NCUA's Responses to Questions for the Record
House Financial Services Financial Institutions and Consumer Credit Subcommittee
Hearing on H.R. 3461, the Financial Institutions Examination Fairness and Reform Act
February 1, 2012

Question Submitted by Congresswoman Carolyn McCarthy

- **Are uniform classification standards achievable or is there an alternative way to bring consistency to the loan classification process for non-performing loans?**

In response to your question, I would like to emphasize, first and foremost, that commercial lending represents less than 10 percent of all lending activity in credit unions and amounts to $37.2 billion in lending activity on an industry asset base of $961 billion. Additionally, NCUA's response refers to the commercial lending activities of credit unions and not consumer lending activities, as the testimony and related questions focused on commercial loans. NCUA also believes the intention was to discuss non-accrual loan classification approaches, as well.

All of the federal regulators, including NCUA, participated in the development of the 2009 *Interagency Guidance on Prudent Commercial Real Estate Loan Workouts*.[1] This authoritative guidance for credit unions details prudent best practices for commercial loan restructures and refinances. While this guidance is not incorporated in regulation, it provides a flexible prudential framework for financial institutions without creating undue regulatory burden or constraining institutions with varying degrees of risk, complexity, and diversity within their business models and commercial loan portfolios.

NCUA has also issued a Supervisory Letter in January 2010 entitled *Current Risks in in Business Lending and Sound Risk Management Practices*.[2] This supervisory release identified NCUA's evaluation of risk in the industry, and set expectations for appropriate risk-management practices, as well as areas of focus by examiners.

NCUA trains examiners on the job and through formal classroom training on commercial lending practices and techniques. NCUA also makes use of specialized examiners with enhanced commercial loan training in our most sophisticated and largest commercial lending credit unions.

Finally, it is important to emphasize that a classification methodology is primarily a vehicle to ensure that loan valuations are correct for financial statement presentation. Those valuations ensure that users of the financial statements, including investors and depositors, have a transparent view of the true financial condition of a financial institution. Any approach that clouds transparency would prove counterproductive and could have the effect of creating greater uncertainty in the marketplace.

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[1] See http://www.ncua.gov/Resources/Documents/LCU2010-07Encl.pdf as well as NCUA's Letter to Credit Unions 10-CU-07

[2] See http://www.ncua.gov/Resources/Documents/LCU2010-02Encl.pdf as well as See NCUA's Letter to Credit Unions 10-CU-02

Identical Classification for Non-Performing Loans

The classification of a commercial loan is, by nature, judgmental and requires both the financial institution management and examiner to evaluate collectability of a loan under unique circumstances related to that specific loan. Differences between loans, institutional underwriting practices, or even geographic concentration risks can vary significantly from one loan to another and one institution to another. It would be very difficult to apply a rigid set of identical standards across regulators when the conditions affecting the classification of a commercial loan can vary widely. As a result, the judgment of management and the examiner are critical to the effective classification of non-performing loans.

Currently, NCUA places the responsibility on credit unions to establish an appropriate classification policy that meets the complexity, size, and risk profile of the institution's commercial loan portfolio. Credit unions are further expected to consistently apply the methodology.

NCUA instructs examiners to evaluate the rigor and appropriateness of the credit union's methodology given the complexity, size, and risk profile of the institution's commercial loan portfolio. NCUA's evaluation will often include testing on individual credits, which can lead to conflict with management over a classification methodology. As mentioned earlier, NCUA's Letter to Credit Unions that circulated the *Interagency Guidance on Prudent Commercial Real Estate Loan Workouts* provides authoritative guidance to credit unions and examiners alike.

Identical Classification for Non-Accrual Loans

H.R. 3461 also would require the establishment of identical definitions and reporting requirements for non-accrual loans. The creation of "bright line" statutory requirements for financial reporting may grant relief during trying economic periods. Such laws, however, may have the opposite effect in periods of economic growth. Additionally, any legislative changes that could blur the public perception that financial statements are not transparent could result in a negative market effect.

The interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* outlines policy considerations that should govern and inform credit unions' non-accrual and classification decision processes based on the size and complexity of the institution.[3]

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[3] Currently, credit unions have the freedom to develop their own loan grading schematic. NCUA does not impose specific standards on credit unions, but provides guidelines to credit unions in a 2006 Interagency ALLL Policy Statement through an Appendix entitled *Loan Review Systems.* Examiners review a credit union's loan grading system as it provides important information on the collectability of the portfolio for use in a number of areas within the examination process. NCUA realizes loan grading assessments by their very nature involve a high degree of subjectivity. And NCUA has observed that a credit union's ability to estimate identify nonperforming loans and estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, our examiners should generally accept management's assessments when evaluating the appropriateness of the credit union's loan grades, and not seek adjustments when management has effectively incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process; and analyzed all significant qualitative or environmental factors that affect the collectability of the portfolio as of the evaluation date in a reasonable manner.

NCUA's approach provides greater flexibility to credit unions to adapt to changing economic conditions. NCUA's approach also ensures that credit unions maintain autonomy in making loan performance judgments based on all the available facts and circumstances affecting loan collectability and performance.

The establishment of a statutory "bright line" to inform judgments that by their very nature require judgment may permit credit unions to ignore other available information about the borrower in consideration of true loan collectability. Less transparency or incomplete analysis can reduce the reliability of financial statements which could prove destabilizing.

NCUA's existing agency guidance allows for credit union and examiner judgments, but cautions examiners on a number of issues addressed in the proposed legislation. The existing guidance, when appropriately implemented, strikes the appropriate balance for all stakeholders.

Many of the concepts revolving around non-performance and non-accrual are also founded in Generally Accepted Accounting Principles (GAAP). Any legislative changes that conflict with GAAP have the potential to reduce transparency on the financial performance of a financial institution and could result in additional administrative burden of maintaining both a statutory and a GAAP financial statement presentation.

NCUA respectfully submits that the way to achieve consistency in the loan classification/grading, loss provisioning, and non-accrual processes is to strengthen consistent implementation of existing interagency guidance.