Chapter 6

Review of Loan Delinquency and Allowance for Loan Losses

Many laws, originally designed to protect the debtor, now make it more difficult for lending institutions to recover collateral and past due payments. As a result, delinquency control requires a comprehensive program involving officials, employees, and members. Generally, a credit union can minimize collections problems if loan personnel assess member needs and circumstances realistically, and keep both the amount of the loan and its repayment terms in proportion.

Even if a credit union follows the strictest policies, however, it can expect some loan losses. To some degree, bad debts are a cost of doing business. Therefore, a credit union should establish an **allowance for loan losses.** This account represents management's judgment of the possible losses the credit union may incur in the collection of loans and other loan-derived **assets (collateral).** Uncollectible loans and loan-derived assets are charged off to this account. Recoveries of such losses are credited to this account.

Internal Controls Over Loan Delinquency and Allowance for Loan Losses

The internal controls checklist for allowance for loan losses (figure 6.1) deals with the adequacy of accounting for delinquencies, charge-offs, and recoveries, and the overall impact they have on the allowance for loan losses account, undivided earnings, and **reserves**. The questions apply to credit unions operating in either a manual or computer environment.

Generally, a credit union can minimize collections problems if loan personnel assess member needs and circumstances realistically, and keep both the amount of the loan and its repayment terms in proportion.

Figure 6.1 Internal Controls Checklist for Allowance for Loan Losses

Test	Procedure	Yes	No
1. Are policies and procedures adequate?	Review policies for collections and procedures for funding the allowance for loan losses. Verify that practices follow the policies.	☐	☐
2. Is repossessed and sold loan collateral properly controlled?	Test-check monthly board minutes for approval by, or reporting to, the board of directors. Loans should be segregated into a separate general ledger account and *not* removed from the monthly report of delinquent loans.	☐	☐
3. Are charge-offs and recoveries properly controlled?	Cross-reference approval for a sample of charge-offs to the board minutes. Minutes should also show reviews of recoveries and of the delinquent loan list.	☐	☐
4. Is the month-end delinquent loan list correct?	Test-check some delinquent loans to confirm the delinquent loan report shows the correct number of months past due. Verify that due dates aren't improperly advanced.	☐	☐
5. Is the collections program active and effective?	Test-check a sample of the collections work on delinquent loans. Compare practices with the collections policies. The records should illustrate that collections efforts are reasonably frequent and effective.	☐	☐
6. Are loans turned over to outside collections properly controlled?	Test-check to ensure that the loan balances are the same at the collection agencies and attorneys as at the credit union. Investigate any discrepancies.	☐	☐
7. Does management monitor loan officer and collector activity?	Review monitoring practices with management to determine if supervisors regularly review reports of key areas.	☐	☐
8. Is recordkeeping accurate?	Record the monthly transactions to the allowance for loan losses on a working paper. Reconcile to the general ledger account for the allowance for loan losses.	☐	☐

Source: NCUA *Supervisory Committee Guide,* chapter 11.

Audit Requirements

In chapter 5 we mentioned that the committee should review a sufficient number of older loans (those made prior to the date of the last audit) to test the accuracy of the most recent delinquent loan report. As loans are reviewed, the committee will determine if a specific loan is delinquent—that is, if the member is behind in making loan payments. If this is the case, it should appear on the most recent delinquent loan report prepared by credit union employees.

Even when the loans tested appear properly on the schedule of delinquent loans, you could expand your test to include a larger number than those in the general loan review. This should satisfy the committee that the schedule is accurate and that it lists all delinquent loans as of a given date.

A detailed annual audit work program developed to test the adequacy of the allowance for loan losses and the accuracy of reported delinquent loans can be found in V300 *Supervisory Committee Duties and Responsibilities*. The adequacy of the allowance for loan losses is a key area in the examinations performed by regulators or external auditors. Significant analysis and judgment are required to determine that this allowance account is adequate to absorb probable loan losses. Regulators and examiners are likely to have extensive work paper documentation of their analyses. The committee could request copies of their work papers, as well as management's analysis, to assist in meeting its evaluation.

Completed Loan Delinquency Work Paper

Figure 6.2 illustrates FCU Form 118, Schedule of Delinquent Loans, which lists three loans delinquent as of June 30. This schedule records the following details:

T. Brown has not made required monthly payments of $200 since February 15 on a loan for $4,500, with an unpaid June 30 balance of $2,300. He was unemployed and promised to begin making payments as soon as he got a job. Because Brown is *three* months delinquent, his unpaid balance appears in column *5*.

J. Clegg has not made required monthly payments of $50 since September 30 on a loan for $800 with an unpaid June 30 balance of $450. He was out of the city and promised to bring the loan up to date in July. Clegg's balance appears in column *6* because it is eight months overdue.

REVIEW OF LOAN DELINQUENCY AND ALLOWANCE FOR LOAN LOSSES

Figure 6.2 Schedule of Delinquent Loans

FORM FCU 118 (REV. 75) - 11107

Example
FEDERAL CREDIT UNION

SCHEDULE OF DELINQUENT LOANS
AS OF: *June 30, 20XX*

SUMMARY		
DELINQUENT CATEGORIES	NUMBER	UNPAID BALANCE
2 TO LESS THAN 6 MONTHS	1	2300 00
6 TO LESS THAN 12 MONTHS	1	450 00
12 MONTHS AND OVER	1	6000 00
TOTALS	3	8750 00

1 ACCOUNT NUMBER	2 NAME OF BORROWER	3 DATE OF LOAN	4 ORIGINAL AMOUNT OF LOAN	5 UNPAID BALANCES OF LOANS DELINQUENT: 2 TO LESS THAN 6 MONTHS	6 6 TO LESS THAN 12 MONTHS	7 12 MONTHS AND OVER	8 DATE OF LAST PAYMENT		9 COMMENTS
950	T. Brown		4500 00	2300 00			2-15-XX		Unemployed
986	J. Clegg		800 00		450 00		9-30-XX		Promised to pay 7-XX
993	A. Leng		8000 00			6000 00	4-20-XX		Member cannot be located; collateral (car) missing.
	TOTAL UNPAID BALANCES OF DELINQUENT LOANS		a	2300 00	450 00	6000 00			
	TOTAL NUMBER OF DELINQUENT LOANS		b	1	1	1			

A. Leng has not made required monthly payments of $450 since April 20 of the prior year on a loan for $8,000 with an unpaid June 30 balance of $6,000. (The credit union was unable to locate Leng to discuss repayment of the loan. The car that secured the note was also missing.) Leng's balance appears in column *7*.

The completed schedule shows:

Line *a*—the total amount of loans listed in each column;

Line *b*—the total number of loans listed in each column;

Column *9*—the explanation for each unpaid balance.

Use this summary information for a quick overview of the credit union's delinquencies or for presentation to the board.

Other Required Work Papers

After the committee has verified the accuracy of the schedule of delinquent loans, it must complete other required audit work papers and procedures that apply to loan charge-offs, loan amounts recovered, undivided earnings, and credit union reserves. Discussion of these auditing procedures and work papers is beyond the scope of this module.