is larger than the fair value of the collateral, the outstanding loan balance should recorded at fair value. The difference between the loan balance and fair market value is charged against the Allowance for Loan Loss Account, with an offsetting entry to the Loans in Liquidation account.

Over Draft Protection (ODP)
A provision for possible loss shall be calculated for all negative balance checking accounts that carry the ODP feature. The required reserve will be based on a 12-month rolling average of the credit union's weighted average net losses associated with negative balance ODP checking accounts.

Documentation
Management should maintain proper documentation supporting the methodology selected to calculate the allowance. In addition, detailed documentation will be maintained supporting monthly calculations used to evaluate the adequacy of the allowance account.

Other Factors to Consider
Occasionally, factors arise that may significantly impact future trends of net charge-offs. Modifications to the existing evaluation methodology should be immediately applied should management determine that it is probable the event(s) will materially impact the future repayment performance of the credit union's loan portfolio. Below are examples of events that may constitute methodology modifications:

a. Recent periods of rapid loan growth (dilutes the NCO ratios for that period).

b. Periods of poor Underwriting standards.

c. Periods of exceedingly high charge-offs followed by a period of strong underwriting standards.

d. Economic trends impacting the member's ability to repay.

e. Changes in collection, charge-off and recovery policies.

f. Changing financial condition of local communities and sponsoring companies.

g. Changes in the loan mix of the credit union.

h. Announcement of new regulatory, judicial or legislative pronouncements (i.e. bankruptcy reform).

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General Policy 1

Historical Record of Policy Changes

Name Change

Date Revised: May 2012
Date Approved: June 2012

~~Vice President of Lending~~ Director of Lending

Date Revised: December 2018
Date Approved: December 2018

7400 ALLOWANCE FOR LOAN LOSS POLICY

Responsibility

Policy Change

(Page 3) Third paragraph, first sentence.

Deleted:

Collections Manager

Replaced with:

Member Solutions/Collections Manager

Methodology

Policy Change

(Page 3) Immediately following the "Methodology" Section

Inserted the following sections:

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