
FOREWORD

The June 2002 revision of the Examiner's Guide is a comprehensive revision that incorporates the risk-focused program with the primary goal of ensuring the overall safety and soundness of the credit union system. The risk-focused program evaluates the degree to which credit union management identifies, measures, monitors, and controls (i.e., manages) the existing and potential risks in their operations.

The risk-focused program is a forward-looking program designed to increase the effectiveness and efficiency of the examination and supervision process. Examiners will perform a risk assessment using the new Scope Workbook and will draw on their professional judgment to better target their efforts to the areas of greatest existing and potential risk. The risk-focused program shifts the examination and supervision emphasis from primarily a transactional review to primarily a process review, meaning that it requires examiners to review the credit union's planning process, policies and procedures, and internal controls. Examiners must also talk with management about recent and proposed changes in products and services and assess management's due diligence regarding existing, new, and proposed products and services to ensure the planning process considered and addressed all related risks.

Required examination procedures have decreased to three: (1) reviewing the supervisory committee audit, (2) reviewing the accuracy of the 5300 Call Report, and (3) reviewing the credit union's Bank Secrecy Act program. The examiner's risk assessment will determine what additional examination and supervision procedures are appropriate.

Many credit unions will look to their examiners to educate and inform them about how to improve their risk management and to convey specifics about NCUA's risk-focused program. This Examiner's Guide provides information about the risk-focused approach in many areas of the credit union's operation, and discusses the risks inherent in services and products that the credit unions may be considering.

This Guide also addresses the changes in funding requirements for the Allowance for Loan and Lease Losses (ALLL) account, mandated by generally accepted accounting principles (GAAP). This change is independent of the risk-focused program, but took place at the same time.

The Automated Integrated Regulatory Examination System (AIRES) has also undergone extensive revision to allow it to better accommodate a risk-focused program. AIRES and the new Scope Workbook allow the examiner, who is onsite and best able to assess the risks in the credit union, to determine the level of scope appropriate for the areas of risk. The risk-focused program will enable examiners to use their professional judgment to balance effectiveness and efficiency.

Representatives from the National Association of State Credit Union Supervisors (NASCUS) were represented on the National Examination Committee and had a voice in the re-writing of the Guide.

Finally, a reminder that the Examiner's Guide remains a guide, not a regulation. The guidance herein is dependable, but may not be the best or final approach in every situation. Examiner judgment and flexibility remain crucial to a successful risk-focused program.


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Examiner's Guide

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Chapter 1

RISK FOCUSED PROGRAM

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Chapter 1

RISK-FOCUSED PROGRAM

Supervision Objectives

- Evaluate management's due diligence processes over the credit union's activities
- Stay abreast of local and national economic conditions that may affect the financial performance and health of credit unions
- Evaluate the credit union's current and potential risk
- Evaluate management's ability to identify, measure, monitor, and control (i.e., manage) risk
- Evaluate the adequacy and accuracy of management's risk reporting and monitoring mechanisms
- Assess the credit union's ability to withstand any negative effects of risks taken in relation to its financial condition and net worth position
- Identify changes in the credit union's risk profile and adjust supervision plans accordingly
- Identify and address emerging risk issues before they become serious problems
- Work with management to resolve problems identified during onsite and offsite contacts
- Work with management to reach agreeable solutions to reduce levels of unwarranted risk
- Direct resources more efficiently by compiling and assimilating relevant risk information that helps prioritize examination schedules and determine need for subject matter examiners (SMEs) and specialists
- Develop a factual, documented administrative record of the credit union's problems and the attempts to resolve them

Overview

A risk-focused program is a forward-thinking approach that allocates resources to the credit unions and areas exhibiting weaknesses or adverse trends. Examiners allot time to reviewing areas containing the most risk for an individual credit union. Activities posing the highest risk receive the most scrutiny.

In the risk-focused program, distinctions between examination and supervision blur. Examination and supervision efforts may, at times, be a continuum to the extent that examiners will call a particular contact an examination, rather than supervision simply because the time frame requires an examination.

Supervision is the ongoing monitoring of a credit union's financial and operational condition. During supervision in the risk-focused program, the examiner looks forward at the direction a credit union takes and the decisions it makes. Examiners can then anticipate when those decisions could result in the credit union assuming undue risk or failing to manage the risk it has taken. Examiners may determine or adjust the timing of the examination based on conditions revealed during the supervision process.

The examiner, through other examiners, trade associations, credit union leaders, news reports, etc., should stay abreast of developments within their district credit unions and the various industries or communities that affect the credit unions. Examiners should act on potentially high-risk activities and problems by contacting credit union officials to verify information received. Depending upon their comfort level after speaking with credit union personnel, they may decide to perform an onsite contact to gain first hand knowledge of the situation, or may reschedule the examination to an earlier date. Examiners should keep their supervisory examiners informed of potentially serious conditions that could adversely affect the credit union.

Due Diligence

Credit unions should have in place a risk management program that includes a strategic plan with implementing policies, procedures, and internal controls necessary to manage the risks inherent in their operations. Successful risk management programs rely on credit union management to employ sufficient staff and have available necessary resources to identify, measure, monitor, and control existing and potential risks.

Management's due diligence involves the analysis of new products and services as well as the ongoing analysis of the credit union's current products, services, and operations to ensure their relevance, efficiency,

and effectiveness. This analysis would include periodic cost-benefit studies.

If the risk to the credit union increases as a result of offering a certain product or service, the credit union should determine whether the additional risk is worth the benefit to the credit union. If not, the credit union may decide to discontinue the product or service. If management decides to continue offering the product or service, they should explore ways to mitigate the risk.

Risk-Focused Supervision

Risk, by definition, implies uncertainty. While performing risk-focused supervision, examiners should look for sources of uncertainty within the operation of the credit union. Based on their findings and using their professional judgment, examiners will prioritize these risks by the magnitude of the potentially adverse effect on the earnings and capital of the credit union.

Financial indicators, while useful, often represent lagging indicators. Indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. However, the risk-focused supervision approach emphasizes the anticipation of future problems by analyzing processes that may serve as leading indicators. These leading indicators include the following:

- Due diligence review by management for new and existing products and services;
- Development and application of strong internal controls;
- Analysis of financial outcomes; and
- Measurement of actual performance against forecasted results.

Risk is fundamental to the operation of a credit union. Examiners, therefore, should not insist that the credit union eliminate risk, but, instead, should ensure that credit unions identify and manage their risks. The desired reward for taking risk is stable profitability and increased net worth. Credit unions must balance risk and reward responsibly. The examiner's job requires assessing that the appropriate balance exists. That assessment begins with determining whether management has performed adequate due diligence with respect to the

risks present and anticipated in the operation of the credit union and whether management has instituted sound internal controls to identify, manage, and mitigate undue risk.

A credit union's capital or net worth constitutes the reserve of funds available to manage or absorb the risks to the institution. The amount of capital that a credit union has accumulated is an important determinant of the amount of risk it can assume.

Generally, credit unions that have more complex operations carry more risk than do credit unions offering fewer products and services. Greater risk requires the credit union to employ able, experienced management and more sophisticated systems of control. The risk-focused supervision system largely depends upon sound controls. These controls include the following:

- Informed officials;
- Well-trained management and staff;
- Sound policies and procedures;
- Adequate due diligence by management prior to engaging in an activity, and ongoing for existing products and services;
- Sound system of internal controls;
- Prudent risk limits; and
- Identifying, measuring, controlling, monitoring and reporting of risk exposures.

Risk-Focused Examination

In the risk-focused examination, the content of the examination centers on key areas of risk. Examiners should review due diligence by management for new products and service, the credit union's risk-management systems, and the internal controls in place. Examiners may, at times, find it necessary to use transaction testing to validate their assessment of risk. They will focus on validating management's ability to identify, measure, monitor, and control risk. Some areas may receive little or no review. The examiner has discretion in determining areas requiring the most attention and allocating the time and resources accordingly. Examiners' emphasis focuses on managing future risks successfully and not expending valuable resources on minor items posing little risk to the safety and soundness of credit unions.

The risk-focused program provides examiners the flexibility to focus on areas exhibiting material current or potential risk. However, the three minimum requirements of each risk-focused examination include the following:

- Reviewing the accuracy of the 5300 Call Report data;
- Reviewing the supervisory committee audit; and
- Reviewing the credit union's compliance with the Bank Secrecy Act (BSA).

Examiners must complete these minimum procedures during each examination. However, examiners should understand that, depending on the credit union, its risk characteristics, and the examiner's familiarity with that credit union, they will perform more than the minimum procedures in most credit unions. Most credit unions will require other procedures for necessary identification and evaluation of existing and potential risks.

Although the actual evaluation of the minimum review areas may take place during supervision contacts, the examiner should document the review of these areas and any material concerns in the examination report. Examiners must also assign the CAMEL rating during the examination.

In carrying out the risk-focused examination program, examiners should allocate examination time based on areas that manifest material risk characteristics. This ensures supervisory attention remains properly focused on credit unions exhibiting existing or potential weaknesses or adverse trends.

**Risk
Categories**

Risk is the potential that events, expected or unanticipated, may have an adverse effect on the credit union's net worth and earnings. The seven categories of risk for credit union supervision purposes are *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation*. Any product or service may expose the credit union to multiple risks; these categories are not mutually exclusive.

Credit Risk

Credit Risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet terms of any contract with the credit union or otherwise fail to perform as agreed. Credit risk exists in all activities where the credit union invests or loans funds with the expectation of repayment.

Interest Rate Risk

Interest Rate Risk is the risk that changes in market rates will adversely affect a credit union's capital and earnings. Interest rate risk arises from (1) differences between the timing of rate changes and the timing of cash flows (repricing risk); (2) changing rate relationships among different yield curves affecting credit union activities (basis risk); (3) changing rate relationships across the spectrum of maturities (yield curve risk); and (4) interest-related options embedded in credit union products (options risk). Not only can a move in interest rates affect the price of investments, it also has an effect on the value of the loan portfolio and on fee income, which is sensitive to changes in interest rates.

The assessment of interest rate risk should consider risk from both an accounting perspective (i.e., the effect on the credit union's accrual earnings, including held-to-maturity and available-for-sale accounts) and the economic perspective (i.e., the effect on the market value of the credit union's loans and investments.) In some credit unions, the broader category of market risk captures interest rate risk.

Liquidity Risk

Liquidity Risk is the current and prospective risk to earnings or capital arising from a credit union's inability to meet its obligations when they come due, without incurring material costs or unacceptable losses. Liquidity risk includes the inability to manage funding sources, including unplanned decreases or changes. Liquidity risk also arises from the credit union's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

Transaction Risk

Transaction Risk is the risk to earnings or capital arising from fraud or error that results in an inability to deliver products or services, maintain a competitive position, and manage information. This risk

(also referred to as operating or fraud risk) is a function of internal controls, information systems, employee integrity, and operating processes. This risk arises on a daily basis in all credit unions as they process transactions.

Compliance Risk Compliance Risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards. Compliance risk may also arise in situations where ambiguous or untested laws or rules govern certain credit union products or activities of the members. Compliance risk exposes the credit union to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, limited opportunities, reduced field of membership expansion potential, and lack of contract enforceability.

Compliance risk goes beyond a failure to comply with consumer protection laws. It encompasses all laws as well as prudent ethical standards, contractual obligations, and exposure to litigation. Compliance risk can blend into operational risk, transaction processing, and even legal risk, increasing the difficulty of identifying this risk.

Strategic Risk Strategic Risk is the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of a credit union's strategic goals, the business strategies developed to achieve those goals, the resources deployed to accomplish these goals, and the quality of implementation. The tangible and intangible resources needed to carry out business strategies include communication channels, operating systems, delivery networks, monitoring systems, and managerial capacities and capabilities.

Reputation Risk Reputation Risk is the current and prospective risk to earnings or capital arising from negative public opinion or perception. Reputation risk affects the credit union's ability to establish new relationships or

services, or to continue servicing existing relationships. This risk, which occurs in activities such as asset management decisions and transactions, can expose the credit union to litigation, financial loss, or a decline in membership base. Reputation risk exposure appears throughout the credit union organization. The officials, management, and staff must accept responsibility to exercise an abundance of caution in dealing with members and the community.

Managing Risk

The key to effective risk management is management. Effective risk management requires an informed board of directors, which guides the credit union's strategic direction including its risk tolerance. Board-approved, written policies define the board's strategic direction. Procedures intended to carry out the board's policies and well-designed monitoring systems enable the board to hold management accountable for operating within established tolerance levels.

Effective risk management also requires capable management and staff. Management must maintain the integrity of the risk management program, including evaluation of the credit union's operational and financial condition, and keep the directors informed of material existing and potential risk. Management's responsibilities include the following:

- Implementing the board's strategic direction;
- Developing formal and informal policies compatible with the strategic goals defining the credit union's risk tolerance;
- Overseeing development and maintenance of timely, accurate, and informative management information systems; and
- Ensuring effective communication of, and adherence to, strategic direction and risk tolerances throughout the organization.

Risk Management Program

Each credit union should develop its own risk management program tailored to its needs and circumstances. Differences in market conditions, fields of membership, and credit union structures preclude any single risk management program working for all credit unions. The

size, complexity, and geographic diversity of each credit union determine the sophistication required of its risk management program. All sound risk management programs, however, have several common fundamentals. For example, staff responsible for implementing sound risk management programs must perform those duties independent of the credit union's risk-taking activities. Regardless of the risk management program's design, each should include:

- **Risk identification.** Proper risk identification focuses on recognizing and understanding existing risks or risks that may arise from new business initiatives. Risk identification should be a continuous process, and should occur at both the micro (transaction) and macro (overall portfolio) levels.
- **Risk measurement.** Accurate and timely measurement of risks is a critical component of effective risk management. A credit union with no risk measurement capabilities has limited ability to monitor or control risk levels. Further, the sophistication of the risk measurement tools should reflect the complexity of the operation and levels of risk assumed. The credit union should periodically verify the integrity of the measurement tools it uses. Good risk measurement systems assess both individual transactions and overall portfolios.
- **Risk control.** The credit union should establish and communicate control limits through policies, standards, and procedures that define responsibility and authority. The credit union should adjust these management tools if conditions or risk tolerances change. Further, the credit union should implement a process to authorize exceptions or changes to risk limits, if warranted.
- **Risk monitoring.** Credit unions should monitor risk levels regularly to ensure well-timed reviews of risk positions and exceptions. Prompt distribution of frequent, accurate, and informative monitoring reports to appropriate management and staff enables them to take needed actions.

**Policies,
Processes,
Personnel, and
Control Systems**

When examiners assess risk management programs, they should consider the credit union's policies, processes, personnel, and control systems. A significant deficiency in one or more of these components constitutes a deficiency in risk management. The sophistication of each system will vary depending upon the complexity of the credit union's operation. Credit unions with simple structures may require and often have less formalized policies, processes, and control systems in place than do credit unions with more sophisticated structures.

Policies reflect the board's intent and commitment in pursuing desired results. Effective management requires written policies that the credit union adheres to in practice. Policies set standards and courses of action to pursue, implement, and enforce specific objectives. Good policies link with, and reflect, a credit union's underlying mission, values, and principles. They also clarify the credit union's tolerance for risk. Credit unions should have mechanisms in place to trigger a review of policies in the event activities or tolerances change.

Processes include the procedures, programs, and practices governing how a credit union will pursue its objectives and define how it will carry out its daily activities. Good processes demonstrate consistency with the underlying policies, efficiency, and adequacy of internal control checks and balances.

Personnel encompass the staff and managers executing or overseeing performance of the processes. Qualified, competent managers and staff should perform as a conscientious board expects. They must understand the mission, values, policies, and processes.

Control systems are tools and information systems managers use to measure performance, assist in decision-making, and assess the effectiveness of existing processes. Sound control systems require timely, accurate, and informative feedback devices. In turn, management must implement reporting systems by which they communicate necessary and sufficient information to the directors.

**Measuring
and
Assessing
Risk**

Ensuring effective risk-focused supervision requires a common framework to document decisions about risk. The risk assessment portions of the Scope Workbook (discussed further in the Scope Development and Planning chapter) provide a method of communicating and documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern, and the direction of risk. Evaluating the seven categories of risks will provide consistency to the risk assessment process. The evaluation factors for consideration in making the assessments provide an overview of issues that can assist in assessing risk.

Assessment of risk must reflect both a current and prospective view of the credit union's risk profile. Examiners should use this assessment to drive supervisory strategies and activities, facilitate discussions with management and directors, and conduct more efficient examinations.

Risk assessment will occur in all credit unions; however, small credit unions may often require more transaction examining because limited staff can impede internal control systems. Assessing risk enables the examiner to provide a common supervisory philosophy while recognizing the differing levels and complexities of risk present in each credit union.

Effectively communicating the rationale for decisions in evaluating risk assists the examiner in accomplishing the desired results from supervision. Examiners should discuss conclusions from the risk assessment with appropriate credit union officials and management. Management's input may help clarify or modify conclusions. These discussions should help management understand the quantity of each risk category (low, moderate, or high), determine the direction of each risk category (decreasing, unchanged, or increasing), focus on the strengths and weaknesses of risk management, and implement corrective actions necessary to achieve future supervisory plans.

Examiners should assess the amount and direction of risk exposure for the seven types of risk using a supervisory process that assesses the following:

- **Quantity of risk** – the level or volume of risk (low, moderate, or high);

- **Quality of risk management** – how well management identifies, measures, controls, and monitors risk;
- **Aggregate risk** – a summary of the level of supervisory concern considering both the quantity of risk and the quality of risk management, weighing the relative importance of each. Mitigating factors not necessarily considered in the quantity of risk and quality of risk management decisions (e.g., insurance) may influence the examiner's assessment of aggregate risk (i.e., low, moderate, high);
- **Direction of risk** – assessed as decreasing, unchanged, or increasing indicates the likely changes to the risk profile over the next examination cycle. Decreasing direction indicates the examiner anticipates, based on current information, the aggregate risk will decline over the next examination cycle. Unchanged direction indicates the examiner anticipates aggregate risk will neither increase nor decrease. Increasing direction indicates the examiner anticipates higher risk during the next examination cycle. For example, when the credit union has moderate but decreasing, credit risk, examiners can anticipate low or lower credit risk in the next examination cycle. The direction of risk often influences both the examiners' examination and supervision strategy.

One of the most significant influences on the anticipated direction of risk is whether the examiner expects management to take the actions necessary to reduce unacceptable risks.

Examiners' expectations of risk to increase or decrease do not necessarily mean the risk level at the credit union will change within the examination cycle. Examiners might expect movement **within** the risk level (e.g., decreasing risk, but not enough to change the characterization of that risk as high). Examiners should provide comments explaining why they do not expect a change in risk level.

Supervisory Risk Areas

Generally, the seven areas of risk fall within two major categories:

- Market risks, which are usually more objective, and lend themselves to measurement include:

- Credit risk
- Interest rate risk
- Liquidity risk

- Institution risks are more subjective and include:
 - Transaction risk
 - Compliance risk
 - Strategic risk
 - Reputation risk

Although the risk-focused examination and supervision process identifies the seven risks as discreet and individual, in reality, these risks are interrelated and inseparable. They often overlap, and risk in one area can cause or mitigate risk in one or more additional areas. Institution risk can result from market risk, and vice versa.

For example, compliance laws exist for protection of the consumers. Most credit unions that have significant compliance risk do not willfully set out to hurt their members; however, if the credit union does not adhere to compliance laws, its reputation could suffer causing increased reputation risk and possibly loss of members. Further, civil money penalties could diminish or even eliminate a credit union's reserves, which could result in increased liquidity risk.

Benefits of Risk-Focused Supervision

On-going risk-focused supervision provides benefits to the examiner as well as to the credit union. Risk-focused supervision enables examiners to do the following:

- Focus on areas of major risk;
- Focus on how well risk is managed over time, rather than at a single point in time;
- Identify risks more accurately;
- Identify risks proactively;
- Express risks in CAMEL ratings more meaningfully;
- Minimize loss to the insurance fund in each credit union;
- Streamline workpaper documentation to support areas of risk; and
- Improve the quality of workpaper documentation and support for conclusions.

The most obvious benefit to many credit unions for sufficiently identifying, managing, and mitigating their risks will be their eligibility for a “may be delayed” category for risk-based examination scheduling. Some additional benefits of the risk-focused supervision system to the credit unions include the following:

- Enables credit unions to focus on their major areas of risk;
- Encourages credit unions to identify the risks inherent in their current products and services and to seek ways to mitigate or manage those risks;
- Encourages credit unions to identify risks inherent in new or proposed products and services and to address management of those risks in the planning stage;
- Encourages examiners to perform preliminary analyses offsite, reducing disruption in credit union operations;
- Encourages frequent, open communication between the credit union and the examiner;
- Provides officials in CAMEL Code 1 or 2 credit unions the option to hold a joint conference with the examiner;
- Encourages credit unions to review their processes and internal controls and to correct deficiencies in those systems;
- Encourages management to proactively identify risks through a system of well-planned and carefully implemented due diligence; and
- Enables examiners to provide the officials with customized examination reports that provide only workpapers and narrative necessary to support the examiner’s analysis and conclusions.

Risk-Based Examination Scheduling

Risk-based examination scheduling permits deferred scheduling of certain credit union examinations. When risk-based scheduling applies, those credit unions can receive two examinations in a three-year

period. Examiners, after consulting with their supervisory examiners, may use risk-based scheduling for credit unions assigned a CAMEL 1 or 2 for the prior two examinations, and having characteristics such as the following:

- In operation for at least 10 years;
- Net worth ratio greater than 7 percent;
- Positive return on assets;
- No major or potentially adverse balance sheet changes;
- Adequate ALM program;
- Adequate internal controls;
- Accurate books and records; and
- No recent high-risk programs not yet reviewed.

Examiners perform offsite monitoring to review trends of credit unions with deferred examination schedules. If needed, examiners may schedule onsite supervision contacts when offsite monitoring indicates potential risk that requires further assessment.

NCUA Instruction 5000.15 provides additional guidance on risk-based examination scheduling.

Risk-Focused Supervision Procedures

Risk-focused supervision procedures often include both offsite and onsite work, including the following:

- Examination planning;
- Evaluating risk indicators;
- Reviewing offsite monitoring tools and risk evaluation reports;
- Developing the scope;
- Conducting a risk assessment;
- Developing and documenting conclusions and recommendations;
and
- Communicating with credit union management.

Often (although not always), examination planning, evaluating risk indicators, and scope development begin with offsite work. Offsite monitoring procedures shape the examiner's focus. The examiner should involve credit union management in the discussion of

subjective issues and mitigating factors; therefore, examiners will usually assess risk and draw conclusions onsite.

**Supervision
Tools**

Examiners have a variety of tools to aid in their supervision efforts, including the following:

- Review of call reports (NCUA 5300s);
- Examination planning contacts;
- Periodic telephone contacts;
- Review of credit union risk management reports (e.g., ALM summary reports, investment shock tests);
- Review of board and committee minutes;
- Review of financial trends;
- Cycle-to-cycle comparisons;
- Review of consolidated balance sheets;
- Review of ALM program and changes to ALM program, policies and procedures;
- Review of offsite risk evaluation and monitoring reports;
- Review of publications, press releases, and news stories about conditions and events that may affect the credit union;
- Review of electronic information sources (e.g., credit union website, NCUA website, etc.);
- Review of the supervisory committee audit report and, if necessary, the audit workpapers; and
- Analysis of the Financial Performance Reports (FPRs).

**5300 Call Report
Review**

During each examination, examiners must verify the accuracy of the 5300 Call Report. The risk-focused program places heavy reliance on the accuracy of the data in the call report. Inaccuracies in the call report may result in misleading evaluation data. Examiners should stress to the credit unions the importance of reporting accurate information on the call report.

Examiners should complete the 5300 Review questionnaire during the preliminary phase of the examination. The questionnaire's design requires answers to four basic control questions. If the answers are "Yes" then the remaining questions do not require an answer, thereby

reducing the time spent reviewing a well-controlled 5300 reporting process.

Examiners should focus their review on the internal controls over the call report and the credit union's process for ensuring its accuracy, by taking the following steps:

- Determine the experience level of the personnel involved in preparing the call report. Examiners can usually place greater reliance on a call report prepared by the same person for the last several years. However, if the same person has prepared the call report and year after year each examination notes deficiencies, examiners should review the accuracy of the call report in detail.
- Determine if the credit union has a verification process. Once prepared, a second employee should verify the accuracy and document the verification by signing off on the call report. If the same person prepares the data, completes the call report, and submits it to the examiner, the examiner should take additional steps to verify the report's accuracy.
- Review the preparer's process for confirming where the numbers originated and documentation of that process. If this documentation does not exist or is not readily available (i.e., stapled to each page and filed), examiners should take additional exam steps to verify the call report's accuracy.

If the credit union lacks a reliable process to ensure call report accuracy, examiners should take the following additional examination steps, as necessary, to ensure the accuracy of the call report and document noted deficiencies in the examination report:

- Trace the statement of financial condition and income statement information to source documentation;
- Trace reported delinquency to information system-generated reports, if available, including mortgages and credit cards maintained by a third party data processor;
- Review the accuracy of uninsured shares documentation;
- Trace investments to reports received from outside parties (i.e., broker, corporate credit union, etc.), ensuring that reported

investments appear in the appropriate time periods based on the call report instructions;

- Trace loan information to the information system-generated reports, if available (manual systems may require that examiners count the loans and trace the number to reported loan information); and
- Trace share information to the information system-generated reports, if available.

To reflect call report changes in the examination report, examiners must upload any material changes to the call report and request a new corrected download.

Offsite reviews of quarterly call reports will not allow the examiner the level of detail described above. Examiners should use other tools such as the 5300 Cycle-to-Cycle Comparison Report or the Consolidated Balance Sheet report trends to identify any fluctuations or adverse trends, making and uploading corrections as necessary. Examiners should report inaccuracies in the examination report at the next examination.

**Examination
Planning
Activities**

Examination planning will assist the examiner in assessing a credit union's risk profile and developing a workable risk-focused examination scope. This scope will enable the examiner to identify and examine those areas that represent potential, material risk to the credit union's capital, earnings, or ability to continue as a going concern. These tools will enable examiners to estimate the time needed for performing the risk assessment and anticipate the need for participation by specialists and/or subject matter examiners (SMEs).

After consulting with their supervisory examiners, examiners-in-charge should request assistance from a SME, if potentially significant risk exists in an area of the SME's experience. Examiners may also choose to use a SME if they are unable to quantify the risk, or if a material risk exists in an area of proven or emerging concern to NCUA. When planning the scope of the next examination, examiners will, when necessary, request participation of a SME. They may also make such a request if supervision contacts reveal material risk that requires the skills of a SME. Obviously, SMEs cannot participate in all

supervision concerns. As with all of NCUA's resources, a SME's participation and the degree of that participation should correlate with the significance of the overall risk to the NCUSIF presented by the credit union in question.

Examination planning tasks may include:

- Reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow up;
- Analyzing 5300 Call Report and Financial Performance Report (FPR) trends, using tools such as the following:
 - 5300 Cycle-to-Cycle Comparison Report – compares the prior examination quarter-end data to the current quarter-end data; and
 - Current (and possibly previous) quarter-end Consolidated Balance Sheet (CBS) report trends;
- Reviewing the Scope Workbook to identify prior risk assessment, recommended areas of review, resource needs, and supervision plans;
- Requesting an organizational chart of the credit union by division or department, along with a list of committees;
- Scheduling interviews with the credit union's management staff in key operational areas, including the CEO, Internal Auditor, staff involved in planning (strategic/business plans); and
- Requesting (and scheduling, if necessary) a meeting with the supervisory committee and/or external auditors to discuss the audit and verification processes (in some instances, telephone or email contacts may suffice).

If examiners cannot schedule a separate onsite planning contact, they should complete onsite planning at the beginning of the examination. Although examiners normally perform the following tasks onsite, circumstances (e.g., distance to the credit union, scheduling conflicts,

or other considerations) may require the examiner to conduct the activities offsite, using telephone, mail, fax, or electronic mail. These onsite planning tasks include:

- Interviewing key management staff about various topics including new products and services and future plans for new products and services;
- Reviewing management's due diligence process for a new activity;
- Reviewing the annual audit workpapers and the audit plan (see the Supervisory Committee chapter), communicating audit work performed in pre-determined, high risk areas to the appropriate team members;
- Reviewing the list of internal audits completed to date and the internal audit planning matrix for the year, identifying internal audit reports needed by team members for review at the onset of their examination work;
- Reviewing the strategic/business plan;
- Reviewing the budget and assumptions;
- Reviewing the board minutes:
 - Identifying discussions about potential risk areas and discussions about website problems, products, services, and planned changes to those products and services; and
 - Identifying revisions to applicable policies and associated changes in practices;
- Reviewing recently adopted new policies and revisions to policies and procedures, providing the information to the team examiners assigned to the various risk areas; and
- Reviewing other applicable internal credit union documents, such as material contracts, engagements, pending litigation, new field of

membership (FOM) groups, website changes, or other operational change documents.

After developing a preliminary risk-focused examination scope, the examiner-in-charge should communicate scope information to the appropriate team members, including expansion or contraction of applicable areas determined through the supervision process.

The risk-focused examination process should determine the adequacy of internal controls and the degree of reliance on the work efforts completed by competent, professional individuals and documented in reports and audits. Examiners should strive to avoid repeating the work of these professionals (e.g., internal audit reports, CPA audit workpapers, board meeting discussions, etc.) Examiners may identify new areas of risk throughout the contact; therefore, the examiner-in-charge should remain flexible and adjust the preliminary scope as needed.

5300 Risk Parameters

Examiners can use the 5300 Risk Parameters tool (Tab D in the Scope Workbook) to assist in the offsite monitoring. Use of this tool aids the examiner in the evaluation process; however, examiners must use their judgment. The 5300 Risk Parameters is only an indicator of risk; it does not supercede the examiner's judgment.

The 5300 Risk Parameters assists examiners in directing what areas they will focus on during their onsite work. Although the indicators may indicate a certain level and direction of risk, examiners should, nevertheless, determine the internal controls, policies, and procedures in that area. The accuracy of the 5300 Risk Parameters directly relates to the accuracy of the 5300. Examiners must review the accuracy of the 5300 as a required examination step. This step will help ensure the accuracy of the 5300 Risk Parameters reports.

The 5300 Risk Parameters is an intuitive, user-friendly tool and provides the following:

- An indication of potential risk - assessment of risk requires review and judgment; and

- Information on the direction of risk - the 5300 Risk Parameters gives an indication of how the risk changed over time.

The 5300 Risk Parameters does not:

- Assess risk - financial stability does not mean the credit union has no exposure to current or future risk;
- Predict future problems - the 5300 Risk Parameters provides an indicator of current or potential problems, but it does not predict future problems;
- Supersede examiner judgment - examiner judgment drives examination and supervision efforts;
- Specify examination procedures - using their knowledge of objective data and subjective factors, examiners must use their discretion in determining what procedures they do and why they do them; or
- Serve as a sole scope determinant - examiners must use their judgment to evaluate the various information and data, determine where to expand their analysis, and move on to another area when sufficient risk does not exist.

Cycle-to-Cycle Comparisons

The Cycle-to-Cycle Comparison Program (CCCP) enables examiners to compare current cycle 5300 financial and statistical data with data from any prior cycle within the previous five years. Examiners can scan the line item results and quickly identify significant changes. CCCP can help alert examiners to adverse or unusual trends while they review the data for accuracy.

Consolidated Balance Sheet

The Consolidated Balance Sheet (CBS) is an Excel spreadsheet that provides detailed financial information derived from 5300 Call Report data. Examiners may request a CBS for an individual credit union, a specific peer group, state, region, asset range, or group of charter numbers for comparison purposes. Other selection criteria include federal credit unions (FCU), federally insured, state chartered credit

unions (FISCU), non-federally insured credit unions (NFICU), limited income credit unions, type of membership (TOM) code, and cycle date.

Examiners request a CBS using the Custom Application program called CBS Request. To request a CBS for a specific credit union, examiners must input the charter number and cycle date. Upon request, the data processing server sends the CBS to the examiner in a spreadsheet format using email. The program contains a “help menu” that explains its operation.

The CBS ratio analysis looks similar to that of the Financial Performance Report; however, the CBS provides more detailed balance sheet, income statement, and supporting schedules. In addition to the ratios and trends provided, examiners can perform additional calculations and more in-depth analyses using Excel functions.

Documenting Supervision Plans

Examiners should document supervision plans for the credit union in the Scope Workbook and follow regional procedures for consulting with their supervisory examiners. They should update the Scope Workbook after supervision contacts, if necessary. Examples of documentation for supervision plans include:

- Type and timing of supervision and examination contacts;
- Brief description of the areas of risk focus for review during the contacts; and
- Staffing recommendations for supervision and examination contacts.

Examiners will complete the Scope Workbook during each examination, documenting the severity and direction of risks found during the examination, and revise the plans when supervision efforts indicate the need for a change. This workbook will serve as the starting point for future supervision efforts. The examiner will update the workbook, as necessary, throughout the year.

The extent of the supervision plans depends largely on the severity and direction of the risks in the credit union’s operation and on management’s ability to manage those risks. The examiner’s

professional judgment is paramount in determining the degree of supervision necessary and the form the supervision efforts will take.

Documenting Changes in Risk Profile and Supervision Plans

Changes in the economy, regulatory environment, financial industry, global and local events, and numerous factors within the credit union itself can affect credit unions, thus, a credit union's risk profile may change between examinations. The supervision process encourages the examiner to identify those changes in profile through the following:

- Review of 5300s;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union (e.g., new regulations, investment broker concerns, etc.).

When examiners become aware of information that affects a credit union's profile (i.e., a change in the level of one or more of the risk categories), they should record that risk level adjustment in the Scope Workbook. The change in the risk profile will likely result in a change to supervision plans. The examiner should record the revised supervision plans in the Scope Workbook. Updating the Scope Workbook allows NCUA to have a current depiction of individual, regional, and national risk levels on any given date. It also facilitates the transfer of information when a region transfers a credit union from one examiner district to another.

Examiners can use the Scope Workbook in conjunction with either onsite or offsite contacts. They should update it as frequently as necessary to reflect a credit union's current risk assessment and their current plans for supervision. In most credit unions, examiners will complete the Scope Workbook only during examinations; however, volatile conditions in credit unions may require more frequent updates to record the changes in risk levels.

Supervision and District Management

Examiners cannot separate effective supervision from effective district management. They must know their district credit unions and provide the supervision needed, in their professional judgment, to identify and address high-risk and potentially high-risk situations.

The risk-focused program involves both of the following:

- Risk-focused examinations; and
- Risk-focused district management.

Examiners have both the authority and the responsibility to manage their own districts. This suggests that examiners establish sufficient rapport with their credit unions so that the credit unions will openly communicate with the examiners about issues and conditions that develop between onsite contacts. Initiation of this communication can reside with either the credit union officials or the examiner, when available information and data indicate the prudence of such a contact.

Successful supervision involves resolving current problems and avoiding future ones. District examiners must provide a credit union the attention it needs to identify and reduce risk and to fully resolve problems. Examiners may determine that some credit unions require frequent contacts to correct the problems, while monitoring 5300 reports may suffice for others. Credit unions with more serious problems may require in-depth monitoring of financial trends.

Additionally, effective supervision in a risk-focused environment means that examiners look beyond the risk in one credit union at a time. They should also be conscious of systemic risk to the NCUSIF. This involves informing the regional office, through their supervisory examiner, when they observe negative effects caused by similar risk (e.g., a “bubble” in the real estate market, risky lending or investment issues, concentration issues, vendors that lack appropriate “due diligence” processes) in several of the credit unions in their district.

**Supervision
of CAMEL 3,
4, and 5
Credit Unions**

Examiners expect that successful supervision will result in better identification of risk and the direction of risk, and prompt reclassification to a less severe CAMEL code, but supervision can also result in merger, liquidation or assistance to a credit union. To ensure the prompt, effective correction of problems, the examiner who identified the problems and developed plans for corrective action should maintain supervisory responsibility, unless the region transfers the credit union to Special Actions. Whenever possible, the examiner-

in-charge should take responsibility for the credit union's supervision through the next examination.

Effective supervision of credit unions coded 3, and 4 (credit unions coded 5 normally do not survive) ensures the long-term viability of the credit unions and ongoing service to members by resolving areas of concern and reducing levels of unacceptable risk. If the credit union has risks it cannot manage, or that cause the credit union to fail, effective supervision minimizes the costs to members, creditors, and the NCUSIF. The following parameters govern supervisory efforts in code 3, 4, or 5 credit unions:

- Code 3 credit unions. The examiner provides Code 3 credit unions with necessary supervision to assist them in improving their operations and condition.
- Code 4 credit unions. If appropriate, NCUA may issue Code 4 credit unions an LUA. The examiner performs supervisory contacts with the purpose of upgrading a Code 4 within 24 months, 12 months being the goal.
- Code 5 credit unions. By definition, a Code 5 credit union will not survive more than 12 months, is clearly insolvent, and the examiner has documented all efforts to save it. Once coded a 5, NCUA will merge, liquidate, or provide other assistance to the credit union expeditiously. The goal for resolution is six months from the assignment of the Code 5 and the performance standard is 12 months.

During supervision in code 3, 4, or 5 credit unions, the examiner should perform the following, as necessary:

- Review previously identified risk areas to determine whether the direction of risk has decreased or remains unchanged;
- Determine the progress made in resolving problems;
- Determine whether the Document of Resolution developed for the credit union is working, and revise the plan with the officials if changes would likely resolve the problem;

- Inform the board of directors of inadequate progress and the status of risk areas;
- Analyze emerging financial trends and risk areas that could threaten the credit union's solvency;
- Determine the credit union's economic viability and, where necessary, explore merger and liquidation alternatives;
- Recommend administrative actions, when necessary, to protect the interests of the members, the creditors, and the NCUSIF;
- Revise, as necessary, the Scope Workbook, future supervision plans, and the schedule for the next examination; and
- Review and revise, if necessary, recommendations for team participants and subject matter examiners.

Administrative Record

Although the risk-focused examination includes few required workpapers, in credit unions coded 3, 4, and 5, examiners must include sufficient workpapers and documentation to establish an administrative record, should administrative or legal actions become necessary. The administrative record is the total collection of information NCUA needs for decision-making purposes. Therefore, the record should present a complete, factual, and documented history of the credit union's problems and the attempts by NCUA and the credit union to resolve them.

Chapter 2

SCOPE DEVELOPMENT AND PLANNING

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Chapter 2

SCOPE DEVELOPMENT AND PLANNING

Scoping and Planning Objectives

- Make a preliminary assessment of expected risk
- Determine appropriate planning activities
- Evaluate information to assign a level of risk for each risk category
- Indicate anticipated direction of risks
- Determine appropriate examination steps and procedures
- Assess examination resource needs

Overview

Effective allocation of resources in a risk-focused program requires that examiners clearly identify areas where a greater potential for loss exists. Examination scope describes the type and depth of review conducted within each risk area during a credit union examination.

Risk areas can vary between examinations. Therefore, examiners must document the examination scope to support the degree of review for specified areas. The Scope Workbook is the tool used to document the scope and risk assessment. This workbook serves as the examiner's documentation for the following:

- Preliminary risk assessments and supporting factors;
- Areas reviewed, depth of review, and reasons for review;
- Adherence of examination to regulatory compliance;
- Final risk assessments and supporting factors;
- Anticipated direction of risk over the next examination cycle;
- Estimates for resource needs over the next examination cycle; and
- Recommendations for future areas of review and supervision plans.

Scope Development

The scope development process enables examiners to evaluate unique characteristics of each credit union and determine what steps the examination will require. Planning activities will allow the examiner to draw more informed conclusions regarding the existence of risk. The Scope Workbook records focal points of the examination.

The risk-focused examination approach requires determination of the scope through a process involving:

- Recommendations from the prior examination and supervision contacts;
- Preliminary risk assessment;
- Consideration of internal and external factors;
- Discussions with credit union management; and
- Evaluations of the credit union's control environment and risk management systems.

Prior Examination and Supervision Recommendations

Reviewing the prior examination report and recent Scope Workbook (or history of Scope Workbooks, if significant developing trends exist) assists the examiner in preparing for the current examination. The examiner should pay close attention to the risk assessment and recommendations for areas of review.

Preliminary Risk Assessment

After evaluating the recent Scope Workbooks, examiners will make a preliminary assessment of the risk they expect to find while performing the examination. This assessment includes the following:

- Analyzing recent call report data;
- Comparing prior recommendations with recent financial trends; and
- Evaluating the credit union's risk profile.

The examiner will assign a preliminary risk assessment for each of the seven risk categories: Credit, Interest Rate, Liquidity, Transaction, Compliance, Reputation, and Strategic. (The Risk-Focused Program chapter provides more information for identifying the seven risks.) Quantitative data and any information the examiner has prior to conducting planning and scoping activities serve as determinants for this assessment. Information obtained through discussions with management and findings identified during the field work may change these preliminary assessments.

Reasons for documenting these preliminary assessments include:

- Demonstrating the examiner's thought process from beginning to end;
- Supporting requests for additional resources; and
- Supporting use of significant resources or transaction testing even though the final assessment may indicate low risk.

The 5300 Risk Parameters (found within the Scope Workbook) is a tool for examiners to use during their initial risk assessment. This tool provides information on the direction of risk and acts as an indication of potential risk. It does not predict future problems and does not supercede the examiner's judgment in assessing risk. It simply serves as one of the tools available to assist the examiner in this process. Other analysis tools available outside of the Scope Workbook include the Consolidated Balance Sheet program, the Cycle to Cycle Comparison program, regional and national risk reports.

**Internal and
External
Factors**

If applicable, examiners should consider the following factors, using the information obtained to mitigate or amplify the initial risk assessment:

- The size and sophistication of the credit union's operation. Examiners should identify the significant activities and all major programs or services offered, including off-balance sheet activities and other proposed ventures; and
- Information necessary to focus the examination scope and maximize the efficiency of onsite examination work. As needed, examiners should review the following sources of information, if available:
 - Previous examination reports, supervision contacts, and results of any special targeted examinations occurring since the last contact;
 - Auditors' reports (both internal and external) and management letters;
 - Management's response to audit and examination reports;
 - Prior examination work papers (paying attention to the depth and breadth of review in each area). Consider the credit union's

level of service (e.g., member business loans, real estate loans, indirect lending);

- Correspondence files;
- Financial Performance Reports (FPRs);
- Call reports and recent financial statements;
- Risk management reports;
- Income and expense budgets and projections;
- Balance sheet (financial) management policy and philosophy;
- Internal management reports;
- Board of director's packages;
- Business, strategic, and marketing plans;
- Asset-liability management (ALM) models, policies, and interest rate risk reports;
- Evidence of management due diligence for existing and anticipated products, services, and systems;
- Internal control structure and process;
- Credit union service organization (CUSO) activities;
- Data processing system and the availability of the automated integrated regulatory examination system (AIRES) download;
- Delivery channels (web-sites, home banking, bill payment services, automated clearing house (ACH)), etc.);
- Sponsor newsletters or news articles;
- Economic environment (locally, regionally, and nationally);
and
- Recent regulatory changes.

**Discussions
with Credit
Union
Management**

After establishing a preliminary risk assessment and evaluating internal and external factors, the examiner conducts discussions with credit union management, preferably onsite. Practical considerations (distance to the credit union, schedules of the examiner and manager, etc.) may mandate a telephone or email contact, which can accomplish the intended purpose. However, examiners may find an onsite contact especially important for more sophisticated credit unions with complex services and products. If examiners-in-charge do not schedule an early onsite visit, they should obtain as much information as possible through questionnaires, telephone, email or other contacts. These discussions enable examiners to develop their own assessments of current examination risk by refining the initial risk assessments.

Discussions with management should focus on changes to management, policies, strategic direction, management information systems, management due diligence, staff turnover, and other significant activities occurring since the last examination or supervision contact. This contact allows the examiner to obtain management's perspective about economic conditions, internal and external audit programs, and the risk management process. The examiner controls the timing of the contact and should schedule it close enough to the examination to ensure the information discussed remains relevant and usable for the examination.

The examiner should make every effort to obtain the following information regardless of whether an onsite or offsite contact occurs:

- Economic conditions that have a direct or indirect impact on the credit union's overall financial condition. Discussions with senior management may include the following issues:
 - Field of membership, including the principal types of businesses within the field of membership and plans for future expansion;
 - Sponsor relationships or special relationships with operating subsidiaries that may affect interpretation of comparative data;
 - Trends of the credit union's local economy and stability of major select groups within the field of membership; and
 - Dependence upon a particular industry or economic sector (e.g., oil and gas, agriculture.)

- Operational and functional changes. The credit union may experience, or management may anticipate, changes in the following areas:
 - Overall objectives or management philosophy;
 - Senior management, the board of directors, official committees, or key operating staff;
 - Types of loans offered and material changes in loan types and volume;
 - Types of shares offered and material changes in share types and volume;
 - Investment strategies or brokers;

- Liquidity position;
 - Operations, including information systems;
 - Policies and procedures;
 - Formal committee structures; and
 - Risk areas posing the highest risk to the operation currently and in the future.
- Internal control risks identified by the internal or external audits, the previous examination, verification of members' accounts or through other reports should prompt examiners to do the following:
 - Consider the following when reviewing the findings of the internal auditor or personnel responsible for evaluating internal controls:
 - i. Independence and experience of personnel conducting internal control reviews, adequacy of staff size, appropriateness of audit schedule, and sufficiency of scope;
 - ii. Reliability and effectiveness of internal control reviews;
 - iii. Quality of audit reports, and management's responsiveness to auditors' findings;
 - iv. Quality of internal audit work papers; and
 - v. Procedures for internal audit reporting;
 - Consider reviewing the external auditors' workpapers if the following risk-related circumstances exist:
 - i. Internal control weaknesses;
 - ii. Substantial exposure to high-risk activities; and
 - iii. Past problems with the quality of the audit or audit firm; and
 - Consider the internal controls surrounding the verification of members' accounts and the quality of the verification.
 - Assessment of the quality of management. Examiners may wish to consider the following:

- Findings from prior examinations and CAMEL coding of Management;
- Changes since the last examination in key management officials;
- Activities of the board and other committees including their degree of activity and participation;
- Education and experience of senior management and key officials;
- Performance evaluation system or process;
- Organizational chart;
- Quality of written policies and procedures;
- Quality of the budgeting and planning processes;
- Member service and membership recruitment;
- Quality of management due diligence, including cost-benefit studies, for existing or planned products, services, and systems; and
- Adherence to policies and procedures by staff.

Examiners' past experience and knowledge of the credit union will affect the amount of time devoted to the scoping and planning phase. Generally, examiners will spend more time and effort on planning for larger than for smaller credit unions. However, asset size alone does not determine the extent of the scope. Examiners must consider the nature of the credit union's services, compliance history with those services, changes in the regulatory environment, and safety and soundness implications.

For larger and more sophisticated credit unions, early review will allow examiners-in-charge greater flexibility in determining necessary resources, including the number, experience, and qualifications of team members.

**Team
Examinations**

The supervisory examiner and district examiner schedule team examinations according to regional policies. In addition to reviewing team participants' workpapers, analyzing the credit union's performance, and meeting with the officials, the examiner-in-charge coordinates, monitors, and facilitates the smooth completion of the examination.

If needed, the examiner-in-charge and selected team members should begin the examination before the full team arrives, unless travel and time considerations preclude an advance team contact. Examiners can lose substantial time during the initial phases of the examination waiting for credit union staff to provide data downloads or loan files.

When examiners-in-charge schedule a subject matter examiner or regional specialist to participate on the examination, they should schedule these examiners first to ensure their availability when needed during the examination. The examiner-in-charge should also consider the amount of time these individuals might need to provide training to other team members during their onsite work.

The examiner-in-charge (or advance team) should complete the following steps before the full team's arrival:

- Contact key officials to inform them of the examination and its probable duration. Examiners-in-charge that plan to hold a joint conference should determine a mutually agreeable date and time (see the Joint Conference/Exit Meeting chapter of this Guide);
- Arrange working space for the team;
- Obtain the supervisory committee work and schedule a meeting with the auditor, if necessary;
- Obtain all relative board policies scheduled for review;
- Select loans for review, as appropriate. Since examiners-in-charge usually request that credit union employees pull the loan files, they should give staff as much time as possible before the arrival of the full team;
- Scan board, executive, ALCO minutes, etc., as appropriate;
- Allocate work assignments to team members. The AIRES Team Examination option gives the examiner-in-charge the ability to import and export loan lists, reports, general ledger worksheets (except balance sheet and income statements) and questionnaires to and from various team members;

- Provide significant portions of the prior examination to the appropriate team members, if possible. The examiner-in-charge often assembles appropriate workpapers, policies, questionnaires and instructions for team members responsible for specific areas of the examination; and
- Notify team members of their assignments before beginning the onsite examination to allow the team time to review their assigned areas and to assemble needed reference material. The examiner-in-charge will then have the freedom to more effectively coordinate and direct the overall examination.

A primary goal for the examiner-in-charge's planning work, after outlining the scope, is to communicate information gathered from the process to the applicable team members. The risk-focused examination process avoids repeating the work already completed by competent, professional individuals and documented in reports and audits.

The examiner-in-charge often holds pre- and post-examination conferences with either the full team or selected team members. During pre-examination conferences, the examiner-in-charge can discuss the credit union's risk profile, relate problems noted during prior examinations and supervision contacts, answer team members' questions pertaining to their delegated areas of responsibility, provide instructions on communicating with personnel at the credit union and, in general, plan the work. The examiner-in-charge should provide an open door of communication throughout the examination, inviting team members to discuss risk assessment adjustments based on their field work.

Post-examination conferences have value in the more complex examinations in which the examiner-in-charge may not have had the opportunity to become acquainted with all phases of the credit union's operations. Team members can brief the examiner-in-charge on requested areas, provide reports on their areas of responsibility, and discuss risk assessment adjustments as necessary. The examiner-in-charge decides whether to hold pre- or post-examination conferences.

The examiner-in-charge should ensure that adequate documentation exists and all appropriate meetings with credit union personnel have occurred before team members depart at the end of the examination.

Scope Determination

Completing the Scope Workbook will assist the examiner in determining and documenting the scope of the current examination. This workpaper uses prior risk assessments and quantitative data from the most recent call report to highlight areas of concern.

Process or Transactional Review

When developing the examination scope, the examiner needs an understanding of the difference between “process” and “transaction” examination steps. **Process** involves the planning, direction, and control aspects, including management’s reporting of information for a given area. **Transaction** involves the actual individual transactions or records of a credit union.

The risk-focused examination enables examiners to perform a process review in the credit union’s well-managed areas, without extensive transaction testing. This type of examination permits examiners to evaluate the credit union’s process for managing risk, including how effectively the credit union uses its information systems.

Level of Risk

The scope determination process culminates in identifying specific procedures the examiners will perform during the examination. If examiners’ preliminary risk assessment indicates an area has high or moderate risk, they will then determine which procedures will most effectively evaluate the depth of the risk and result in recommendations for improvement. If examiners judge an area to contain low risk, they may choose to perform no procedures or a very limited process review.

Adjusting the Scope

The final scope determination relies on examiner judgment. Examiners should adjust the scope of the examination as appropriate. This will require the examiners to use sound professional judgment and analysis, and to maintain open lines of communication with management. A successful examination requires discussing relevant concerns as they

arise. The Scope Workbook provides a forum for the examiner to summarize the scope of the examination and document the areas reviewed.

**Minimum
Procedures**

Examiners will evaluate the credit union's overall risk profile to determine most of the procedures they plan to perform during an examination. However, the examiners must complete the following three procedures during each examination, regardless of risk:

- Verify the accuracy of the call report. The steps required to perform this verification will vary based on the risk characteristics present in each credit union. Credit unions with multiple internal control checks in the accounting and reporting areas may require little verification. In those credit unions lacking an effective system of internal controls, examiners may need to perform more extensive testing to satisfy themselves as to the accuracy of the report.
- Review the supervisory committee audit and verification. Again, this review will vary significantly based on the qualifications of the auditors, the audit findings, the extent of the audit scope, and the level of oversight provided by the supervisory committee or internal auditors.
- Verify compliance with the Bank Secrecy Act (BSA). The Federal Credit Union Act requires NCUA to determine compliance with this law during each examination. Part 748 of NCUA's Rules and Regulations specifies some of the requirements of this law. The Compliance chapter of this Guide provides further information on the BSA.

**Documenting
the Scope**

Examiner's discretion determines the extent of documentation. Although no specific requirements exist, the documentation should demonstrate:

- The extent of procedures and testing performed;
- Review of regulatory compliance in applicable areas (e.g., if a credit union grants member business loans, the examiner should

evaluate and document compliance with Part 723 of the Rules and Regulations);

- Reasons and factors considered in determining areas and extent of review;
- Analysis and assessment of risk areas;
- Conclusions reached and recommendations made; and
- Adequate support for conclusions and recommendations.

In cases that result in losses or administrative action, the examination workpapers will lay the groundwork for building an administrative record.

Final Risk Assessment

The examiner will evaluate all information gathered to assign a final assessment of risk for each of the seven risk categories. Information obtained during the examination may result in changes to the preliminary risk assessment.

Each category of risk will receive a risk assignment of high, moderate, or low, depending on the factors present in the credit union. At the conclusion of the examination, the examiner will also indicate the anticipated direction (increasing, decreasing, or unchanged) of the risk over the next examination cycle. Some factors contributing to this anticipated direction include the examiner's expectations regarding:

- Management's ability to monitor and control identified risks;
- Management's willingness to monitor and control identified risks; and
- Anticipated changes in management, services, economic environment, field of membership, etc.

Attachment 2.1 contains a list of risk indicators for each risk category. Examiners should use this attachment only as guidance in the assignment of risk level.

Budget and Plans

After conducting the examination, the examiner begins the planning cycle again by suggesting future review areas and estimating resource needs for the next examination and interim supervision. The Budget and Plans section of the Scope Workbook documents these

recommendations. Examiners should consider the following items when completing this sheet:

- Level of complexity in any given area;
- Need for subject matter examiners or regional specialists;
- Recommendations for transactional reviews;
- Recommendation for risk-based examination scheduling category;
- Anticipated changes in field of membership, charter, services, management, etc.;
- Known or expected changes in senior management, board of directors, official committees, or key operating staff;
- Known or expected regulatory changes affecting the credit union;
- Known or expected events affecting budgeted hours (merger, conversion, voluntary liquidation, involuntary liquidation, etc.);
and
- Known or expected trends in local and national economy.

When the examiner uploads the scope workbook, the Budget and Plans section records the hours anticipated for the next examination and interim supervision. The supervisory examiner will have the opportunity to review this document as part of the completed workbook.

Credit Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of credit risk and has a fully effective process in place to control that risk.	Reasonably understands key aspects of credit risk and has an adequate process in place to control that risk	Does not understand risks, has chosen to ignore, or does not have a satisfactory process in place for key aspects of credit risk.
Risk Management	Management anticipates and identifies issues before they become problems, including those resulting from changes in market conditions.	Management has an adequate system in place to identify problems and adequately respond to those signals, including those resulting from changes in market conditions.	Management does not anticipate problems or is ineffective in responding to problems once they occur.
Policies	Current, effective and followed.	Satisfactory.	Ineffective.
Diversification	Credit risk diversification is actively managed.	Adequate attention to credit risk diversification.	Unsatisfactory credit risk diversification.
Loans Granted, Loans or Investments Purchased	Conservative in structure, terms, growth, or settlement practices. Effective due diligence.	Prudent in structure, terms, growth, or settlement practices. Due diligence is adequate.	Aggressive in structure, terms, growth, or settlement practices. Due diligence is lacking, ineffective, or inadequate.
Underwriting Standards	Sound and few or no exceptions exist.	Sound with a limited volume of exceptions.	Not adequate or are not prudent and a large volume of exceptions exist.
Concentrations	Appropriate diversification	Adequate diversification.	Significant concentrations exist.
Collateral Values	Collateral values satisfactorily support credit exposure.	Values protect credit exposure.	Collateral is illiquid or values provide inadequate support.
Problem Assets	Low volume, resolution times are within normal course of business and process is controlled.	Moderate volume, reasonable resolution times, and adequate reporting.	High volume, extended resolution times, and inadequate reporting.
Reserves	Reserves adequately cover inherent losses. Exposure to loss of earnings or capital from credit risk is minimal.	Inherent losses should not seriously deplete current reserves or require more than normal provisions. Exposure to loss of earnings or capital is manageable.	Losses may seriously deplete current reserves or require abnormal provisions. Exposure to loss of earnings or capital is substantial.
Internal Audit and Review	Timely, comprehensive, and independent. Promotes early identification of emerging risks. Management responds to findings quickly.	Acceptable. Promotes reasonable identification of problems. Management responds to findings.	Serious weaknesses exist such as lack of independence, timeliness, or scope of review. Does not promote early identification of problems and risk. Management ignores findings.
ALL Methodology	Evaluation method is sound, well documented, and appropriate coverage of risks exists.	Method is generally acceptable and provides an acceptable coverage of risks.	Method is flawed and provides insufficient coverage of risks.

Interest Rate Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of IRR.	Reasonably understands key aspects of IRR.	Does not understand or ignores key aspects of IRR.
Responsiveness to Market Conditions	Anticipates and responds well to changes.	Adequately responds to changes.	Does not anticipate or take timely and appropriate actions in response to changes.
Monitoring & Measuring	Process is independent from those executing risk-taking decisions. Effective reporting of IRR exists.	Process is independent from those executing risk-taking decisions. Adequate reporting of IRR exists.	Process is not independent from those executing risk-taking decisions. Lack of monitoring and reporting of IRR.
Risk Exposure	Little repricing risk and minimal exposure to basis and yield curve risk.	Repricing risk, basis risk, yield curve risk, and options risk exposures are collectively maintained at manageable levels.	Significant levels of repricing risk, basis risk, yield curve risk, or significant levels of options risk exist.
Mismatches	Mismatched positions are short-term.	Mismatched positions may be longer but are managed effectively.	Mismatched positions are longer term and inadequately managed.
Risk to Capital and Earnings	Mismatches are unlikely to cause earnings or capital volatility due to the movement of interest rates.	Substantial volatility in earnings or capital due to the movement of interest rates is not anticipated.	High probability of substantial volatility in earnings or capital due to the movement of interest rates.
IRR Process	Effective, documented, and proactive.	Adequate.	Deficient.
Measurement Tools and Methods	Enhance decision making by providing meaningful and timely information under a variety of defined and reasonable rate scenarios.	Minor weaknesses, but are appropriate given size and complexity of the credit union's on-and off-balance-sheet exposures.	Overly simplistic in light of the relative size and complexity of the credit union's on- and off-balance-sheet exposures.
MIS Reporting	Timely, accurate, complete, and reliable.	For the most part, timely, accurate, complete and reliable.	Significant weaknesses.
Risk Limits	Clear parameters, that are regularly reviewed, are set for risk to earnings and the economic value of equity under defined stressed interest rate scenarios.	Adequate to control the risk to earnings and the economic value of equity under defined stressed interest rate scenarios.	Not reasonable or do not reflect an understanding of the risks to earnings and the economic value of equity.

Liquidity Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of liquidity risk.	Reasonably understands key aspects of liquidity risk.	Does not understand, or chooses to ignore key aspects of liquidity risk.
Management Responsiveness	Anticipates and responds well to changes in market conditions.	Adequately responds to market condition changes.	Does not anticipate or take timely or appropriate actions in response to changes.
Liquidity Position and Risk Exposure	Favorable position with negligible exposure to earnings and capital.	Not excessively vulnerable to funding difficulties should an adverse change in market perception occur. Earnings or capital exposure is manageable.	Access to funds is impacted by poor market perception or market resistance, resulting in substantial exposure to loss of earnings or capital.
Funding Sources	Ample funding sources exist. Funding sources provide the credit union with a competitive cost advantage.	Sufficient funding sources exist to provide cost-effective liquidity.	Funding sources and portfolio structures suggest current or potential difficulty in sustaining long-term and cost-effective liquidity.
Borrowing Sources	Widely diversified, with little or no reliance on wholesale or other credit-sensitive funds providers.	Diversified with few providers or groups sharing common investment objectives and economic influences.	Concentrated in a few providers, or providers with common investment objectives or economic influences.
Future Liquidity Position	Market alternatives exceed demand for liquidity with no adverse changes expected.	Liquidity position is not expected to deteriorate in the near term.	Liquidity needs may be increasing with declining medium- and long-term funding alternatives.
Risk Management Process	Processes reflect a sound culture that has proven effective over time.	Processes are adequate.	Processes are deficient.
MIS Reporting	Timely, complete, reliable, and reviewed by management.	For the most part, timely, complete, reliable, and reviewed by management.	Do not provide useful information for managing liquidity risk.
Balance Sheet Management	Appropriate attention is given to balance sheet management and the cost effectiveness of liquidity alternatives.	Attention to balance sheet management is appropriate. Access to funding markets is properly assessed and diversified based upon size and complexity.	Attention to balance sheet management is inappropriate. Management has not realistically assessed the credit union's access to funds and has not paid sufficient attention to diversification.
Contingency Plans	Well-developed and effective.	Effective and the cost of liquidity alternatives is adequately considered.	Nonexistent or incomplete. Cost of alternatives has not been adequately considered. High probability exists that contingency funding sources are needed. Improvement is not expected in the near future.
Cash Flow Analysis	Effective, reliable and timely analyses are conducted.	Adequate analysis conducted based upon size and complexity.	Analysis not done or is inadequate.

Transaction Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of transaction risk.	Reasonably understands key aspects of transaction risk.	Does not understand, or chooses to ignore key aspects of transaction risk.
Responsiveness to Market and Technological Conditions	Anticipates and responds well to changes.	Adequately responds to changes.	Does not anticipate or take timely or appropriate actions in response to changes.
Risk Exposure	Only a slight probability of damage to reputation, capital, or earnings.	Possible loss to reputation, earnings or capital exists but is mitigated by adequate internal controls.	Weak internal controls expose the credit union to significant damage to reputation, or loss of earnings or capital.
Transaction Processing Controls	History of sound operations. Likelihood of transaction processing failures is minimal due to strong internal controls.	History of adequate operations. Likelihood of transaction processing failures is minimized by generally effective internal controls.	History of transaction processing failures. Likelihood of future failures is high due to absence of effective internal controls.
Systems and Controls	Strong control culture that results in systems, internal controls, audit, and contingency and business recovery plans that are sound.	Adequate operating and information processing systems, internal controls, audit coverage, and contingency and business recovery plans are evident.	Serious weaknesses exist in operating and information systems, internal controls, audit coverage, or contingency and business recovery plans.
MIS	Satisfactory	Minor deficiencies may exist that relate to transaction and information processing activities.	Significant weaknesses in transaction and information processing activities.
New Products or Services	Favorable performance in expansions and introductions of new products and services.	Planning and due diligence prior to introduction of new services are performed although minor weaknesses exist.	Inadequate. CU is exposed to risk from the introduction or expansion of new products and services.
Conversion Management	Conversion plans are clear, comprehensive, and followed.	Conversion plans are evident, although not always comprehensive.	CU may be exposed to processing risks due to poor conversion management, either from the integration of new acquisitions with existing systems, or from converting one system to another.
Problem Identification and Corrective Action	Management identifies weaknesses quickly and takes appropriate action.	Management recognizes weaknesses and generally takes appropriate action.	Management has not demonstrated a commitment to make the corrections required to improve transaction processing risk controls.

Strategic Risk Indicators

Factor	Low	Moderate	High
Risk Management Practices	Practices are an integral part of strategic planning.	Quality is consistent with the strategic issues confronting the credit union.	Practices are inconsistent with strategic initiatives. A lack of strategic direction is evident.
Strategic Planning	Strategic goals, objectives, culture, and behavior are effectively communicated and consistently applied throughout the institution. The depth of management talent enhances strategic direction and organizational corporate efficiency.	Demonstrated the ability to implement goals and objectives and successful implementation of strategic initiatives is likely.	Operating policies and programs inadequately support strategic initiatives. The structure and talent of the organization do not support long-term strategies.
Management/Staff Turnover	Changes in key management or staff are well managed and minimal. Succession plans are documented and effective.	Key management or staff changes recently occurred. Succession plans are adequate.	Key management or staff turnover is high and poorly managed. Succession plans are non-existent, inadequate, or ignored.
Track Record	Management has been successful in accomplishing past goals and is appropriately disciplined.	Management has a reasonable record in decision-making and controls.	Deficiencies in management decision-making and risk recognition do not allow the institution to effectively evaluate new products, services, or FOM expansions.
MIS	Management information systems effectively support strategic direction and initiatives.	Management information systems reasonably support the credit union's short-term direction and initiatives.	Management information systems supporting strategic initiatives are seriously flawed or do not exist.
Risk Exposure	Exposure reflects strategic goals that are not overly aggressive and are compatible with developed business strategies.	Exposure reflects strategic goals that are aggressive but compatible with business strategies.	Strategic goals emphasize significant growth or expansion that is likely to result in earnings volatility or capital pressures.
Impact and Risk of Initiatives	Initiatives will have a negligible impact on capital, systems, or management resources. The initiatives are well supported by capital for the foreseeable future and pose only nominal possible effects on earnings volatility.	Actual practices have only minor inconsistencies with planned initiatives. Initiatives are reasonable considering the capital, systems, and management. Decisions are not likely to have a significant adverse impact on earnings or capital and can be reversed without significant cost or difficulty.	The impact of strategic decisions is expected to significantly affect net worth. Strategic initiatives may be aggressive or incompatible with developed business strategies. Decisions are either difficult or costly to reverse.
Appropriateness of New Products & Services	New products/services are supported by sound due diligence and strong risk management. The decisions can be reversed with little difficulty and manageable costs.	New products/services will not materially alter business direction, can be implemented efficiently and cost effectively, and are within management's abilities.	Strategic goals are unclear or inconsistent, and have led to an imbalance between the credit union's tolerance for risk and willingness to supply supporting resources for new product/service offerings.

Reputation Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Response to Change	Anticipates and responds well to changes of a market or regulatory nature that impact its reputation in the marketplace.	Adequately responds to changes of a market or regulatory nature that impact the institution's reputation in the marketplace.	Does not anticipate or take timely or appropriate actions in response to changes of a market or regulatory nature.
Organization and Overall Operations	Management fosters a sound culture that is well supported throughout the organization and has proven very effective over time.	Administrative procedures and processes are satisfactory. Management has a good record of correcting problems.	Weakness may be observed in one or more critical operational or administrative activities. Management information at various levels exhibits significant weaknesses.
Risk Management	The credit union effectively self-polices risks.	The credit union self-polices risks.	The credit union's performance in self-policing is suspect.
Internal Controls and Audits	Fully effective.	Generally effective.	Not effective in reducing exposure. Management has either not initiated, or has a poor record of, corrective actions to address problems.
Net Worth Exposure	Net worth is only minimally exposed by reputation risk. Minimal member complaints received, involving minor issues. Complaints are handled promptly, effectively, and efficiently.	The exposure of net worth from reputation risk is controlled. Adequate systems exist to process member complaints satisfactorily.	Net worth is substantially exposed by reputation risk shown in significant litigation, large dollar losses, or a high volume of member complaints. The potential exposure increases with the number of accounts, the volume of assets under management, or the number of affected transactions.
Legal Risk	Losses from fiduciary activities are low relative to the number of accounts, the volume of assets under management, and the number of affected transactions. The credit union does not regularly experience litigation or member complaints.	The credit union has avoided conflicts of interest and other legal or control breaches. The level of litigation, losses, and member complaints are manageable and commensurate with the volume of business conducted.	Poor administration, conflicts of interest, and other legal or control breaches may be evident.
Disaster Recovery Plans	Documented, tested, and effective plans are in place.	Adequate plans are in place.	Inadequate or non-existent plans.
Promotional and Educational Efforts	Effective promotional and educational efforts are made to reach existing and potential members.	Adequate promotional and educational efforts are undertaken.	Inadequate or non-existent promotional and educational efforts.

Compliance Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of compliance risk and exhibits a clear commitment to compliance. Commitment is communicated throughout the institution.	Reasonably understands the key aspects of compliance risk. Commitment to compliance is reasonable and satisfactorily communicated.	Does not understand, or has chosen to ignore, key aspects of compliance risk. The importance of compliance is not emphasized or communicated throughout the organization.
Authority and Accountability	Authority and accountability for compliance are clearly defined and enforced.	Authority and accountability are defined, although some refinements may be needed.	Management has not established or enforced accountability for compliance performance.
Response to Changes	Anticipates and responds well to market or regulatory changes.	Adequately responds to market or regulatory changes.	Does not anticipate or take timely or appropriate actions in response to market or regulatory changes.
Product and Systems Development	Compliance considerations are incorporated into product or systems development.	While compliance may not be formally considered when developing product or systems, issues are typically addressed before they are fully implemented.	Compliance considerations are not incorporated in product or systems development.
Violations & Risk Exposure	Violations, noncompliance, or litigation are insignificant, as measured by their number or seriousness.	The frequency or severity of violations, noncompliance, or litigation is reasonable.	Violations, noncompliance, or litigation expose the credit union to significant impairment of reputation, value, earnings, or business opportunity.
Error Detection and Corrective Action	When deficiencies are identified, management promptly implements meaningful corrective action.	Problems can be corrected in the normal course of business without a significant investment of money or management attention. Management is responsive when deficiencies are identified.	Errors are often not detected internally, corrective action is often ineffective, or management is unresponsive.
Risk Management	Good record of compliance. The CU has a strong control culture that has proven effective. Compliance management systems are sound and minimize the likelihood of excessive or serious future violations.	Compliance management systems are adequate to avoid significant or frequent violations or noncompliance.	Compliance management systems are deficient, reflecting an inadequate commitment to risk management.
Controls and Systems	Appropriate controls and systems are implemented to identify compliance problems and assess performance.	No shortcomings of significance are evident in controls or systems. The probability of serious future violations or noncompliance is within acceptable tolerance.	The likelihood of continued violations or noncompliance is high because a corrective action program does not exist, or extended time is needed to implement such a program.
Training and Resources	Training programs are effective and the necessary resources have been provided to ensure compliance.	Management provides adequate resources and training given the complexity of products and operations.	Management has not provided adequate resources or training.

Chapter 3

TOTAL ANALYSIS PROCESS

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Chapter 3

TOTAL ANALYSIS PROCESS

Examination Objectives

- Evaluate the components of CAMEL
- Review quantitative measurements
- Review qualitative considerations
- Interpret examination results and reach conclusions
- Recommend and help develop action plans

Overview

The CAMEL Rating System provides an accurate and consistent assessment of a credit union's financial condition and operations in the areas of Capital Adequacy, Asset Quality, Management, Earnings, and Asset/Liability Management. This internal tool measures risk and allocates resources for supervision purposes. Examiners can access NCUA's most recent Letter to Credit Unions regarding the CAMEL Rating System in the Letters to Credit Union section of Reference Information on the NCUA website (www.ncua.gov).

The CAMEL rating culminates the examination process. Key ratios alone do not automatically determine the rating. Examiners should look behind the numbers to determine the significance of supporting ratios and trends. When evaluating the components of CAMEL, examiners look at the seven risks discussed in the Risk-Focused Program Chapter and the quantitative measurements and the qualitative considerations outlined in the Letter to Credit Unions discussed above before determining a final rating. Examiners have the discretion to increase or decrease any rating they deem necessary using their professional judgment. They should support increases or decreases in the examination report.

The total analysis process includes:

- Collecting data;
- Reviewing data;
- Interpreting data;
- Reaching conclusions;

- Making recommendations; and
- Developing plans for action.

Collecting Data

The examiner collects statistical data during the planning phase of the examination. Some financial data appears on the 5300 Risk Parameters tab of the Scope Workbook, with more detail on the various AIRES work papers including the Financial History and Key Ratio forms. Examiners obtain qualitative data by observation (e.g., reading the minutes, policies, recent correspondence, prior examination reports, watching as staff performs their duties) and by discussion with officials and employees. Several examination work papers (e.g., Loan Exceptions, Examiner Findings, Informal Discussion Items) document qualitative and quantitative data. The Examination Overview summarizes the data in a narrative form.

The Financial History, a key form for performing the total analysis process, compiles examination data for computing ratios on the Key Ratio Analysis form. For periods other than those on the Key Ratios form, examiners may collect and analyze data using optional AIRES work papers or alternative analysis tools like the Consolidated Balance Sheet or Cycle-to-Cycle programs.

Reviewing Data

The imported data automatically carries forward to Financial History, Key Ratios and various investment, loan, and share reports. The prior year-end and current quarter-end 5300 information flows from the Calculated 5300 Accounts spreadsheet to the appropriate forms. Examiners should verify the integrity of the 5300 data. If the examiner finds errors on the 5300, they should upload corrected data through the host system and make corrections during the current examination. The examiner should also consider requiring that the credit union restate the appropriate financial statements.

In this portion of the total analysis process, the examiner (1) breaks down and reassembles the data, relating individual parts to the whole; (2) notes the trends; and (3) evaluates the data. This complex evaluation of the examination data requires examiners to use their professional judgment.

Levels of Analysis

Examiner judgment affects the overall analytical process. The examiner sets the tone for the data review process by asking management appropriate questions, and reviewing and completing the Preliminary Risk Assessment tab of the Scope Workbook. The review of data takes place in varying levels of analysis, including:

- Structural analysis,
- Trend analysis,
- Reasonableness analysis,
- Variable data analysis, and
- Qualitative data analysis.

Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group, depending on the type of analysis being performed. For example, some individual ratios may not provide an accurate picture without a review of the related trends. Analyzed as a group, however, the ratios may depict important trends not seen when reviewing individual measures.

Structural Analysis

Structural analysis includes the review of the component parts of a financial statement in relation to the whole. The examiner analyzes financial data and the ratios developed from that data. For example, the return on average assets is a structural analysis ratio developed from the income and assets.

The examiner should first develop expectations of the relationships of these financial components or ratios to each other and as a whole. In developing expectations, the examiner may refer to comparable prior periods, budgets, industry trends, etc.

The examiner then compares the anticipated results with the relationships actually taking place among financial elements within the period. This highlights two important aspects of structural analysis: (1) structural analysis is static in the sense that the examiner reviews the composition of the financial statement as of a specific date or as of a particular cut-off date; and (2) the credit union's resulting financial ratios should fall within reasonable parameters or the examiner's

expectations. Examiners may use the Reasonableness worksheet in the ExamOptional workbook to assist in making this determination.

One or more ratios outside those reasonable parameters can indicate an at-risk, misstated, or otherwise suspect financial condition. For example, consider the close relationship between asset composition and gross income. If loans comprise 90 percent of a credit union's assets and those loans have a 15 percent annual percentage rate (APR) and nominal loan delinquency, the examiner would expect relatively high gross income. However, if gross income as a percentage of average assets equals only 6.9 percent, the results fall outside the examiner's reasonable parameters or expectations and should raise questions that warrant further review.

Additionally, the examination process, while not designed to detect fraud, may warrant expanded procedures when red flags exist (the Management and General Ledger chapters and the appendix to the Share Structure chapter contain red flags.)

When analyzing the financial and operational structure, examiners should:

- Step back from examination details and individual ratios (and often from the computer);
- Think about the big picture, how the various aspects of the examination interact and the individual ratios relate to each other; and
- Assess management's ability to identify, measure and control current and future risk.

The risk-focused examination provides examiners flexibility in the examination scope (i.e., examiners should expand procedures when they note high related risks.) For example, if management has a poor process for managing credit risk, examiners should expand the loan review. The structural analysis process enables examiners to (1) analyze internal controls, (2) judge how much reliance they can place on those controls, and (3) persuade the officials to identify and correct weaknesses and other conditions conducive to fraud and embezzlement.

During structural analysis, the examiner reviews the statistical data on the AIREs Financial History form and the 5300 Risk Parameters tab of the Scope Workbook and calculates structural ratios on the Key Ratio work paper in AIREs. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition as of the examination date. However, examiners may require other structural ratios to complete the analysis or to corroborate the tentative conclusions reached after reviewing the required key structural ratios. The analysis of management's financial vision includes reviewing key ratios against the credit union's projected ratios in the budget or business plan. Examiners should expand a review when they identify risk indicators.

To determine the level of risk, examiners review structural ratios individually and in relation to each other. For example, if a credit union has a lower than normal net income level, but strong and stable capital ratios, the examiner may initially suspect that the credit union has an earnings problem. However, in reality, management may reward the members with higher dividend rates that do not threaten the credit union's strength. In any case, if the credit union has negative year-to-date return on average assets, the examiner should determine whether earnings pose a potentially serious problem.

During the structural ratio review, the examiner may carefully compare the credit union's ratios to the same ratios of similar size credit unions. Economic, geographic and other differences between one credit union and another preclude indiscriminate comparisons. Peer ratios do not represent standards or goals for the credit union to attain; they serve only as benchmarks. As such, examiners should use peer ratios as analysis points only, and should not carry this type of comparison to the Overview. Examiners should keep in mind a basic tenet of ratio analysis: ratios never answer questions; they only raise them.

Examiners should not recommend specific action either orally or in the examination report when the only reason offered is that the credit union should meet a peer or national average. Pursuing the reasons for the adverse ratios often allows the examiner to distinguish between unacceptable risks and appropriate trends for the particular credit union.

Structural analysis enables examiners to identify potential risks; however, examiners need trend analysis, in addition to the structural approach, to reach appropriate conclusions and make sound recommendations to management. Trend analysis helps determine the level and direction of the risk.

Trend Analysis

Trend analysis involves comparing the component parts of a structural ratio to itself over several time periods. Seasonal fluctuations may warrant the examiner using other than annual trend analysis periods. While trend analysis often requires looking back at prior ratios, it also serves as a valuable forecasting tool that allows the examiner or credit union to project outcomes if the credit union chooses another solution or resists making needed corrections.

Trend analysis enables identifying, questioning, and evaluating the changes in results of operations. For example, assume a credit union has a ratio of delinquent loans to total loans of 10 percent. If the structural ratio were 5 percent at the previous examination, the examiner would determine the reasons for the increase by reviewing the trends of each component, total loans and total delinquent loans. The increase may result from (1) delinquent loans increasing while total loans decrease or remain unchanged; (2) both delinquent loans and total loans increasing, but delinquent loans increase at a faster rate; (3) both delinquent loans and total loans decreasing, but total loans decrease at a faster rate; or (4) delinquent loans remaining unchanged while total loans decrease.

Determining which situation applies provides a basis for expanding the depth of analysis needed to fully assess the potential risk. During the total analysis process, examiners should:

- Determine whether material negative trends exist;
- Ascertain the action needed to reverse unfavorable trends; and
- Formulate, with management, recommendations and plans to ensure implementation of these actions.

Reasonable-ness Analysis

As needed, the examiner performs necessary reasonableness tests to ensure accuracy of financial performance ratios. For example, if the

cost of funds exceeds the average stated rates, the yield on loans in a highly loaned out credit union with no reported delinquency equals less than half the stated rate, or the yield on investments falls well below market in comparison to the balance, the examiner should determine the cause. AIRES has the capability (optional) to compute share costs and loan yields within the Critical worksheets for shares and loans. AIRES also calculates reasonableness ratios on the optional worksheet, Reasonableness Ratios.

By performing reasonableness tests, the examiner might identify transaction risks such as (1) unauthorized disbursements, (2) out-of-balance conditions, (3) negative share accounts (overdrafts), (4) payment of personal expenses from credit union funds, and (5) fictitious loan or share accounts (or other fictitious records). The existence of fraud or embezzlement often causes the financial performance ratios to fail tests of reasonableness, which may serve as a red flag indicating the need for more in-depth review by the examiner.

Most individual balance sheet items provide limited usable information that examiners can retrieve to analyze the credit union's financial condition. If examiners decide to perform an account analysis, they must understand what entries make up the whole account.

**Variable Data
Analysis**

Examiners can often analyze an examination area in many different ways. For example, during the loan review, a variety of options exist by which examiners may analyze loans, including:

- The amount current and the amount delinquent (the amount delinquent can be further broken down into length of delinquency);
- The amount collectible or uncollectible;
- The number of loans involved;
- The average unpaid balance of each loan;
- The loan turnover rate;
- The percentage of high risk loans (may require profiling loans);
- The amount allocated to a new loan program (e.g., risk-based lending);
- The amount unsecured and secured;

- The types of security and the amount secured by each type (e.g., co-makers, automobiles, real estate, etc.); and
- The appraised or market value of the security compared with the unpaid balances of the secured loans.

Ascertaining any one of the above remaining items may provide a basic understanding. Obtaining additional items may allow the examiner to perform a more meaningful analysis. Rather than categorizing each loan, examiners can determine the appraised or market value of the security using a sampling process.

Likewise, examiners can break down other examination areas (e.g., investments, shares, etc.) to facilitate the analysis. The total analysis process enables examiners to look beyond the "static" balance sheet figures to more accurately assess the financial condition, quality of service, and risk potential.

Qualitative Data Analysis

Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc. Nevertheless, they have an important bearing on the credit union's current condition, and will undoubtedly affect its future. Examples of qualitative data include lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, economic conditions within the general economy and of the sponsoring organization, and attitude of the sponsoring organization.

In an effective examination, qualitative analysis requires the examiner to go beyond merely identifying trends and to look for causes behind the quantitative performance. When events beyond management's control adversely affect the credit union (e.g., loss of the sponsor, strike at the sponsor, natural disaster, etc.), the examiner should work with the officials to develop policies or procedures that will counteract or lessen unfavorable influences, both internal and external.

The main purposes for reviewing qualitative data are to (1) help project the credit union's future, and (2) determine the control environment surrounding various operations. The credit union's future heavily depends on management's ability to identify, monitor,

measure, and manage risks. The total analysis process requires the examiner to perform varying levels of analysis (structural, trend, reasonableness, variable data, and qualitative) before interpreting the results of the review.

Interpreting Data

Interpreting the data involves the most complex phase of the total analysis process. The examiner's ability, judgment, experience and skill all come into play in this process of questioning the data. If examiners place too much emphasis on inconsequential facts or underplay or ignore significant facts, they may arrive at erroneous conclusions that could harm the credit union. For example, individuals often charter a credit union primarily to provide loans to members. Lending programs require that the credit union take a reasonable business risk, which results in earnings sufficient to maintain or build net worth. However, by emphasizing zero delinquency and loan losses, the examiner could diminish a primary reason for the credit union's existence and unnecessarily decrease its income. Performing the following will increase understanding and possibly change the examiner's preliminary assessment of risk:

- Inquire about the sponsor's support and viability, local economic conditions, and other relevant information not directly available within the confines of the credit union's office;
- Differentiate between important and unimportant data; and
- Place all data in its proper perspective.

Reaching Conclusions

After collecting, reviewing, and properly interpreting all appropriate data, the examiner arrives at conclusions. In this part of the total analysis process, the examiner identifies concerns, explains the causes, and assesses risk to arrive at a CAMEL rating. The examiner will determine the level (high, moderate, or low) of the overall strategic, interest rate, credit, liquidity, transaction, compliance, and reputation risks. The examiner will also evaluate the direction of these risks (increasing, unchanged, or declining). For example, the examiner may determine that the member business loan portfolio has high credit risk. However, member business loans may only make up a small percent of total assets. As a result, the examiner may conclude that the credit union has low or moderate credit risk depending on the remainder of

the balance sheet and management's future plans for their member business loan program.

Depending on a credit union's circumstances and the degree of examiner judgment required for each case, examiners may find some conclusions relatively simple to reach, while they find others difficult. Examiners can make sound recommendations only by reaching informed and logical conclusions.

**Making
Recommend-
ations**

After analyzing the operation, the examiner makes recommendations for action based on the conclusions reached and final risk assessments. The recommendations usually consist of general statements addressing what the credit union should do to correct its problems and reduce unacceptable risk. Examiners should assist the officials in developing a specific plan for carrying out the recommendation.

**Developing
Plans for
Action**

Well-designed, achievable, and measurable action plans should reduce unacceptable risks and prevent problems from recurring. Since management's responsibility includes implementing the action plans, the examiner and management should jointly develop the plans. While examiners usually have an approach for the plan in mind, they should be tactful, flexible, and receptive to alternatives suggested by management, who will more likely implement the plan if they participate in developing it.

Management often corrects less serious weaknesses during the examination, thus eliminating the need for a formal written plan. Examiners should document the significant agreed upon action plans, describing the reasons and causes in the written examination report.

An action plan should specify the following:

- Who will take the action;
- Description of the action;
- Completion dates; and
- Responsible oversight by the supervisory committee or officials, if necessary.

The action plan should remain in effect until the examiner and board agree the improved financial condition and level of risk reduction warrants discontinuance or relaxation of the plan. If the credit union has not made sufficient improvement, the examiner and the board should strengthen or revise the plan.

Testing the Results

Valid results of the total analysis process depend on the examiner considering and accurately interpreting all pertinent data. The examiner then has the tools to make meaningful recommendations and design action plans that will reduce unacceptable risks and prevent future problems. If examiners have not properly applied the total analysis process, inappropriate recommendations and action plans may result. To reduce this possibility, the examiner should:

- Make a final review of all data;
- Discuss analysis, risk assessments, and conclusions with management;
- Determine that recommendations and action plans are practical, specific, and understandable; and
- Determine that the plans will achieve an appropriate level of risk reduction.

Workpapers and References

- Work papers
 - Financial History
 - Key Ratios
 - Scope Workbook
 - Examination Overview
 - Confidential Section
 - Supplementary Facts
 - Examiner's Findings
 - Financial Triggers Questionnaire
 - Document of Resolution

Chapter 4

INTERNAL CONTROLS

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Chapter 4

INTERNAL CONTROLS

Examination Objectives

- Determine whether the credit union has implemented efficient and effective operations and risk management systems
- Determine whether the credit union accurately records transactions
- Determine timeliness and reliability of financial reporting
- Determine whether the credit union complies with regulations, internal policies, and internal procedures
- Assess whether the credit union has implemented adequate internal controls to safeguard assets

Associated Risks

- Strategic risk occurs when management fails to (1) perform necessary due diligence as it applies to internal controls surrounding existing and proposed products and services, (2) act on recommendations included in examinations and internal/external audit reports, and (3) allocate the necessary resources to implement proper internal controls;
- Transaction risk occurs when internal controls do not sufficiently deter or detect errors, omissions, or material misstatements;
- Compliance risk occurs when the credit union fails to adhere to applicable laws and regulations; and
- Reputation risk occurs when management fails to meet its fiduciary duties, resulting in poor publicity or administrative action.

Overview

Internal control is defined as a process, developed by a credit union's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations;
- Reliability of financial reporting; and
- Compliance with applicable laws and regulations.

Internal control does not guarantee that the entity will achieve its objectives or even remain in business. Rather, internal control provides

management with reasonable assurance regarding the achievement of objectives. Inherent limitations to internal control exist and cost/benefit considerations will prevent implementation of all possible controls. Inherent limitations may also limit the effectiveness of internal controls.

§113 of the *FCU Act* states that the board of directors shall have the general direction and control of the affairs of the credit union, including the proper and profitable conduct of credit union operations, the safety of credit union assets, and the accuracy and adequacy of financial statements. The board retains overall responsibility for the affairs of the credit union. As part of that responsibility, the board establishes internal controls, which include organizational plans, policies, and operating procedures to maintain control over the duties delegated to paid employees.

Internal control systems assist management with the following:

- Measuring performance, making decisions, evaluating processes, and managing risks;
- Achieving its objectives and avoiding surprises; and
- Detecting mistakes caused by personal distraction, carelessness, fatigue, errors in judgment, or unclear instructions in addition to fraud or deliberate noncompliance with policies.

Effective and well-designed control systems are still subject to execution error. In other words, human beings still must execute most control systems and even well trained personnel with the best of intentions can become distracted, careless, tired or confused.

Consistent application and thorough understanding of internal control by credit union personnel can determine the effectiveness of board and management policies. Controls typically (1) limit authorities, (2) safeguard access to and use of records and credit union assets, (3) separate and rotate duties, and (4) ensure both regular and unscheduled reviews, including testing.

Safety and Soundness

The *FCU Act* and the bylaws establish the basic organizational pattern for credit unions. A credit union's growth necessitates further divisions

of duties and responsibilities. The following organizational procedures enhance the attainment of internal control:

- Approval of loan applications by a separate credit committee elected by the members or appointed by the board, or by a loan officer appointed by the credit committee or the board;
- The signing and countersigning of checks and notes by a person other than a disbursing officer;
- Approval of membership applications by the board, executive committee, or membership officer, rather than by the paid board officer, the financial officer, any assistant to the paid board officer or financial officer, or a loan officer;
- Internal audits by the supervisory committee or internal auditor conducted independently of any official or employee; and
- Maintenance of separate lists of accounts opened and closed for the information of the directors and supervisory committee by persons other than those handling the accounting records.

The bylaws and *Supervisory Committee Guide for Federal Credit Unions* contain other examples and information for achieving control through organization. (Appendix 4A, Conflicting Management Positions, addresses prohibited positions within the credit union and the officers or employees.)

Accurate Financial Statements

Essentially, the accounting system provides a credit union's management with the complete and accurate financial information needed to conduct sound and effective operations. Management uses financial statements produced by the system to report to the members, creditors, insurers, and NCUA. Adherence to generally accepted accounting principles and standards will assure compliance with the full and fair disclosure provisions of §702.402 of *NCUA Rules and Regulations*.

**Other Laws
and
Regulations**

Internal controls are checks and balances built into policies and procedures. The *FCU Act* requires several internal controls, while others develop out of daily experience.

Internal controls for credit unions prescribed by law, regulation, or sound business practices include providing a statement of account to each member, which shows the record of the member's transactions, and obtaining evidence from each borrower regarding receipt of loan funds.

The credit union's operating procedures should contain internal controls such as the following:

- Dividing duties so that no one person has sole control over any transaction and its recording;
- Establishing the flow of work so that one employee, acting independently, automatically verifies the work of another without necessarily duplicating any work already performed; and
- Providing physical and mechanical facilities that support the maximum level of accuracy and work output.

**Internal
Control
Components**

The formality of any control system will depend largely on a credit union's size, the sophistication of its operations, the number of employees, and its risk profile. Small credit unions can design less formal and less structured control systems that can achieve similar effectiveness as more formal and structured control systems at larger or more sophisticated credit unions. Effective control systems should have:

- A control environment;
- Risk assessment;
- Control activities;
- Accounting, information, and communication systems; and
- Self-assessment or monitoring.

Control Environment

The control environment reflects the commitment of the board and management to internal control. It provides discipline and structure to the control system. Elements of the control environment include:

- The organizational structure of the credit union. (Is the credit union's organization centralized or decentralized? Are authorities and responsibilities clear? Are reporting relationships well designed?);
- Management's philosophy and operating style. (Are the credit union's business strategies formal or informal? Is its philosophy and operating style conservative or aggressive? Have its risk strategies been successful?);
- Personnel's integrity, ethics, and competence;
- The external influences affecting the credit union's operations and risk management practices (e.g., independent audits);
- The attention and direction provided by the board of directors and its committees, especially the audit or risk management committees; and
- The effectiveness of human resources' policies and procedures.

Risk Assessment

Risk assessment is the identification, measurement, and analysis of risks - internal and external, controllable and uncontrollable, at individual business levels and for the credit union as a whole. Management must assess all risks in the credit union. Uncontrolled risk-taking can prevent the credit union from reaching its objectives and can jeopardize its operations. Effective risk assessment helps determine the risks, needed controls, and management of those controls.

Control Activities

Control activities are the policies, procedures, and practices established to help ensure that credit union personnel carry out board and management directives at every business level throughout the credit union. These activities help ensure that the board and

management act to control risks that could prevent a credit union from attaining its objectives. They should include:

- Reviews of operating performance and exception reports. For example, senior management should regularly review reports showing financial results to date versus budget amounts, and the loan department manager should review weekly reports on delinquencies or documentation exceptions;
- Approvals and authorization for accessing and performing transactions and activities, including wire transfers. For example, an appropriate level of management should approve and authorize all transactions over a specified limit, and authorization should require dual signatures;
- Segregation of duties to reduce a person's opportunity to commit and conceal fraud or errors. For example, custody of assets should not rest with the person who authorizes or records transactions;
- Dual control or joint custody over access to assets (e.g., cash, negotiable collateral, official checks, etc.);
- The requirement that officers and employees in sensitive positions take two consecutive weeks of out-of-office vacation each year, if practical;
- Design and use of documents and records to help ensure recording of transactions and events. For example, using pre-numbered documents facilitates monitoring;
- Safeguards for access to and use of assets and records. For example, to safeguard data processing areas, a credit union should secure facilities and control access to computer programs and data files; and
- Independent checks on completion of jobs and accuracy of recorded amounts. Examples of independent checks include account reconciliation, computer-programmed controls, management review of reports that summarize account balances, and user review of computer-generated reports.

Credit union directors must hold management and staff responsible for their actions. Credit unions must maintain written procedures or controls for certain areas, including, but not limited to, lending, investments, fraud prevention, the Bank Secrecy Act, privacy, and Truth in Savings. Although credit unions should have written internal control procedures in all areas, the mere existence of the procedures will not suffice. Personnel must understand control procedures and follow them conscientiously.

Control Systems

Accounting, information, and communication systems capture and distribute pertinent and timely information in a form that enables the board, management, and employees to carry out their responsibilities.

Accounting systems contain the methods and records that identify, assemble, classify, record, and report a credit union's transactions.

Information and communication systems assist staff in understanding (1) how they fit into the credit union's control system, (2) how their roles relate to those of others, and (3) how they must maintain their accountability. Information systems produce reports on operations, finance, and compliance that enable management and the board to run the credit union. Management must understand the information system's full capabilities (e.g., availability and content of reports.). Communication systems disburse information throughout the credit union as well as to members and regulators. (Appendix 4B contains a list of Information Systems Reports that examiners may find useful during an examination and when evaluating a credit union's internal controls.)

Self-Assessment or Monitoring

Self-assessment or monitoring is the credit union's own oversight of the control system's performance; employees within the area evaluate departmental or operational controls. Part of the normal course of daily operations and activities should involve ongoing monitoring. Internal and external audit functions, as part of the monitoring system, may provide independent assessments of the quality and effectiveness of a control system's design and performance.

All credit union personnel should share responsibility for self-assessment or monitoring. All employees should understand their responsibility to report breaches of the control system.

**Internal
Control
Evaluation**

Evaluating internal control involves:

- Identifying the internal control objectives relevant to the credit union;
- Reviewing pertinent policies, procedures, and documentation;
- Discussing controls with appropriate levels of personnel;
- Observing the control environment;
- Testing transactions as indicated by the level of risk;
- Sharing findings, concerns, and recommendations with the board of directors and senior management; and
- Determining that the credit union has promptly corrected noted deficiencies.

Examiners should base the scope, type, and depth of an internal control review on the credit union's size, complexity, scope of activities, and risk profile. Assessment of the credit union's audit function plays an important part in this determination. When management or examiners note internal control weaknesses, the credit union should take immediate action to correct the deficiencies.

**Strategic
Risk**

The strategies developed by management often determine effectiveness and efficiency of operations. Factors impacting the control environment include the integrity and ethical values of management, the competence of personnel, management philosophy and operating style, assignment of authority and responsibilities, and the guidance provided by the board. Examiners should also consider the following when assessing strategic risk:

- Involvement of board and management in the risk evaluation process. The board should perform due diligence on proposed, new and existing products and services and should evaluate internal or external resources used by management to ensure identification and monitoring of risk areas;

- The competency, knowledge level, and adequacy of resources of personnel involved in the risk assessment and evaluation processes;
- Whether the board and management discuss and appropriately evaluate risks and consider control issues during the planning stages for new products and activities;
- Whether audit personnel or other internal control experts participate when the credit union develops new products and activities;
- Whether the board and management consider and appropriately address technology issues; and
- The adequacy of the fidelity bond or other risk insurance coverage in relation to the requirements in *NCUA Rules and Regulations*.

**Transaction
Risk**

Policies and procedures set by the board and implemented by management should ensure the accuracy and integrity of data and information. Examiners should consider the following items when evaluating this type of risk:

- Whether current policies and procedures exist to ensure decisions made by officials, management and staff have appropriate approvals and authorizations for transactions and activities;
- Whether accounting controls exist to provide reasonable assurance that staff carries out transactions according to management's authorization, and records transactions to permit accurate and timely preparation of financial statements;
- Whether processes exist to ensure that:
 - Staff independently verifies the performance and integrity of each function (e.g., lending, wire transfers, etc.) using an appropriate sample of transactions;

- Staff reconciles accounts continually, independently, and in a timely manner and resolves and clears outstanding items, both on and off balance sheet;
- Staff keeps policy overrides to a minimum and reports exceptions to management;
- Management has limited the control for employees in sensitive positions or risk-taking activities (see the Control Activities section of this chapter.)

**Compliance
Risk**

Credit unions must comply with applicable laws and regulations. Examiners should assess the adequacy of information systems by determining:

- The type, number, and depth of reports generated for operational, financial, managerial, and compliance-related activities;
- Whether the credit union reviews the reports;
- Whether the credit union runs sufficient reports to properly run, monitor, and control the institution;
- Whether the credit union properly restricts access to information systems;
- Whether management performs the appropriate depth of due diligence and compliance review; and
- Whether management addresses compliance issues when considering new products and services.

**Reputation
Risk**

Reputation risk revolves around adequacy of information as it applies to credit union staff and management, members, and third parties (e.g., vendors, external auditors, etc.) To assess the adequacy of communication systems, examiners should consider the following:

- Reviewing procedures for imparting significant information throughout the credit union (from the top down and from the bottom up in the organizational chain), ensuring that personnel understand the following:
 - Their roles in the control system;
 - Their activities in relation to others; and
 - Their accountability for the activities they perform;

- Reviewing information disbursed to external parties for compliance with fair credit and privacy regulations prior to its release;

- Assessing the frequency and thoroughness of verification of accounting, information, and communication systems by considering the following:
 - Frequency of testing given the level of risk and sophistication of the systems;
 - Sufficiency of ongoing reviews of the systems' accuracy;
 - Competency, knowledge, and independence of the personnel doing the testing;

- Determining oversight by senior management and the board over internal controls, control reviews, and audit findings. The board or a designated board committee should review management's actions to address material control weaknesses and verify the objectivity and adequacy of corrective actions. Examiner's should review the following:
 - Minutes of appropriate board and committee meetings, and
 - Audits or other control review reports and follow-up reports;

- Reviewing the frequency and comprehensiveness of reports to the board or board committee and senior management. Sufficient detail and timely presentation will allow for resolution and appropriate action;

- Assessing the oversight by the board or supervisory committee of audit and other control functions. The board or supervisory

committee should review the qualifications and independence of personnel evaluating controls (e.g., external auditors, internal auditors, or line managers);

- Evaluating the adequacy and independence of the audit or other control review function by considering the following:
 - Organizational structure and reporting lines;
 - Scope and frequency of audits or reviews;
 - Results of audit or other control review evaluations and supporting work papers;
 - Audit or control review reports, management responses, and follow-up reports; and
 - Appropriate and prompt attention directed in areas with identified control weaknesses; and
- Reviewing management's responses, documentation, and tracking of findings to enact adequate follow-up. Credit unions should establish a system of accountability to ensure satisfactory and effective follow up on control weaknesses.

**Workpapers
and
References**

- Workpapers
 - Management Review Questionnaires
 - Loan Internal Control Questionnaires
 - Loans-Lines of Credit/Credit Cards
 - Collection Program
 - Investment Internal Control Questionnaires
 - Cash Control Questionnaire
 - Information Systems Review
 - Red Flags
 - Red Flag Procedures
- References
 - *Federal Credit Union Act §113*
 - *NCUA Rules and Regulations §702.402*
 - *Supervisory Committee Guide for Federal Credit Unions*
 - *Accounting Manual for Federal Credit Unions*
 - Generally Accepted Accounting Principles
 - *Federal Credit Union Handbook*

CONFLICTING MANAGEMENT POSITIONS - APPENDIX 4A

Conflicting Positions

Positions In Federal Credit Unions and Persons Who are Prohibited From Holding Them

Position	Prohibited by Law, Regulation, or Bylaw	Prohibited by Principles of Sound Internal Control
Chief Executive Officer (CEO)	Vice President Secretary Assistant Secretary Treasurer Assistant Treasurer Manager Assistant Manager Membership Officer (if the President countersigns checks)	Member of the supervisory committee Supervisory committee assistant Credit union employee
Assistant Executive Officer	President Secretary Assistant Secretary Treasurer Assistant Treasurer Manager Assistant Manager Membership Officer (if the Vice-President countersigns checks)	Member of the supervisory committee Supervisory committee assistant Credit union employee
Recording Officer (Secretary)	President Vice President Manager Assistant Manager	Member of the supervisory committee Supervisory committee assistant Credit union employee
Assistant Secretary	President Vice President Treasurer	
Financial Officer (Treasurer)	President Vice President Member of the supervisory committee Supervisory committee assistant Membership Officer Assistant Secretary	Member of Credit Committee
Assistant Treasurer	President Vice President Membership Officer	Member of the supervisory committee Supervisory committee assistant
Director	Manager Assistant Manager (Only one director may also be a member of the supervisory committee)	Credit union employee

EXAMINER'S GUIDE

Position	Prohibited by Law, Regulation, or Bylaw	Prohibited by Principles of Sound Internal Control
Executive Committee Member	Any officer or employee other than a director (Only directors may serve as Executive Committee members)	Member of the supervisory committee Member of the credit committee Credit union employee Membership Officer
Supervisory Committee Member	Member of the credit committee Credit union employee Treasurer (Only one board member may also serve on this committee.)	Loan Officer Membership Officer Assistant Treasurer President Vice-President Secretary
Credit Committee Member	Member of the supervisory committee Supervisory committee assistant (Only one credit committee member may also be appointed a loan officer.)	Treasurer Manager
Loan Officer	Membership Officer (Only one credit committee member may be appointed a loan officer.)	Member of the supervisory committee Supervisory committee assistant
Membership Officer	Treasurer Assistant Treasurer Loan Officer Manager Assistant Manager President or Vice-President if checks are countersigned	Member of the supervisory committee Supervisory committee assistant
Manager	Member of the board of directors except by bylaw provision President Vice-President Member of the supervisory committee Supervisory Committee Assistant Membership Officer	Relative of any official Member of the credit committee
Assistant Manager	Member of the board of directors Member of the supervisory committee Supervisory Committee Assistant Membership Officer	Relative of any official

CONFLICTING MANAGEMENT POSITIONS - APPENDIX 4A

Position	Prohibited by Law, Regulation, or Bylaw	Prohibited by Principles of Sound Internal Control
Supervisory Committee Assistant	Treasurer Assistant Treasurer Manager Assistant Manager Member of the credit committee Credit union employee	Loan Officer Membership Officer Relative of any official or employee Assistant Treasurer President Vice-President Secretary
Credit Union Employee	Member of the supervisory committee Supervisory Committee Assistant	Relative of any official Member of the board of directors

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INFORMATION SYSTEM (IS) REPORTS – APPENDIX 4B

Examiners may use the following loan, share, and other reports frequently generated by the credit unions' information system (IS) to assist in the review of internal controls whether the credit union provides a download or generates the reports in-house. Good internal controls also require regular review of these reports by credit union management and the internal audit staff.

File Maintenance report - Identifies all changes made through the computer system that affect members' accounts. Also called the Non Financial Transaction report, this report usually differentiates between old and new data so the user can determine the credit union's changes. Changes that occur most often include: addresses, telephone numbers, loan due dates, payment amounts, interest rates, and maturity dates. Examiners may review a sample of these changes to determine that management properly authorized the changes and staff properly documented them.

Paid Ahead Loans report - Identifies loans with advanced due dates. When reviewing this report, the examiner should compare the borrower's actual payments over time to the note's required payment schedule. If discrepancies exist, the examiner should review a sample of related loan files, being especially cognizant of paid ahead loans where staff performs frequent file maintenance changes or where the prior activity date is long past (may be a deficiency balance that the credit union failed to charge off). Since a payment is due every month on open-end loans, they should not appear on the paid ahead report. Most IS reports flag open end loans so they do not appear on this report; however, the credit union may not have implemented this feature.

Accrued Interest Greater than Scheduled Payment report - Often reveals large portions of accrued interest that the credit union has not collected on specific accounts. In most cases, the majority of borrowers on this report are also delinquent or the note is a single payment note. If delinquency is not an issue, the examiner should determine why the account is on this report.

No Payments in the Last 90 Days report - Accounts listed are typically delinquent or single payment notes. This report can help the examiner pinpoint collection department problems. Examiners should inquire as to discrepancies between this report and the paid ahead report, and should review file maintenance changes made to these accounts.

Interest Rates < 5% or > 18% report - Examiners should review loan rates that fall into these categories and determine their accuracy. Interest rates greater than 18% are in error or illegal. Likewise, examiners should determine reasons for rates less than 5% (loans with no or special interest rates could be work-out loans).

Supervisory Override report - Documents system overrides by personnel who have the authority to make the specified changes. Credit unions should establish parameters that limit employees' access to the overall IS (proper segregation of duties). Because of staff limitations in small credit unions, one person may have the authority to make all changes, making the review of internal controls more critical.

First Payment Date >45 days from Original Loan Date report - Determines if the credit union has advanced due dates of any closed-end loans. In cases where the IS calculates delinquency from the first payment date rather than from the next due date, the IS must change the first payment when it advances the due date. The credit union should review the files of the loans appearing on the report to determine that the credit union appropriately approved an extension.

Loan Accounts with a PO Box report - Reveals different loan accounts with the same post office box, which could disclose fictitious loans.

Non-Amortizing Loans report - Reveals those loans with no principal reduction over time. Single payment or student loans may appear on this report. Examiners should review loans on the report and determine if and why the IS advances due dates.

Cash Transactions over \$10,000 report - Identifies cash transactions that the credit union must report on the Currency Transaction report

and file with the Treasury Department. The review of this report may reveal fictitious deposits.

Cash Payment Loans report - Reveals those loan accounts where the credit union applied cash payments rather than payroll deduction payments to the remaining principal. Examiners may find this report useful if they suspect fictitious loan activity.

Negative Share and Share Draft report - Identifies accounts with negative balances as of the report date (usually printed as of month end); however, examiners may ask the credit union to print the report while they are on-site to determine if the credit union is hiding overdrafts. Reviewing a sample of related accounts may allow examiners to ascertain the reasons for and the duration of the negative accounts.

Shares > \$100,000 report - May identify the credit union's share mix, share concentrations, uninsured shares, and possibly illegal deposits.

Share Accounts with a PO Box report - Reveals if different accounts have the same post office box. The credit union (or examiners at the examination) should trace a sample of accounts to membership cards and review them for validity. If the credit union provides a download of share accounts, the examiner can apply various sort commands to the accounts on the report.

NSF's YTD report - Tracks those members with the most non-sufficient funds (NSFs) for the year. The credit union (or examiners) should compare the report to the credit union's share draft policies to review for NSF abuse. Most IS can generate this report.

Dormant Share Accounts report - Identifies accounts with no activity for the past year (or another given time frame.) Examiners should determine that the credit union is in compliance with the state's abandoned property laws.

Insiders' report - Identifies the accounts of officials and often includes accounts of key management and family members of officials and key management.

Chapter 5

SUPERVISORY COMMITTEE

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Chapter 5

SUPERVISORY COMMITTEE

Examination Objectives

- Determine the necessary supervision and examination scope based on the review of the supervisory committee audit, internal audit reports and risk management reports
- Determine whether the supervisory committee audit and verification meets the requirements of §715 and §741.202 of the *NCUA Rules and Regulations*
- Determine if the supervisory committee performs other duties to meet their fiduciary responsibility
- Determine the advisability of other audits (e.g., e-commerce, internal control, *Statement of Auditing Standard (SAS) No. 70*, etc.)

Associated Risks

- Compliance risk – Includes the risk that the audit and verification does not comply with the laws and regulations;
- Reputation risk – Includes the risk that the supervisory committee did not meet its fiduciary duties, resulting in poor publicity or administrative action;
- Strategic risk – Includes the risk that management fails to act on recommendations included in examinations or internal/external audits, or did not allocate the necessary resources to implement proper internal controls; and
- Transaction risk – Includes the risk that internal controls do not sufficiently deter or detect errors, omissions or material misstatements.

Overview

Reviewing the supervisory committee audit is a required and important aspect of the annual examination. The quality of the audit helps examiners determine the depth of their review. A quality audit can lead to examiner confidence in the records and thereby limit the extent of review. Conversely, a poor audit may necessitate expanding the examination scope.

The examiner should ensure that persons performing the audit and verification functions performed them in accordance with §715 of

NCUA's Rules and Regulations. The examiner's review and evaluation of these functions serve as key elements in determining the examination's scope. Examiners will complete the required questionnaire, SC- Pre-Examination Supervisory Committee Audit And Verification Review.

Additionally, examiners may also complete the following optional questionnaires depending on the type of audit performed:

- SC-Financial Statement Audit by CPA (described in Appendix A);
- SC-Balance Sheet Only Audit by CPA (described in Appendix A);
- SC-Examination of Internal Control over Call Reporting by CPA (described in Appendix B); and,
- SC- Non-Opinion (described in Appendix C or D).

Scope Development and Planning

The following documents can provide guidance for the examiner during the scope development and planning phase:

- Any report of reportable conditions or material weaknesses (sometimes referred to as a management letter);
- The annual audit report;
- Engagement Letter;
- Internal audit reports, if any;
- Risk management or any other applicable audits, if any;
- Support for the verification of accounts; and
- Minutes of the supervisory committee meetings;

Meeting with the Supervisory Committee

The examiner may arrange a meeting with the chairman of the supervisory committee to:

- Explain the examiner's mission in reviewing the audit and verification functions;
- Discuss the supervisory committee's role and responsibilities, if necessary (§715.3);
- Answer any questions the supervisory committee may have; and
- Determine the extent of the committee's knowledge of the credit union's operations, management, and the status of the credit union's financial condition.

Meeting with the Internal Auditor

The examiner may arrange a meeting with the internal auditor to:

- Evaluate the independence and experience of personnel conducting internal control reviews, adequacy of staff size, appropriateness of audit schedule, and sufficiency of scope;
- Assess the reliability and effectiveness of any internal control review;
- Review audit reports, letters reporting material weaknesses or reportable conditions, and management's written response to auditors' findings; and
- Review internal audit working papers.

Meeting with the External Auditor and Review of Working Papers

The type of audit and the examiner's familiarity with the external auditor will determine the extent of the meeting and review of the audit working papers. If examiners choose to contact the external auditor, they may find it beneficial to obtain the auditor's risk assessment, their conclusions, and resulting modifications to the audit program, including the following:

- Auditor memorandums relating to audit planning, preliminary analytical procedures, materiality thresholds, discussions with management, etc; and
- Working papers related to general risks (client's business and industry; significant changes; materiality; general summary of internal controls; and general assessment of risk) and the auditor's assessment detailing conclusions reached.

To clarify the auditor's risk assessment as it relates to the examination scope, the examiner should ask about the following:

- Significant accounts (higher risk is generally localized in a few account balances);
- Risk level assessed (low, moderate, high) for inherent, control, detection, and assertions risk for each significant account.

Inherent risk plus Control risk = Risk of Material Misstatement (RMM);

- Risk factors in place to mitigate risk (e.g., monitoring by third parties, inquiry or observation of controls, prior audit experience, and procedures performed in understanding and testing controls provide evidential matter);
- Conclusions and findings of control testing. **No assurance = Maximum control risk;** and
- The auditor's assessment of combined risk (RMM) and resulting determination of audit program steps.

The examiners' understanding of these aspects of the auditor's work may help them plan and determine the examination scope. If examiners decide to review the supervisory committee and its functions, but have not obtained the information discussed above in the planning phase, they should obtain these items early in the fieldwork phase to minimize duplication of effort, when possible. If the examiners cannot rely on the work of the external auditor, they may need the duplication of efforts to properly assess risk areas.

Reviewing the Annual Supervisory Committee Audit

NCUA Rules and Regulations §715.4-§715.8 set forth the minimum requirements for a supervisory committee audit and verification consistent with the *FCU Act* §115. Supervisory committees often engage external auditors to assist them in meeting this requirement.

The approach the examiner should take in reviewing the audit depends on the type of audit for which the supervisory committee contracted:

- Financial statement opinion audit (Appendix A);
- Balance sheet only opinion audit (Appendix A);
- An examination of internal controls over call reporting (Appendix B); or
- Other supervisory committee audits such as:
 - CPA Agreed-Upon Procedures Audits (Appendix C); and
 - Non-opinion audits (Appendix D).

Certain circumstances may prompt the examiner to consider requiring an independent audit performed by a CPA. Refer to §715.11, Sanctions for failure to comply with this part, and §715.12, Statutory audit

remedies for Federal Credit Unions, of the *NCUA Rules and Regulations*.

Reviewing the Engagement Letter

NCUA Rules and Regulations §715.9 (b), Engagement letter, requires that the supervisory committee obtain an engagement letter when they hire a compensated auditor. Also, §715.9(c), Contents of the letter, §715.9(d), Complete scope, and §715.9(e), Exclusions from scope, discuss the minimum requirements for such an engagement letter.

CPAs generally submit engagement letters to the supervisory committee before beginning their work. The examiner should review the engagement letter in light of §§715.9 (b) through (e) to determine if the supervisory committee properly contracted for the audit. Examiners may find these letters a source of valuable information. These letters include, among other things, the audit scope, the audit period, and the expected reports. In many cases, the auditor will summarize highlights of these matters in the body of the letter and provide greater detail in schedules or appendices to the letter. The letter may specify procedures for various audit areas. In addition, it may specify any limitations on the auditor's scope, including omission of auditing procedures (e.g., evaluation of the allowance for loan losses or confirmation of loans or deposits, if required.)

Sometimes, a supervisory committee can predetermine an unacceptable audit simply by failing to include necessary items (scope, timing, delivery, etc.) Examiners should review the Engagement Letter to ensure the supervisory committee contracted for an acceptable audit. §715.9 of the *NCUA Rules and Regulations* encourages improved contracting practices with the goal of improving compliance with regulatory requirements for audits.

Engagement letter provisions particularly helpful to the examination process, if enforced, include:

- Timely delivery of the audit report within 120 days of completion of the period under audit (§715.9(c)(6));
- Except for opinion audits, the appendix to the letter setting forth the agreed upon procedures (§715.9(c)(3));

- Certified scope, or alternatively a list of exclusions from scope and qualifying reminder that the supervisory committee remains responsible for excluded scope (§715.9(d)(e)); and
- A clause to the effect that the independent accountant agrees to permit the regulator to review and to photocopy applicable original working papers, as the regulator may request (§715.9(c)(7)).

**Finding an
Audit or
Verification
Unacceptable**

Examiners may consider an audit or verification unacceptable and may develop plans of action when they determine:

- The audit scope did not include material areas of the credit union operations;
- Working papers do not support material parts of the audit; or
- Lack of independent control over the verification process.

When examiners take exception to the annual supervisory committee audit, they should convey the following information to the credit union and document it in the examination working papers:

- Specific audit sections in question;
- Records or accounts with significant errors or record keeping deficiencies; and
- Time anticipated for resolving the problems.

Examiners should consult with their supervisory examiners, and in state-chartered credit unions the state supervisory authority, before enforcing *NCUA Rules and Regulations* §715.11, Sanctions for Failure to Comply With This Part and §715.12, Statutory Audit Remedies for Federal Credit Unions.

**If Compensated
Auditor's Audit
Appears Lacking**

When examiners have concerns with the acceptability of the CPA's work, they have several options available. At a minimum, they should sit down with the CPA and discuss their concerns. The meeting will serve as a fact-gathering opportunity that assists the examiner in determining whether the auditors used additional audit steps and if so, how they used the additional steps. Examiners must maintain their objectivity and independence, and should reserve adverse, constructive comments for the final meeting with the supervisory committee. If the

supervisory committee agrees with the examiner's conclusions, they should together determine timeframes for making the corrections.

If, after reviewing the audit working papers and discussing concerns with the independent accountant, examiners have not satisfied themselves that the independent accountant met the minimum requirements of the audit, they should consult with their supervisory examiners. Examiners should clearly describe the circumstances, procedures followed, findings, and conclusions in their working papers. If examiners cannot determine adequate completion of certain audit steps or if they have concerns with independence or thoroughness, they should discuss all major audit findings with the supervisory committee and document the discussion in their working papers. Additionally, an examiner may:

- Recommend that the supervisory committee perform the additional tests in the coming year, before the next examination, to provide NCUA with needed assurances; or
- Recommend that the board and supervisory committee include additional special procedures in engagement letters of future audits.

In extreme, rare, and well-documented instances, supervisory examiners should consult with the regional director or associate regional director regarding cases that may require forwarding referrals through the Office of Examination and Insurance to either the state licensing authority, the AICPA Ethics Division, or to take other action as the Office of General Counsel may advise.

In such cases, examiners should not rate the audit itself unacceptable even though they cannot determine evidence of the satisfactory completion of various test checks or audit procedures. NCUA's policy is that independent, licensed, certified public accountants have established and documented auditing standards which govern their work, whether "opinion" audits (GAAS) or "agreed-upon procedures" engagements (refer to SSAE No. 10). Before examiners find audits "unacceptable" in meeting §715, they should request that Central Office program and legal staff perform a review in relation to the professional accounting and auditing standards, and the likelihood of prevailing (cost/benefit) should the agency decide to proceed legally.

NCUA recognizes that independent accountants can err. Therefore, agency policy encourages examiners to review and to question, when appropriate, an independent accountant's work. However, examiners should stop short of labeling the audit "unacceptable", unless NCUA can solidly assert that the CPA fell short of this standard and support this assertion in a due process proceeding.

**Reviewing
the Internal
Audit
Department**

Internal auditors can serve several valuable functions. They appraise the soundness and adequacy of accounting, operating and administrative controls.

The success of the internal audit function depends in large part on the independence maintained by internal audit personnel. Internal auditors should report directly to the supervisory or audit committee, rather than to management. This enables the function to be "free from influence" of management and, to some degree, the board of directors.

The major factors that the examiner must consider while reviewing and evaluating the internal audit function are (1) the independence and thoroughness of the internal auditors, and (2) the adequacy and effectiveness of the audit program.

The qualifications and responsibilities of internal auditors vary with the credit union's size and complexity and the emphasis that the board places on the audit function. In some credit unions, auditors have no other responsibilities beyond the internal audit function; in others, they are regular employees with part-time audit duties.

Examiners should satisfy themselves that audit staff supervisors possess an adequate knowledge of audit objectives and an understanding of the audit procedures performed by the staff.

The final measure of the auditor's thoroughness is the quality of the work performed and the ability to communicate the results of that work. Accordingly, the examiner's conclusions should reflect the adequacy of the audit program and the audit reports.

**Internal Audit
Program
Adequacy**

The examiner should consider the following:

- Scope and frequency of the audit work;
- Documentation of the work performed;
- Content of the audit programs; and
- Conclusions reached and reports issued.

A documented record of the work performed (best created through audit working papers) must exist. These working papers should contain, among other things, audit work programs and analyses that clearly indicate the procedures performed, the extent of testing, and the basis for the conclusions reached.

Audit work programs deserve separate attention. The work programs, normally found in large complex credit unions with internal audit departments, serve as the primary evidence of the audit procedures planned and performed. As such, they should be written and should cover key areas of a credit union's operations. Each program should provide a clear, concise description of the audit work required, and present individual audit procedures logically. The detailed procedures included in the program will vary depending on, among other factors, the size and complexity of the credit union's operations. Most audit programs should include:

- Surprise audits, where appropriate;
- Maintenance of control over records selected for audit;
- Review and evaluation of the credit union's policies and procedures and the system of internal control;
- Proof of detail to related control records; and
- Verification of selected transactions or balances.

Completion of the specific procedures included in all work programs should enable the internal auditor to reach conclusions that will satisfy the related audit objectives. The work performed should support conclusions drawn and audit reports prepared from the work program results. When appropriate, the reports should include the internal auditor's recommendations for required remedial actions.

Prompt and effective management response to the auditor's recommendations is the final measure of the audit program's effectiveness.

Internal Audit Review

The examiner's review and evaluation of the internal audit function are key elements in determining the scope of the examination. Based on careful evaluation, examiners should conclude whether they find the work performed by the internal auditors acceptable, partially acceptable, or not acceptable.

The concept of partial reliance or acceptability applies only to the review and evaluation of the internal audit function. The examiner may detect weaknesses in the internal audit function or procedures that are not of such magnitude to make the internal audit function unacceptable. In such situations, the examiner should draw a partially acceptable conclusion.

Verifications

NCUA requires federal credit union supervisory committees to verify the members' accounts with the credit union's records at least once every two years. *NCUA Rules and Regulations* §715.8, Requirements for verification of accounts and passbooks, provides that the supervisory committee (or their representative) can base the verification on a 100 percent sample, a random statistical sample, or, for CPAs only, a non-statistical sampling option. Examiners should refer to Chapter 24 of the Supervisory Committee Guide, "What Must a Verification Involve?"

Working Paper Access

In reviewing the audit, the examiner should determine if the auditor properly documented completed audit procedures in working papers in support of the audit or verification report. The *NCUA Rules and Regulations* §715.10, Audit report and working paper maintenance and access, requires the committee to maintain adequate working papers to support its audits.

The auditor's working papers include all the evidence gathered to show work done, the methods and procedures followed, and the conclusions reached. There are no standard working papers. The committee or

auditor prepares working papers that best serve their intended purpose. The working papers should:

- Coordinate and organize all phases of the audit;
- Facilitate preparation of the final audit report; and
- Substantiate in detail the opinions and findings in the report.

When the supervisory committee performs the verification or audit, the examiner generally has little or no difficulty accessing the original working papers. These papers form the basis for judging the adequacy of a supervisory committee audit.

Examiners may have more difficulty obtaining the working papers when the supervisory committee directs a CPA to complete some or all of the work. Independent accountants generally consider the working papers confidential and the property of the accounting firm. The CPA may ask that the examiner:

- Sign a document before obtaining access to working papers; and/or
- Review the working papers in the CPA's office.

In the latter case, the auditor may also require the presence of an employee during the examiner's review. With the exception of signing a waiver document, the examiner should cooperate as fully as possible with these practices.

Signing Waiver Document to Gain Working Paper Access

It is NCUA's policy that examiners not sign waiver letters. Most letters go beyond simply acknowledging receipt of the working papers. The letters often contain qualifying language and restrictions on the regulator's use of information obtained in the working papers.

Supervised Access

Reviewing working papers may require significant time and travel when the auditing firm is not local. In such instances, the examiner-in-charge may arrange through the supervisory examiner for another examiner to review the working papers. While auditing firms generally permit examiners supervised access, some will not permit examiners to photocopy original working papers. Regional or national accounting firms often have this policy. An examiner should not take exception to

the denial of photocopying privileges unless it clearly and directly affects the examiner's ability to discern and document the audit's acceptability.

Denial of Access In rare instances, an independent auditor may refuse the examiner access to working papers. The examiner should then contact the supervisory committee chairman for help in getting access to the papers. *NCUA Rules and Regulations* §715.10(b), Working papers, requires allowing the examiner access to original audit working papers. If the auditor still refuses, examiners should notify the supervisory committee that they could rate the auditor's work unacceptable and possibly require the supervisory committee to re-do it. With some of the larger firms, the Office of Examination and Insurance (E&I) can assist in obtaining examiner access by contacting and interceding at the national level.

Examiners should reserve comments about audit working papers until they finish the review and develop an overall picture of the work's adequacy. After completing the review, the examiner discusses the findings with the auditor and the supervisory committee.

Addressing Deficiencies with the Supervisory Committee Examiners should reach specific agreements with the supervisory committee to correct deficiencies during the next audit or verification or within a reasonable time. Examiners should request that the board president invite the chairman or whole committee to the joint conference or exit interview.

Mandatory Auditor Rotation If a credit union has used a particular external auditor for a series of years, and the independence, competence, and level of audit work is otherwise adequate, examiners should not recommend that the credit union routinely rotate external auditors. Examiners should not suggest auditor rotation for rotation-sake. If examiners have concerns about the quality of the audit, they should document these specific concerns and raise them with the supervisory committee. The questioning of a particular auditor's quality of work and citing of §715.11 and §715.12 in applicable circumstances will most likely bring the supervisory committee to its own conclusion to hire another auditor.

**Other
Committee
Duties**

The supervisory committee has responsibilities beyond the audit and verification functions. These additional duties (Chapter 4 of the Supervisory Committee Guide) include (1) resolution of member complaints; (2) strengthening internal controls; (3) authority to call special membership meetings and remove officers, directors, or credit committee members; and (4) reviewing management's corrective action.

**Working
Papers and
References**

- Working papers
 - Scope Workbook
 - Supervisory Committee Questionnaires
(Required) SC - Supervisory Committee Audit and Verification Review; and
(Optional) depending on the type of audit performed:
SC-Financial Statement Audit by CPA;
SC-Balance Sheet Only Audit by CPA;
SC-Examination of Internal Controls over Call Reporting by CPA; and,
SC- Non-Opinion

- References
 - *Federal Credit Union Act*
 - 111 - Compensation
 - 115 - Supervisory Committee
 - *Federal Credit Union Bylaws*
 - Article IV (12/87 and 10/91)– Meeting of Members
 - Article V (10/99) - Meetings of Members
 - Article X (12/87 and 10/91)- Supervisory Committee
 - Article IX (10/99) – Supervisory Committee
 - *NCUA Rules and Regulations*
 - 715 - Supervisory Committee Audit
 - 741.202 – Requirements for Insurance
 - *Supervisory Committee Guide*
 - AICPA Audit and Accounting Guide (relevant to Credit Unions)

OPINION AUDITS - APPENDIX 5A

Reviewing Financial Statement or Balance Sheet Only Opinion Audits

An “opinion audit” expresses an opinion on the fair presentation of the financial statements in all material respects in accordance with generally accepted accounting principles (GAAP). These audits include the following:

- A financial statement audit - the auditor will audit the balance sheet, income statement, statement of equity and other comprehensive income, and statement of cash flows, and will present an opinion on all the statements, taken as a whole; or
- A balance sheet only audit - the auditor will audit the balance sheet and render an opinion. That means the auditor will not audit the income statement accounts, statement of equity and other comprehensive income, and statement of cash flow information.

The objective of an independent, licensed CPA conducting an audit differs from the objectives of an internal audit or an NCUA examination. In unusual situations, the examiner may conduct an in-depth review of the thoroughness and independence of the CPA or the adequacy of the CPA's audit.

The American Institute of Certified Public Accountants (AICPA) establishes standards for thoroughness and independence of CPAs, the auditing standards CPAs must follow in connection with their audits of financial statements, and standards governing CPAs' reports. All CPAs are not members of the AICPA; however, all must follow professional standards adopted, whether by their respective state societies or the state agency issuing their licenses.

Peer Review

Accounting firms receive a peer review (a quality control-type review) performed by another (external) certified public accounting firm on a regular basis (every two to three years). The examiner should request and review a copy of the most recent peer review report. They should note any areas that may trigger expansion of procedures or reduced reliance on the audit and verification.

Professional Standards

GAAS is the standard that an independent accountant's opinion audit must meet. Generally accepted auditing standards¹ (GAAS) fall into three categories: general standards, standards of fieldwork, and standards of reporting.

The general standards require that the person performing the audit:

- Have adequate technical training and proficiency;
- Maintain an independence in mental attitude; and
- Exercise due professional care in the performance of the audit and the preparation of the report.

Review of Independence

CPAs must remain independent of those they serve. Independence is defined as the ability to act with integrity and objectivity. Ordinarily the examiner will not need to test for independence. However, the examiner may occasionally have sufficient reason to question a CPA's independence or the quality of the work.

The examiner should investigate a recent change in CPAs by a credit union, particularly if the change occurred after an audit began.

The examiner should also investigate if the CPA:

- Has a direct financial interest in the credit union;
- Is connected with the credit union in a capacity equivalent to that of a member of management or was a director of the credit union;
- Maintains, completely or in part, the books and records of the credit union and did not perform audit tests with respect to such books and records; or,
- Has received from the credit union an unsecured loan considered material in amount relative to the net worth of the borrower.

In such instances (the above list is not inclusive), the CPA would not have complied with professional standards. Accordingly, the examiner should not rely on any work performed by the CPA without reviewing the procedures followed in the audit. The examiner should perform a

¹ Auditing standards, as distinct from auditing procedures, are concerned not only with the auditor's professional qualifications, but with the judgment exercised in the performance of an audit and with the resulting reports.

review of the CPA's working papers. If the procedures satisfy the Part 715 requirements, the examiner can rely on the work performed.

If an examiner remains concerned that the auditor has not complied with independence standards, the examiner should document these concerns and follow the guidance detailed in the Supervisory Committee chapter. Examiners should not state, either orally or in examination reports or working papers, that they question the CPA's independence.

**Review of
Compliance
with Fieldwork
Standards**

Fieldwork standards require the following:

- Adequately planned work;
- Properly supervised assistants, if any;
- Proper study and evaluation of existing internal controls as a basis for reliance thereon for determining the audit scope and procedures, including the extent of testing; and
- Sufficient evidence to afford a reasonable basis for an opinion regarding the financial statements under audit.

The examiner may occasionally have sufficient reason to question a CPA's thoroughness. If the examiner questions thoroughness, the examiner should not rely on any work performed by the CPA without reviewing the procedures followed in the audit. If the procedures satisfy the Part 715 requirements, the examiner should rely on the work performed.

**Review of
Audit
Procedures**

The examiner should review the last report issued by the CPA. If an audit is currently in progress, the examiner may review the engagement letter, the auditors' risk assessment, and their conclusions and resulting modifications to the audit program.

The examiner should obtain and review any adjusting journal entries suggested by the CPA to determine if such entries are normal recurring accruals or if the entries indicate inadequate accounting records.

**Standards
Governing
Reporting**

The reporting standards deserve particular attention because examiners must understand CPAs and their functions. Reporting standards require that CPAs:

- Conduct their audits in accordance with generally accepted auditing standards (GAAS);
- State whether they presented the financial statements in conformity with generally accepted accounting principles (GAAP); and
- State whether such principles have been consistently applied in the current period in relation to the preceding period.

In addition, the CPA must provide reasonably adequate informative disclosures in the financial statements or otherwise in the report. The report must contain an expression of opinion regarding the financial statements taken as a whole, or an assertion that the CPA cannot express an opinion. The CPA must state in the report any reasons for the inability to express an overall opinion on the financial statements.

When no material exception exists, the CPA will issue an unqualified (clean) opinion. When a material exception exists, but not so material as to negate an opinion on the financial statements taken as a whole, a qualified opinion is appropriate. Judgment in the circumstances determines what is sufficiently material. If the matter relates to the scope of the procedures or the fairness of presentation of the financial statements, the phrase, "except for" normally appears. Only in situations where an uncertainty exists should the auditor use the phrase "subject to". The following circumstances may require departure from the auditor's standard report:

- The credit union has restricted the scope of the audit, or conditions exist that do not permit the application of auditing procedures considered necessary in the circumstances;
- Inadequate disclosure or lack of conformity with GAAP affect the financial statements in that they do not fairly present financial conditions, results of operations, or changes in financial position;
- Consistent application of accounting principles has not occurred;
or
- Unusual uncertainties exist as to the outcome of future events, and the auditor cannot reasonably estimate their effect on the financial statements.

CPAs issue an adverse opinion when the matter to which they have taken exception is so pervasive that the financial statements do not present fairly the financial position, results of operations, or change in financial position, or do not conform to GAAP.

CPAs issue a disclaimer of opinion when either the credit union or circumstances restricted the scope of their examination in important respects, or when uncertainties affect the financial statements.

In the case of a qualified, adverse or disclaimer of opinion, the auditor should set forth all material reasons for issuing the particular report form. As to limitations of scope, the report would specify the omission of any generally accepted auditing procedures and the reasons for the omission. If the credit union requested the omission, the report should so specify.

If examiners remain concerned that the CPA did not comply with general standards, the standards of fieldwork or the reporting standards, they should document the concerns and refer to the section of the Supervisory Committee chapter entitled, "If Compensated Auditor's Audit Appears Lacking" for guidance on how to proceed. Examiners should not state, either orally or in examination reports or working papers, that they question the CPA's competence.

References

- Supervisory Committee Guide
- AICPA Audit and Accounting Guide, Audits of Credit Unions

EXAMINATION OF INTERNAL CONTROL OVER CALL REPORTING BY A CPA - APPENDIX 5B

Engagement Performance

Performing an examination of internal control over call reporting requires that the auditor:

- Plan the engagement;
- Obtain an understanding of internal control;
- Evaluate the design effectiveness of the controls;
- Test and evaluate the operating effectiveness of the controls; and
- Form an opinion on the effectiveness of the credit union's internal control, or management's assertion, thereon, based on the control criteria. (AT 400.16)

Reviewing an Examination of Internal Control Over Call Reporting

The examination of internal control over call reporting differs from an audit of the financial statements in many ways, including the following:

- In a financial statement audit, the auditors' consideration of internal control enables the auditor to plan the audit and determine the nature, timing, and extent of testing they will need to perform. Such work forms the basis for the expression of an opinion on the fair presentation of the financial statements, taken as a whole, in all material respects in accordance with GAAP.
- In an examination of internal control over call reporting, the auditor examines management's assertion about the effectiveness of the credit union's internal control, to express an opinion about whether the credit union maintained, in all material respects, effective internal control as of a point in time based on chosen control criteria.

Accordingly, an auditor's consideration of internal control in a financial statement audit is much more limited than that of an auditor engaged to examine management's assertion about the effectiveness of the credit union's internal control over call reporting.

In examining management's assertions with regard to internal control over call reporting, the auditor can express an opinion on either of the following:

- The effectiveness of the credit union's internal control, in all material respects, based on the control criteria; or
- Whether management has fairly stated its assertion about the effectiveness of internal control, in all material respects, based on the control criteria.

The opinion relates to the credit union's internal control taken as a whole, and not to the effectiveness of each individual component.

A credit union's internal control over call reporting includes those policies and procedures that pertain to the credit union's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the call report. Management may present its assertions about the effectiveness of the credit union's internal control in either a separate report that will accompany the auditor's report or a representation letter to the auditor.

An auditor engaged to examine management's assertion about the effectiveness of a credit union's internal control should comply with the general, fieldwork and reporting standards relative to "opinion audits." (See the Supervisory Committee chapter for additional information.) This appendix also discusses some additional requirements the auditor should perform.

**Management's
Assertion and
Representations**

A sample management assertion might read as follows:

... that ABC Federal Credit Union maintained effective internal control over call reporting as of [date];

or

... that ABC Federal Credit Union's internal control over call reporting sufficiently meets the stated objects as of [date].

For many credit unions, the auditor may help management draft the written assertion, which will become the subject of the engagement.

Management will also provide the auditor written representations, which may include the following:

- Acknowledging management's responsibility for establishing and maintaining internal control;
- Stating that management has performed an evaluation of the effectiveness of the credit union's internal control and specifying the control criteria used;
- Stating that management has disclosed all significant deficiencies in the internal controls that could adversely affect the credit union's ability to record, process, summarize, and report financial data in the call reports;
- Describing any fraud that involves management or other employees who have a significant role in internal control; or
- Stating whether any subsequent internal control changes occurred, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

Management's refusal to furnish all required representations could cause the auditor to qualify or disclaim an opinion in the report.

**Control
Criteria**

By selecting the definition and description of internal control for the purpose of assessing its effectiveness, management determines the components of the credit union's internal control (AT400.12). The internal control framework most often cited, and the one most credit unions will select, based on the advice of their auditor, will most likely be *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. This definition and description of internal control includes the following five components:

- Control environment;
- Risk assessment;
- Control activities;

- Information and communication; and
- Monitoring.

This appendix does not provide an in-depth discussion of these control criteria, or of other control criteria the credit union may use. The management assertion under examination should specify and describe the control criteria management has selected for examination of the credit union's internal controls.

Engagement Performance

Some of the types of auditor functions and documentation an examiner should see when reviewing work-steps and working papers for an Internal Control Over Call Reporting engagement include the following:

- Planning the engagement:
 - Review overall strategy for the scope and performance of the engagement;
 - Understand financial reporting practices, economic conditions, laws and regulations, technological changes, organization, operating characteristics, capital structure, etc.;
 - Review preliminary judgments about materiality levels, inherent risk, and other factors relating to possible material weaknesses; and
 - Review preliminary judgments about the effectiveness of internal control (internal audit function).
- Obtain an understanding of internal control:
 - Inquire of appropriate management, supervisory, and staff personnel;
 - Inspect credit union documents; and
 - Observe credit union activities and operations.
- Evaluate the design effectiveness of the controls:
 - Understand controls within each component of internal control; and

- Focus on the significance of controls in achieving the objectives of the control criteria rather than on specific controls in isolation.
- Test and evaluate the operating effectiveness of the controls:
 - Obtain sufficient evidence to support the opinion and corroborate the results of the tests; and
 - Perform tests of controls to learn the nature of the control, significance of the control in achieving the control criteria, operating effectiveness of the control, risk of noncompliance with the control, etc.
- Form An Opinion:
 - Communicate reportable conditions and material weaknesses.
 - Report should include the following regarding the examination of Internal Control Over Call Reporting by a CPA (AT 400.45):
 - i. Title which includes “independent”;
 - ii. Identification or statement of management’s assertion about the effectiveness of the credit union’s internal control over call reporting;
 - iii. Statement that the assertion is the responsibility of management;
 - iv. Statement that the auditor’s responsibility is to state an opinion with regard to management’s assertion;
 - v. Statement that the examination was conducted in accordance with attestation standards of the AICPA;
 - vi. Statement that the examination provides a reasonable basis for the opinion;
 - vii. The opinion; and
 - viii. Auditor’s signature and date.

Example of Auditor’s Written Opinion

Following is a sample, unqualified opinion as set forth in attestation standards (AT 400.46) that an examiner might see as the product of this type of engagement:

We have examined management's assertion included in the accompanying [title of management report], that ABC Federal Credit Union maintained effective internal control over call reporting as of December 31, 200X based on [identify stated or established criteria]. Management is responsible for maintaining effective internal control over call reporting. Our responsibility is to express an opinion on the effectiveness of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over call reporting, testing, and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over call reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, ABC Federal Credit Union maintained, in all material respects, effective internal control over call reporting as of December 31, 200X, based on [identify stated or established criteria].

References

- AICPA Audit and Accounting Guide (relevant to Credit Unions)

AGREED UPON PROCEDURES ENGAGEMENTS – APPENDIX 5C

Agreed Upon Procedures Audit Performed By a CPA

Supervisory committees may hire CPAs to perform a review that, in conjunction with procedures performed by the supervisory committee, meets the minimum requirements of a supervisory committee guide audit under Part 715 of the *NCUA Rules and Regulations*. Statement on Standards for Attestation Engagements (SSAE) No. 10 guides the independent accountant's performance for this type of engagement.

An agreed upon procedures (AUP) engagement is one in which the credit union supervisory committee engages an independent accountant to issue a report of findings based on specific procedures performed on specified subject matter (elements, accounts, or items of the financial statements.) The supervisory committee and the independent accountant agree upon the procedures that the supervisory committee believes the independent accountant should perform (*Supervisory Committee Guide*, Appendix A sets forth minimum procedures).

Agreement on Sufficiency of Procedures

The supervisory committee has responsibility for the sufficiency (nature, timing, and extent) of the procedures. The examiner reviews the supervisory committee function and the annual audit report for compliance with the *Federal Credit Union Act* and Part 715 of the *NCUA Rules and Regulations*.

Some independent accountants may seek NCUA's written assurance on the sufficiency of the procedures and ask NCUA to take responsibility for sufficiency of the procedures along with the supervisory committee. Examiners should not provide such assurances nor agree to NCUA's being identified as a specified user.

Standards Governing Agreed Upon Procedures by a CPA

Examiners should understand that the general (training and proficiency, adequate knowledge of subject matter, suitability and availability of criteria, independence, due professional care), fieldwork (planning and supervision, obtaining sufficient evidence, representation letter), and reporting standards for attestation

engagements govern the performance and reporting by independent accountants for these types of engagements (AT 101 and 201.)

**Examiner's
Review of
Agreed Upon
Procedures by
a CPA**

The examiner should focus on the following:

- Whether the (combined) scope of work adequately meet *NCUA Rules and Regulations* §715.7, Supervisory Committee audit alternatives to a financial statement audit, and related minimum requirements set forth in Appendix A of the *Supervisory Committee Guide*. (Scope includes aggregate work performed by the supervisory committee, audit work performed by others, and agreed upon procedures performed by a CPA.); and
- Whether individuals performing the work used procedures adequate to fulfill the scope requirements (i.e., can users place full reliance on the procedures performed.)

Scope Review

In reviewing and assessing the adequacy of the audit's scope, the examiner should use good judgment and reasonableness in what they deem acceptable. The *Supervisory Committee Guide*, Appendix A, sets forth the minimum audit scope. NCUA has provided the following in its Guide:

By publishing this Appendix, NCUA is not representing that a supervisory committee which performs or has performed these minimum procedures, and these procedures only, will have fully meet the requirements of Part 715.

The supervisory committee determines the scope of the work based on the risk, exposure, and other circumstances of the individual credit union. The supervisory committee must ensure that the audit meets the minimum requirements of *NCUA Rules and Regulations* Part 715. They cannot delegate that responsibility to a CPA. The engagement letter may omit certain key scope requirements (e.g., assessment of the reasonableness of the allowance for loan losses in the valuation of loans.) Consequently, the CPA may meet the terms of the engagement letter yet the audit scope may lack key scope requirements. The examiner should direct findings and exceptions about scope to the supervisory committee, not the CPA.

If, on the other hand, the CPA did not meet the engagement letter obligation or the examiner has independence or thoroughness concerns, the examiner should follow the procedures outlined in the Supervisory Committee chapter for taking action regarding the independent accountant.

**Review of
Procedures
Performed to
Meet Scope**

Attestation standards limit the procedures independent accountants can perform. They cannot perform procedures open to varying interpretations. Independent accountants should not use terms of uncertain meaning (e.g., general review, limited review, check, or test) to describe the procedures. Examiners should understand this aspect of professional standards when evaluating work steps performed by an independent accountant to meet *NCUA Rules and Regulations* §715.7(c) requirements.

Examples of appropriate procedures include (AT 201.17):

- Execution of a sampling application after agreeing on relevant parameters;
- Inspection of specified documents detailing attributes thereof;
- Confirmation of specific information with third parties; and
- Comparison of documents, schedules, or analyses with certain specified attributes.

Examples of inappropriate procedures include (AT 201.18):

- Evaluating the competency or objectivity of another party;
- Obtaining an understanding about a particular subject; and
- Interpreting documents outside the scope of the auditor's professional expertise.

**Findings and
Working
Papers**

Report standards require independent accountants to present the results of applying Agreed Upon Procedures to specific subject matter in the form of findings. Independent accountants should avoid vague or ambiguous language in reporting findings.

The auditor should prepare and maintain working papers appropriate to the circumstances to support the Agreed Upon Procedures engagement, i.e., quantity, type, and content. Working papers should affirm that the

auditor adequately planned and supervised the work, and obtained evidential matter to provide a reasonable basis for the finding. While the working papers remain the property of the independent accountant (in most jurisdictions), the auditor must maintain them for the NCUA's review, consistent with requirements of Part 715 of the *NCUA Rules & Regulations*.

Example of Auditor's Written Agreed Upon Procedures Findings

Following is a sample written finding of Agreed Upon Procedures as set forth in attestation standards (AT 201.32) and which may serve as the product of this type of engagement:

To the Supervisory Committee and Board of ABC Federal Credit Union:

We have performed the procedures enumerated below, which were agreed to by the supervisory committee and Board of ABC Federal Credit Union, solely to assist you in connection with your supervisory audit of ABC Federal Credit Union conducted pursuant to §715 of the *National Credit Union Administration Rules & Regulations*. The procedures performed by us and enumerated in the attached supplement are in accordance with the minimum procedures described in Appendix A of the National Credit Union Administration's *Supervisory Committee Guide for Federal Credit Unions*. Because the committee is responsible to ensure that a complete set of procedures is performed and because Appendix A procedures are designed for smaller, less complex credit unions, we performed other procedures at the committee's request. This engagement to apply agreed-upon procedures was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of the procedures is solely the responsibility of the specified parties. Consequently, we make no representation regarding the sufficiency of the procedures described in the supplement either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to, and did not, perform an audit, the objective of which would be the expression of an opinion on the specified elements, accounts, or items. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of [the specified parties] and is not intended to be and should not be used by anyone other than these specified parties.

[Signature of Independent Auditor]
[City, State]
[Date]

References

- *Federal Credit Union Act*
 - 115 - Supervisory Committee
- *NCUA Rules and Regulations*
 - 715 - Supervisory Committee Audit
- *Supervisory Committee Guide*
- AICPA Audit and Accounting Guide (relevant to Credit Unions)

NON OPINION AUDITS – APPENDIX 5D

Non-Opinion Audit Con- ducted by the Committee or Its Non-CPA Designee

In an audit performed by the supervisory committee or its designee, the examiner looks for a critical and systematic examination of the internal controls, statements, records and accounting transactions prepared by management. Unlike an audit performed by a CPA, professional standards governing competence and independence do not govern this type of audit. Examiners use similar criteria for reviewing and evaluating non-CPA audits as for reviewing and evaluating a CPA's work.

An acceptable audit satisfies the requirements of *NCUA Rules and Regulations* §715.7 (c), *Audit per Supervisory Committee Guide*, in a particular credit union. An unacceptable audit does not meet the requirements. Exact acceptability standards for audits performed in credit unions do not exist. Examiners must judge the risk and exposure in each case to determine if an audit fulfilled the requirements of *NCUA Rules and Regulations* Part 715.

Examiners must use certain standards in reviewing supervisory committee work. Part 715 of the *NCUA Rules and Regulations*, the *Supervisory Committee Guide*, and the supervisory committee section of the *Examiner's Guide* contain information on these standards.

Appendix A, an important and key section of the *Supervisory Committee Guide*, sets forth the minimum procedures for performing a supervisory committee audit. Examiners should familiarize themselves with the caution expressed in the Foreword language to the Appendix. Also, as part of the review, the examiner should determine if the supervisory committee properly documented the completed audit procedures in working papers included in the audit or verification report (see Working Paper Access section.)

In some cases, minimum audit procedures remain inadequate because of the services or circumstances in a particular credit union. "High risk areas" (e.g., cash operations, share drafts, ATMs, or when a credit union experiences record keeping problems) may require expanding procedures.

Areas experiencing unusual activity or volume, or those containing recently added programs or requirements also may require expanding audit procedures. For example, unusual activity might include excessive amounts charged to officers' and directors' travel expenses for a specific period. Unusual volume might include a 30 percent loan to share ratio with the remainder of the assets invested. The first case might require an expansion of the expense review; the second might require an expansion of the investment review.

References

- *NCUA Rules and Regulations*
 - 715 - Supervisory Committee Audit
- *Supervisory Committee Guide*

Chapter 6

INFORMATION SYSTEMS AND TECHNOLOGY

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Chapter 6

INFORMATION SYSTEMS AND TECHNOLOGY

Examination Objectives

- Evaluate management's ability to recognize, assess, monitor, and control information systems and technology (IST) related risks
- Assess whether the credit union has sufficient expertise to adequately plan, direct, and control IST operations
- Determine whether the board of directors has adopted and implemented adequate policies and procedures
- Determine whether practices comply with established policies and procedures
- Determine adequacy of internal controls and oversight to safeguard assets (including IST assets) and members' information

Associated Risks

- Reputation risk stands out from the others primarily due to the risks associated with introduction of Internet services for credit union members;
- Transaction risk occurs when internal controls do not sufficiently detect errors, omissions, or material misstatements;
- Compliance risk occurs when inadequate systems and lack of controls affects conformity with compliance laws and regulations; and
- Strategic risk occurs when management due diligence has not sufficiently planned for unforeseen events.

Risk-Based Examination Considerations

When determining whether to perform a review of the IST function during an examination, examiners need to understand the associated risks of the systems (hardware and software) used by the credit union, the types of services provided, sensitivity of the data stored, and controls implemented by the credit union to protect the systems and data. Other considerations include:

- Results of the last examination;
- Recent external or internal audit results;
- Results of most recent third-party review;

- Results of the most recent risk analysis and/or penetration test, if conducted;
- Occurrence of security breaches or unauthorized access;
- Filing of a claim or a loss related to IST;
- Material change in services, key personnel, policies, or practices;
- Material change in systems (hardware or software); or
- Change in vendors which provide:
 - Critical systems or services; or
 - Support systems or services for critical systems or services.

Overview

Examiners cannot consider reviewing a credit union's IST function as a separate examination issue. Most credit unions tightly integrate their information processing activities into the functional operation of the credit union. For example, credit unions often use stand alone or personal computers connected to a network to supplement integrated IST functions for such things as audio response systems, loan application and approval functions, credit report retrieval, budgeting, payroll systems, website and e-Commerce systems. The nature and complexity of IST processing may significantly increase the potential risk exposure to disaster, error, or fraud within or outside the credit union or service bureau operation. While the fundamental concepts of internal control (e.g., separation of duties, audit trails, back-up, monitoring, and contingency plans) remain the same in either a computerized or manual system, the techniques and approach required to review these systems differ.

The examiner's primary responsibility in reviewing IST operation is to recognize the procedures and internal controls that minimize the exposure to loss and disruption of service. The following conditions may raise questions about the IST operations of the credit union:

- A board or management unaware or uninterested in IST operations and services;
- Inadequate short- and long-term planning for computer operations;
- Conversion to a new information processing system or modification of an existing system since the previous examination;
- Significant evidence of inefficiency or inaccuracy (e.g., slow daily balancing, delayed closing of books, delayed distribution of members' statements, inaccurate statements or records, etc.);

- Weak physical or internal controls; and
- Negative comments by users (internal and external) of the systems.

Many credit unions use the Internet to provide financial services to their members. This IST environment exposes a credit union to external threats that previously were not an issue (see Appendix 6A for a discussion on e-Commerce issues.) As a credit union's IST environment changes (vendor, hardware, or software), management must re-evaluate the associated risks.

NCUA does not expect examiners to perform a detailed IST review. Based on their judgment, examiners may request additional resources such as an IS&T subject matter examiner (SME), regional office analyst, or central office information systems officer (ISO) for needed assistance. When determining the additional resources required, the examiner should consider the following:

- Associated risks;
- Complexity of products and services;
- Management experience and expertise;
- Asset size; and
- IST vulnerabilities (IST related losses or claims, system penetration, unauthorized access, website defacements, etc.).

Credit unions or others (e.g., CUSOs, vendors) may occasionally ask the examiner to express an opinion concerning specific hardware or software systems for use in credit union operations. NCUA examiners will not make recommendations concerning specific information processing systems or services for purchase, lease, or contracting by credit unions. Credit unions that purchase accounting services must comply with the *NCUA Rules and Regulations*, §701.26, Credit Union Service Contracts.

Processing Environment

Based on the physical location of the computer and the degree of credit union management control over the day-to-day operation of the computer system, credit unions can classify their IST operations into two broad categories:

- **In-house processing** means the computer is located on the credit union premises and credit union management directs the day-to-day operation of the computer. Distinguishing between the two classes of in-house processing depends on the degree of credit union involvement in the programming, system design, and program maintenance efforts required for an on-going IST operation:
 - Turnkey systems are in-house processing systems for which a credit union has no direct responsibility for programming, system design, or program maintenance. Turnkey systems include both the hardware and software necessary to process credit union information. The credit union only furnishes adequate space and personnel to operate the computer; an outside party provides programming and continuing support. The vendor supplying the turnkey system may also arrange training for credit union staff using the system.
 - User-designed systems are in-house processing systems for which the individual credit union retains responsibility for programming, system design, and program maintenance. Even though the credit union may purchase the initial software for a user-designed system, the vendor or systems designer will modify it to meet the credit union's specific needs. Credit unions may purchase hardware directly from the manufacturer or a hardware vendor. The size of these systems can vary widely; they are not limited to large mainframe computers.

Responsibility for programming and maintenance remains the primary distinction between turnkey and user-designed data processing systems.

- **Service bureau processing** refers to information processing services located away from the credit union and managed by an outside party. Credit unions can obtain service bureau processing from several sources, including:
 - Another financial institution;
 - A credit union service organization (CUSO);

- An independent information processing vendor; or
- The credit union's sponsor.

Regardless of the processing source, the distinguishing characteristics of outside processing include the physical separation from the credit union's operations and the absence of direct management responsibility for computer operations.

Controls

IST controls prevent, detect, correct, and enable recovery from problems that can result from accidents, errors, misuse, sabotage, loss of equipment, loss of data, and any other occurrence that may lead to an unwanted or unexpected disruption of service. The three major categories of IST controls are (1) management controls, (2) general controls, and (3) applications controls.

Management Controls

The examiner should have a good understanding of how a credit union manages its information system and services. Similar control issues exist for this area as for those generally found in other operational areas, and they require similar review procedures. Good IST management includes the following:

- **Organization.** A credit union should have a well-defined organizational structure that includes the IST department or service area. Ideally, credit unions should establish IST as a separate entity that reports directly to management and not through another department. The IST department should maintain an up-to-date topology (a visual representation of the hardware layout) to describe how various systems interact and share data.
- **Planning.** The credit union's short- and long-term plans should identify management's direction regarding its IST operation. Management should regularly document, update, and review these plans, which should include well-thought-out designs for installation of new systems and the modification of existing ones. Effective planning includes input from various sources such as a team with representatives from senior management, information technology, human resources or personnel, legal, and customer

service. A diversified team allows for different perspectives in development of IST plans and effective policies and procedures.

- **Policies and Procedures.** The credit union should have well-documented policies and procedures for the IST operation. Management should review and update written procedures regularly. Documentation should reflect the actual practices at the credit union.
- **Monitoring Operations.** The crucial oversight function of IST operations can involve the use of committees such as an IST management committee, IST steering committee, or the supervisory committee.
- **Audit.** Auditing the IST area is a cost of doing business. Credit unions should require regular internal and external reviews of IST operations and services. IST audits or reviews will differ from one credit union to another based on the importance of IST services to the credit union and the credit union's size and complexity.
- **External Requirements.** Credit unions must comply with the laws, regulations, and guidelines of various governmental and regulatory bodies (international laws, federal and state regulations, etc.) as they pertain to the IST operations (see Appendix 6A.)

General Controls General controls apply to areas of an information processing system not specifically related to any one application or function. General control issues exist in any automated environment and remain essential to the proper day-to-day operation of an information processing system. Proper general controls address the following issues:

- **Organizational.** Credit unions should establish and maintain separation of duties, a key element of any IST operation. In an IST environment, good internal controls prevent any single employee from having control over the input, processing, and output of transactions. Compensating controls, such as frequent and detailed review of transaction logs, can help offset weaknesses in this area.

Management should also address other important concerns of an IST environment including personnel issues, such as employment procedures, job descriptions, security statements to help control data, and termination procedures.

- **Systems Design, Development, Modification, Testing, and Implementation**, commonly referred to as System Development Life Cycle (SDLC). Credit unions should document the methods and procedures for developing and testing new and enhanced systems. Implementing these procedures will help maintain the integrity of programmed applications.
- **Data Center Management**. The operation of the data center includes, among other things, the control and scheduling of input and output, problem prevention and correction, and reporting. Credit unions should thoroughly document procedures and regularly update them.
- **Software Controls**. Credit unions must control access to software by unauthorized persons, especially the control and use of the operating system, software utilities, communications, and security packages. Control of production application software helps ensure the system's integrity. System logs are useful tools for monitoring activity and changes to the system if management produces and reviews them regularly.
- **Hardware Controls**. Credit unions should document and enforce external controls on hardware such as access controls, terminal usage, and system support and service. Computers have internal hardware controls, such as validity, parity, and echo checks that most users do not see, however, these hardware controls monitor and check for proper hardware function.
- **Physical Security**. The computer room or area should demonstrate evidence of physical controls such as access controls and logs, fire and theft protection, terminal access controls, and protection of data files and media. Log-on procedures, such as user IDs, passwords, and physical or electronic keys may provide additional access control to the system.

- **Contingency Plan.** The ability to retain, restart, and replace information processing activity quickly is an important control feature of an information processing system. Keys to a well-run and controlled IST operation include a written and tested contingency plan, proper backup and recovery actions and procedures, and management's commitment to contingency planning.

Application Controls

Application controls apply to the processing of data into, through, and out of the computer system. An awareness of IST controls enhances the review of automated parts of the process. While examiners do not extensively review application controls, conditions at the credit union may warrant an applications review. In these situations, the examiner should recommend that management obtain a third-party review.

Application controls consist of the following:

- **Data Origination.** Credit unions should design source documents for easy and accurate data input. Management should properly authorize data before staff enters it into the system. Basic controls of data origination include batch totals, control totals, turnaround documents, and retention of source documents.
- **Data Input.** Controls of data input involve conversion, validation, editing, error handling, and separation of duties.
- **Data Processing.** External data processing controls maintain the operation of the system until completion of the application processing. These controls include system start-up procedures, backup and emergency procedures, error message debugging, and system and job status reporting. Internal processing validation and editing routines built into the programming check for errors. Upon completion of processing, the credit union should have in place error handling procedures to identify and correct transaction errors.
- **Data Output.** Management or staff should use all output from the system. Balancing and reconciliation, distribution, error handling, and records retention procedures (see *NCUA Rules & Regulations* §749 - Records Preservation Program And Record Retention Appendix) complete the application processing function.

Backup and Recovery

A multitude of problems that may cause breakdown, damage and other detrimental effects can plague computer systems. Users may question the integrity of the data in the system when problems occur. Credit unions must regularly and routinely back up computer data. Following are several considerations involved in the backup and recovery of computer information:

- **Frequency.** Credit unions should back up (1) data files at least daily; (2) application files both when they make changes and routinely, usually monthly or quarterly; (3) a current copy of the operating system, and (4) vital records every three months.
- **Generations.** Credit unions should have available at least three generations of backups; however, many credit unions keep five sets of data file backups, one made on each day of the week.
- **Storage.** Credit unions must store vital records offsite, at a location far enough from the credit union's offices, to avoid the simultaneous loss of both sets of records. Credit unions should keep backup files both on- and off-site, one set of backups at each location, in order to facilitate recovery of operations should an event occur.
- **Management.** Credit unions should routinely control, maintain, and test backup files for quality and accuracy.
- **Recovery.** Credit unions should address and document relevant issues such as the speed of data file recovery, who can recover them, and under what conditions.

Contingency Planning

Restoring operations to an acceptable level within a reasonable amount of time requires that all credit unions using any type of IST services have a comprehensive, written, accurate, up-to-date, tested contingency plan. Responsibility for developing this plan lies with management. The examiner may review the contingency plan during each examination.

Credit unions should develop detailed contingency plans. These plans should take into account local as well as region-wide disasters.

Contingency plans should also consider any single point of failure issues (such as telecommunication and data lines, electrical services, etc.) Management should routinely test the contingency plan and document the results of those tests. Where the testing process identifies a failure or weakness, management should correct those issues and retest the plan. Management should ensure the contingency plan addresses the following considerations:

- Notification and contact procedures (staff, vendors, federal agencies, state agencies, local authorities, members, other appropriate third parties, etc.);
- Hardware and software requirements and needs;
- Timeframes, including acceptable downtime for the credit union and the time needed to bring processing services up after a disaster;
- Critical, priority, and support systems;
- Backup and recovery of operating system, application software, and data files;
- Current written documentation;
- Alternative sites for processing;
- Communications needs (telephone lines, fax capabilities, cell phones, data lines (T1, T3, fiber optic, etc.) and capabilities (bandwidth and throughput);
- Employees' knowledge (understanding of their duties and needs) and training;
- Administrative needs and supplies;
- Insurance coverage and requirements;
- Security for the credit union and the alternative sites; and
- Testing.

Examination and Audits

The examination and audits of the information processing and services, including both internal and external reviews, give the credit union assurance that the system's design and operation function as intended. Internally, the credit union should perform, at a minimum, quality and accuracy checks on the system's processing to ensure the presence of at least the minimum control requirements for the type of system in use. Depending on its size, type of system, and complexity, a credit union may need a complete third-party audit. Larger credit unions may need an internal IST auditor to perform routine, recurring reviews of the system.

Based on the risk-focused examination considerations discussed earlier in this chapter, examiners may perform some level of IST review during the examinations of credit unions having automated systems. Most credit unions rely on automated systems. Many credit unions could not operate at their present service level without these systems. The audit software available in AIREs allows for sampling and querying share and loan data. A download from the credit union's system helps the examiner analyze the data in the computer system by allowing the examiner to compare AIREs results with the credit union's reports. Examiners can review records for quality, completeness, and accuracy. Additionally, examiners can compare data from separate sources for consistency, and can summarize and sort data in various ways.

During the IST review, examiners should perform a review of IST management and general controls. Examiners can address review results in one or more of the following ways:

- No recommendations, based on the quality and acceptability of the review;
- Recommendation that management improve certain areas of the IST operation or services;
- Recommendation that management obtain a partial or complete third-party review; or
- Notification to the supervisory examiner of extensive problems in the system.

Service Bureaus

Credit unions that use service bureau operations (also called service centers) to process their information have many of the same responsibilities as those using in-house services. Management can make a serious mistake by relying heavily on a service bureau without providing adequate oversight. Management should recognize and monitor important issues including ownership and control of data, timeliness, accuracy and completeness of information processing functions, contractual obligations, contingency planning, backup and recovery of data files, financial stability of the service bureau, and service bureau audits (financial, SAS 70, etc.)

Examiners should pay particular attention to the contract between the service bureau and the credit union. A written contract must specify responsibilities of both parties. Credit union management must understand the contents of the contract with the service bureau. The provisions often contained in an IST service contract include:

- Specific work that the service bureau agrees to perform, and the frequency and general contents of the related reports;
- The basis of costs, including development, conversion, and processing, together with additional charges for special requests;
- Established time schedules for receipt and delivery of work;
- Audit responsibility, including the right of user representatives to perform audit procedures (such as a SAS 70 Report);
- Backup and record protection provisions (equipment, program, and data files) to ensure timely processing by the service bureau in emergencies;
- Establishment of liability for source documents while in transit to and from the service center (the service center should have adequate insurance coverage for those liabilities for which it bears responsibility);
- Maintenance of adequate insurance for data losses from errors and omissions;
- Confidential treatment of records;
- Ongoing compliance with federal regulations;
- Ownership and escrow of computer programs and related documentation;
- Ownership of master and transaction data files and their return in machine-readable format upon the termination of the contract or agreement;
- Price changes, cost and method of cancellation of the contract, or withdrawal from the servicing arrangement by either party, including adequate time allowance;
- Notification from the service center to the users of all systems of changes that would affect procedures, reports, etc.; and
- Financial information that the service bureau agrees to provide periodically (preferably at least annually) to credit unions.

Outsourcing

Credit unions often rely on third parties to provide and support technology-related functions and services. Outsourcing arrangements

can help manage costs, provide expertise, and expand and improve services offered to members. The credit union may outsource the system or service; however, management ultimately remains responsible for managing the risks associated with the system or service. The following four key points pertain to managing outsourced technology:

- The board of directors and senior management bear responsibility for understanding the risks associated with outsourcing arrangements for technology services and ensuring implementation of effective risk management strategies and practices;
- Once the credit union has completed its risk assessment and determined its risk acceptance level, management should evaluate service providers to determine their operational and financial abilities to meet the credit union's needs;
- Credit unions should require clearly written and sufficiently detailed contracts that provide assurances for performance, reliability, security, confidentiality, and reporting; and
- Credit unions should implement an oversight program to monitor each service provider's operations and controls, financial condition, and performance standards.

(For a more in depth discussion on outsourcing, see NCUA Letter #00-CU-11, *Risk Management of Outsourced Technology Services*.)

Security and Privacy

NCUA developed the security and privacy guidelines in §716 and revised §748 of the *NCUA Rules & Regulations* in response to the Gramm-Leach-Bliley Act (GLBA).

Security

NCUA Rules and Regulations §748.0 requires each federally-insured credit union to develop a written security program. This program must strive to:

- Protect each credit union office from robberies, burglaries, larcenies, and embezzlement;

- Ensure the security and confidentiality of member records, protect against anticipated threats or hazards to the security or integrity of such records, and protect against unauthorized access to or use of such records that could result in substantial harm or serious inconvenience to a member;
- Assist in the identification of persons who commit or attempt such actions and crimes; and
- Prevent destruction of vital records, as defined in §749.

The appendix to §748 provides guidelines to assist credit unions in meeting the above four criteria. The guidelines, while not mandatory, provide a good framework from which credit unions can work to develop their policies and procedures.

Security Policies and Procedures

Credit unions may find the following considerations useful when developing security policies and procedures:

- Identifying the services provided and systems (hardware and software) used;
- Identifying the risks and threats associated with each system and service;
- Determining the likelihood the risk or threat could occur;
- Identifying and evaluating various methodologies to mitigate the risks or threats;
- Developing the policies and procedures to address the risks or threats;
- Monitoring, and adjusting if necessary, the policies and procedures to achieve the desired results;
- Reviewing policies and procedures at least annually; and
- Training and educating staff.

Though not required, credit unions should establish a security team assigned with the responsibility of developing, implementing, monitoring, and revising security policies and procedures. Team members should include representatives from senior management, information technology department, human resources or personnel department, legal department, and customer service department. A diversified team will provide input from different perspectives in

development of effective policies and procedures (see *NCUA Rules and Regulations* §748 and Appendix).

If a credit union demonstrates a weakness in one or more of the preceding steps, examiners should address that concern in a manner consistent with the risk and potential effect on the credit union.

Privacy

Credit unions must ensure their IST policies, procedures, practices, systems design, and operations comply with the privacy requirements in *NCUA Rules and Regulations* §716 (see NCUA Letter #01-CU-02, *Privacy of Consumer Financial Information* for a detailed discussion.) Credit unions must also work with their vendors to ensure that their vendors comply with the credit union's privacy statements.

**IS&T
Question-
naires**

AIRES contains three questionnaires to assist the examiner in performing and documenting the IST review. The purpose and description of each questionnaire is:

- e-Commerce I (EC1). EC1 is a high-level questionnaire designed to assist examiners in their review of credit union e-commerce services. EC1 primarily focuses on credit union management's actions regarding the planning, implementation, and oversight of e-commerce systems and services;
- e-Commerce II (EC2). EC2 is a detailed questionnaire designed to assist examiners in conducting an in-depth review of e-commerce systems and services. Generally, examiners use EC2 when the results of EC1 indicate problems or issues exist which, in the examiner's judgment, warrants further review. EC1 and EC2 have eleven identical major sections allowing examiners to identify concerns using EC1 and then use the corresponding section in EC2 to perform additional examination procedures as warranted. Examiners also use EC2 in large and complex credit unions; and
- Electronic Data Processing Review (EDPR). EDPR is a technical questionnaire designed to assist examiners in their review of credit union IST systems. Generally, examiners use EDPR when they wish to perform a review of a credit union's automated systems

(not just e-Commerce) or, when in their judgment, a review is warranted due to:

- Significant weaknesses noted in IST areas;
- Lack of an adequate internal or external review program for IST systems;
- Lack of adequate management oversight, risk analysis, or risk control;
- Lack of adequate policies, procedures, and practices; or
- EC1 and/or EC2 review results reveal IST concerns regarding e-Commerce systems and services (if concerns exist for e-Commerce systems and services, similar concerns may exist for core processing systems and services.)

CAMEL Impact

Examiners should use the Management component of the CAMEL rating to address IST concerns. As part of this assessment, examiners should consider the following:

- Strategic Plan & Goals:
 - Has management developed a strategic plan for the credit union's IST systems and services?
 - Has management developed strategic goals, policies, and procedures to implement the strategic plan?
 - Are those strategic goals, policies, and procedures adequate in relation to the following:
 - i. Size and complexity of the credit union;
 - ii. Type of services offered;
 - iii. Volume of IST activity;
 - iv. Member demand, usage, and expectations; and
 - v. Criticality¹ of systems and services?

¹ Management should determine whether IST systems and services are critical or non-critical to the credit union's operations. Management should base this determination on factors such as, but not limited to, the following: risk exposure (transaction, security, compliance, reputation, etc.), type of services offered, transaction volume (number and dollar), interconnectivity impact with other credit union technology systems, member usage, and member expectations and perceptions.

- Risk Analysis:
 - Has management performed a risk analysis? If so, does the analysis include the following components:
 - i. Assessment;
 - ii. Impact analysis/evaluation;
 - iii. Mitigation;
 - iv. On-going/periodic monitoring; and
 - v. Reporting procedures?

- Policies:
 - Has management developed appropriate and adequate policies that address the following:
 - i. Security;
 - ii. Compliance;
 - iii. Business continuity/resumption;
 - iv. Disaster recovery; and
 - v. Vendor management?

- Oversight:
 - Does management provide adequate oversight including:
 - i. Adequate staffing;
 - ii. Knowledgeable/informed staff (in IST activities); and
 - iii. Adequate reporting procedures at various management levels?

 - Has the internal and/or external review program been modified to include reviewing procedures for IST activities?

 - Does management address issues/concerns effectively, adequately, and timely?

 - Does management have adequate vendor oversight policies, procedures, and practices?

**Workpapers
and
References**

- Workpapers
 - Electronic Data Processing Review (EDPR)
 - E-Commerce I (EC1)
 - E-Commerce II (EC2)
- References
 - Federal Laws/Regulations
 - Computer Fraud and Abuse Act (CFAA)
 - Electronic Funds Transfer Act (EFTA, REG E)
 - Expedited Funds Availability Act (EFAA, REG CC)
 - Child On-Line Privacy Protection Act (COPPA)
 - Gramm-Leach-Bliley Act (GLBA)
 - Electronic Signatures in Global and National Commerce Act (E-Sign)
 - *NCUA Rules and Regulations*
 - 701.26 - Credit Union Service Contracts
 - 712 - Credit Union Service Organizations
 - 716 - Privacy of Consumer Financial Information
 - 721 - Federal Credit Union Incidental Powers
 - 748 - Credit Security Program, Report of Crime and Catastrophic Act and Bank Secrecy Act Compliance
 - 749 - Records Preservation Program And Record Retention Appendix
 - Regulatory Alerts
 - 01-RA-07 *Children's Online Privacy Protection Act (COOPA)*
 - 01-RA-06 *Regulation E (Electronic Fund Transfers)*
 - 01-RA-03 *Electronic Signatures in Global and National Commerce Act (E-Sign Act)*
 - 00-RA-01 *Electronic Transfers Accounts*
 - 98-RA-08 *Electronic Transfer Act*
 - 98-RA-04 *Interagency Guidance on Electronic Financial Services and Consumer Compliance*
 - 97-RA-12 *Guidance for Reporting Computer-Related Crimes*
 - Letters To Credit Unions
 - 01-CU-04 *Integrating Financial Services and Emerging Technology*

- 01-CU-02 *Privacy of Consumer Financial Information*
 - 00-CU-11 *Risk Management of Outsourced Technology Services*
 - 00-CU-09 *AIRES 2000 Loan and Share Record Layout Specifications*
 - 00-CU-07 *NCUA's Information Systems & Technology Examination Program*
 - 00-CU-04 *Suspicious Activity Reporting*
 - 00-CU-02 *Identity Theft Prevention*
 - 98-CU-12 *Business Resumption Contingency Planning*
 - 98-CU-02 *Year 2000 Contingency Planning*
 - 97-CU-05 *Interagency Statement on Retail On-line PC Banking*
 - 97-CU-03 *Corporate Business Resumption and Contingency Planning*
 - 97-CU-01 *Automated Response System Controls*
 - 96-CU-04 *Internal Control Structure*
 - 109 *Information Processing Issues*
- *Accounting Manual for Federal Credit Unions*
- *FFIEC Information Systems Examination Handbook*
- Websites
- Cybercrime: <http://www.cybercrime.gov/>
 - Computer Crime and Intellectual Property Section (CCIPS):
<http://www.usdoj.gov/criminal/cybercrime/comprime.html>
#CC
 - Federal Computer Incident Response (FedCIRC):
<http://www.fedcirc.gov/>
 - Financial Crimes Enforcement Network (FinCen):
<http://www.treas.gov/fincen/>
 - Federal Trade Commission (FTC): <http://www.ftc.gov/>
 - Internet Fraud Complaint Center (IFCC):
<https://www.ifccfbi.gov/>
 - National Infrastructure Protection Center (NIPC):
<http://www.nipc.gov/>
 - Electronic Privacy Information Center (EPIC):
<http://www.epic.org/>

- Incidents.org-By The SANS Institute:
<http://www.incidents.org/>
- Internet Security Systems, Inc.: <http://www.iss.net/>
- National Institute of Standards and Technology Resource Center: <http://csrc.ncsl.nist.gov/>
- SecurityFocus (BugTraq): <http://www.securityfocus.com/>
- CERT® Coordination Center: <http://www.cert.org/>
- Internet Fraud (IFW):
<http://www.fraud.org/internet/intset.htm>
- Information Technology Association of America:
<http://www.ita.org/>
- SANS Institute Online:
<http://www.sans.org/newlook/home.htm>
- Security & Exchange Commission-Division of Enforcement - Complaint Center:
<http://www.sec.gov/enforce/comctr.htm>

INTERNET AND e-COMMERCE - APPENDIX 6A

Overview

Many credit unions offer services to members via electronic means, often through the Internet and World Wide Web. Electronic financial services pose inherent risks to credit unions. Management must understand those risks and take measures to mitigate them.

Electronic financial services (EFS) comprise those services that a credit union provides via electronic means including, but not limited to, the following:

- Electronic Commerce Systems and Services:
 - Internet/World Wide Web services;
 - Home Banking (direct dial in) Services;
 - Wireless Services;
 - Audio Response/Phone Based;
 - Kiosk; and
 - e-Commerce Account Transaction Processing Services. Online e-Commerce account services include, but are not limited to, the following:
 - i. Account Inquiry;
 - ii. Check Order Requests;
 - iii. Loan Applications;
 - iv. Bill Payment;
 - v. Funds Transfers;
 - vi. Third-Party Transfers;
 - vii. Stop Payment Requests;
 - viii. On-Line Wire Transfers;
 - ix. Automated Clearing House (ACH) Originations; and
 - x. Account Aggregation/Screen Scraping.¹

¹ Account aggregation and screen scraping are two different methods used to gather user account information from various sources and then compile that information in one location for the user.

- Electronic Payment Systems:
 - ACH Transactions;
 - Stored Value Cards;
 - Electronic Money; and
 - Electronic Wallets.

- ATM Systems.

There are three types of website systems:

- Informational. An Informational system displays general information such as loan/share rates, credit union contact information, and privacy notices;

- Interactive. An Interactive system contains features of an Informational website plus members can request information such as share balances, loan balances, account statements, and disclosure statements. Members can complete loan applications, member applications, share account applications, etc.; and

- Transactional. A Transactional system contains features of an Interactive website plus members can initiate and perform transactions such as paying bills, making loan payments, transferring money or funds (between one or more credit union accounts; between the credit union and third-parties), and opening new share accounts.

The introduction of website services (whether hosted internally or externally) exposes a credit union to increased risk. In addition, the type of website affects the level of risk the credit union assumes (i.e., transactional websites generally have a higher level of risk than an interactive website.)

The following four tools will assist examiners in their risk-based approach to evaluating credit union management in the area of electronic financial services:

- e-Commerce I (EC1) - high level e-Commerce questionnaire;
- e-Commerce II (EC2) - detailed review program for reviewing a credit union's e-Commerce activities;
- EDP Review (EDPR) - Electronic Data Processing Review Program for reviewing a credit union's overall information and technology systems; and
- Computer Desktop Encyclopedia computer disk.

AIRES contains the first three tools. The Computer Desktop Encyclopedia is on a computer disk with updates issued periodically throughout the year.

Threats and Vulnerabilities

Credit unions that provide web-based services face additional threats and vulnerabilities. Generally, these concerns arise because the credit union has adopted an "open environment." This is one in which external parties have access to one or more of the credit union's internal systems. Typical threats and vulnerabilities associated with the Internet and web-based services include:

- Eavesdropping or Packet Sniffing;
- Snooping or Downloading;
- Tampering;
- Spoofing;
- Jamming or Flooding (Distributed Denial of Service (DDoS));
- Injecting Malicious Code (viruses and Trojan Horses);
- Exploiting Flaws; and
- Cracking.

Effective policies, procedures, and practices, which address the following, provide the best way to deal with these threats and vulnerabilities:

- Risks assessments;
- Security measures;
- Monitoring requirements;
- Incident response procedures;
- Vendor oversight; and
- Contingency planning and business resumption contingency planning.

Risk Assessments

The credit union should have implemented a risk assessment procedure that enables it to do the following:

- Identify the threats and vulnerabilities;
- Assess the risk (likelihood of occurrence and effect on credit union);
- Establish risk tolerance thresholds (how much given risk is the credit union willing to assume);
- Implement risk mitigation strategies; and
- Monitor and adjust, as needed, risk mitigation strategies on a regular basis.

Security Measures

The types of security measures a credit union employs depends on the types of systems and services it provides, the complexity of those systems and services, the credit union's risk tolerance thresholds, and the experience of IST management. *NCUA Rules & Regulations* §748 delineates the security requirements credit unions must meet and provides guidelines they may employ to meet those requirements. A business decision by the board addresses how the credit union will implement security for its systems and data. When providing web-based services, best practices suggests using the following:

- Routers (to route data to the appropriate destination);
- Firewalls (to filter incoming and outgoing traffic);
- Virus protection (to prevent or control viruses and Trojan horses);
- Intrusion detection (to alert management when an intruder is attempting to breach, or successfully has breached, the credit union's perimeter security systems);
- Vulnerability assessments and penetration testing (to identify and determine weaknesses associated with individual systems and the IST environment as a whole);
- Security bulletin and alert monitoring (to remain aware of new security issues and install new updates and patches in a timely manner);
- Incident response procedures and employee training (to limit damage once an incident has occurred); and
- Vendor oversight program (to ensure vendors and contracts meet the credit union's minimum requirements.)

Monitoring Requirements

Each credit union should establish monitoring requirements for all phases of its IST activities, from monitoring internal systems (e.g., systems log reviews) to monitoring the operations of the vendors. Monitoring procedures allow a credit union to determine what works and what does not. This provides management the ability to make appropriate adjustments to policies, procedures, and practices.

Incident Response Procedures

The credit union's incident response plan should provide assurance that the credit union has the ability to deal with various types of incidents within reasonable timeframes, thus minimizing the risk of loss. Key factors for dealing with incidents include (1) what action to take, (2) when to take it, and (3) how to implement that action. The amount of detail in a credit union's incident response plan should relate to the size of the credit union, the complexity of its operations, and the structure of its IST environment. For example, a credit union operating in a complex in-house developed IST environment would have a different incident response plan from a credit union solely operating in an outsourced environment.

Vendor Oversight

A credit union should establish a vendor oversight program that ensures its vendors meet pre-established criteria such as security and privacy. The credit union should carefully review its vendor contracts to ascertain each party's rights and obligations and to ensure that service level agreements meet the credit union's expectations and needs. If available, credit unions should obtain and review vendor financial statements to determine the short- and long-term viability of their vendors. The credit union should decide whether obtaining a copy of a vendor's SAS 70 or other audit report (if available) would assist in determining the quality of the vendor's management, various controls, policies, procedures, and practices. Credit unions should regularly communicate with their vendors to obtain current information regarding the vendors' hardware and software systems.

Contingency Planning and Business Resumption

A credit union should determine the importance of its web-based services and products to its operations. Based on the level of criticality, the credit union needs to develop appropriate procedures to ensure an incident or disaster will minimally impact, or impact only to a

predetermined acceptable level, member services and credit union operations. Occurrence of an incident or disaster can result in reputation risk, a risk that credit unions commonly overlook. Therefore, credit unions should address not only the disruption of services and potential financial loss (volume and dollar transactions), but also the long-term costs to their reputation and the industry.

**Bond
Insurance
Coverage**

Credit unions should have implemented a risk management program to manage the risks inherent in their operations. Insurance can play a role in mitigating risks to an acceptable level so the credit union can achieve its strategic objectives.

NCUA Rules and Regulations §713, Fidelity Bond and Insurance Coverage for Federal Credit Unions, requires that each federal credit union board review its insurance coverage for adequacy in relation to the potential risks facing the credit union. The board must review the insurance coverage at least annually. A thorough risk assessment process would help determine the adequacy of the coverage in relation to the credit union's activities, including e-Commerce.

A credit union should reevaluate insurance needs whenever it considers a new product, service, or vendor relationship. These may introduce new risks for which insurance coverage may require modification.

Risks associated with e-Commerce are wide-ranging. An insurance carrier's product offerings may cover these risks in various places such as the fidelity bond, electronic computer crime coverage, and other optional coverage. The credit union and, if necessary, the examiner should review each type of coverage closely to determine its adequacy in relation to the credit union's risk exposure. The following types of insurance may cover EDP activities:

- Fidelity bond coverage principally covers the direct loss due to a physical crime such as theft of certain defined property (e.g., negotiable items) stolen by a first party (e.g., employee from an employer);

- Electronic computer crime coverage fills some of the gaps in fidelity bond coverage. It typically covers the direct loss due to an electronic computer crime resulting in the loss of defined property (e.g., negotiable items). Moreover, it can cover the risk of viruses and the manipulation or destruction of data and programs; and
- Other optional coverage fills some of the gaps in the fidelity and electronic computer crime coverage. These may cover indirect losses (e.g., business interruption or resumption and extortion) and expand defined property to include confidential member and credit union data. Some may cover additional related liabilities or expenses (even in relation to external service providers and litigation.)

Coverage varies among insurance carriers. Moreover, carriers often bundle their insurance offerings in different packages with unique marketing names. The coverage afforded by these policies may change in the future based on the insurance industry's perceived risk and claims experience.

Chapter 7

MANAGEMENT

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Chapter 7

MANAGEMENT

Examination Objectives

- Assess management's ability to recognize, assess, monitor, and control risk
- Assess whether the credit union board of directors has sufficient expertise to adequately plan, direct, and control the operations of the credit union
- Determine whether the board and management adequately plan for future conditions and developments
- Determine whether the board is appropriately fulfilling its responsibilities and duties
- Determine whether the board has adopted adequate policies and operating strategies to conduct prudent credit union operations
- Determine whether the board establishes appropriate limits and provides direction before offering a new service or product
- Determine whether operating management has developed procedures to implement board policy
- Determine whether management performs due diligence on new, existing, and planned products and services
- Determine whether management has implemented adequate internal controls to ensure the sound operation of the credit union
- Determine whether management appropriately reports credit union operations and risk information to the board
- Determine promptness of corrective action initiated by management when deficiencies or violations in policies, practices, procedures, or internal controls arise

Associated Risks

Management affects all seven risks found in credit union operations – credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. (The Risk-Focused Program chapter contains a description of the seven risks faced by credit unions.) This chapter will focus on the following risks:

- Strategic risk occurs when management fails to (1) perform adequate due diligence for existing, new, and proposed products and services, (2) act on recommendations included in examinations

and internal/external audit reports, and (3) allocate the necessary resources to adequately manage the credit union in a safe and sound manner;

- Compliance risk occurs when the credit union fails to adhere to applicable laws and regulations; and
- Reputation risk occurs when management fails to meet its fiduciary duties, resulting in poor publicity or administrative action.

Overview

Management is responsible for identifying, monitoring, measuring and controlling (i.e., managing) the risks faced by the credit union. Their ability to manage these risks determine whether the credit union can correctly diagnose and respond to financial stress. Examiners should not assess management solely on the credit union's current financial condition, nor should the management rating be only an average of the other component ratings.

Meeting with Management

Examiners should complete the credit union update questionnaire for guidance in reviewing credit union management, especially when the examiner begins examining the credit union. Examiners may use the list of topics in this section to discuss, observe, and analyze the effectiveness of management. When acquainting themselves with the credit union's activities, the list may aid examiners in engaging the managing official (often the chief executive officer or CEO) and other management in discussions about their respective areas of responsibility. This may assist the examiner in assessing management's effectiveness.

Examiners should conduct a preliminary interview with senior executive officials to discuss items such as the credit union's operations, strategic plan, products, and services. Responses to certain topics or the examiner's observations may trigger expansion of examination scope and, if necessary, corrective action.

The following list is not all-inclusive. Examiners must use their judgment if their observations direct them toward exploring other topics. Depending on the size, complexity, risk profile, and organizational structure of the credit union, examiners will discuss or

observe the following or similar matters with the appropriate management staff:

- Key personnel changes since the previous examination and future plans;
- Significant new or planned programs or services, as well as the extent to which members use existing products and services;
- Due diligence performed by management on new and planned programs and services;
- Significant acquisitions of new facilities and future plans;
- EDP conversions, upgrades or material changes;
- Problems with the sponsors and the field of membership;
- Working relationship with the board of directors;
- Material change in the investment portfolio and future plans;
- Material change in the loan portfolio and future plans;
- Recordkeeping issues (e.g., balanced general ledger, balanced individual share and loan ledgers, cash reconcilements);
- Off-balance sheet risk areas;
- Lawsuits or other contingent liabilities;
- Material changes in key policies or procedures, and future plans regarding policies and procedures;
- Return on assets, capital accumulation strategy, meeting goals;
- Management succession plan;
- Systematic review of policies and procedures;
- Frequent need for borrowed funds;
- Ground rules for dealing with department heads and other staff; and
- Procedures for daily management discussions.

To review credit union management, examiners may consider the following procedures:

- Review the credit union's strategic and business plans and analyze management's integration of risk management with planning and decision making;
- Review responsiveness to examination and audit suggestions and recommendations, and assess corrective actions taken to address risks identified in prior examinations and audits;

- Review the minutes of regular and special board and committee meetings for significant items;
- Review policies and procedures in each area of operation (e.g., lending, investment, personnel, etc.) and ensure that the policies and procedures are updated at least annually;
- Review the credit union's budget, budget assumptions, and budget variance analysis (budgeted items against actual performance);
- Review documentation of management's due diligence regarding existing, new, and planned products and services;
- Review the adequacy of the allowance for loan and lease losses and other valuation reserve accounts;
- Review material contracts signed by management since the last examination; and
- Review and analyze the supervisory committee's annual work plan, including the audit and verification programs and internal control procedures, using the Supervisory Committee Audit and Verification Review questionnaire, to help determine the level of general ledger review. (Refer to the Supervisory Committee chapter.)

**Board,
Committees,
Operational
Management**

The board of directors has the ultimate decision-making authority. It approves policies that direct daily operational management and delegate to staff the authority necessary to fulfill their job responsibilities. (Appendix 4A to the Internal Controls chapter contains a list of management conflicting positions.) The board of directors and management have fiduciary responsibility to the members to maintain high standards of professional conduct.

Evaluating the quality and the effectiveness of management is an important part of the total analysis process and a major examination objective. Examiners evaluate the quality of management by determining the effectiveness of the board of directors, the committees, and operational management. To evaluate board and committee

effectiveness, examiners can review various documentation including board and committee minutes, the credit union's policies, the strategic and business plans, management due diligence, and financial and operational results.

Red Flags

Examiners should be aware of any “red flags” which may indicate that the examiner needs to expand analysis and review of the applicable operations. Red flags as they relate to management may include the following:

- Overly dominant manager;
- Manager or key employee involvement in gambling;
- Manager or key employee not taking regular vacations or always working late hours;
- Nepotism on part of the directors or management;
- Other forms of insider abuse or preferential treatment;
- Limited personnel not conducive to segregation of duties;
- Lack of adequate segregation of duties when the credit union has adequate staffing to achieve such;
- Failure to provide, or delays in providing, standard reports, records, and documents;
- Records maintained at home and not in credit union’s control;
- Management or staff provide copies of documents rather than originals;
- Inactive supervisory committee;
- Lack of, unacceptable, or non-independent audit or verification;
- Inadequate internal controls and information systems (IS) controls;
- No internal review of override of non-financial reports;
- Bank account frequently overdrawn;
- Large amounts of cash in transit;
- High volume of excessive transactions;
- Use of borrowed funds in spite of large cash balances;
- Lack of a fraud policy;
- Extravagant management or employee lifestyle relative to salary;
- Low return on assets or on various asset categories; and/or
- Payment of above market dividends to attract deposits.

**Board
Responsibility**

The board of directors has the following four basic responsibilities:

- Select qualified management and evaluate management's performance;
- Establish, regularly review, and revise as necessary business goals, standards, policies, and procedures;
- Review operating results and performance of new and existing activities; and
- Ensure compliance with applicable laws and regulations, and the credit union's own policies and procedures.

While fulfilling these responsibilities, board members should:

- Operate independently from management;
- Attend board meetings regularly;
- Avoid conflicts of interest and self-serving practices; and
- Ensure the credit union serves the credit and savings needs of its field of membership.

The board of directors and management should comply with all applicable laws and regulations. The board should consider obtaining an attorney's opinion on compliance when implementing new services or products. In addition, the board of directors and management must comply with laws and regulations that promote equal opportunity for all members regardless of race, color, religion, gender, national origin, age, or handicap.

Management must not use the credit union for private gain. They should restrict use of credit union property to authorized activities. Management must act impartially and not give preferential treatment to any individual.

Federal credit unions may not have fewer than five or more than 15 board members. A quorum for board meetings is the majority number (50 percent plus one) of directors that a credit union's bylaws prescribe, even if the credit union has not yet elected the prescribed number.

**Board and
Committee
Minutes**

Minutes of board and committee meetings are a primary source of information by which examiners evaluate a board and its actions. The minutes should support conclusions reached by the officials in the meeting. Analysis of the minutes should enable the examiner to evaluate how the officials and management interact and perform their job responsibilities. This information can help determine the adequacy of management and the effectiveness of the policies. Examiners may use the AIRE Board Minutes document to record information during the review of board and committee meeting minutes. By reviewing the minutes, examiners should be able to determine the following:

- Adequacy of management's reports to the board. Thorough and accurate minutes should cover all aspects of the credit union's operations and should document significant changes to capital, financial performance results, and major credit union activities. Likewise, the minutes should document supervisory committee reports presented to the board.

A board's excessive reliance on benchmark financial statistics rather than on comprehensive financial analysis suggests that the directors may fall short in their oversight of the credit union's affairs. Undue reliance on only a few indicators may result in erroneous conclusions about the credit union's condition. Examiners should determine that reports to directors support complete, understandable, and accurate information appropriate to the size and complexity of the credit union.

The minutes should also include significant actions such as the following (list is not all-inclusive):

- Delegations to management;
- Loan policy changes;
- Increase or decrease to allowance accounts;
- Agreements on collection problem loans;
- Loan rate changes;
- Recordkeeping problems;
- Dividend declarations;
- Consideration of new programs;
- Investment activities;
- Capital accumulation and maintenance policies;

- Approval of charged-off loans;
 - ALM and budget review;
 - Financial statement review;
 - Material fixed asset purchases;
 - Loans to officials;
 - Progress in meeting goals;
 - Review of audit reports; and
 - Compliance with CUMAA requirements.
-
- Oversight of management. Minutes should reflect the board's discussion and approval of major strategic or operating decisions, degree of management's due diligence, and adoption of major operating policies and procedures. Management should obtain board approval before implementing new policies, offering a new service, or engaging in new activities.

 - Attendance and participation. Minutes should evidence attendance by board members. Article VI, Section 8 of the *FCU Bylaws* states that if a director fails to attend regular board meetings for three consecutive months, or four meetings within a calendar year, or otherwise fails to perform the duties of a director, the board may declare the office vacant and may fill the vacancy in accordance with the Bylaws. Minutes should identify board members who ask important questions or make motions to indicate they actively participate in the meetings.

 - Performance evaluations. Minutes should reflect the board's election of officers, its review of management's performance, and its deliberations regarding salaries and compensation for officers and fees for attorneys, appraisers, internal and external accountants, etc.

 - Compliance with board directives. Credit unions should have internal systems to monitor operations and ensure that management takes appropriate actions that conform to board approved policies and directives.

If examiners find missing or incomplete minutes, they should advise the board that minutes comprise vital corporate records that document all board actions.

Annual Meeting

The credit union must hold an annual membership meeting, election, and a reorganizational meeting of the board in accordance with the §110, §111, and §112 of the *FCU Act* and Articles IV and V of the *FCU Bylaws*. Credit unions must adhere to the requirements contained in the specified sections of the Act and Bylaws. Additionally, credit unions should follow *Robert's Rules of Order* to ensure the annual meeting meets the standards of a properly run business meeting. The examiner should review the minutes of these meetings.

Board Appointment

The board must appoint a supervisory committee composed of not less than three, nor more than five, members who are independent of management and free from any relationship that would interfere with the exercise of independent judgment as a committee member. The supervisory committee's responsibilities include performing or causing to be performed the annual audit of the credit union and the biennial verification of member accounts. As such, the supervisory committee's independence from the board, management, and operating personnel is vital. (Refer to the Supervisory Committee chapter for more information.)

In credit unions that do not have an elected credit committee, the board may appoint a credit committee, which in turn, can appoint loan officers. The board appoints loan officers in credit unions that have no credit committee (see Article VI, Section 6 of the *FCU Bylaws*).

The board may also appoint a membership officer, if the board does not choose to act on membership applications themselves. The board should also appoint a security officer.

Depending on the size and complexity of the credit union's operation, the board may also hire an internal auditor (or in the case of a large credit union, an internal audit staff), who monitors and reports on the credit union's operations for compliance with applicable laws and regulations as well as credit union policies and procedures. Ensuring that the credit union has adopted adequate internal controls and that the officials, management, and staff adhere to these controls also falls within the purview of the internal auditor.

Operating Management

The board's most important responsibility involves selecting a capable, competent, and trustworthy manager or chief executive officer (CEO) for the credit union. Officials should define the CEO's duties and responsibilities in writing and then give the CEO the latitude needed to run day-to-day operations.

Ensuring continuity of operations requires an adequate management succession plan. A succession plan helps ensure continuity of the credit union's operation in the event the CEO or another key manager can no longer carry out the duties assigned. Adequacy of a succession plan depends largely upon the size and sophistication of the credit union. Credit unions need succession plans for not only the CEO, but also for other key personnel. An integral part of management succession plans involves cross training of both management and staff to ensure necessary backup for vacant positions.

Management contracts should not contain provisions that may cause hardship to the credit union (e.g., salary increases tied to asset growth, salary not commensurate with asset size, unreasonably long contracts, golden parachutes, and unreasonable termination provisions.) The board must implement and adhere to performance standards for the CEO and senior management and should provide written evaluations of performance at least annually.

Policies and Procedures

The board adopts policies to direct the credit union's activities. Procedures represent the methods by which the credit union implements the policies. Operating policies and procedures establish management's strategy for realizing the credit union's goals, and they provide a basis for gauging performance.

The board must provide a clear framework within which the CEO can operate and administer the credit union's affairs. This includes setting forth the credit union's business strategy in the business plan, investment and loan policies, capital planning, funds management, and risk management. The board must approve all major policies. Further, it should review and, if necessary, update those policies at least annually.

Board policies and procedures should meet the following parameters:

- Exist for all major phases of the credit union's operations;
- Establish and provide guidance and direction for a credit union's operations;
- Suffice for the credit union's operations and risk profile; and
- Provide guidance and promote controlled and efficient operating practices.

**Board
Oversight of
Operating
Management**

The board of directors must ensure that operating management has procedures in place to implement board-adopted policies. If applicable to the size, complexity and operation of the credit union, operating management's responsibilities include the following functions:

- Implementing the board's policies;
- Providing periodic reports and analysis to the board concerning policy compliance, such as interest rate risk (IRR) exposure reports, earnings projections, and capital projections;
- Reviewing the board's policies periodically and, when appropriate, suggesting changes;
- Managing the operations and staff to achieve the goals and objectives set forth by the board;
- Establishing operational procedures;
- Supervising investment portfolio management activities, including investing excess liquid funds in instruments that complement the credit union's overall risk/return profile;
- Maintaining an awareness of the economic and interest rate environment, particularly local economic conditions, prepayment trends, volatility, and related regulatory developments;
- Reviewing asset quality, including trends in delinquencies, non-accrual loans, real estate owned, charge offs, and recoveries. Also reviewing the adequacy of reserves and quantifying the effect of non-performing assets on the risk/return profile;

- Developing, reviewing, and monitoring capital, business, and strategic plans, and ensuring integration of these plans into the budgeting function. Also, generating variance, rate, and volume analysis reports;
- Providing adequate support, planning, and oversight when the credit union enters new business ventures, CUSOs, or new products and services. Performing due diligence, including cost-benefit analyses of new products and services throughout the planning stages. Ensuring that product development activity and pricing coincide with the credit union's overall risk/return profile. Setting specific standards concerning risks and assumptions;
- Managing capital market activities, debt issuance, dividend policies, and merger and acquisition analysis within the credit union's overall risk/return profile; and
- Ensuring that the credit union's services, products and pricing support its overall risk/return objectives. Periodically performing due diligence, including cost-benefit studies of credit union's services, business ventures, and products and comparing the credit union's pricing to that of its competitors.

Risk/Return Tradeoff

The board and management must realize that the credit union can generate higher returns in any given economic environment only if it takes on greater risk; this is the risk/return tradeoff. The choice between these two alternatives relates to the management of all the credit union's financial functions. The board should analyze risk/return tradeoffs in both its planning and decision-making processes.

Examiners should not criticize management for merely taking risks. Rather, the examiner's role is to evaluate management's ability to identify, measure, control, and monitor the risk.

Financial Management

At the direction of the board and in conformance with the credit union's goals and strategic plan, management should develop, and the board should approve, financial and operational policies appropriate to the size and complexity of the credit union, including:

- An annual operating budget supported by specific written assumptions and a pro forma balance sheet;
- An investment policy complying with Part 703 of the *NCUA Rules and Regulations* (see the Investment chapter);
- Written lending and collection policies that comply with NCUA's Rules and Regulations, Federal Reserve Board regulations, and other applicable federal and state laws (see the Loans chapter);
- An ALM policy providing for adequate profitability, cash flow and monitoring (see the Asset-Liability Management and Liquidity chapters);
- Periodic cost-benefit analysis on major services including CUSO and branch operations;
- A growth policy consistent with the credit union's net worth needs and potential risks; and
- Procedures to address material risk presented by off-balance sheet items (e.g., letters of credit, bonds borrowing, CUSOs, any contingent liabilities).

The directors must review and give final approval to the policies and budget developed by management. Realistic policies and budget should contain adequate controls to safeguard the credit union's assets, and should correlate with the strategic plan. Examiners should review expenses, including salary increases and dividend payouts, in a credit union experiencing unstable or declining levels of capital or earnings.

**Personnel
Management**

The examiner should determine that the board has approved the following, as appropriate for the credit union's size and complexity:

- Written personnel policies that address (and include a training program) among other things, sexual harassment, violence in the workplace, and dealing with the media;

- Written, detailed position descriptions and performance standards for all employees including top management;
- Carefully planned recruiting and screening of new employees;
- Appropriate training for credit union management and staff;
- Salary administration;
- Annual written performance evaluations of all employees, including top management;
- Internal controls for all key areas of operation including information systems, segregation of duties, audit program, recordkeeping, liquidity contingency plans, and disaster recovery;
- Written procedural manuals for all areas of operation;
- Provisions for communication;
- A fraud policy that includes appropriately filing necessary SAR forms;
- A management succession plan that addresses the steps necessary for finding a new manager or president for the credit union should termination, retirement, or resignation of the current manager/president occur; and
- An on-going concern plan that addresses possible alternatives that management will implement if the sponsor ceased or significantly reduced operations. Such a plan is especially critical in one-sponsor credit unions. Examiners should encourage management of one-sponsor groups to develop written contingency plans that include consideration of changing the credit union's charter to allow for expansion and diversification.

**Service to
Members**

Management's efforts to educate the membership play a key role in the credit union's ongoing success. Educational materials discussing the

history, philosophy, and uniqueness of the credit union industry may foster participation and loyalty by current and potential members.

The goals of credit unions are diverse. They include:

- Meeting the financial service needs of members;
- Providing access to low-cost lending programs; and
- Providing secure savings accounts.

Management must recognize demographic changes and the effect these changes have on the services needed to keep the credit union competitive. When reviewing service to members, examiners should consider the following areas:

- Loan to share ratio. Examiners should look closely at credit unions with low loan to share ratios (particularly where safety and soundness concerns are associated with low loan to share ratios) to determine management's efforts to promote and generate loan demand.
- Market penetration. The future success of the credit union largely depends on management's efforts to promote membership and services to all potential members.
- Rate structure. A credit union's future success also largely depends upon the board setting and maintaining competitive rates.
- Management due diligence. This includes cost-benefit analyses of new, existing, and planned products and services, including branch operations and CUSO activities. The cost-benefit studies should include whether an equitable assessment of fees to members for the various services exists.

Planning

To anticipate and address rapid changes that may affect a credit union's operation, effective management requires dynamic planning that encompasses the officials' and management's shared perception of future actions.

Planning, which requires a structure and a process, falls within two classifications: strategic and operational. Strategic planning focuses on the long-term, extensive allocation of resources to achieve the credit union's goals and objectives. Operational planning (e.g., business plan) concentrates on shorter-term actions designed to implement the strategies outlined in the strategic plan. The operational plans flow logically from the strategic plan.

The credit union should carefully monitor and document the planning function, and periodically revise projections as circumstances change. Examiners should watch for deviations in strategic or operational plans that may potentially harm the credit union (e.g., excessive use of brokered funds; initiating higher risk lending or investment programs without proper planning, experience, or controls; failure to investigate and document extensions of credit; and willingness to forgo long-term stability for short-term profits.)

Following are some key elements of a successful planning process:

- Strong commitment from the board and management;
- Meaningful engagement in the process from key stakeholders;
- Development of measurable goals, including a series of short-term goals;
- Development of strategic objectives;
- Clearly defined responsibility, authority, and accountability;
- Efficient and effective operational processes;
- Necessary managerial, financial, technological, and organizational resources to achieve goals and objectives;
- Policies, internal controls, staffing, training, and management information systems to support each area of operation and overall objectives;
- Communication of goals, objectives, and detailed business plans throughout all levels of the organization; and
- Periodic reassessment of the progress and effectiveness of the strategic plan.

Strategic Plan

Consistent with the credit union's size and complexity, the board of directors should establish a strategic plan that documents management's course in assuring that the credit union prospers in the

next two to three years. At a minimum, this plan should outline the credit union's future direction and the optimal capital position relative to share and asset growth.

The strategic plan encompasses all areas of operations and often sets broad goals. It enables the credit union to maintain a well thought out focus, make sound decisions, and may help identify risks or weaknesses within its operation that an economic downturn may magnify. An integral part of the strategic plan should include strategic goals addressing the credit union's information systems and technology. This assessment should address the following:

- Evaluating the types and volume of e-Commerce services the credit union offers or plans to offer (e-Commerce services include those a credit union provides, and members access, via electronic means including, but not limited to, internet and world wide web services, home banking services, online bill paying services, account aggregation, and account transaction processing services);
- Determining the importance of the e-Commerce systems and services to the credit union's operation (e.g., website systems, home banking or PC based systems, audio response or telephone based systems, wireless systems, and kiosk); and
- Determining proper levels of monitoring and oversight of the information systems area, given the size and complexity of the credit union.

Examiners should review the credit union's planning function and goals as they relate to the credit union's risk profile and operation, including its policies, procedures, and budget. They should also review the goals that address the information system as it exists and as the credit union plans for changes in its products and services.

Business Plan

Consistent with the credit union's size and sophistication, management should establish a business plan for the next one to two years that implements the strategies outlined in the strategic planning process. Smaller credit unions with a simple balance sheet may have a short, concise, written business plan, while credit unions with more

sophisticated operations should have an extensive and detailed business plan.

Before approving the business plan, the board should ensure its consistency with the strategic plan. Likewise, examiners should review the business plan in relation to the strategic plan to determine their consistency.

The business plan should incorporate the following five steps:

- An assessment of the environment in which the credit union will operate over the medium term. The credit union should evaluate its risk profile and the external and internal factors influencing its business, including (1) economic and regulatory issues, (2) its membership base, (3) its competition, and (4) its competitive opportunities. The credit union should plan for different scenarios such as high and low interest rate environments, full employment, and layoffs.

Essential to this assessment is the credit union's charter type, which will fall within one of the following (see §109 of the *FCU Act* and IRPS 99-1 for further details of available charters):

- Single common-bond – one group that has a common bond of occupation or association;
- Multiple common-bond – more than one group, each of which has a common bond of occupation or association; or
- Community – persons or organizations within a well-defined, local community, neighborhood, or rural district.

From this assessment, officials define measurable key objectives and the acceptable level of risk that management is willing to assume in attaining the goals. Management documents the plan's assumptions and ensures consistency of the budget, policies, procedures, and resources with the plan's objectives. The examiner should determine that management knows of the different types of charters, and should assess management's effectiveness in developing and implementing the business plan and achieving established objectives.

- A clear, written statement of key objectives. These objectives should have the following characteristics:
 - Consistency with the strategic plan, addressing the results of the credit union's analysis of external and internal factors;
 - Measurability, including details of the mechanism the credit union will use to measure progress against the established objectives; and
 - Expression in terms of income and expense paths, projected balance sheets, and other performance indicators, accompanied by a clear statement of the acceptable level of risk that the credit union assumes in achieving the plan and the need for sufficient capital to support any risk-taking.
- Consistency with federal and state laws and NCUA regulations.
- Communication of the plan's objectives to management and staff to assure adherence to both the business plan and strategic goals.
- Implementation of the plan. The credit union's policies, procedures, and resources (employees, capital, equipment, marketing, and member relations) must support achieving the business plan's objectives. Financial performance provides a strong indicator of the credit union's viability. Therefore, the credit union's performance in achieving its plans influences the management rating.

Examiners should evaluate the business plan in light of the strategic plan to determine consistency of the plans. They should also assess whether the credit union has implemented the plan and whether the plan operates as the board intends.

**Net Worth
Restoration
Plan**

The board must prioritize maintaining an adequate level of capital for the credit union. Prompt corrective action may require development of a net worth restoration plan (NWRP) when a credit union becomes less than adequately capitalized. A NWRP addresses the same basic issues as does the business plan. The board must consider the credit union's

size, complexity of operations, and field of membership when developing its NWRP. The board should specify in the NWRP the steps the credit union will take to become and remain adequately capitalized. If the credit union requires a NWRP, the examiner will review the credit union's progress toward achieving the goals set forth in the plan. (See the Prompt Corrective Action chapter).

**Material
Contracts**

As part of determining the safety and soundness of the credit union, examiners may review all material contracts entered into by the credit union during the examination period. The extent of analysis will depend on the effect on the credit union of the contracts, either singularly or collectively. Examiners should assess the credit union's ability to fulfill the terms of long-term contracts. Examples of material contracts can include management contracts, agreements with an information processing servicer, or long-term leases on land, building, or equipment.

The examiner must understand that management agreements are confidential documents. Examiners will not disclose the terms of such agreements to anyone outside NCUA, and will disclose management agreement terms to persons within the Agency only when necessary to promote the safety and soundness of the credit union's operation.

Examiners should discuss questions concerning legality with the officials, the supervisory examiner, or the regional office, as appropriate. Examiners should send unresolved legal questions to the regional office, accompanied by a copy of the contract.

**Executive
Compensation**

Appropriate compensation policies and practices for management and staff include defining and implementing performance standards, and providing written annual performance evaluations prior to salary adjustments. The compensated director, senior management personnel, and staff should receive reasonable compensation commensurate with their duties and responsibilities. Compensation includes any payment of money or other items of value in consideration of employment including the following:

- Base salary;
- Commissions;
- Bonuses;
- Pension and profit sharing plans;
- Severance payments;
- Retirement;
- Director or committee fees;
- Automobile; or
- Fringe benefits.

The *FCU Act* §112 only permits compensation for one elected official. Credit unions must specifically name this position (often the Treasurer or Chief Financial Officer) in the Bylaws. Other elected official positions are volunteers. Even though the credit union may not pay its directors (except for one), it may provide or reimburse them for items such as the following:

- Mileage;
- Insurance (including reasonable life, health, and accident insurance); and
- Travel expenses.

Officials should understand their fiduciary responsibilities when establishing reimbursements, fees, and benefits for themselves. Each director should understand the importance of their responsibility for establishing policies that protect the assets of the credit union.

Credit unions can enter into employment contracts with officers and other employees with the specific approval of the board of directors; however, credit unions may not enter into contracts that constitute an unsafe or unsound practice. Unsafe or unsound practices could lead to a material financial loss or damage.

Examiners review compensation expenses for reasonableness, just as they do other credit union expenses. Examiners usually defer to the board's decision concerning executive compensation arrangements. However, if a troubled condition exists in the credit union or it experiences earnings problems that could present significant safety or soundness concerns leading to material financial loss or damage to the credit union, the examiner should address the problem.

Examiners should consider all of the CAMEL components in their review of employment contracts and other compensation arrangements. Examiners should ensure that the board annually reviews all employment contracts and compensation arrangements for senior management personnel. Board minutes should document justification and approval of these reviews. Likewise, renewal or extension of employment contracts requires board approval. Any director who has a personal interest in the compensation arrangements should not participate in the deliberations or vote on the arrangements.

**Unsafe and
Unsound
Compensation
Practices**

While examiners generally should not require changes to compensation arrangements in healthy credit unions, they should note, when appropriate, unsafe and unsound compensation practices. The examples below (not all-inclusive) provide illustrations that may constitute unsafe or unsound compensation provisions:

- Compensation arrangements that provide incentives contrary to the safe and sound operation of the credit union. For example, compensation based primarily on short-term operating results may encourage unreasonable risk-taking to achieve short-term profits. The board should closely monitor compensation tied to current operating results;
- Compensation arrangements that significantly exceed compensation paid to persons with similar responsibilities and duties in other insured credit unions of similar size, in similar locations, and under similar circumstances, including financial health and profitability;
- Contracts that contain automatic renewals or extensions without providing for the board's explicit review and approval;
- Contracts that provide for an excessive term. Generally, a term should not exceed three years;
- Compensation arrangements that provide for excessive total compensation paid out upon the departure of an employee, regardless of the reason (e.g., three times the employee's average annual compensation for the prior five years.) Credit unions should

not make any payment when termination is for cause. Total compensation includes payments for the remaining contract term, if applicable, as well as any severance payments;

- Contracts that do not adequately reflect or define the duties and responsibilities of the employee;
- Compensation programs (including deferred compensation, retirement, and insurance) not commensurate with the duties of the employee (e.g., vesting requirements that force an employee to forfeit previously accrued amounts if they do not serve for a minimum number of years);
- Contracts that the credit union collateralizes or otherwise guarantees, unless the terms provide that the contract is unenforceable if the credit union becomes a troubled credit union or the regional director approves the contract;
- Contracts that provide for employer reimbursement of costs that employees incurred seeking to enforce employment contract terms in the absence of legal judgment or settlement;
- Change in control provisions that provide for immediate vesting, particularly for credit unions in a troubled condition;
- Contracts that require payment upon the voluntary resignation of the employee; and
- Contracts that contain golden parachute provisions, including provisions such as:
 - The credit union makes a payment to a person affiliated with the credit union and contingent on this person's resignation; and
 - The credit union makes the payment while it is in troubled condition.

**Directors'
Conduct**

Directors must continually remain aware of the credit union's obligation to serve its members. Examiners should recognize self-serving practices that include the following:

- Gratuities to directors to obtain their approval of financing arrangements;
- The unauthorized or inappropriate use of credit union services;
- The use of credit union funds by insiders to obtain loans or transact other business; and
- Transactions involving a conflict of interest.

Conflicts of Interest

Conflicts of interest (or the appearance of such) can adversely affect a credit union's profitability and reputation risk and can undermine member confidence. Officials have a fiduciary duty to avoid advancing their own personal or business interests, or those of others with whom they have a personal or business relationship, at the expense of the credit union. Thus, officials must avoid conflicts of interest of any sort, or even the appearance of a conflict of interest. They should also avoid nepotism.

The sale of assets to insiders, including fixed assets, repossessed assets, OREOs, and foreclosures, can constitute a conflict of interest and may carry additional reputation risk to the credit union and a potential cost to the share insurance fund. The sale of assets to insiders raises the possibility of negative public perception of such transactions. Insider sales may appear as sweetheart deals, even if economically sound. Credit unions must ensure that sales of covered assets occur as arms-length transactions.

The credit union should have a specific plan for dealing with conflicts of interest, including implementation of controls for avoiding abuses and procedures for dealing with policy violations. The examiner should determine if directors and management comply with the policy and, if not, comment in the examination report and take appropriate action on actual or apparent conflicts of interest.

On rare occasions, examiners may request additional information about related organizations or individuals, in order to properly analyze the financial situation of a credit union. If they do not receive the information, the examiners should contact the supervisory examiner for assistance in working with the regional office. If necessary, the Office of General Counsel may issue an order of investigation and an administrative subpoena.

**Use of
Consultants**

The board of directors must justify and approve contracts that the credit union enters into with third parties. The board may delegate this responsibility to the CEO. Hiring consultants to perform some functions does not remove responsibility for decisions regarding credit union operations from the board and management. The board should adopt a policy requiring management to obtain bids when contracting with third parties on behalf of the credit union. A cost-benefit study may help management determine if performing the job using consultants would result in more cost efficiency and benefit to the credit union than performing the job in-house. The board should reach agreements with the consultants on what output the consultant will provide and should develop reports that will track that output.

Management must use care in contracting with outside parties that propose to provide business plans or financial models at no direct cost to the credit union. These vendors often expect the credit union to transact business with them on an exclusive basis, and management may feel an obligation to do so. Contracting with such parties could lead to proposals or transactions that do not serve the credit union's best interest.

Management should guard against excessive reliance on outside consultants and should remain wary of overly simplistic assumptions. Credit unions sometimes hire third parties, such as consulting firms, investment brokers, lawyers, accountants, information systems and technology specialists, or other professionals to provide services not usually required in the normal course of business.

**Political
Contributions**

The board of directors is responsible for authorizing any political activity by a credit union.

The Federal Election Commission (FEC) administers, interprets, and enforces the *Federal Election Campaign Act of 1971* (the Act) as amended (2 USC §431 et seq.) The FEC regulations, 11 CFR Part 100 et seq., contain implementing regulations that govern political contributions of credit unions in connection with any election, whether federal, state, or local.

The FEC regulations generally prohibit a federal credit union from making political contributions and expending funds for political communications. However, an exception may apply when a federal credit union acts as a collecting agent for a separate segregated fund or political action committee. The FEC regulations, under 11 CFR §114, describe the rules and special restrictions for collecting agents. Federal credit unions that serve as collecting agents must also comply with reporting requirements imposed by the FEC under 11 CFR §102. Directors should consult legal counsel regarding questionable activities related to political contributions and loan expenditures on behalf of any political candidates or committees.

Besides the requirements of the Act and FEC regulations, state and local political activity laws may also govern credit unions engaged in such activity.

Examiners should report apparent violations and, when appropriate, forward them to their supervisor. NCUA may forward the referral to the FEC for enforcement action.

Credit unions may request an FEC advisory opinion from the:

Federal Election Commission
Office of the General Counsel
999 E Street, N.W.
Washington, D.C. 20463

**Other Areas
of Review**

Examiners should include in the review of management:

- **Management Official Interlocks.** §711 and §741.209 of *NCUA Rules and Regulations* address management official interlocks. These sections generally prohibit a credit union management official from serving two nonaffiliated depository organizations in situations where the management interlock would likely have an anticompetitive effect.
- **Indemnification Payments.** A credit union may indemnify its directors, officers, and current and former employees (see §701.33(c)) for liabilities or legal expenses when the director,

officer or employee is subject to an enforcement proceeding as a result of their official duties.

A credit union that elects to provide indemnification must specify whether it will follow applicable state law or the relevant provisions of the *Model Business Corporation Act*. Indemnification and the method of indemnification may be provided for by charter or bylaw amendment (must be approved by NCUA), contract, or board resolution, whichever state law or the *Model Business Corporation Act* permits.

The rule permits credit unions to buy commercial insurance on behalf of its officials and employees to cover liabilities and expenses resulting from performance of their official duties if applicable state law or the *Model Business Corporation Act* permits such insurance.

Internal Controls

The *FCU Act* gives the board responsibility for the general direction and control of the credit union. This responsibility includes the proper and profitable conduct of credit union operations, the safety of credit union assets, and the accuracy and adequacy of financial statements. Since the directors do not normally perform the work resulting from these responsibilities, the employees normally act for them. Thus, it is crucial that the board establish internal controls sufficient to ensure that management and staff carry out the organizational plans and operating procedures according to the board's expectations.

Sound internal controls mitigate the credit union's risks by enhancing the safeguards against system malfunctions, fraud, and errors in judgment. Although a credit union's controls often receive careful review and evaluation, they remain an area of major concern. Without proper controls in place, management cannot identify and track its exposure to risk. Controls also enable management to ensure that staff operates within the parameters established by the board and senior management.

The following aspects of internal controls deserve special attention (see the Internal Controls chapter for additional information):

- Information systems. Credit unions need information systems that can quickly and efficiently sort and assemble information. Effective controls will ensure the integrity, security, and privacy of information contained on the credit union's computer systems. A tested contingency plan provides protection in the event of a failure of the credit union's information system.
- Segregation of duties. Ideally, credit unions have adequate segregation of duties and professional resources in every area of operation; however, the number of employees in smaller credit unions may limit this control.
- Audit program. Examiners should review the credit union's audit program to determine the credit union's compliance with board policy. A sound audit function and process requires independence, with the auditors reporting to the Supervisory Committee without conflict or interference from management. An effective annual audit plan ensures examination of all risk areas, with those of the greatest risk receiving priority. The auditors (both internal and external) normally issue their reports to management for comment and action, then forward the reports to the board with management's response. The auditors follow up on unresolved issues (e.g., examination exceptions) and cover these issues in subsequent reports. The Supervisory Committee's responsibilities also include performing a verification of members' accounts at least once every two years.
- Recordkeeping. Credit unions with assets of \$10 million or greater must file their call reports in accordance with generally accepted accounting principles (GAAP), which means most will keep their books and records consistent with GAAP. The records and accounts should reflect the credit union's current financial condition and results of operations, and provide an audit trail containing sufficient documentation to follow a transaction from its inception through its completion. The credit union's subsidiary records should balance with the general ledger control accounts.
- Protection of physical assets. Safeguarding assets requires limiting access to those assets to authorized personnel. Credit unions can protect assets by developing and implementing operating policies

and procedures for cash control, joint custody (dual control), teller operations, and physical security of equipment.

- Staff education and training programs. Credit unions should implement training programs for staff in specific daily operations, as well as in credit union industry philosophy. Credit union training programs should meet management's needs and cross-train staff.
- Succession planning. The ability to fill key management positions in the event of resignation or retirement could affect the credit union's ongoing success. A detailed succession plan that provides for trained management personnel to step in at a moment's notice enhances the credit union's long-term stability. A succession plan should address the CEO and other senior management positions.

Fidelity Bond and General Insurance

Credit unions must maintain adequate fidelity bond and directors' and officers' insurance coverage. Management is responsible for assessing the credit union's insurance and bonding needs; however, the board must formally approve the coverage, including any riders or endorsements. The board should evaluate the adequacy of the credit union's insurance coverage at least annually. In determining insurance and bond requirements, the board should consider items including the following:

- The size of the credit union's asset portfolio and share base;
- The effectiveness of the internal controls;
- The amount of cash, securities, and other property that the credit union normally holds;
- The number of employees, their experience level, levels of authority, and turnover rate;
- The reliability and security of the information system (IS); and
- The types of services offered.

If the credit union's office is located on the sponsor's property, the sponsor's insurance policies may cover risks related to property and liability. However, management should maintain written evidence of current insurance coverage, including the types of insurance, the benefits provided, and the limits on coverage. The credit union may

need to supplement existing insurance. If the credit union has relocated since the last contact, the examiner should determine that the credit union identified and properly insured any new risks.

Bond coverage provides protection against loss resulting from employee or director dishonesty or lack of faithful performance. Generally, a bond covers losses from burglary, robbery, larceny, theft, mysterious disappearance, forgery, counterfeit money, and other perils. Various optional endorsements to the bond include directors' and officer's liability, audit expenses, safe deposit box, consumer legislation, plastic cards, ATM, EFT, ACH, IRA, errors and omissions, and officer and staff coverage. (For additional surety bond information, refer to the Bond Coverage chapter in this Guide.) Safety and soundness concerns may arise if a credit union with minimal reserves or high exposure to risk lowers its bond coverage in efforts to reduce expenses.

Listed below are the most common types of insurance coverage (often included in the credit union's "package of protection") that a credit union might need:

- Property and Related - coverage protects against physical loss to buildings, business property, information processing equipment, mechanical equipment, etc.;
- Financial - coverage for financial records (destruction), real estate errors and omissions, single interest-financed property, chattel lien non-filing, etc.;
- Liability - coverage for bodily injury and property liability exposures of the credit union arising from the use of the premises, building, or business activities;
- Worker's Compensation - coverage, if required by state law, to indemnify employees who are injured or killed in the course of their employment;
- Group Accident - coverage for qualified employees and credit union officials, which pays a specific sum in case of death, dismemberment, or permanent disability;

- Insurance for Members - coverage includes various group or individual programs such as loan protection, life savings, credit disability, and accidental death and dismemberment;
- Employee Benefits - coverage provided for employees such as group life, health, and retirement. Appropriate fidelity bond coverage for pension and retirement programs administered by the credit union should exist; and
- Fiduciary Liability – coverage required if the credit union acts as a fiduciary in connection with an ERISA-covered plan when providing pension and deferred compensation plans for their compensated employees and officers (§701.19(b)).

The examiner should determine if management meets its responsibilities by reviewing the board minutes and insurance policies. Examiners should discuss any insurance inadequacies with the officials. The examiner should comment in the examination report on the absence of prudent risk management by the officials.

Examiners should inquire about any self-insurance programs that the credit union offers its employees or members. Generally, NCUA considers self-insurance programs impermissible, unsafe, and unsound. However, federal credit unions may enact partially self-funded employee benefit health plans if the plans meet certain conditions. The examiner should follow the provisions of NCUA Instruction No. 4062.1 (May 30, 1996) and, after obtaining regional concurrence, consult with NCUA's Office of General Counsel for further guidance.

Credit unions frequently buy life insurance policies for the benefit of employees. Credit unions may also obtain key-person protection. If the beneficiary of the policy is the employee, the credit union will treat the cost of the coverage as compensation. The board should annually review and approve the policy for reasonableness.

NCUA has long prohibited federal credit unions from entering into the business of insurance on several grounds. First, the *FCU Act* does not grant federal credit unions express insurance powers. Second, insurance powers do not meet the test for a permissible federal credit union incidental authority. The Office of General Counsel has issued

prior opinion letters restating NCUA's position on self-insurance (See OGC Opinion Letters #95-1148, #97-0632, and #99-0447).

**FIRREA
Requirements
for New or
Troubled
Credit Unions**

Any federally insured credit union chartered in the last two years or in a troubled condition (CAMEL 4 or 5) must give NCUA written notice of any addition, replacement, reassignment or change in the board of directors, committee members, or senior executive officers. The NCUA regional director must receive written notice at least 30 days before the effective date. NCUA may disapprove the addition, replacement, or employment of the individual within a 30-day period (may be extended an additional 30 days) if it finds that the competence, experience, character, or integrity of the individual would not serve well the members' or the public's interests. Federally insured, state-chartered credit unions will also file a copy of the notice with their state supervisory authority.

Credit unions need not give prior notice for new members elected to the board of directors or credit committee at a meeting of the members. However, credit unions must file a completed notice within 48 hours of the election. Federally insured state-chartered credit unions must also file a copy of the notices with their state supervisor.

The notice should contain, at a minimum, the following information for each individual:

- Identity;
- Personal history;
- Business background;
- Experience, including material business activities and affiliations during the past five years;
- Any pending legal or administrative proceeding in which the individual is a party; and
- Any criminal indictments or convictions of the individual by a state or federal court.

In addition, the individual on whose behalf the credit union files the notice must attest to the validity of the information filed and authorize performance of a credit check.

After receiving a complete package of information requested, the regional director has 30 days in which to issue a written notice of approval or disapproval to each individual and to the credit union. If the credit union and individual have submitted all requested information and the regional director has not issued a written decision within the applicable time period, the regulation specifies that the individual is approved (§701.14(d)(1)).

**Incompetent
or Inefficient
Management**

The examiner should never recommend the termination of credit union management or personnel to the directors. Rather, the examiner should fairly and accurately present findings concerning management's effectiveness.

When the examiner believes that management's incompetence or inefficiency has or will have a material effect on the credit union's risk profile, the examiner should contact the supervisory examiner before discussing the issue with the credit union. To avoid misunderstandings, the examiner should consider having a second person present (the supervisory examiner or another examiner) when discussing sensitive issues with management.

The examiner should adhere to the following guidelines when discussing incompetent or ineffective management with a board of directors:

- The examiner should document in the file and furnish to the officials specific facts that support the conclusion of management's ineffectiveness. Examiners should ensure thorough documentation exists of conversations with officials regarding management.
- If material weaknesses in management exist, normally the examiner and officials jointly develop a plan (Document of Resolution) to correct these deficiencies. Such action could take the form of:
 - Clearly communicating the board's expectations for the managing official;
 - Conducting periodic performance appraisals;

- Hiring additional management personnel to bolster supervision in high risk areas;
- Providing outside remedial training for the manager or official; and
- Seeking remedial assistance from outside sources (e.g., leagues, accounting services, etc.)

However, if the corrective action takes the form of replacing management, this is solely the decision and responsibility of the board of directors.

- If the manager chooses to resign, the credit union should obtain a written resignation. The board of directors has sole responsible for deciding whether to accept it.
- If the board terminates the manager, the examiner should fully document this action, emphasizing that the decision to terminate was the board's and not the result of an order or recommendation of the examiner.

The officials should consider what effect termination of management (including the effect of an employment contract) may have on the credit union. The board of directors should not consent to “hold harmless” the manager in exchange for the manager’s written resignation. Such an agreement might impair the credit union’s ability to recover on a bond claim. The examiner should encourage the board of directors to consult with their attorney on these issues.

Criticism of management by the examiner does not relieve the credit union of its contractual and other legal obligations. If the credit union board does not take steps to deal with management ineffectiveness, the examiner should consider recommending administrative action (see the Administrative Actions chapter for additional information.)

**Workpapers
and
References**

- Workpapers
 - Management Review
 - Board Minutes

- References
 - *Federal Credit Union Act*
 - §110 - Members' meetings
 - §111 - Management; board of directors; credit committee; supervisory committee; compensation
 - §112 - Executive officers; general manager
 - §113 - Board of directors; meetings; powers and duties; executive committee; membership officers; membership applications
 - §114 - Credit committee; meetings; powers and duties; loans and lines of credit; security
 - §115 - Supervisory committee; powers and duties; suspension of members; passbook
 - §206 - Termination of insured credit union status; cease-and-desist orders; removal or suspension from office; procedure
 - *Federal Credit Union Bylaws*
 - Article IV - Meetings of Members
 - Article V - Elections
 - Article VI - Board of Directors
 - Article VII - Board Officers, Management Officials and Executive Committee
 - Article VIII - Credit Committee or Loan Officers
 - Article IX - Supervisory Committee
 - *NCUA Rules and Regulations*
 - §701.14 - Change in Official or Senior Executive Officer in Credit Unions that are Newly Chartered or are in Troubled Condition
 - §701.21 - Loans to Members and Lines of Credit to Members
 - §701.33 - Reimbursement, Insurance, and Indemnification of Officials and Employees
 - §702 - Prompt Corrective Action
 - §711 and §741.209 - Management Official Interlocks
 - §747 - Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations

Chapter 8

GENERAL LEDGER

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Chapter 8

GENERAL LEDGER

Examination Objectives

- Evaluate adequacy of policies, practices, procedures, and internal controls regarding financial transactions
- Determine that personnel operate in conformance with established guidelines
- Determine that the credit union properly recognizes and promptly records assets and liabilities
- Review compliance with the *FCU Act*, *NCUA Rules and Regulations*, and appropriate accounting practices
- Determine accuracy of the Financial and Statistical Reports (NCUA 5300)
- Assess promptness of corrective action initiated by management when deficiencies or violations in policies, practices, procedures, or internal controls regarding financial transactions arise

Associated Risks

- Strategic risk. The timely, accurate and consistent recording of financial transactions affects management's development and monitoring of the strategic plan. Deficiencies in financial statement presentation may lead to ineffective evaluation of new products and services, and failure to attain financial objectives.
- Transaction risk. Policies and procedures established by the board and implemented by management should ensure the accuracy and integrity of data and information. In conjunction with the review of internal controls, examiners should consider the following items when evaluating this type of risk:
 - The recording of financial transactions in accordance with appropriate accounting methods;
 - The volume and complexity of financial transactions; and
 - The expertise and willingness of management to implement corrections for improving financial reporting.
- Compliance risk. Credit unions must comply with applicable laws and regulations, including:

- The *FCU Act*;
- *NCUA Rules and Regulations*; and
- Regulatory accounting procedures, accounting bulletins, etc.

Additionally, they should be guided by

- The *Accounting Manual for Federal Credit Unions* (for credit unions that are less complex); and/or
 - Generally accepted accounting principles (GAAP.)
- Reputation risk. Examiners should consider reputation risk when developing the Scope Workbook. When evaluating reputation risk, they should assess whether the credit union:
 - Provides current and accurate financial statements and NCUA 5300 reports;
 - Implements new accounting procedures and requirements within acceptable time frames;
 - Responds promptly to recordkeeping problems;
 - Provides accurate and timely member statements;
 - Responds promptly to members' concerns; and
 - Performs a thorough analysis of operational needs, staffing, risk management systems, compliance issues, and long-term benefits, prior to implementing new products and services.

Overview

Examiners should use their professional judgment to tailor the general ledger review to the complexity of the credit union operation and the risks present in and around this operation. The review of a credit union's general ledger and its related subsidiary ledgers should give the examiner a clear impression of the credit union's financial position and its relative financial stability.

During the scope development process, examiners should review the supervisory committee audit report and, if necessary, the workpapers. Reviewing the prior examination report will assist in determining the scope of the general ledger review. The scope of the general ledger review will vary depending upon the following:

- Reliability of the audit;
- Concerns noted in previous examination or audit reports;
- Interviews with management and staff;
- Extent and quality of management's due diligence regarding the credit union's products, services, and systems;
- Review of internal audit work, if applicable; and
- Review of the internal controls of the credit union.

§741.6(b) of *NCUA Rules and Regulations* requires credit unions with assets of \$10 million or more to present their NCUA 5300 in accordance with GAAP. Credit unions with less than \$10 million in assets may present their financial statements using regulatory accounting principles as set forth in the *Accounting Manual for Federal Credit Unions*.

Expanded Review Procedures

The depth of review necessary for each general ledger account will vary within a credit union and from one credit union to another. The most critical element for determining the degree of variance and the necessary depth of review is the examiner's professional judgment, experience, and risk perception. Examiners can implement the following additional procedures when warranted:

- Determine that the general ledger account balances with each respective subsidiary ledger total;
- Review the debits and credits and analyze any unusual activity; and
- Determine the propriety of the entries.

One effective method of reviewing or reconciling general ledger accounts is to trace entries to source documents or actual receipts. Except in unusual circumstances, the examiner should not audit or verify individual entries in either subsidiary ledgers or control accounts. If material inaccuracies exist in the general ledger accounts, examiners may support their analyses either by footnoting the credit union's financial statements or using the Statement of Financial Condition and Statement of Income. To avoid distortion of examination trends and ratios, the examiner prepares adjusting entries in the General Ledger Journal Adjustments when a material out-of-balance condition exists between a subsidiary ledger and its general ledger control account.

Red Flags

Some of the red flags in the accounting area that may require examiners to consider expanding their procedures include the following:

- Ongoing recordkeeping problems;
- Cash and bank reconciliations not complete, in arrears, or with (fluctuating) out of balance amounts;
- Excessive teller overages or shortages, either in number or amount;
- IOU's in teller or vault cash;
- Numerous erasures, corrections, whiteouts, line-outs;
- Numerous voided or third party checks;
- Numerous stale-dated outstanding checks;
- Numerous stale-dated reconciling items;
- Lump sum postings not conducive to good audit trail;
- Checks or transactions receipts missing or out of sequence;
- Timeliness of deposits not in accordance with Bylaw requirements, if adopted by the credit union;
- Bank account activity and/or bank account balances (or share draft clearings/total share draft balances) exceeding realistic needs;
- Excessive number of depository accounts providing potential for kiting; and
- Excessive cash/assets ratio (indicating poor cash management or possibly fraud.)

Out-of-Balance Conditions

The examiner normally does not attempt to balance or audit subsidiary ledgers to the control accounts. The examiner should discuss the concern with management and obtain agreement for corrective action. (When examiners suspect fraud or embezzlement, they should immediately contact their supervisory examiners for further guidance.)

Materiality

The credit union's size and its ability to absorb potential losses may significantly affect what examiners consider material. In assessing the materiality of a general ledger account, the examiner considers its effect on the credit union's profitability and net worth. In some instances, the account may have minimal effect on the balance sheet, while it may have a material effect on the income statement. For example, overstating accrued income may have little or no effect on

the balance sheet but could mean the difference between a negative and positive bottom line on the income statement.

**Unusual
Activity**

Unusual activities include those the examiner deems improper or uncommon, or which might adversely affect the credit union. This review should consider the size and frequency of the transactions. These accounts may have numerous entries during an accounting period, but clear out by the end of the period (e.g., ATM, credit cards, travelers' checks, money orders, and share draft clearing accounts.) The examiner may review this activity on a test basis to ensure the appropriateness of the entries (this may include a sample review of source documents or receipts.) The review should also satisfy the examiner that the account entries do not temporarily camouflage other activities.

**Examination
Period
Activity**

Examiners should concentrate the scope of the general ledger review primarily on activity during the examination period. For example, if the credit union purchased its building in a prior examination period, and if examiners reviewed the account during the last examination, current examiners need not perform another complete analysis. Instead, they may determine the credit union's current fixed asset position and the ability of the earning assets to support the non-earning assets.

NCUA 5300

The examiner will review the accuracy of the Financial and Statistical Reports (NCUA 5300 Call Report) submitted since the last examination and the credit union's process for ensuring accuracy of the 5300s. The review of 5300s often takes place during supervision. If examiners discover material errors or omissions, they should inform the officials, provide appropriate instructions to ensure proper completion in the future, and make corrections according to regional policy.

**Accounts
Receivable**

Accounts Receivable generally represent funds due the credit union from persons other than members. Receivables may include payroll deductions, insurance premiums, taxes, etc. If a credit union has material accounts receivable, the examiner may determine that (1) the

receivables exist, (2) the credit union receives payments on schedule, and (3) staff reconciles the subsidiary ledgers. Staff should promptly follow up on receivables that do not clear. Receivables that do not eventually clear will ultimately result in charges to an expense account and could affect the financial stability of the credit union.

**CLF Stock/
NCUSIF
Deposit**

When a credit union is a direct member of the Central Liquidity Facility (CLF), the examiner may review the CLF stock subscription computation. If either an overpayment or an underpayment exists, the examiner should require the credit union to notify the CLF.

When reviewing the Share Insurance Capitalization Deposit, the examiner should compare and reconcile the credit union's recorded deposit to that reported by the periodic statements from the share insurance fund. Examiners should also review for accuracy uninsured shares reported on the 5300 Call Report as of December 31, since they affect the capitalization deposit.

**Prepaid and
Deferred
Expenses**

Prepaid and Deferred Expenses represent expenses that the credit union has paid for, and supplies or services that have remaining value to the credit union (i.e., not fully used up.) Common examples include office supplies, prepaid fidelity/bond insurance, and prepaid league dues. The credit union often pays for these items annually so that at any point before year-end, some value remains (i.e., an item paid on January 1 for the full year would have six months' value (and expense) remaining in June.) These prepaid expenses must have a future value for a coming period, and not cover a prior period. Unless materiality factors exist, the examiner usually limits the review to the reasonableness of the entries in these accounts.

Fixed Assets

The credit union may either own or lease (under a capital lease) its fixed assets. Fixed Assets include three major, and often material, categories:

- Land and buildings;
- Furniture and equipment; and
- Leasehold improvements.

Before making a major investment in fixed assets, the board of directors should instruct management to perform due diligence, including carefully analyzing the need for the asset, and its expected effect on the credit union's future earnings ability from the standpoint of both the additional depreciation expense and the lost opportunity costs of the income. (Credit unions may better serve their members by providing faster and more convenient services using advanced computer technology such as home banking than by brick and mortar expansion.) Income from the earning assets (loans and investments) should support the investment in fixed assets.

Management should also consider the credit union's reserve position and ratio of "non-cost" capital (the income retained by the credit union as Undivided Earnings or reserves, for which the credit union pays neither interest nor dividends) to non-earning assets. A relatively high capital level reduces the burden on earning assets.

The credit union may employ various capital budgeting techniques to determine the payback method, the accounting rate of return, or the internal rate of return.

Investments in fixed assets require board approval. Management should purchase fixed assets in compliance with established board policy. Credit unions should record the purchase price and set up depreciation schedules in accordance with acceptable accounting practices.

The examiner may determine that the credit union complies with §701.36 of the *NCUA Rules and Regulations* regarding the purchase of fixed assets. Credit unions eligible for Part 742, Regulatory Flexibility Program, may be exempt from §701.36(a), §701.36(b), and §701.36(c.) When reviewing the regulation, the examiner should understand that while GAAP affords capital leases and operating leases different accounting treatments, the regulation requires inclusion of both operating and capital leases in the definition of "investment in fixed assets."

Capital Leases

From the standpoint of the lessee, two major categories of leases exist: capital and operating. Generally, a capital lease transfers substantially

all of the benefits and risks of ownership of the asset, while operating leases more closely resemble rental payments.

Real Estate Sales

Transactions involving the sale of credit union-owned property often have complicated accounting treatments with various profit recognition and disclosure requirements. An examiner encountering sales of credit union owned real estate should determine the facts and circumstances of the sale and, if necessary, discuss the situation with the supervisory examiner.

Accrual Income

Accrued Income is income the credit union has earned but has not yet received. Common examples include accrued interest on loans and accrued income on investments. Loans and many investments earn income from the day the credit union establishes the asset. The credit union may not receive income from these assets for a month (with loans) or longer (with investments.)

When a credit union adopts accrual accounting between examinations, the examiner should determine that the accounts were properly established. Examiners may verify the accruals for accuracy. Depending on the complexity of the credit union's operations, the examiner should review and analyze the schedules used in calculating the accrued income on loans or investments.

If the information system (IS) generates estimated accruals, the examiner may verify their accuracy through sampling. For example, some automated accounting systems can generate a detailed list by account number for the accrued income on loans. The examiner should also determine that the credit union does not accrue interest on loans 90 days or more delinquent.

If the examiner's estimate differs substantially from the recorded accrual, the examiner should expand the analysis to determine proper formulation of, and adherence to, policies and practices for accrual of interest on delinquent loans. The examiner should also review how the credit union arrived at its figures. When assessing the materiality of inaccuracies identified in the accruals, examiners should consider the

effect on reported income. Either an under- or over-statement in the estimated accrual can materially affect profitability.

Other Assets

Other Assets can include deposits with public utilities, insufficient funds checks, the premium stabilization deposit, monetary control reserve deposits, escrow accounts on serviced real estate loans, and assets acquired in liquidation. In general, the examiner may determine the reasonableness of the balances and dates recorded. The credit union should charge off the portion of an account representing a nonrefundable or nonrecoverable amount.

The examiner may verify that the credit union books the value of assets acquired in liquidation in accordance with acceptable accounting practices.

Accounts Payable

Accounts Payable represent obligations of the credit union including payroll deductions that the credit union has not yet distributed to share accounts, remittances due for travelers' checks, insurance premiums due, etc. The examiner may (1) determine the date of origin, and (2) review material amounts to ensure the credit union reconciles subsidiary ledgers with control accounts and makes payments when due.

Notes Payable

Notes Payable are borrowings by the credit union, typically through the corporate credit union network or other financial institutions. Credit unions may borrow from any source in an aggregate up to 50 percent of its paid-in and unimpaired capital and surplus. The board is responsible for developing a use and repayment plan for borrowed funds.

Dividends Payable

Credit unions use this account only at the end of dividend periods to reflect the actual or estimated amount of dividends due and payable to the members. Dividends Payable, while set up at the end of each dividend period, should normally clear out shortly afterwards. If a balance remains in the account as of the examination date, the examiner should explore the reasons and may determine that the

amount ties to a dividend payable report or represents a reasonable estimation.

Interest Refunds Payable

Some credit unions use interest refunds as a method of returning part of the credit union's profits to the members. Members, who have paid interest on loans during the period, receive back a portion of the interest they have paid.

Taxes Payable

Taxes Payable depict accounts payable to governments, usually including Social Security, federal, and state withholding taxes. These accounts will normally clear out monthly or quarterly. If not, the examiner may determine whether the credit union uses proper accounting for these accounts. Although the amounts payable in taxes usually are immaterial, credit unions can incur substantial fines and penalties for nonpayment. Since NCUA does not enforce Internal Revenue Service or state tax regulations, examiners should direct their concern toward the credit union's prevention of tax problems.

Accrued Expenses

Accrued Expenses represent expenses that the credit union has incurred and which it owes in the current period but will pay in a future period. These may include compensation, employee benefits (e.g., vacation and sick leave pay), and office operations. An accrued expense is an expense for the current or prior period. Credit unions may not prepay them. As is true of accruing income, accruing expenses more accurately presents the credit union's financial position.

Accrued expenses include accrued dividends payable. Credit unions that accrue dividend expenses more frequently than the actual dividend period should record the liability in Accrued Dividends Payable. Even credit unions that use the modified cash basis of accounting must accrue dividends contracted for or specified in advance, such as share certificates, to comply with the full and fair disclosure requirements of §702.402 of the Rules and Regulations. The examiner may determine the reasonableness of the recorded dividend accrual on share accounts where the credit union specifies or contracts for the dividend rate in advance.

**Other
Liabilities**

Other Liabilities include liabilities under pension plans, collections on loans and other obligations serviced, obligations under capital leases, monetary control pass-through deposits, and undisbursed loan proceeds. Material balances should reconcile to the appropriate subsidiary ledgers or external statements.

**Unapplied
Data
Processing
Exceptions**

The Unapplied Data Processing Exceptions account allows the credit union to reconcile the general ledger control accounts with the individual share and loan ledgers when the IS rejects entries in the latter. For example, if staff posted a share withdrawal to both the journal and cash record and to the individual share ledger but keyed in an incorrect account number, the share ledger will exceed the journal and cash record by the amount of the rejected withdrawal. If the credit union closes its books before making the correction, the general ledger will not balance with the individual share ledger. Correcting the exception requires debiting a general ledger suspense account, Unapplied Data Processing Exceptions, and crediting the general ledger shares account, thus balancing shares to the share ledger. The credit union will debit shares and credit the suspense account to correct the entry.

Complicated transactions can occur in this account when compounded by payroll deduction errors, input errors on refinanced loans with temporary disability insurance, corrections to prior period's dividends, etc.

An unreconciled suspense account can contribute to a severe record keeping problem with the potential for material adjustments and losses. Depending on materiality, the examiner may (1) determine that the balances reconcile to an appropriate subsidiary ledger, (2) ensure that reconciling items clear out on a timely basis, and (3) review frequent or consistent transactions through these accounts for appropriateness. Whether or not the suspense account has a balance as of the examination date, the examiner may review the activity in the account since the last examination.

**Deferred
Credits**

Deferred Credits represent income received but not earned. Deferred Credits includes fees the credit union charges a member for entering

into an agreement to make a loan and direct loan origination costs. If the member exercises the commitment, the credit union transfers the net balance to the appropriate loan contra account for net commitment fees. The credit union may choose whether to follow GAAP or to amortize the fees over the life of the loan or ten years, whichever is shorter, as an adjustment of yield using the interest method. Credit unions on a modified cash basis, or if the amount is immaterial, should amortize the net fees over the shorter of the life of the loan or ten years, as an adjustment of yield using the interest method.

Contingent Liabilities

Examiners should discuss with management and, if necessary, fully analyze contingent (unrecorded) liabilities, or "off-balance sheet" items, to determine the financial effect on the credit union. Examples include long-term management contracts with employees, long-term contracts with information processing suppliers, long-term leases for fixed assets, claims that significantly exceed premiums on a select risk-rating insurance plan, employee pension plans, accrued sick leave and vacation, unused lines-of-credits and credit cards, unfunded construction loan commitments, and pending legal suits.

The reviews of board minutes and audit reports often provide clues to the existence of contingent liabilities. Asking questions of management about the degree of credit union involvement in these activities along with reviewing significant contracts, insurance policies, and pension plan information aid examiners in analyzing this area.

When examiners note significant contingent liabilities, they should determine that the credit union meets full and fair disclosure requirements. They can determine full and fair disclosure in several ways, such as the establishment of proper accrual accounts or footnotes to the financial statements. If the credit union's financial and statistical reports do not show material contingent liabilities as footnotes, examiners should reach agreements that management will provide the footnotes on future reports.

**Individual
Share and
Loan Ledgers**

Credit unions use many different accounting systems to track individual share and loan accounts: hand posted ledger books, ledger cards, in-house computers of various capacities, and outside service bureaus. Each system differs somewhat from the others. The examiner should take the time to become familiar with each system and understand what the data represents. Although the systems have differences, they share the common purpose of maintaining the subsidiary ledgers to general ledger control accounts.

Small credit unions often have two subsidiary ledgers, the individual share and loan ledgers, and two control accounts, the general ledger share and loan accounts. Larger or more sophisticated credit unions may have many subsidiaries for both shares and loans, including separate ledgers for real estate loans, student loans, consumer loans, regular shares, share drafts, etc. In all cases, subsidiary ledgers must balance with the control account and the total of subsidiary ledgers for both shares and loans with their respective general ledger accounts.

**Ledgers Out
Of Balance**

If the trial balance totals of the individual share and loan ledgers do not agree with their respective control accounts in the general ledger, or if one or more subsidiary ledgers do not agree with their respective control accounts, the out-of-balance condition could represent varying degrees of seriousness. These could vary from an innocent error in extension of balances to an embezzlement of sizeable proportions. The examiner should verify the reason for material out-of-balance conditions. The examiner may guide the officials in resolving the situation.

Regardless of the mechanics required to correct the out-of-balance condition, the examiner should make it clear to both the treasurer and the board that the treasurer has responsibility for keeping accurate books and records current and in balance. Responsibility for locating and correcting existing errors, determining the reasons for the errors, correcting the causes, and preventing a recurrence ultimately falls to the board.

The examiner should not attempt to balance the records or spend considerable time searching for errors after pinpointing the type of error that occurred, unless evidence of dishonesty exists. If dishonesty

exists, the examiner should consult with the supervisory examiner before proceeding with additional test checks. The examiner should develop specific plans of action with the officials to find errors, balance the ledgers, and eliminate the causes.

Credit unions must resolve out-of-balance conditions. However, a difference, which could affect the financial condition of the credit union, requires more immediate correction than does a difference of a few dollars made in a recent dividend calculation.

Even though a substantial difference may exist, a stable difference presents a lesser problem than a difference that fluctuates from period to period. A stable difference usually occurs in an identifiable, specific period and does not usually represent a continuing problem with internal controls and record keeping. It may represent a one time occurrence.

**Arbitrary
Adjustments**

When any of the credit union's records (General Ledger, Journal and Cash Record, Individual Share and Loan Ledgers, or material subsidiary ledgers) are in arrears and staff cannot bring them current during the examination, the examiner should consider delaying the completion of the examination until staff brings the records current. This should also hold true if the general ledger is out of balance. When examiners delay the examination, they should reach agreements with the officials to correct the problem. Examiners should discuss any delays in the examination with the supervisory examiner for concurrence with plans before reaching agreements with officials.

If, upon returning to the credit union, examiners find that the officials have failed to follow through on agreements reached, they should complete the examination using the most current meaningful data available. As appropriate, they will discuss the situation with the supervisory examiner and come to an agreement on how best to handle the situation, in accordance with regional policy.

Serious and persistent record keeping deficiencies may warrant administrative action. Persistent record keeping deficiencies may constitute serious recordkeeping problems that continue to exist past a usual and normal period of time. NCUA considers persistent

recordkeeping deficiencies serious if a reasonable doubt exists (1) that the credit union's financial statements accurately and fairly present the financial condition of the credit union, or (2) that management practices and procedures sufficiently safeguard the members' assets. In addition to administrative actions, NCUA can require the credit union to obtain an outside, independent audit by a certified public accountant. (See §715 of the *NCUA Rules and Regulations* and the Supervisory Committee section of this Guide.)

When the credit union cannot determine available earnings because it has not prepared an accurate financial statement, it may not declare dividends until the board of directors can determine if the credit union can pay a legal dividend.

If examiners do not consider differences material and the differences have not fluctuated during the previous three months, the examiner may ask the directors and the supervisory committee to authorize an arbitrary adjustment for the difference.

Pension Plans

The examiner's objective in reviewing pension plans should determine the following:

- Subsidiary records exist to document the existence of the pension plan;
- Proper methods account for the plan;
- The financial statements contain the appropriate pension plan disclosures; and
- The board of directors has recognized and approved the plan.

A pension plan is a contract between a credit union and its employees whereby the credit union agrees to pay benefits to employees upon their retirement. Pension benefits generally consist of monthly payments and may provide for additional payments when employees die or become disabled.

A pension plan may be formal or implied by credit union practice. A credit union, individually or collectively with other credit unions, may establish a plan. Due to their complexity, credit unions should only undertake participation in any pension plan with the advice of legal

counsel. If the pension plan involves the placement of pension funds in trust or custodial accounts in the credit union, the credit union must comply with the applicable *Federal Credit Union Bylaws* (if the credit union has so adopted), and Part 724 of the *NCUA Rules and Regulations*. A substantial difference can exist in a credit union's obligation between a defined benefit plan and a defined contribution plan. Additionally, credit unions should ensure and document compliance with IRS regulations, Pension Benefit Guaranty Corporation guidelines, and Department of Labor requirements.

Pension plans may be either funded or unfunded. Under a funded plan, the credit union makes regular periodic payments to an insurance company or trustee, which agrees to assume the responsibility of distributing retirement checks to recipients. In an unfunded plan, the credit union makes periodic payments directly to its retired workers. The plan may be contributory, where the employees bear part of the cost, or it may be noncontributory, where the credit union pays the entire cost.

Accounting for Pension Cost

When a credit union adopts a pension plan, actuarial tables determine the past service cost and the normal cost. Once the credit union ascertains the costs, it establishes a funding policy. Credit unions usually fund normal costs and expense those costs the same year they occur. The funding policy for past service costs also affects the amount of recorded expenses for any period. However, no requirement exists that the amount of pension expense related to service costs must equal the cash put into the fund to finance those costs during any one period. A particular credit union's funding and expense policies will result in one of the following:

- The amount of recorded pension expense equals the cash paid into the fund. This situation can only arise when the amortization period equals the funding period for past service costs. In this example, no requirement exists to establish an account in the general ledger for any over- or under-accrual of the liability for pension costs.
- The amount of recorded pension expense exceeds the amount paid into the fund, creating a pension liability. This arises when the

funding period for past (and changes in prior) service costs extends longer than the expense amortization period.

- The amount of recorded pension expense is less than the amount paid into the fund, creating a pension asset. This arises when the funding period for past (and changes in prior) service costs is shorter than the expense amortization period.

Due to the complex nature of accounting for pension plans, the credit union should obtain competent outside assistance, if needed, to fully comply with GAAP and disclosure requirements. As credit unions grow larger and employ more staff, credit union pension plans increase in importance within the expense structure of a credit union. Proper accounting and the need for full and fair disclosure become increasingly necessary.

**Workpapers
and
References**

- Workpapers
 - Statement of Financial Condition
 - Statement of Income
 - Journal Entries Summary
 - Financial History
- References
 - *NCUA Rules and Regulations*
 - 701.36 – FCU Ownership of Fixed Assets
 - 702.402 - Full and Fair Disclosure
 - 715 – Supervisory Committee
 - 724 – Trustees and Custodians of Pension Plans
 - 725 – Central Liquidity Facility
 - 741.6 – Financial and Statistical and Other Reports
 - *Accounting Manual for Federal Credit Unions*
 - *Federal Credit Union Bylaws*
 - *Federal Credit Union Act*

Chapter 9

CASH ANALYSIS

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Chapter 9

CASH ANALYSIS

Examination Objectives

- Determine whether adequate accounting policies, practices, procedures, and internal controls exist for all phases of cash operations
- Determine whether the credit union has established guidelines addressing cash operations within which officials and employees operate
- Determine whether adequate security measures and surety bond coverage exist for cash operations including cash storage, replenishment, deposit activities, and transportation of cash and cash-like items

Associated Risks

Cash operations have various associated risks. Following are the primary risks associated with cash analysis:

- Liquidity risk - the credit union should have sufficient cash to meet member share and loan demand and pay operating expenses;
- Transaction risk - the board should adopt, and management should implement policies and procedures that ensure the accuracy and integrity of data and information regarding the credit union's cash accounts. In conjunction with the review of internal controls, examiners should consider (1) the proper recording of cash transactions, and (2) the volume of cash transactions when evaluating transaction risk;
- Compliance risk - examiners should ensure the credit union has an adequate program in place to properly report cash balances and cash transactions as required by current laws and regulations, including Regulation D, BSA and OFAC; and
- Reputation risk - when evaluating reputation risk, examiners should assess whether the credit union maintains the highest level of integrity and honesty over cash accounting and transactions.

**Cash and
Cash-Like
Items**

The following are cash and cash-like accounts established by the credit union's board of directors for specific purposes. The board authorizes the amount for each cash account (petty cash, teller change fund, vault change fund, ATM change fund and bank cash):

- Petty cash - used for making incidental payments and defraying other immaterial expense items;
- Teller change fund - used for processing member transactions; may vary in amount based on temporary, seasonal, and projected demands;
- Vault change fund - replenishes drains on teller change funds; may vary in amount based on temporary, seasonal, and projected demands;
- ATM change fund - provides cash for proprietary ATMs to process member ATM transactions; may vary in amount based on temporary, seasonal, and projected demands. Occasionally, credit unions assign ATMs "teller numbers" and include the funds in the teller change fund general ledger account. If so, each ATM on the system should have an identifying number to allow for an audit trail of cash differences by individual ATM;
- Bank cash - (1) includes cash in banks, savings banks, savings and loans, etc.; (2) usually replenishes vault, teller, and ATM change funds; (3) covers loan disbursements, expense disbursements, payroll, and share withdrawals; and (4) usually is a non-interest bearing account or one that earns only a nominal rate. Credit unions should maintain bank cash at reasonable levels or at minimum compensating balance requirements to limit fee assessments;
- Money orders, travelers checks, postage, theater/amusement park tickets - sold by credit unions as a service to the members; represent negotiable monetary instruments that can easily convert to cash; not normally recorded in the general ledger or reflected on the Statement of Financial Condition; and

- Other negotiable instruments - rarely encountered negotiable monetary instruments; warrant review when the examiner identifies them during the course of an examination.

Red Flags

Examiners should watch for the following “red flags”, which can alert them to diversion or manipulation of cash by management or staff:

- Accounting/Reconciliations:
 - Ongoing recordkeeping problems;
 - Cash and bank reconciliations not completed, in arrears, or with fluctuating out of balance amounts;
 - Excessive teller overages or shortages, either in number or amount;
 - IOU's in teller or vault cash;
 - Numerous erasures, corrections, whiteouts, line-outs;
 - Numerous voided or third party checks;
 - Numerous stale dated outstanding checks;
 - Numerous stale dated reconciling items;
 - Lump sum postings not conducive to good audit trail;
 - Checks or transactions receipts missing or out of sequence;
 - Timeliness of deposits not in accordance with Bylaw requirements;
 - Bank account activity and/or bank account balances (or share draft clearings/total share draft balances) exceed realistic needs on any single day;
 - Excessive number of depository accounts providing potential for kiting; and
 - Excessive cash/assets ratio (indicates either poor cash management or possibly fraud.)
- Management:
 - Overly dominant manager;
 - Manager or key employee involvement in gambling;
 - Regular vacations not taken, always working late hours;
 - Nepotism;
 - Other forms of insider abuse or preferential treatment;
 - Limited personnel not conducive to segregation of duties;
 - Lack of adequate segregation of duties when the credit union has adequate staff;

- Failure to provide, or delays in providing, standard reports, records, and/or documents;
 - Records maintained at home or in inappropriate location;
 - Management or staff provide copies of documents rather than originals;
 - Inactive supervisory committee;
 - Lack of, unacceptable, or non-independent audit or verification;
 - Inadequate internal controls and information systems (IS) controls;
 - No internal review of override/non-financial reports;
 - Bank account frequently overdrawn;
 - High volume of excessive transactions;
 - Use of borrowed funds in spite of large cash balances;
 - Extravagant management or employee lifestyle relative to salary; and
 - Lack of a fraud policy.
- Other:
 - Low return on assets or on various asset categories; and
 - Payment of above market dividends to attract deposits

Expanded Review Procedures

The depth of review necessary for each cash account will vary within a credit union and from one credit union to another. The most critical element for determining the degree of variance and the necessary depth of review is the examiner's professional judgment, experience and risk perception. Examiners can obtain assistance in assigning the level of risk by reviewing the appendix to the Risk-Focused Program chapter. The remainder of this chapter includes additional procedures that the examiner may implement when warranted.

Petty Cash Review

Although the petty cash fund authorization is generally immaterial, in cases where examiners note problems they may decide to review the fund to determine that:

- The balance of this fund does not exceed the authorized amount;
- Management has physically segregated it from other cash funds and provides accountability by limiting access;

- Valid receipts or signed cash vouchers evidence payments from the fund, and the sum of the fund, receipts, and vouchers total to the authorized amount;
- Management replenishes the fund in a timely manner and records the proper expense categories at least monthly;
- Management approves any changes in the fund's balance; and
- The supervisory committee or other independent party periodically verifies the fund.

Teller Change Fund Review

Depending on transaction volume and temporary, seasonal, and projected demands, teller change funds can represent a substantial portion of cash inventory. Examiners' scrutiny of teller fund operations may include a review of the following:

- Master Log maintained by the head teller or operations manager;
- At least two days of individual, signed, end-of-day, teller cash counts including related daily work transaction vouchers. If a teller is off work on the day of the verification, examiners must obtain the prior working day's end-of-day teller cash count and related transaction vouchers;
- At least two days of system-generated individual teller summary transaction activity reports that reflect the system's beginning and ending cash balances, check transactions, and cash transactions;
- Teller change fund general ledger detail; and
- Log of Bait Money, including denominations, and serial numbers assigned to each individual teller.

The entries on the Master Log should balance to the individual and aggregate, end-of-day, teller cash counts. The individual teller cash counts should balance to the ending cash balance on the system-generated teller summary reports. The total ending cash balances for all tellers should balance to the amount of the overall change fund appropriated to teller change funds in the general ledger.

Individual, end-of-day, teller cash counts should balance with the next day's beginning cash on the system-generated teller summary reports. Some data processing systems allow manual input of beginning cash balances. This weakness could disguise or postpone recognition of an out-of-balance condition or shortage. If the credit union cannot modify its computer system, management can mitigate concerns about this weakness by rotating teller drawers among tellers on a surprise basis.

Examiners and auditors routinely perform month-end examinations and audits; however, examiners do not perform cash counts. Management or supervisory committee personnel should periodically perform surprise cash counts.

Examiners should consider the following if they decide to review teller change funds:

- The amount set up in the teller change fund does not exceed the maximum established by the board of directors, the individual teller change funds do not exceed the amounts established by management, and the board has established reasonable total change funds;
- The credit union adheres to management's established maximum teller drawer limitations and maximum teller transaction limitations. Tellers sell their excess teller drawer cash to the vault change fund during days of high transaction activity;
- Supervisory committee, internal audit department, or other appropriate personnel perform periodic random audits of teller change funds;
- The credit union has procedures in place to immediately remove terminating tellers' access to cash operations and to audit, seal or close, vacationing tellers' drawers on their last work day;
- Management restricts tellers, both by policy and computer authority, from processing transactions on their own accounts, accounts of family members, or accounts of other relatives;

- Management restricts tellers' computer authority, in terms of access levels, and has controls in place to identify teller transactions by unique teller stamps, teller codes, or ID numbers;
- Management instructs employees to keep confidential their teller log-on IDs and passwords and periodically changes IDs and passwords;
- The computer has an activated time-out feature that requires tellers who are away from their stations for an extended period of time to sign-on again. If the credit union has not activated the time-out feature, tellers should sign-off when away from their stations for an extended period of time;
- Tellers lock their drawers when away from their stations and secure their funds in the vault overnight;
- Management restricts a teller's access to an individually assigned drawer and uses dual controls to prevent unauthorized access to teller drawers;
- The credit union clears any checks accepted in processing member transactions daily and prohibits tellers from holding cash items (checks, IOU's, drafts, etc.) as part of their change fund balance;
- Debit or credit memos signed by both parties evidence cash purchases from and cash sales to the vault change fund. Credit unions should prohibit cash purchases and sales between tellers;
- The credit union maintains a clear audit trail by promptly and accurately recording to the general ledger all cash activity, including teller differences. Supervisory personnel should regularly review the cash transactions records;
- The credit union provides transaction receipts to members for all transactions;
- The credit union does not have a "slush fund" built over time by overages that a staff member could use to conceal shortages;

- The credit union adequately segregates “bait money” to prevent teller usage;
- Management maintains dual control access to night depository funds and mail deposits, and requires the presence of both persons when removing, processing, and logging the contents;
- Teller change fund policies, practices, procedures, controls, and balancing procedures provide for adequate safeguards over teller operations and accountability; and
- Amounts in tellers’ drawers do not exceed surety limits, if surety specifies limits.

If examiners encounter significant weaknesses as a result of the cash review, they may request a controlled random or total teller drawer count or perform a review of individual teller transaction reports.

Vault Change Fund Review

The vault change fund generally represents the largest portion of cash inventory and may fluctuate from time to time depending on anticipated transaction volume, temporary, seasonal, and projected demands. Because of the volume and fluctuation, the credit union should internally balance the vault change fund daily. If examiners review the vault change fund, they should consider that management has instituted the following:

- Master Log, listing end-of-day vault cash balances, maintained by head teller or operations manager;
- End-of-day vault change fund counts signed by head teller or operations manager;
- Vault change fund general ledger detail;
- Reasonableness of the amount maintained in the fund (including the teller change fund) for the needs of the credit union;

- Adherence to maximum vault change fund limitations established by the board of directors, which should correspond to limits established by the bylaws and any applicable surety limits;
- Periodic audits of the vault change fund by the supervisory committee, internal audit department, or appropriate personnel;
- Restricted access to the vault change fund for accountability, both by policy and vault combination or key distribution;
- Required dual control for opening and counting vault change fund replenishments, and signed bank debit memos evidencing the replenishments. Ideally, management should maintain a cash shipment log, and the timing of cash shipments should vary to reduce recognition of an identifiable pattern;
- Restriction of computer access levels for persons having access to the vault change fund. Examiners should review the employee transaction access limitation report to determine adequacy of the credit union's controls in this area;
- Maintenance of a clear audit trail by promptly and accurately recording to the general ledger all vault change fund activity, regardless of whether the fund is fixed or floating. Staff should record and promptly resolve any cash differences;
- Two-part debit or credit memos signed by both parties evidence cash purchases from and cash sales to the vault change fund. Examiners should trace a few transactions;
- Implementation of procedures to prevent an employee responsible for both vault cash and a teller cash drawer from commingling the funds; and
- Adequate safeguards and accountability over vault cash operations provided by vault change fund policies, practices, procedures, controls, and balancing procedures.

ATM Change Fund Review

The credit union must internally balance the ATM change fund daily, recognizing, however, that it cannot perform a true balancing until it replenishes the ATM and verifies the remaining cash, records deposits, and records withdrawals to machine output reports or audit tapes.

If examiners review the ATM change fund, they could ensure the ATM audit tape totals, adjusted for reconciling items, balance to the general ledger ATM change fund balance. Examiners can verify randomly selected individual reconciling items to source documentation, ATM detail tape, or general ledger detail.

During this review process, the examiner could also determine that:

- Management maintains dual control for opening, counting, replenishing, and balancing ATMs;
- Management maintains ATM deposits under dual control with both responsible employees present during opening, listing, and processing of machines and envelopes;
- Management prohibits personnel having custody of member access cards from having access to personal identification numbers;
- Management properly segregates duties involving the balancing of individual ATMs and balancing of system totals;
- Supervisory committee, internal audit department, or other appropriate personnel periodically audits the ATM change fund;
- Management assigns an employee having no duties nor authorizations in the teller or ATM areas of operation responsibility for captured ATM cards; and
- ATM change fund policies, practices, procedures, controls, and balancing procedures provide for adequate safeguards over ATM cash operations and accountability.

If the credit union owns several ATMs, these machines can hold a substantial amount of cash. Some credit unions (usually those maintaining large cash reserves) contract with outside parties, such as armored car services, to replenish and service their ATMs. The credit union should have agreements in place with bonded third parties. The supervisory committee, or other appropriate personnel, must periodically audit and verify these cash reserves, per specifications of surety.

**Bank
Account
Review**

Examiners may verify the most recent month-end bank reconciliation and review at least one other randomly selected month-end bank reconciliation. When credit unions use a corporate credit union for their primary banking purposes, examiners apply the same review procedures to the corporate account reconciliation. Examiners may verify and review at least the following:

- Bank reconcilements for (1) the most recent month-end, (2) the randomly selected month-end, (3) the reconciliation preceding the most recent month-end, and (4) the reconciliation preceding the randomly selected month-end. Examiners need these four bank reconcilements to verify outstanding items and adjustments for the two months' reviews selected;
- Original bank statements correspond with the reconcilements chosen for verification and review, and the current month's original bank statement, if available. If examiners do not have the current month's bank statement available and if they note unusual activity, they may decide to order a cut-off bank statement;
- Outstanding check registers and canceled checks correspond with the reconcilements chosen for verification and review. When the bank truncates the credit union's checks, examiners may substitute voucher copies for canceled checks. Examiners should trace a few checks to the general ledger and bank statement to ensure the checks agree with the amount on the reconciliation;
- Bank stamped original deposit receipts and original bank debit and credit memos correspond with the reconcilements chosen for verification and review;
- Original corporate account statements correspond with the reconcilements chosen for verification and review;
- List of authorized signers on the bank accounts (trace to board authorizations); and
- Bank accounts general ledger detail.

If examiners review bank account reconcilements and statements, they may include the following steps:

- Tracing the book balances to the general ledger and reconciliation of bank statement balances to the bank statements;
- Footing the credit union's bank reconcilements and corresponding outstanding check registers;
- Tracing all reconciling items to source documents, and to statement or general ledger details;
- Verifying that previous month's outstanding checks cleared on the month of review's bank statement for the amount shown on the previous month's outstanding check register;
- Reviewing aging of reconciling items, non-sufficient funds (NSF) items, and outstanding checks. Generally, credit unions should appropriately clear items older than 90 days unless staff is researching them or settling a dispute (i.e., staff should not clear such aged items to another suspense-type general ledger account rather than resolving the problem);
- Reviewing management aging report detailing suspense-type general ledger accounts to ensure proper monitoring and clearing;
- Verifying that the previous month's deposits-in-transit cleared the month of review's bank statement for the amount shown on the previous month's reconciliation. Tracing the most recent month's deposits-in-transit as shown on the reconciliation to bank stamped deposit receipts or current month's bank statement, if available. Credit unions should make deposits promptly as specified in the *FCU Bylaws*. If necessary, the deposit-in-transit review may include a random review of receipts to deposits. Staff should not clear deposits-in-transit to another receivable-type general ledger account;
- Reviewing the origin and destination of a random sample of wire transfers provided on the bank statements and verifying that the credit union posted these wire transfers to the general ledger or

carried them as reconciling items. While the destination of wire transfers is generally the corporate account, examiners should trace destinations to other than the corporate account to source documentation from the originator;

- Determining the credit union adequately controls non-FEDWIRE transfers. Sound controls require that the originating bank or institution confirm the transfer with appropriate personnel not responsible for initiating the transfer;
- Reviewing canceled and outstanding checks for unusual payees, unusual dollar amounts, or unauthorized signatures;
- Verifying that staff properly marks voided checks “VOID”, and crosses or cuts out the signature portion of the voided check or, more importantly, punches the MICR line;
- Determining the reasonableness of the volume of bank account activity and average bank account balance in relation to the credit union’s asset size, volume and amount of member transactions, and compensating balance requirements;
- Determining that the supervisory committee, internal audit department, or other appropriate personnel periodically audits bank account reconcilements; and
- Reviewing that bank account reconciliation policies, practices, procedures, and controls provide for timely reconcilements, adequate safeguards over the bank account, and accountability. Credit unions should complete reconcilements by the due date of the financial statements as specified in the bylaws.

If the bank or corporate account reconcilements are more than 60 days in arrears, examiners should reach agreement with the credit union to bring the reconcilements current, usually within 30 days. If the reconcilements are six or more months in arrears, the credit union is deemed to have serious and persistent recordkeeping problems (per §715.12 of the *NCUA Rules and Regulations*) requiring the credit union to hire an outside, independent auditor to perform an opinion audit. When reconcilements are seriously in arrears, the examiner may

perform a simplified bank reconciliation to determine how close the bank balance is to the book balance and verifying, to the extent possible, outstanding checks and deposits-in-transit.

When the credit union has not properly reconciled accounts or properly researched and corrected adjusting entries, examiners should follow-up to determine that the credit union makes the needed corrections. Examiners should discuss the necessary level of supervision with the supervisory examiner.

**Credit Bank
Account
Balance**

Examiners should not criticize credit unions for having a credit balance in the cash account when the credit union has not overdrawn the bank account. Likewise, examiners should not criticize credit unions for overdrawing the bank account infrequently, if the credit union has a written agreement with the bank indicating the bank's willingness to honor checks drawn by the credit union, even though the credit union may not yet have sufficient funds deposited. Examiners should review the costs credit unions must pay when they overdraw their bank account; the costs may be higher than if they had borrowed the funds.

Conversely, if the credit union regularly overdraws its bank account and has no written agreement, it should increase the account balance accordingly. Additionally, if the credit union frequently overdraws its account, with or without a written agreement, examiners should analyze the effect on liquidity and operating costs. Frequent overdrafts could indicate liquidity risk, transaction risk, and reputation risk.

**Sweep
Accounts**

Some banks offer a "sweep account" feature to their customers, which allows the bank to sweep some or all of the balance of the credit union's bank account into some form of overnight marketable securities. Using this feature, the credit union can often improve earnings on its bank account. However, the credit union generally bears all of the market risk liability inherent in the sweep transaction.

If examiners identify sweep account arrangements that warrant review, they should determine that (1) a written agreement exists between the bank and credit union, (2) the agreement should coincide with the

credit union's investment policies and practices, (3) the credit union has an acceptable market risk liability, (4) the bank records the sweep transactions in the credit union's name, and (5) the bank sweeps the credit union's cash into investment securities permissible for credit unions.

Treasurer's Drafts

Treasurer's drafts are drafts that a credit union issues against itself and uses in the same way it would use a checking account at a bank. The credit union does not establish a share draft account for itself. It merely issues drafts that it promises to honor when properly presented. The treasurer's draft is an alternative to the bank checking account and allows the credit union to use the float to its advantage.

Credit unions establish treasurer's drafts by using a clearing account at the payable-through bank. The drafts, issued for loan disbursements, share withdrawals, and expense disbursements, clear in the same manner as the members' share drafts. As the payable-through bank receives the drafts, it pays them from the credit union's clearing account at the payable-through bank.

Official Check Programs

"Official check" programs (e.g., Travelers Express, American Express) often appeal to smaller credit unions that do not have their own checking account at a bank, although other credit unions may also use this service. Each day the credit union writes drafts payable through a bank. At the end of the day the credit union wires the total of the drafts written to the official check company.

The credit union earns income on the float and once a month the official check company sends the credit union a list of draft items not cleared (the outstanding check list for the month.) This program does not eliminate the cash reconciliation function. While NCUA does not prohibit this program, default by the official check company could negatively affect the credit union's financial condition and reputation.

On-Us Share Draft Accounts

Frequently, larger credit unions use in-house share draft accounts for processing loan disbursements, share withdrawals, expense disbursements, and even payroll. The process is similar to that of

Treasurer's drafts, but the credit union uses a share draft account rather than a treasurer's draft payable account. The on-us share draft accounts serve as an alternative to the bank checking account and allow the credit union to use the float to its advantage.

Examiners can identify these share draft accounts through (1) inquiries with management, (2) review of canceled and outstanding drafts, and (3) review of zero balance or overdrawn share draft reports. Account numbers of such accounts generally begin with "9's". These are actually liabilities and not share accounts. If a credit union uses on-us share draft accounts, it can inflate or deflate actual total share account amounts, which could affect the capitalization deposit.

At any given month-end, the balance remaining in these share draft accounts actually represents outstanding drafts. The examiner could determine that the credit union appropriately accounts for and controls such accounts, and that it closes any remaining balance in these share draft accounts to the related liability account before finalizing month-end financial statements.

**Money
Orders and
Travelers
Checks**

If examiners review money orders and travelers checks, which are generally off-balance sheet consignment items, they could determine whether the following exists:

- The credit union has adequate policies, practices, and controls to safeguard these negotiable monetary instruments and provide for accountability over the reserve supply and working supply;
- The supervisory committee or other appropriate personnel periodically reconciles the money orders and travelers checks;
- Management maintains the inventory of money orders and travelers checks at reasonable levels as governed by membership demand. If the agreement also requires surety limits, the examiners should review compliance with those limits;
- The credit union opens, counts, and records the shipments of money orders and traveler's checks under dual control;

- The credit union maintains records of serial numbers of money orders and traveler's checks held in the reserve supply and teller working supply;
- The credit union stores the reserve inventory and working supply inventory in the vault during non business hours;
- The credit union posts sales fees to the appropriate income accounts daily;
- The credit union sends sales remittances to the issuer promptly; and
- The credit union destroys money orders and travelers checks, if necessary, under dual control and appropriately logs this activity on a destruction log signed by both parties.

If the review of money orders or travelers checks discloses significant procedural deficiencies, or if staff has not completed current reconcilements, the examiner should observe staff performing an inventory during the examination. As part of this inventory procedure, the examiner should ask the credit union to request from the issuer a listing of money orders and travelers checks issued, but not yet paid. The examiner's inventory should balance with issuer's inventory. The examiner must reach agreement with the credit union to resolve any discrepancies between the two inventories.

**Other
Negotiable
Items**

Other negotiable items include, but may not be limited to, postage stamps and theater and amusement park tickets.

Credit unions frequently sell postage stamps, theater tickets, and amusement park tickets. If examiners review postage stamps, theater tickets, and amusement park tickets, they should ensure that the credit union performs inventories at least quarterly and has adequate internal control procedures.

**Excessive
Transactions**

Examiners may incorporate reviews of specialized information systems reports, such as the "Excessive Transaction Report", into their

evaluation of cash operations in automated credit unions. The credit union can change the parameters on the Excessive Transactions Report, but usually sets them to display transactions over \$10,000. While the \$10,000 parameter is actually for Bank Secrecy Act (BSA) compliance purposes, review of this report may reveal unusual or excessively high transaction volume, which would necessitate further investigation. Refer to the Bank Secrecy Act chapter.

Federal Reserve's Payment System Risk Program

With any payment system, a sending institution may not be able to settle its obligations within a specified time. All FEDWIRE transfers are final and irrevocable when the Federal Reserve Bank (FRB) sends notice of the payment to the receiving institution. Therefore, the receiving institution can pass collected funds immediately to its customer and will bear no risk if the sending institution fails. If the sending institution has insufficient funds in its reserve account at the time the payment order occurs, it incurs a "daylight overdraft." If the sending institution fails that day, before bringing its reserve account into balance, the FRB absorbs the loss.

Systemic risk means the risk that a system participant's failure to settle its net debit position will affect others. The major objective of the FRB's policy statement is to reduce the risk of a settlement failure. The policy statement seeks to achieve this goal by reducing the level of daylight overdrafts and by encouraging institutions to exercise better control over the remaining credit exposure through voluntary adoption of a "cross-system sender debit cap". This cap represents the maximum net debit a depository institution may incur at any one time on all of the large dollar wire transfer systems. It further limits the amount by which an institution's outgoing wire transfers may exceed the value of the transfers received across all systems.

Under the policy statement, the FRB encourages depository institutions to establish their net debit cap based on a self-assessment of three criteria:

- (1) Creditworthiness;
- (2) Operational controls, policies, and procedures; and
- (3) Credit policies and procedures.

Based on the depository institution's evaluation of its strength in these three areas, the FRB determines an overall assessment of the institution. When a depository institution establishes its sender net debit cap, the FRB expects the institution to maintain supporting documentation, a back-up file of its self-assessment, and evidence of its board of directors' review and approval of the cap selected. Appendix 9A, Wire Transfers, provides additional information.

Fraud Detection

If examiners discover fraud or a shortage, they should document the fraud or shortage as completely as possible and notify the supervisory examiner. With supervisory examiner concurrence, the examiner should notify the board of directors and the supervisory committee and request completion of the Suspicious Activity Report (SAR). The examiner will encourage the officials to, at a minimum, (1) suspend the personnel involved with pay, (2) control the access of personnel involved to the credit union, (3) fill the operational void caused by the suspension, (4) contract to perform a fraud audit, (4) notify surety, and (5) file a bond claim after all facts are known.

Ultimately, NCUA must decide the likelihood of pursuing prohibition actions against dishonest individuals. The examiner should seek input for this decision from the supervisory examiner, regional office, and, if necessary, the Office of General Counsel. Should conviction of a crime result for an individual, NCUA usually can obtain a prohibition more easily.

Alternative Examination Procedures for Small Credit Unions

Internal control limitations, primarily the lack of segregation of duties due to limited staff, can exist for many smaller credit unions. When examining non-complex smaller credit unions, examiners may substitute the following review procedures, which may adequately address their internal control concerns in the cash area:

- Observe staff count all cash in the presence of a credit union official or manager, and determine that the count balances to the corresponding general ledger accounts;
- Determine that the reconcilements balance for two month-ends since the previous examination, and documentation exists for

reconciling items (e.g., deposit slips for outstanding deposits.)
Examiners may randomly select one month and confirm clearing of reconciling items within reasonable time frames, but the second month should be the most recent month-end bank reconciliation. Review “stale” outstanding checks and outstanding adjustments over 30 days old;

- “Flip” checks. Select a representative month, look at canceled checks for unusual activity (e.g., payee and check signer are the same person, unusual endorsements, etc.);
- Perform receipts and disbursements test for two months since the previous examination. Examiners may randomly select one month, but the second should be the month prior to the current examination. The testing includes reconciling total debits and credits of the general ledger with the total of debits and credits shown on the bank statements. If the receipts and disbursements test results in differences that need further review, the reconciliation of receipts with deposits may pinpoint the differences; and
- Verify that the credit union makes deposits intact and within timeframes consistent with the FCU Bylaws.

If examiners perform this type review, they should document their review.

Receipt and Disbursement Test

The purpose of the receipts and disbursements test is to quickly determine whether or not cash receipts and disbursements posted to the credit union’s books tie out to the actual receipts and disbursements on the bank statement. This test will help identify falsified deposits and checks, month-end lapped deposits, and several other areas of cash manipulation; however, examiner’s judgment is needed to determine the cause of the problem.

Receipts Test

- 1) Place the total of the receipts from the general ledger in a cell on the computer or in the memory of a calculator;
- 2) Total the deposits on the current bank statement;

- 3) Subtract the outstanding deposits from the previous month as shown on the bank statement, since this represents activity from the previous month. Also, verify that the prior month's deposits appear intact on the current bank statement;
- 4) Add the outstanding deposits for the current month;
- 5) Subtract the total of the current month's outstanding deposits (Step 4) from the stored total of general ledger receipts (Step 1):
 - If the answer is zero (i.e., the receipts equal the deposits), no apparent problems exist;
 - If they are not equal, determine the source of the difference. Small differences often represent re-deposited, non-sufficient funds (NSF) checks. Examiners should look for credit and debit memos and determine how they affect the statement. Larger differences may require the examiner to check the deposits back individually to determine if an error occurred (see reconciliation of receipts with deposits).

Disbursements Test

The procedures are similar to those for the receipts test, except they involve checks written and cleared instead of deposits. Again, if the test does not zero out, determine the reason for the difference. Reasons may include NSF checks, service charges, check printing fees, or other reconciling items. Examiners may find it necessary to prove out the daily totals by running tapes of each day's checks when they cannot readily determine the differences or when they suspect fraud.

Examiners should be able to perform these tests quickly to uncover posting or other problems. They may develop spreadsheets to speed the work and allow the computer to do the calculating.

Reconciliation of Receipts with Deposits

Examiners may choose the test check of tracing or reconciliation of receipts, as recorded in the credit union's books (or tellers' cash received summaries, if not posted), with deposits recorded by the bank. Examiners may use this test check in situations where the receipts and disbursements test indicates problems that require further research. This test also supports and ties in the cash count and the bank reconciliation.

The reconciliation of receipts with deposits documents that the credit union makes bank deposits intact (i.e., the deposits include the exact amount of one or more day's receipts) and deposits them in the bank within the time limitations set forth in the bylaws. Additionally, this test determines that the credit union does not summarize receipts of more than one day on the same cash received summary. (The credit union should prepare a cash received summary each day and attach it to that day's individual teller cash received summaries.)

Examiners could trace funds received from entries on the credit union's books (or tellers' cash received summaries, if not posted) to evidence of deposits in the bank. The suggested minimum period starts with the beginning of the month prior to the month in which the examination takes place and runs through the day of the cash count. The purpose of this test check is to furnish the examiner with a reasonable appraisal of the credit union's practices with respect to depositing of funds received.

**Workpapers
and
References**

- Workpapers
 - Red Flag Questionnaire
 - Cash Internal Control Questionnaire
 - Money Order and Travelers Checks Questionnaire
 - ATM Questionnaire
- References
 - *NCUA Rules and Regulations* – 715.12
 - *FCU Bylaws* – 12/87 – XV,1.
 - *FCU Bylaws* – 10/99 – XIII, 1.

WIRE TRANSFERS - APPENDIX 9 A

Overview

An electronic funds transfer (EFT) is any transfer of funds initiated through an electronic terminal, telephonic instrument, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a financial institution to debit or credit an account. Credit unions primarily use wire transfers to transfer their own funds (e.g., for investments or payment of expenses) from one institution to another. However, credit unions also transfer members' funds upon request.

The majority of credit unions wire funds by calling their corporate credit union (or correspondent bank) and instructing the corporate to (1) access the credit union's settlement account at the corporate to fund a wire transfer, (2) forward the funds and the wire instructions to the Federal Reserve, and (3) post the transaction to the credit union's settlement account at the corporate.

Credit unions that have an Internet-based request system may also submit requests for wire transfers to the corporate credit union or correspondent bank electronically. Many larger natural person credit unions directly access the FEDLINE system (or telephone the Federal Reserve directly) and conduct their own transfers. (FEDLINE, the personal computer-based electronic delivery system by which credit unions access the Federal Reserve System's on-line services and information, provides settlement services, cash services, and a means to transfer funds and securities between institutions.)

In any case, all credit unions offering wire transfers must abide by written security policies and procedures that consistently promote safe and accurate transactions. Credit unions can limit their liability and risk of loss by using recommended security procedures, referred in UCC Article 4A as "commercially reasonable security procedures" (e.g., recorded telephone lines, codes, passwords, personal identification numbers (PINs), encryption, etc.) These procedures help assure the authenticity and correctness of payment orders, and apply to telephone, personal computer, or other electronic transmission of the orders to the credit union.

**Transaction
Security**

Credit union officials must write and adhere to transaction security policies. Examiners should review the written policies and determine their appropriateness for the credit union's size and number of employees. Examiners should also request the list of employees authorized to initiate wire transfers and review it to ensure the credit union keeps it current.

Proper controls depend on accountability (including accurate recordkeeping and sufficient documentation) and adequate separation of duties, which small credit unions having few employees can find a particular challenge. Nonetheless, all credit unions involved in wire transfers should carefully develop and strictly adhere to good internal controls.

Most corporates, correspondent banks, Federal Reserve or FEDLINE terminals mandate that credit union employees authorized to send funds by wire identify themselves by passwords, PINs, or test keys.

The credit union should require frequent changing of passwords, depending on the volume of wire activity (e.g., credit unions should change FEDLINE passwords every 30 days and members' passwords at least semiannually.) Credit unions that require regular changing of passwords reduce the risk of an unauthorized user gaining access to a member's account.

The examiner should determine that the credit union properly controls the system of assigning and communicating passwords, and that it promptly acts on suspected compromises of this security by canceling the password and assigning a new one. Examiners should walk through the wire transfer procedure with the credit union staff. Following are examples of controls that credit unions should enact:

- Assign a unique password to each user. Sharing passwords increases the potential to compromise control and accountability;
- Discourage users from selecting easily remembered passwords (e.g., initials, family member's name), or ones that rotate in a pattern, by using PINs or test keys;

- Ensure confidential and secure communication of newly-selected passwords, PINs, or test keys between the credit union and employees authorized to perform wire transfers;
- Instruct employees to close files, turn computer screens from the view of other employees, and refrain from discussing confidential information, including passwords; and
- Control access to the system, passwords, and any backup software when storing passwords on a shared electronic system such as a local area network (LAN.)

Requests for Wire Transfers

To positively identify members, credit unions should require members requesting a wire transfer of any amount to complete and sign a standard authorization form. However, many members make requests for emergencies when the member cannot come to the credit union. In these cases, the credit union should attempt to identify the member over the phone and establish a limit for the amount it will wire under these conditions. Requesting account numbers, social security numbers, or birth dates does not meet minimum security standards for wire transfers. Information not easily accessible to someone other than the member requesting the wire is acceptable (e.g., mother's maiden name, password, etc.) Written procedures should establish a maximum limit (i.e., an amount the credit union has determined it could lose in an unauthorized wire - usually \$2,000-\$3,000) for wires requested by telephone.

For members regularly requesting telephone wire transfers, the credit union should establish passwords or PINs which it changes routinely. In addition, regular users should sign formal wire transfer agreements that fix responsibility between the parties. The credit union should maintain the agreements on file.

The credit union needs to document wire requests. It must understand that a FAX does not comprise a legal document. Phone calls, unless made on recorded lines, are also difficult to prove; therefore, the credit union should consider installing a telephone recording system on phone lines used for wire transfer calls. At a minimum, the credit union should call back the member to verify authorization of the wire

transfer and record on the wire form the date, time, and initials of the person receiving the request and the person performing the callbacks.

Various credit union departments making wire requests for investments or payment of expenses should record those requests on standard request forms after obtaining approval from individuals authorized to make investments or pay expenses.

**Methods of
Sending Wire
Transfers**

Most credit unions wiring through their corporate or a correspondent bank call the institution and request the transfer or submit the request for transfer using a product such as U.S. Central Credit Union's Open Door system or another institution's browser-based transaction program. Authorized users state or enter their passwords or PINs and make or enter the request.

Corporate staff should read back a telephone request order to the requesting credit union for accuracy and may confirm the request by a telephone callback. For Internet based programs, the corporate will probably employ automated checks for accuracy; but may confirm the request through a telephone callback.

Corporate staff should ensure the caller has authority to make the request, and that the requested amount falls within the caller's authority. Most often the credit union's responsibility includes assigning authority to request wires to specific employees and assigning a maximum dollar limit on each employee's authority. The corporate then verifies the caller's authorities to a listing provided by the credit union.

Passwords and callbacks have different purposes and should not substitute for each other. Passwords allow a user into the system, while callbacks confirm the order's source and authenticity. Credit union management may not always recognize this distinction.

Less common (and inappropriate) methods of requesting wire transfers include telegram, telex, and FAX. The ease of compromising the security of these transactions provides each with a great potential for fraud. The examiner should take exception to a credit union's use of any of these methods.

Assuming the credit union has adequate security and proper controls, examiners should not take exception to other forms of electronic transfer, such as Western Union wire terminals, or alternative software such as U.S. Central Credit Union's Open Door product or other browser-based wire request programs.

**Pre-
Authorized
(Card) Wires**

Credit unions establish many repetitive wire transfers (e.g., regular or periodic transfers of credit union funds to an investment account at another institution.) For these repetitive wire transfers, the wiring instructions remain the same except for the dollar amount.

The receiving institution (usually the corporate or Federal Reserve) often establishes pre-authorized (card) transfers by creating a template screen in the FEDLINE terminal or within the browser-based transaction program. Then, when the credit union calls in or submits a wire request via the Internet, the caller or person entering the request only gives or enters a password or PIN number and states the need for, or enters, a wire for a certain dollar amount in the credit union's account at "ABC Bank." The caller does not have to give an account number or the bank's ABA number, which results in a more efficient transaction.

The examiner should review the security procedures for establishing, changing, or deleting the credit union's template screen on the FEDLINE terminal or within any browser-based wire request programs. Adequate accountability and control requires a written and confirmed request to establish, change, or delete a pre-authorized template. Additionally, someone other than the operators performing the "initiation" and "verification" functions on the terminal should establish or edit the template screens.

**FEDLINE
Terminal**

A credit union having its own FEDLINE terminal must institute additional controls and security measures beyond those required for accessing the FEDLINE through a corporate or correspondent bank.

Funds transfer messages sent over the FEDLINE terminal must go through two processes before transmission. Initiation involves entering the message into the terminal, while verification requires re-entry into

Sample FEDLINE User Access Report

Local Administration	*MC-F6*	MM/DD/YYYY	14:09:03L 2/C19

User-ID: _____	Name: _____		
Password: _____	Verify password: _____		
Current states: A	Password last changed on: _____	re-try cnt: _____	

An 'X' designates what function category a user is allowed to access with an application. No 'X's imply non-restricted functions only.

	Application	Function categories					
	Code	Inq.	E/U	V/T	A. Supv.	Supv.	Mngr.
1							
2							
3							
4							
5							
7							
8							
9							

Sample Miscellaneous Security Settings Report

Misc. Security Settings	Local Administration	MM/DD/YYYY	9:37:58L 6.38
<p>LOCAL ADMINISTRATION ACCESS OPTIONS</p> <p>User's ID will be suspended after 3 consecutive bad password attempts</p> <p>User must change password every 45 days</p> <p>Verification rule N (use < F6 > Key)</p> <p>Override & Release rule N (use < F6 > Key)</p> <p>User-ID will be signed-off after 15 minutes of inactivity</p>			

Illustration 9A-1

the terminal of all or part of the message. The security options on the system allow the credit union to decide exactly which data fields within the message it will re-enter. After staff completes the verification process, the FEDLINE terminal automatically transmits the message and transfers the funds.

The examiner should determine that the credit union requires two different employees to perform the initiation and verification processes on the terminal. Both the credit union's written policies and its established control parameters on the system should require this separation of duties. Examiners should ask the local administrator to screen print the "Miscellaneous Security Settings" for purposes of reviewing the controls. (Illustration 9A-1 contains examples of the FEDLINE User Access Report and Miscellaneous Security Settings screen print.)

Miscellaneous Security Settings

The examiner should have the local administrator screen print the Miscellaneous Securities Settings during the examination. The screen print will show:

- Settings for the Verification Rule;
- The Override and Release Rule;
- The number of bad password attempts allowable before the system suspends a user ID;
- The number of minutes the system allows the FEDLINE terminal to remain unattended before it automatically logs off;
- Whether the system suppresses the keyboard eavesdropping message each time a user enters the FEDLINE; and
- Whether the system prints a full or summary account of deleted transactions during the cycle-date rollover.

Verification Rule

The Miscellaneous Security Settings screen displays the setting of the "verification rule" to N, U, or E. The "N" designator allows the same FEDLINE operator to perform initiation, editing (if needed), and verification functions on the same message. In other words, this designator allows one FEDLINE operator to transmit funds. The "U" designator restricts the FEDLINE operator who last initiated or edited a message from verifying that message. Thus, this designator requires

at least two FEDLINE operators to transmit funds. The "E" designator is the most restrictive. It requires that a FEDLINE operator other than the initiator or the editor perform the verification function.

The "N" designator for the verification rule does not require adequate separation of duties; therefore, it is unacceptable for credit unions. Larger credit unions should set this designator at "E" thus requiring the highest level of separation of duties. However, the examiner may accept a setting of "U" for the verification rule, especially if the credit union has limited staff, and if, in the examiner's judgment, it has other adequate controls.

**FEDLINE
Functions
and Access
Levels**

A two-character code identifies each application in FEDLINE. The following codes assign access authority to an operator:

**	All Applications
AH	Automated Clearing House
AS	Accounting Services
BA	Book-Entry Securities
CS	Cash Services
CH	Check Services
FT	Funds Transfer
HC	Host Communication
HD	Help Desk
LA	Local Administration
MS	Miscellaneous Support
RA	Local Reserve Account
RR	Reporting and Reserves
SB	Savings Bond
SS	Startup/Shutdown Control
ST	Securities Transfer
TA	Treasury Auction
TT	Treasury Tax and Loan

The following six access levels exist within each application:

- Inquiry
- Entry/Update
- Verify/Transmit

- Assistant Supervisory
- Supervisory
- Managerial

The credit union can assign an employee one or more access levels within an application; they need not be the same for each application. For example, the credit union may give an employee inquiry capability for the Securities Transfer (ST) Application, and managerial capability for the Funds Transfer (FT) Application. Also, the credit union need not assign all six levels of access within each application.

The credit union may choose to customize some local options in accordance with the institution's specific operating environment. These rules apply to the entire FEDLINE system installed on the computer, not to a specific application.

The local access options are:

- Number of invalid password attempts;
- Password expiration interval;
- Key verification requirements;
- Override and release rule;
- Automatic sign-off and time-out intervals;
- Suppression of possible keyboard eavesdropping; and
- Cycle-date rollover print delete option.

Local Administrator

The credit union will designate one or more employees as a local administrator for the FEDLINE terminal. The local administrator may add or delete authorized users and authorized functions of established users. (For example, funds transfer is only one of several functions. Others include securities transfers, ACH transactions, etc.) The local administrator can also select, add, delete, or change an individual's security options.

The local administrator should be an employee who works outside the operational area responsible for the terminal and who the credit union (1) would challenge for trying to gain terminal access routinely, and (2) will not assign any other duties on the FEDLINE terminal. The

examiner may have to make certain allowances for the limited staff in a smaller credit union.

User Profile Report

During the examination, the examiner should identify and ask the local administrator to print out FEDLINE's User Profile Report in the examiner's presence.

The User Profile Report shows all authorized users, the functions each may perform, and the authority level within each authorized function. The examiner should identify all users on this report and determine that the credit union has broad enough authorization levels to allow staff to efficiently carry out their duties and responsibilities, yet sufficiently restricts these authorization levels to ensure sound internal controls.

The examiner should pay particular attention to the following function codes:

- ** (Double asterisk) - Allows the user to perform any function
- LA - Local administrator function
- FT - Funds transfer function
- ST - Securities transfer function

Anyone with the "***" function code can perform any function. The examiner should determine the appropriateness of giving such widespread authority. Two different employees should always perform the initiation and verification functions. However, when possible, NCUA strongly encourages greater separation of duties.

As mentioned earlier, the personnel authorized to perform the LA function should not have authorization to perform any other function. Under certain circumstances, a local administrator could unilaterally set himself up to perform other functions at any time. However, the additional time required to set up the new authorization and the attention that would result from the local administrator being at the terminal, as well as constant internal auditing and monitoring of FEDLINE activity, should deter any unauthorized actions by the local administrator. Internal auditing and monitoring of the FEDLINE

system should include review of user access by someone not involved in the funds transfer process, other than the local administrator.

The FT code designates those employees who may perform funds transfer functions. The examiner should determine that the credit union has assigned this code to the minimum number of employees necessary for efficient operation. No employee outside the funds transfer department should have authorization to perform the FT function at any level higher than "inquiry."

The ST code designates those employees who may perform securities transfers on the FEDLINE terminal. Examiners review the use of this code in conjunction with the examination of the credit union's securities safekeeping program.

User Access Report

The examiner should ask the local administrator to print the User Access Report.

FEDLINE Security Features

- Number of password tries. Every user on the FEDLINE terminal has a personal password that the system requires before an individual can perform any function. The system requires periodic change of personal passwords. The local administrator can set the number of times a user may enter an erroneous password before the system locks out that user's ID. The miscellaneous security settings screen shows this setting.

The examiner should determine the appropriateness of the number of password-attempts setting. Normally, the credit union setting should allow no more than three bad attempts.

- Override and Release Rule. This setting, which restricts the overriding and releasing of messages, has available the same three options as the verification rule.
- Automatic log-off of unattended FEDLINE terminal. The miscellaneous security settings screen also states the number of minutes that the FEDLINE terminal will stay active before automatically logging off. The local administrator can set this

parameter at any number from 0 to 999. If the local administrator sets this number at other than zero, the terminal will automatically log off after being left unattended for the pre-set number of minutes. If the local administrator sets the number at zero, the terminal will not log off automatically.

If the local administrator sets the time parameter too long, chances increase that one operator may gain access to the terminal while it is still logged on under another operator's user ID, resulting in a loss of accountability.

The examiner should review the unattended FEDLINE terminal setting and determine its appropriateness. Normally, the credit union should set the parameter between one and five minutes.

- **Suppress Possible Keyboard Eavesdropping.** This setting permits the administrator to turn off the "possible keyboard eavesdropping" message noted each time a user enters FEDLINE.

The examiner should determine that the administrator has not suppressed the message. The credit union should enact and monitor a control preventing a Terminate and Stay Resident (TSR) program on the terminal to ensure that no one copies various keystrokes.

- **Cycle Date Rollover.** Before beginning each day's work, a credit union employee must perform a function on the FEDLINE terminal known as the "cycle date rollover," which resets the date on the terminal. The FEDLINE system requires the operator to clear or cancel messages still pending (i.e., initiated but not verified or transmitted) before performing this function. The policies should require canceling and reporting to management any pending messages.

The security administrator can set the system to print either a full or a summary account of deleted transactions during the cycle-date rollover process. Either report documents pending message problems. While the detailed report contains all the information about the transaction, the summary report shows only limited information about the transaction.

- Update Message Application Attributes. This function allows staff persons with managerial access to customize several control related aspects of outgoing message processing including: verification thresholds, a duplicate reference number edit, and an accountable message transmission limit. Management can establish these verification requirements for the message processing functions at the application level for Funds Transfer, Securities Transfer, Checks, or Treasury Tax and Loan (TT&L) messages. Examiners can determine whether the credit union has set any of these customized features by asking that the staff person with managerial access to the applications screen print the settings on the update message application attributes' screens.

The credit union can set verification thresholds for accountable and non-accountable messages for which it will impose the verification requirement. If the credit union sets the dollar amount at 0.00, it will verify all messages; whereas, if the credit union sets the dollar amount at 99,999,999,999.99, it will verify no messages. For other settings, it will verify any amount over the amount set. NCUA recommends that the dollar amounts be set at 0.00 to verify all messages.

The credit union can automatically check for duplicate reference numbers when creating or updating information depending on the numbering of source documents. Good internal controls require activation of this edit check to prevent duplication of numbers. Examiners should determine that the credit union uses a different number on each source document.

Credit unions can prevent transmission of accountable messages (including those with a verified status) until an authorized operator using the message status override function releases the messages. Credit unions with larger staffs usually activate this additional control; however, credit unions with smaller staffs often set the control at "N" indicating that the system will automatically queue verified messages for transmission. Examiner's judgment will determine the adequacy of the setting.

Reconciliation of the FRB Account and Funds Transfers

The credit union should reconcile the number and dollar amounts of funds transferred to the Federal Reserve account balance throughout the day. Periodic reconciliation discourages fraud. Smaller credit unions may reconcile only two or three times during the day; larger credit unions more often. In addition, staff must perform a detailed reconciliation of the Federal Reserve account daily. The individual responsible for reconciling should not otherwise perform funds transfer duties.

Audit Copy of FEDLINE Messages

A FEDLINE printer records messages on the FEDLINE terminal. There are three categories of messages:

- Outgoing transactions;
- Incoming transactions; and
- Miscellaneous messages.

The credit union can have all messages going to the same printer, or direct different categories of messages to different printers. The FEDLINE system assigns a sequence number to each message. Each category has a separate sequential numbering.

In order to establish an audit trail, the credit union should use multiple-part paper on the FEDLINE printer. The credit union should maintain one copy of the messages in continuous form for the entire day, from log-on to log-off. If staff must perforate the paper (e.g., when the box of paper runs out), a supervisor other than a FEDLINE terminal operator should inspect the old and new continuous forms to account for all messages and should initial the beginning and end of each form where the gap occurs. Supervisory review of the entire audit trail for unauthorized attempts to access the system, unauthorized messages, etc., should occur daily. The supervisor should initial the audit trail indicating the review. The credit union must retain daily audit trails through both the next audit and examination periods.

**Functions,
Applications,
and Security
Parameters in
Browser-
Based
Systems**

Corporate credit unions or other third-parties, including correspondent banks, provide a number of browser-based programs used by credit unions to submit wire transfer requests. Each program has its own defined functions, applications, and security parameters. While each program has differences, the functions, applications, and security parameters should essentially mirror the control features available using Fedline.

A wire transfer made through a corporate credit union or correspondent bank using browser-based software rather than FEDLINE does not change the need for involving two credit union employees in performing the initiation and verification processes. System parameters similar to FEDLINE controls should require this separation of duties. Examiners should ask the browser-based program local administrators to print out a screen similar to the FEDLINE "Miscellaneous Security Settings" screen, showing the availability and activation of a dual control feature. Browser-based programs also generally provide for maximum dollar limits for each user. Usually, examiners can verify the presence of dollar limits by accessing the system's User Authority Reports.

**Physical
Security**

Following are important aspects of physical security:

- Location of the FEDLINE terminal. Ideally, the credit union should locate the FEDLINE terminal in a secured room dedicated solely to wire transfer activities, with only authorized terminal operators and their supervisors having access. However, smaller credit unions having limited space often cannot place the terminal in a secured room. In that case, the credit union should place the terminal in a low traffic area, but within sight of the workstations of all the terminal operators or the operators' supervisor. This reduces the likelihood of unauthorized personnel gaining access to the terminal.
- Number of staff present. The credit union's written wire transfer policies and procedures should require the presence of at least one employee who understands and can operate the FEDLINE terminal and a supervisor whenever the FEDLINE terminal is operational.

- Security of telephone lines. The examiner should determine the security from eavesdropping of the credit union's telephone lines. A breach of security could occur from outside or inside the building. The telephone company bears responsibility for security outside the building; security inside the building rests with the credit union.

Examiners should evaluate the security of the room containing the credit union's telephone switching panel (i.e., locked with management maintaining the key) and determine that the telephone system does not allow one extension to listen in on another system. An unauthorized person could listen in on a telephone line at this switching panel with the aid of relatively simple equipment. If a repairman needs access to the panel, management should verify the repairman's identification and take necessary precautions to avoid breaches of security any time the panel is unsecured.

- Security of encryption key diskette. The Federal Reserve provides all authorized, licensed users with a diskette containing the encryption key for the FEDLINE terminal. The terminal has a security feature that requires the reload of the encryption key if the credit union moves the terminal. FEDLINE licensing agreements allow maintaining only two copies of the diskette; one copy at the credit union and the other offsite for use during disaster recovery. The credit union should keep both diskettes in secure areas with controlled access, such as a safe or safe deposit box.

**Policies,
Procedures,
and
Guidelines**

The AIRE Wire Transfers Questionnaire inquires about internal control practices pertaining to the wire transfer operation and, more specifically, whether the written policies and procedures address certain practices. Examiners should determine that employees follow written procedures.

Written internal control procedures help ensure consistent application, enforcement, and accountability, even when a change of staff or management occurs. Appropriate procedures should include:

- Written funds transfer agreements. The credit union should have a written funds transfer agreement with each applicable institution,

outlining the duties and responsibilities of each party to protect the interests of both institutions. The agreement should specify the responsibilities of the institutions regarding security features such as passwords, PIN numbers, test keys, and telephone callback.

The institutions should also have written documentation that authorizes certain employees or officials to request or send funds transfers. If this is the only documentation, the examiner should take exception and require the development of a formal funds transfer agreement.

Credit unions that send members' wires should also have written agreements with their members notifying them of their duties and responsibilities, assigning liability in the event of a loss, and documenting the security procedures to be used.

- Personnel policies for wire transfer operation. To enhance the funds transfer operation internal controls, written personnel policies should incorporate items that may help improve the credit union's chances of collection if someone files a bond claim against an employee who violates the policy. These should include restricting or limiting the hiring of relatives for key areas, filling vacancies internally, and eliminating access on termination or resignation.
- Contingency planning for wire transfer operation. The examiner should determine that the credit union has an adequate disaster recovery plan for its wire transfer operation, and that management has sufficiently familiarized all wire unit employees with the plan. Some credit unions, particularly those whose disaster recovery plans include relocating to a "hot site," may have the capability of remaining online with the Federal Reserve during a disaster. For those, procedures and controls should remain much the same as during normal operations. However, many credit unions plan for their funds transfer operations to go offline in case of a disaster. Either way, the credit union must maintain proper security over the operation during execution of the disaster plan and must periodically test the plan and document the test results.

- Audit or review of wire transfer operation. The sensitive nature of wire or securities transfers requires an audit or review at least annually. The credit union's internal audit department or external auditors may perform the review. If the credit union has its own wire or securities transfer system, it should hire auditors who have independent training in the credit union's wire transfer communication system, and who participate in planning for changes in equipment, systems, and operating procedures. The auditors should establish a formal audit program covering all aspects of the wire or securities transfer operation.

Record-keeping Requirements

The Federal Financial Institutions Examination Council (FFIEC) encourages credit unions to support law enforcement's efforts to identify and prosecute money laundering activities involving large-value funds transfer systems. This support includes maintaining, to the extent practical, complete originator and beneficiary information when sending payment orders over any funds transfer system.

Additionally, the Bank Secrecy Act (BSA)¹ requires certain recordkeeping requirements for credit unions engaged in wire transfer operations on behalf of their members (applies only to transmittals of \$3,000 or more).

- The credit union must retain records (originals, copies, electronically, or on microfilm) for five years; and
- When the credit union is the originator's financial institution, it must retain the following records:
 - Name and address of the originator;
 - Amount of the payment order;
 - Execution date of the payment order;
 - Payment instructions received from the originator with the payment order; and
 - Name, address, account number and any other specific identifier of the beneficiary, if these are received with the payment order.

¹ NCUA Letter to Credit Unions No. 173, July 1995, contains additional information about the BSA revision.

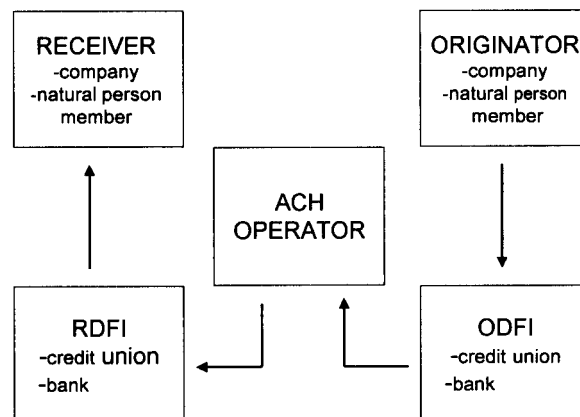
AUTOMATED CLEARING HOUSE NETWORK - APPENDIX 9B

Overview

The Automated Clearing House (ACH) network electronically exchanges funds and related information among individuals, businesses, financial institutions, and government entities. The ACH Operator provides a central distribution and settlement point for transmitting funds electronically between an originating depository financial institution (ODFI) and a receiving depository financial institution (RDFI.)

The following illustration depicts the ACH Network and their interrelationships:

How the ACH System Works



- **Originator.** The originator directs a transfer of funds to or from a receiver's account by providing the ODFI with payment instructions. The originator agrees to initiate ACH entries into the payment system according to an agreement with a receiver. A company usually acts as the originator (but an individual member can also originate ACH transactions) directing a transfer of funds to or from a consumer's or another company's account. The term "company" refers to the originator of electronic ACH entries and does not imply exclusion of other types of organizations.

- **Originating Depository Financial Institution (ODFI.)** The ODFI receives the payment instruction from the originator and forwards the instructions to the ACH operator. A depository financial institution (DFI) may participate in the ACH Network as a RDFI without being an ODFI; however, if a DFI chooses to originate ACH entries as an ODFI, it must also agree to act as an RDFI.
- **ACH Operator.** The ACH operator is a central processing facility operated by the Federal Reserve Bank or a private sector organization that (1) receives entries from ODFIs, (2) distributes entries to appropriate RDFIs, and (3) performs settlement functions for the affected financial institutions.
- **Receiving Depository Financial Institution (RDFI.)** The RDFI receives ACH entries from the ACH operator and posts them to the accounts of its depositors (receivers.)
- **Receiver.** The receiver is a natural person or organization whose account is either debited or credited in payment or collection. The receiver must authorize an originator to initiate an ACH entry to the receiver's account with the RDFI.
- **Third-Party Processor.** Third-party processors are data processing service bureaus, financial institutions, or other organizations that provide ACH processing services for financial institutions. A third-party processor may serve as an agent for an ODFI or RDFI; however, the ODFI or RDFI remains responsible for compliance with ACH rules.

Small credit unions and large credit unions approach ACH transactions differently.

- **Small credit unions** usually perform transactions through a third-party processor. The parties either courier or fax detailed information back and forth or communicate using modem communications.
- **Large credit unions** usually perform transactions directly on a FEDLINE terminal that communicates with a Federal Reserve

Bank (ACH operator) or uses alternative software to communicate with a processor.

**Data Flow
versus Fund
Flow**

Unlike the wire transfer and check systems, the ACH is both a credit and a debit payment system. ACH credit transactions transfer or distribute funds from the originator to the receiver, resulting in a deposit to the receiver's account. Conversely, ACH debit transactions transfer or collect funds from the receiver to the originator resulting in a withdrawal from a receiver's account.

Regardless of the funds flow, ACH data flows in the same direction, from originator to receiver as follows:

- 1) The originator initiates a debit or credit payment order to the ODFI.
- 2) The ODFI transmits the payment information to the ACH operator.
- 3) The ACH operator receives data from the ODFI and sorts the entries by routing number.
- 4) The ACH operator transmits the entries to the RDFI.
- 5) The RDFI receives, processes, and posts the ACH data to the receiver account on settlement day.

**ACH
Applications
Codes and
Uses**

The ACH Network supports a number of different payment applications. A unique Standard Entry Class (SEC) Code identifies each application and the related ACH record format used to carry the payment and payment-related information. An originator initiating entries into the system codes the entries as either a debit or credit, which affects either a consumer or a corporate account at the RDFI. Listed below are SEC Codes and the different products each code supports.

**Consumer
Applications**

- Prearranged Payment and Deposit Entries (PPD) include both Direct Deposits and Direct Payments.
 - Direct Deposit is a credit application that transfers funds into a consumer's account at the RDFI. These funds represent a variety of products, such as payroll, interest, pension, etc.

- Direct Payment (Preauthorized Bill Payment) is a debit application. Companies with billing operations may participate in the ACH Network through the electronic transfer (direct debit) of bill payment entries. Through standing or single entry written authorizations, the consumer grants the company authority to initiate periodic charges to their account as bills become due. Examples of recurring bills paid by ACH include insurance premiums, mortgage payments, and installment loan payments. Utility payments represent a non-recurring bill (i.e., the amount varies) paid by ACH.

- Point of Purchase Entries/Shared Network Transactions (POP/SHR). Two SEC Codes that the consumer most often initiates via a plastic access card, representing point of sale debit applications in either a shared or non-shared environment. POP transactions also include conversion of checks to an ACH debit application at the point of sale.

- Machine Transfer Entries (MTE). The Network supports the clearing of transactions from automated teller machines (ATMs.)

- Customer Initiated Entries (CIE). Credit applications where the consumer initiates the transfer of funds to a company for payment of funds owed to that company, typically through some type of home banking product.

- Telephone Entries (TEL). A single entry debit application initiated by an originator pursuant to an oral authorization obtained over the telephone to effect a transfer of funds from an account of the receiver. This type of entry applies only to a single entry where no standing authorization exists and originator and receiver have an existing relationship or, absent the existing relationship, the receiver initiates the call.

- Web Entries (WEB). Debit applications initiated by an originator pursuant to an authorization from the receiver via the Internet to effect a transfer of funds from an account of the receiver.

Corporate Applications

- Cash Concentration or Disbursement (CCD). A credit or debit transaction where corporate entities either disburse or collect funds between themselves. This application can serve as a stand-alone funds transfer (CCD) or it can support a limited amount of payment-related data with the funds transfer (CCD+).
- Corporate Trade Payments (CTP). These allow corporations to transfer funds (debit or credit) within a trading partner relationship.
- Corporate Trade Exchanges (CTX). These support the transfer of funds (debit or credit) within a trading partner relationship in which a corporation sends full ANSI ASC X12 message or payment-related UN/EDIFACT information with the funds transfer.

Other Applications

- Automated Accounting Advice (ADV). An optional service provided by ACH operators that identifies automated accounting advises of ACH accounting information in machine readable format to facilitate the automation of accounting information for participating DFIs.
- Automated Notification of Change or Refused Notification of Change (COR). An RDFI or ODFI uses this when originating a notification of change or refusing notification of change in automated format. Also, the ACH operator uses it when converting paper notifications of change to automated format.
- Death Notification Entries (DNE). Agencies of the federal government use these to notify a DFI that the recipient of government benefits has died.
- Returned Entries (RET). ACH operators that convert paper returns to automated format use these. ODFIs that originate dishonored returns also use them when the dishonored return carries the SECC RET.
- Truncated Entries (TRC/TRX). These identify batches of truncated checks.

- Destroyed Check Entries (XCK). An institution can use these for collecting certain checks that were destroyed.

**Regulations
That Apply to
ACHs**

ACH Rules. National Automated Clearing House Association (NACHA), the governing body for the ACH network, publishes the rules annually. The rules incorporate those items approved by the NACHA members.

User compliance with the ACH rules enables the ACH Network to operate efficiently. These rules provide warranties and indemnification addressing origination, receipt, and prompt return of the entries. Primary responsibility rests with ODFIs for most of the warranties and indemnifications. However, if the parties enact an agreement stipulating different responsibilities, many of the ODFI's responsibilities can pass through the ODFI to the originator. These warranties and indemnifications reside with ODFIs and originators because they have primary control over the initiation of entries.

- ODFIs must:
 - Ensure proper authorization of the entries;
 - Submit timely entries into the ACH system;
 - Terminate the origination of entries when appropriate;
 - Meet the requirements for data security and personal identification numbers in certain applications, when appropriate;
 - Ensure that the entries contain the appropriate information;
 - Assure an agreement is in place with originators and sending points; and
 - Comply with the ACH rules.

The ODFI indemnifies the RDFI, ACH operator, and ACH association against loss when breaching any of these warranties. NACHA may require ODFIs that fail to adhere to the ACH rules to reimburse an RDFI or ACH operator for claims, losses, or expenses (including attorneys' fees and costs) that result directly or indirectly from the breach of warranty. Thus, a failure to comply with the warranties may result in a loss to an ODFI. While ODFIs assume responsibility for most warranties related to ACH

transactions, the RDFI warrants to each ODFI, ACH operator, and ACH association that the law permits it to receive entries allowed by the ACH rules and to comply with the requirements of the rules concerning RDFIs and participating DFIs.

- RDFIs must perform the following in a timely manner:
 - Receive and validate all ACH entries;
 - Post to receiver's accounts;
 - Validate pre-notifications;
 - Return entries that do not post within proper timeframes;
 - Handle remittance data as receiver requires;
 - Make funds available to the receiver within proper timeframes; and
 - Fulfill responsibilities when using a receiving point.

To limit their risk exposure, credit unions must acquire information and knowledge of ACH rules. They must also comply with the following applicable regulations:

- Electronic Funds Transfer Act (EFTA). Provides for rights and duties of consumers and financial institutions regarding electronic funds transfer. EFTA covers transfers initiated by both the private sector and the government;
- Regulation E. Issued by the Federal Reserve Board of Governors implementing EFTA to ensure consumers a minimum level of protection in disputes arising from electronic funds transfers;
- UCC-4A. Developed in part for wire transfers, but also applies to wholesale (institution-to-institution) ACH credit transactions and certain ACH credit transactions that are not subject to the EFTA. UCC-4A does not apply to ACH debit or to ACH credit transactions subject to EFTA; and
- Green Book. Published by the Financial Management Services agency of the Treasury Department. The Green Book specifies procedures for ACH transactions originated for the Federal Government.

**Risks to the
Credit Union**

The amount of risk associated with processing ACH payments varies based on whether the item is an ACH debit or an ACH credit, and whether the credit union receives or originates the item. Similar risks exist in the ACH system as those within the wire transfer and check payment systems.

Credit unions must understand payment processing risks (i.e., credit or exposure, operational, fraud, systemic, and third-party processing) and implement detailed written policies and procedures in place to control them.

**Credit
(Exposure)
Risk**

The risk that a party to a transaction will not have sufficient funds for settlement is called credit (exposure) risk. This risk often arises when one company that is a party to the transaction fails or is bankrupt before settlement occurs. The examiner must determine that the credit union limits the risk through necessary controls.

- ODFI Credit Risks
 - ACH Credits. An ODFI incurs temporary exposure to credit risk for the period of time between the initiation of an ACH credit file (from one of its originating companies) and the time when the company funds the account (normally on the settlement day, which is one to two business days after initiation.) ACH rules do not allow the ODFI to reverse ACH credits for failure of the originator to fund its account at the ODFI. Therefore, the ODFI is financially responsible for one to two days or until it receives funding from the originator. During this period of time the ODFI has, in effect, granted an unsecured short-term loan. Losses could occur if the company went bankrupt or failed to fund the account between the date of origination and the date of settlement.

The amount of risk an ODFI assumes is the total amount of the file not the individual transactions. Therefore, ODFIs must establish risk control parameters and limits based on the file totals as well as transaction amounts.

If a credit union is an ODFI, it must establish credit monitoring and control procedures over its members for whom it originates ACHs (similar to business lending requirements.) Credit union ODFIs must assign members' ratings and exposure limits and must continuously monitor them throughout the various departments of the credit union.

Requiring pre-funding of the accounts also enables credit unions to protect themselves. When credit unions take this step, they are only at risk if the originating company filed for bankruptcy between the origination date and the settlement date. In this instance, the funds may become property of the trustee of the bankruptcy court. Usually, this would merely delay the credit union's obtaining final funds. To further protect themselves, credit unions could require that the originating party deposit pre-funded amounts on the origination date into an escrow account in the credit union's name. This would reduce the likelihood of a dispute between the bankruptcy court and the credit union. Examiners should note that ACH rules do not require pre-funding and credit unions that require pre-funding could put themselves at a competitive disadvantage.

- ACH Debits. The ODFI incurs temporary risk from the day the originating company has the funds available until the RDFI or the receiver can no longer return the individual ACH debit entries. An ACH return is an ACH debit or credit that the ACH operator, receiver, or the RDFI returns to the ODFI. Reasons for returning ACH debits include insufficient funds, closed accounts, unauthorized transactions, stop payments, etc.

Return time for ACH debits falls within two general categories: (1) RDFIs may return non-authorized or revoked authorization consumer debits up to 60 calendar days after the original settlement date, and (2) all other returns, which the RDFI's operator must receive by its deposit deadline in order to make the return entry available to the ODFI no later than the opening of business on the second banking day following the settlement date of the original entry.

Normally, the ODFI charges back a returned ACH debit item to the account of the originating company. However, when bankruptcy or other legal actions leaves the originator's account closed, frozen or with insufficient funds, the ODFI may suffer a loss for the amount of the returned ACH debit item. Controlling this risk presents difficulty because an institution cannot judge whether or not the RDFI and receiver will have the funds necessary for the transaction to occur.

The amount of risk from originating an ACH debit application is generally for the amount of returned individual items and not for the amount of the entire file. Typically, this risk is low, particularly for consumer ACH debit applications such as preauthorized debits and point of purchase (POP) transactions. These consumer transactions generally have small dollar amounts. However, the consumer's right of recision under the ACH rules and Regulation E can cause greater temporary risk. Examiners should be aware of one exception: the ODFI can have risk for the entire amount of the originated file for cash concentration debits.

Credit unions can control the risk of ACH debit returns by placing holds on a portion of the originator's account for a reasonable period of time until the receiver most likely will not return the items. Additionally, they can require the originator to place collateral in an account in the credit union's name. Ensuring against return of all originated volume would require holds for up to sixty business days, a rarely encountered practice. Generally, hold amounts equal a percentage of the total files and reflect historic return rates for each originator and application. Credit unions can also control debit return risk by lowering the exposure limits for the originating company.

- **RDFI Credit Risks**
 - **ACH Credits.** The risk to the RDFI in receiving an ACH credit corresponds directly to the finality granted by its ACH operator and can vary. If the Federal Reserve serves as the ACH operator, ACH credits received by an RDFI are final (the point in time where the Federal Reserve cannot reverse the entry

from the RDFI's reserve account) after the close of business on settlement day. The Federal Reserve interprets finality for ACH credits as when the credit union posts the transactions to its reserve account, which can be as late as just prior to the opening of business on the day following settlement.

If the ODFI fails before or during the day of settlement, the Federal Reserve may reverse ACH credit transactions originated by the ODFI and settling on that day. Usually, when the RDFI receives credits, the Federal Reserve credits the receiver's account on the settlement day leaving the credit union open to risk if the ODFI fails and the Federal Reserve reverses the entries. The RDFI's exposure extends only to the amount of funds it made available before settlement is final. If it reverses the transaction, the RDFI will debit the member's account that it previously had credited. The RDFI runs the risk that the receiver's bankruptcy or failure will prevent it from recovering these funds.

RDFIs face operational risks related to ACH credits. Most liability centers on promptly posting the credits. RDFIs may expose themselves to legal costs and civil penalties when they fail to comply with these posting deadlines. Therefore, credit unions acting as RDFIs must comply with the rules governing ACH transactions.

- ACH Debits. The RDFI's operational risk in processing ACH debits lies in deciding whether or not to return an ACH debit by its ACH operator's deposit deadline, so the ODFI has the return entry available no later than the opening of business on the second banking day following the settlement date of the original entry. However, deadlines for unauthorized debits, and instances where authorization has been revoked, allow up to sixty days for a return. RDFIs that fail to meet these return timeframes may experience a loss if the ODFI dishonors the return as untimely.

Credit unions can control this risk by automatically returning ACH transactions for insufficient funds. However, some credit unions may choose to assume some credit risk in processing

ACH debits by allowing an ACH debit to post, even if it overdraws the receiver's account. While some credit unions may allow this as a common practice (similar to allowing members to overdraw their checking accounts), the examiner should determine whether or not the credit union has implemented adequate controls and monitoring procedures.

Operational Risk Operational risk, which varies with the type of processing, is the danger that an unintentional error will alter or delay a transaction. Examiners should determine that the credit union has implemented necessary controls to limit this risk. Following are examples of operational risks and the necessary controls that credit unions must have in place to protect against them:

- Hardware failure. Management reduces this risk through reliable equipment, regular maintenance, responsive service personnel, and adequate backup (including addressing hardware substitution or replacement in the credit union's disaster recovery plan.)
- Software failure. Management limits this risk by adequately testing the vendor's or service provider's software before relying on it for processing. Credit unions that develop their own software can reduce the risk of disruption due to software problems with sound software development practices (e.g., adequate documentation, sound testing procedures, tight change control procedures, effective recovery facilities, and periodic internal and external audits.)
- Data loss. Management can reduce this risk by implementing the following controls:
 - Storing data securely. Management must protect electronic files against unauthorized or inadvertent change by using file security techniques and must keep hard copy records in locked storage;
 - Limiting access to data to authorized personnel;
 - Duplicating, backing up, and storing data offsite to protect against data loss or destruction;
 - Establishing and maintaining audit trails of all transactions and changes;

- Accounting for all files to ensure that staff (1) only processes current files, and (2) does not inadvertently duplicate or omit a file from processing; and
 - Balancing file totals during processing to ensure that staff does not drop, change, or duplicate transactions.
-
- Telecommunications failure. Management can limit this risk by (1) maintaining telecommunications equipment (lines, modems, authentication or encryption devices, etc.) in working order; (2) physically protecting the equipment; and (3) developing diagnostic tools and backup modes of transmission in the event of a problem.
 - Power failure. Management can reduce this risk by obtaining an uninterruptible power supply system to remove spikes and transients from public power and provide auxiliary power during a blackout. Additionally, management should arrange for a generator to handle longer-term power failures.
 - Human error. Management can reduce this risk through (1) good supervision, (2) detailed operating procedures, (3) effective training, (4) periodic internal and external audits, (5) monitoring file and dollar controls, and (6) adequate audit trails.
 - Staffing problems. Management can reduce the risk of problems resulting from absences, turnover, work stoppages, etc., which vary with the size of the credit union, by emphasizing cross training and good supervision. Staffing problems in small credit unions often result from only one or two people knowing the process. In very large credit unions, the specialized nature of each activity enables few people to know the overall process.
 - Natural disasters. Management cannot control this broad category of operational risk, which includes disasters such as earthquake, flood, and fire. However, management must develop and test disaster recovery plans to identify alternate modes of operations and alternate operating sites and to ensure that operations will continue should a disaster occur.

Fraud Risk

Fraud risk is the danger that an employee or interlopers who gain unauthorized access to the system will initiate or alter a payment transaction in an attempt to misdirect or misappropriate funds.

Examiners should review for adequacy the credit union's controls, which should include the following:

- Personnel practices. Management must write personnel policies that enhance internal controls within the ACH operation.
- Physical security. Management must (1) limit access to computer and communications equipment sites to authorized personnel, (2) protect sensitive equipment within the secured area using access controls or device locks, and (3) secure and limit access to all data on portable media (tapes, disks, hard copies, microfiche, etc.)
- Data security and integrity. Management should (1) purchase commercially available software products to access production data files; (2) limit access to specified programs or user IDs by setting up each file for read-only or read-and-write access; and (3) employ encryption, authentication, and dial back data protection techniques when accessing data-in-transit from one participant to another.

Both the encryption and authentication require the use of a key, which may reside on a hardware component such as a circuit card or may be a data element that authorized personnel enters into a security program or system. The assignment, distribution, and control of encryption or authentication keys represent important data security controls.

- Software and data changes controls. Management must maintain detailed written development and change policies.
- Access restriction. Management must restrict access on software products using (1) operator passwords to prohibit entry by unauthorized personnel; (2) automatic features to control the number of unsuccessful password attempts, password expiration, or designated periods of inactivity; (3) multilevel functions by password to require dual control and ensure that no single employee can create and send transactions (e.g., restricting one

operator to file creation and a second operator to file approval or transmission); and (4) system administration level procedures that require secondary approval to assign, initiate, and maintain passwords.

- Processing dollar and file limit controls. Management must require use and enforcement of exposure limits (1) at the time of entry, batch, or file creation; (2) at the time of transmission; or (3) both (1) and (2.)
- Operational controls. Management must require procedures to implement the following operational controls:
 - File controls to ensure that staff (1) accounts for all files at each step in ACH processing, (2) only processes current files, and (3) does not accidentally or intentionally duplicate or omit files from processing;
 - Dollar controls to (1) confirm dollar totals at each step in ACH processing, and (2) help ensure in-balance ACH files, accurately posted accounts, and properly settled ACHs;
 - Date controls (file creation date, effective entry date, and settlement date) to monitor that staff processes the files within the time frames established by the various regulations;
 - Exception reporting to monitor (1) circumstances such as over-limit activity, (2) anticipated files not received, and (3) file inconsistencies that may suggest error, intrusion, or duplication;
 - Audit trails including procedures to (1) maintain a record of all ACH transaction data and all changes to static data, (2) respond to member inquiries, (3) reconstruct a sequence of events if a problem occurs, and (4) comply with NACHA rules;
 - Reconciliation of the actual entries on the Federal Reserve Statement of Account or similar statement from a correspondent financial institution to verify that the ACH work settled as anticipated. Proper segregation of duties requires that

the staff member responsible for reconciling ACH transactions should not be otherwise involved in the ACH processing; and

- Internal audits of the ACH process. NACHA rules require each financial institution to complete an internal audit of its ACH operations at least once every year (a copy of which the credit union must retain on file.) Completion of the audit by all financial institutions reinforces compliance with the ACH rules and improves the overall quality of the ACH network.

Systemic Risk

Systemic risk is the danger that the inability of one funds transfer system participant to settle its commitments prevents other participants from settling their commitments. Systemic risk is closely related to credit risk. While a fraudulent or erroneous transaction could constitute a source of systemic risk, a participant's failure would more likely trigger a major settlement failure.

The likelihood of systemic risk varies greatly among payment systems. A connection exists between the dollar volumes a network handles and the systemic risk involved: the greater the number of high dollar payments a network processes, the greater the systemic risk, and the greater the need for elaborate risk controls.

A small threat of systemic risk relates to ACH transactions, because a far less average dollar value exists for ACH transactions than for FEDWIRE or CHIPS. Rarely does a financial institution's position with respect to gross ACH settlement approach its capital level. A financial institution's position on the FEDWIRE or CHIPS network will more likely exceed its capital.

Third-Party Risk

Third-party processors include data processing service bureaus, financial institutions, or other organizations that provide ACH processing services for credit unions. Examiners should understand the risks and concerns present when a credit union uses a third-party processor and should determine that the credit union has current, detailed agreements in place that fix responsibility and accountability between the parties. Third-party risks are as follows:

- Allowing a corporate member to send files directly to the ACH operator. A credit union, acting as an ODFI, that allows a corporate member (originator) direct access to its ACH operator exposes itself to credit, fraud, and operational risk. The credit union warrants the validity of the transactions sight unseen and bears ultimate responsibility for the transactions. If the corporation fails or transmits fraudulent or erroneous entries, the credit union bears responsibility for the corporation's actions.
- Using a correspondent DFI for processing and/or settlement. A correspondent bank or corporate credit union provides processing and/or settlement services to the credit union acting as an ODFI. This situation exposes the credit union to credit, operational, and fraud risk because the correspondent could make a mistake or fail to process or settle its transactions.
- Using a correspondent DFI or data processing organization for ACH processing only (not settlement.) A credit union acting as an ODFI is exposed only to the risk that the third party will make a mistake or error. In this situation, the credit union faces only fraud and operational risk with respect to the third-party processor.

**ACH Risk
Management
Handbook
and Self-
Audit
Survival
Guide**

NACHA publishes a comprehensive guide called the *ACH Risk Management Handbook*, which further details the ACH risk issues and control procedures discussed in this appendix. Additionally, NACHA publishes a self-audit survival guide for financial institutions that anticipate conducting or have conducted audits of its compliance with the ACH operating rules. These required annual audits assist the credit union in assessing its risk regarding its wire transfer activities and compliance responsibilities. The examiner should ask the credit union if it has completed this audit and if it has obtained the results of each third-party processor's annual ACH self-audit. The credit union can obtain both publications by writing or calling NACHA at National Automated Clearing House Association, 607 Herndon Parkway, Suite 200, Herndon, Virginia 22070, telephone: (703) 742-9190.

ITEM PROCESSING - APPENDIX 9C

Overview

Item processing is the internal processing of share drafts or checks by the credit union. The three basic types of item processing are in-clearings, transit items, and inter-clearing arrangements, defined below. Item processing results in settlement (payment or collection) through the Federal Reserve Bank (FRB) or a correspondent bank and posting of transactions to the member's account. Many larger credit unions are developing in-house item processing to reduce the costs of external check processing. Services are also available in corporate credit unions, credit union service organizations (CUSOs), banks, and national or regional check-processing service centers.

Third-Party Item Processing

Many third-party institutions have a contractual arrangement with the credit union whereby the credit union pre-funds processing activities by placing and maintaining a deposit at the institution. The required deposit relates to the credit union's average daily processing activity and, though it varies from institution to institution, may represent a substantial portion of the credit union's assets. When the deposit exceeds the insured limit (if applicable), the credit union is at risk for this excess in the event that the third-party institution fails.

Credit unions using third-party institutions for item processing must institute policies and procedures to minimize the potential risk of loss. Additionally, credit unions must exercise due diligence, both before entering into a contract with a third-party institution and periodically thereafter. At a minimum, credit unions should:

- Contact several processors. By reviewing the financial statements, the most recent audit report, and other pertinent reports or correspondence, the credit union can assess the financial condition of each institution before entering into a contract.
- Review contract terms and conditions. The credit union and its legal counsel should carefully review the terms and conditions of each institution's contract.

- Assess periodically the financial condition of the institution. On an ongoing basis, credit unions should review the institution's financial statements, peer group ratios and rankings, and audit reports at least annually, paying particular attention to capital and profitability ratios.
- Change processors, if necessary. If the financial stability of the institution becomes questionable, the credit union should consider changing to another institution. The credit union must consider issues such as the cost of changing processors and the terms of the contract. Credit unions can considerably reduce the cost of changing processors if they use their own routing and transit number on share drafts (payable-at method) rather than using the routing and transit number of the payable-through bank (payable-through method.) Credit unions using their own routing and transit number need not reissue new share drafts if they change processors. Before selecting the payable-at method, officials should discuss this option with individual processors. The terms, conditions, and level of credit union responsibility for a routing and transit program vary from processor to processor.

**Share Draft
In-Clearings**

Some credit unions process their own checks. After a member writes a share draft to pay a bill, the merchant or vendor deposits the share draft in the local bank. The bank encodes (with the bank's routing and transit number on the drafts) the deposit and sends the share draft to the FRB. The FRB processes the draft, credits the local bank's account, and charges the credit union's account. The FRB then sends the share drafts to the credit union by courier.

The credit union sorts and microfilms the drafts and posts the in-clearings to the members' draft accounts. The next morning, a share draft exception report identifies accounts with insufficient funds. The credit union pulls returns and sends them to the FRB for return to the local bank. The bank charges the vendor's account.

**Deposit
Processing**

Some credit unions process in-house check deposits for credit to members' accounts. The credit union takes the day's deposits, encodes the checks with the credit union's routing and transit number,

processes them, and sends them to the FRB for credit to the credit union's account.

Local Clearing House Arrangements

A group of banks or other financial institutions in a defined geographical area may form a local clearing association to directly process their checks.

A member writes a share draft and the payee deposits it at the local bank. After processing, the local bank sends the checks and a cash letter by courier directly to the credit union. The credit union processes the checks, confirms the payment amounts on the cash letter, and posts the amounts to the members' share draft accounts. The credit union then pays the local bank (usually by FEDLINE wire).

The credit union then sorts the members' local checks deposited at the credit union according to bank, and sends each participating bank a cash letter and a bundle of checks issued by that bank with a demand for payment. The bank processes the checks and wires settlement to the credit union.

Examination Concerns

Item processing involves substantial risk. Deficiencies in the internal controls, such as failure to process items promptly or correctly, could result in significant losses.

When examining credit unions involved in item processing, the examiner should (1) evaluate management control of operations, (2) determine the risks to the credit union, and (3) ensure that the credit union has instituted policies and procedures to minimize the potential risk of loss. Individual item processing operations will vary; however, all operations require necessary management and internal controls.

The examiner should develop an understanding of the credit union's item processing operation. At a minimum, the examiner should review policies and procedures and understand the flow of items through the entire system. This understanding comes through discussions with management and system demonstrations. The examiner should also determine that the credit union accurately and promptly posts all

general ledger accounts used in the process and promptly clears exceptions.

If deficiencies exist, the examiner should expand the scope of the review (after obtaining the supervisory examiner's concurrence), which may require additional examiner staff with item processing expertise.

**Business
Plan, Budget,
Cost
Analysis, and
Profitability**

Before establishing an item processing operation, credit union management must develop a business plan, including a budget that identifies the item processing services offered, and the resources needed to support the service. After developing and analyzing the business plan, the credit union may find that it cannot afford to maintain an item processing operation. The business plan requires periodic revision once the item processing department is operational. The business plan should document:

- The costs and revenue projections associated with an item processing department and the accounting system used;
- The overall effect of the processing operation on the credit union's financial performance;
- Identified risks and internal controls necessary to manage those risks;
- Department structure including staffing and management needs;
- System configurations including hardware and software needs;
- Training, both initial and on-going, for management and staff; and
- Disaster recovery, including testing.

**Equipment
and Software
Requirements**

An item processing operation requires a significant investment in hardware and software. A sorter performs sorting, microfilming or imaging, return pulling, data accumulation, and data transmission functions.

A credit union that processes its own checks transmits applicable data to its own information processing system for posting to its members' accounts. A credit union that processes for other credit unions establishes systems to electronically transmit the data to the other credit unions' computer systems for posting.

Other equipment needed includes reject/reentry stations, encoding stations, correspondence desks (positions for resolving and researching differences), check storage areas onsite and offsite, microfilming duplicating services, microfilm machines, and computer terminals.

The credit union must maintain adequate physical access controls and segregation for the item processing equipment, computer controller, storage areas, and different work areas. Climatic controls, fire control equipment, and security controls are examples of other hardware needed.

**Staffing
Requirements**

An item processing operation requires staff with specific experience and training in item processing. Often credit unions recruit staff from the larger banks, corporate credit unions, and service centers. Sufficient internal controls, adequate separation of duties, and corresponding authority on the computer are important for operations of all sizes.

**Microfilming
and Data
Backup**

Item processing operations rely heavily on microfilm or electronic imaging. Cash letter differences, other adjustments, and disputes (from members, banks, or FRB) require the evidence that microfilming or imaging provides. The credit union must have controls in place to safeguard the microfilm or image files and ensure readability. The credit union must backup processing data from the sorter and controller daily and must maintain adequate generations both onsite and offsite. (Credit unions must maintain at least two full copies of the microfilm or image files offsite.)

**Policies and
Procedures**

Sound policies control item processing risks, operations, and management. Management must review operations to ensure compliance with policy.

Management must also develop detailed procedures for all item processing positions. These procedures should document required functions, deadlines, internal control steps, and policy requirements.

The board should establish a write-off policy. Management can authorize staff to write off small differences (e.g., those under \$1.) Larger write offs should require documentation supporting the write off and management authorization.

**Internal
Control and
Review of
Operations**

Management must establish internal controls for item processing that include adequate separation of duties, active account reconciliation, and prompt clearing of differences.

The following duties must be separated: reject reentry, return processing, correspondent services (research and clearing of adjustments and differences), Federal Reserve account reconcilements, cash balance management, and review of documentation supporting reconciliation and clearing differences. Cash letter totals must reconcile to transmission totals, and staff must identify and promptly clear any differences.

An independent staff member should review documentation for adjustments of uncleared items. Management should closely control and separate return processing and reject reentry functions from the check processing function. Additionally, staff must reconcile both transmission totals (electronic posting to member accounts) and reconciliation of processing and transmission totals to the FRB account daily.

The item processing operation could involve three computer systems: (1) check processor, (2) general ledger and share and loan trial balance system, and (3) the computer that interfaces the check processor with the general ledger and share and loan trial balance system. The internal control plan must correspond to the plan for appropriate segregation of duties.

**Internal
Control
Review of
Accounting**

The review of accounting should begin after the examiner obtains a basic understanding of how the system processes, posts, and settles transactions. After performing a test of the FRB account reconciliation and all clearing and suspense accounts, the examiner should then trace all reconciling items for the period tested through to clearing on the statement or to independent source documents.

**Legal
Agreements**

The examiner should review the legal agreements established by the credit union in the following areas:

- Line-of-credit agreements for credit unions that process checks and deposits for other credit unions, transmit posting data to other credit unions, and receive debits or credits at their FRB (or correspondent bank) on their routing and transit number. Settlement lines of credit cover check clearing settlement if the other credit union's account balance is insufficient to cover clearings;
- A disaster recovery plan that includes agreements for alternate site processing and equipment use;
- Vendor agreements outlining responsibility for software and hardware maintenance and support;
- Agreements with the FRB (or other correspondent bank) and hardware and communication vendors for funds settlement and electronic transmission activity; and
- Any other material agreements needed to support the item processing operation.

**Disaster
Recovery
Plan**

The examiner should review management's disaster recovery plan to ensure that it enables the credit union to recover from difficulties that could interrupt the item processing operation. Recovery systems should include:

- Staff knowledge about the disaster recovery plan;
- An alternate processing location;
- Offsite maintenance of a copy of the disaster recovery plan;
- Duplicate equipment, either purchased or rented, sufficient to operate the item processing center; and
- A regular review process of the disaster recovery plan to ensure the plan is current and viable.

The credit union should perform full periodic testing of the disaster recovery plan as it relates to the item processing operation originating from alternate site equipment and different system configurations.

Chapter 10

LOANS

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Chapter 10 – Part 1

LOANS – GENERAL LOAN REVIEW

Examination Objectives

- Evaluate management's ability to identify and manage risk
- Evaluate the quality of the loan portfolio and the extent of related risks in lending activities
- Evaluate whether management has established adequate lending standards and maintains proper controls over the program
- Determine whether management adequately plans for all lending programs, committing the necessary resources in terms of technology and skilled personnel
- Assess whether the credit union has the financial capacity to conduct lending safely, without undue concentration of credit and without overextending capital resources
- Analyze the loan portfolio's performance, including profitability, delinquency, and losses
- Consider management's response to adverse performance trends, such as higher than expected delinquencies, charge-offs, and expenses
- Determine if the credit union's compliance program effectively manages the fair lending and consumer protection compliance risks
- Determine whether management has implemented an effective internal loan grading system (if applicable) to identify credit risk

Associated Risks

- Credit risk. Credit risk, which involves the ability of the member to repay the obligation, affects all types of loans. Loans with a guarantee (student, VA, SBA, FHA, NCUA purchase) contain a lesser degree of credit risk.
- Compliance risk. Each loan type has various degrees of compliance risk. Various NCUA regulations, state laws, and federal consumer compliance laws apply to both consumer loans and real estate loans. Failure to comply with these laws and regulations exposes the credit union to fines, civil money penalties, and diminished reputation.

- Interest rate risk. Interest rate risk increases as the terms of the loans extend. Monitoring this risk involves a large segment of a credit union's asset-liability management (ALM) program. Credit unions engaging in real estate lending should recognize that changes in interest rates affect the fair value of their balance sheet. Variable-rate loans also can experience interest rate risk since they may contain lifetime and periodic "caps" that limit the credit union's ability to increase (reprice) loan rates.
- Strategic risk. Strategic risk appears in the diversification of loans offered to members. Management's due diligence in the planning effort before implementing new loan programs will greatly affect the amount of this risk. A well-established program should have less risk than a proposed or newly instituted program.
- Transaction risk. Numerous transaction risks accompany lending. The strength of the credit union's internal controls will determine the extent of the risk. Management may demonstrate their control of transaction risk through reviewing internal reports such as Paid Ahead Loans, Non-Amortizing Loans, File Maintenance, Supervisory Override, Accrued Interest Greater than Payment, etc. Appendix 4B to the Internal Controls chapter of this Guide discusses other specific loan-related reports.
- Liquidity risk. The success of any lending program determines the level and type of liquidity risk involved. Credit unions engaging in real estate lending should evaluate and understand the variability of mortgage cash flows and the corresponding effect on its balance sheet. When interest rates fall, mortgage cash flows increase; conversely, when interest rates rise, mortgage cash flows decrease. This could result in a credit union having either too much or too little liquidity. To control liquidity risk, management must understand the interrelationships of interest rates, mortgage cash flows, prepayment risk, extension risk, and the effect on the fair value of its assets.
- Reputation risk. Lending and the types of loan programs offered greatly affect reputation risk. Collection efforts, or lack of them, influence the members' perception of the credit union, as do lending personnel and how they deal with the public. If the credit

union has an indirect dealer loan program, the reputation of the dealer can affect the reputation of the credit union and the program.

Overview

A credit union usually derives its primary source of income, as well as a major source of risk to its solvency, from its loan portfolio. Therefore, credit unions support this major asset account with sound business planning, policies, and internal controls.

Examination Guidelines

Examiners should try to obtain either an AIRES loan download or an ASCII formatted download file. Examiners should use their best judgment in considering whether, and to what extent, to review a particular portfolio. When examiners identify material concerns during the scope process, they should expand procedures to identify the cause of the problems, determine the severity of the noted problems, and devise plans for corrective action.

If examiners determine the analysis of the risk areas noted in the Scope Workbook warrants a loan review, they can use the AIRES Loan Review or a self-designed workpaper to document their review. The loan review may include any or all of the following, based on the examiner's judgment:

- **Charged off loans.** Examiners should scan the charged off list for unusual activity and review basic internal controls (board approval, proper accounting, assignment to a collection agency, etc.) They may expand their scope to review individual loans charged off to determine the extent of the problem and to develop plans for resolution. Examiners should encourage the credit union to perform an ongoing analysis of charged off loans to determine common characteristics, or loss trends by loan type for ALLL analysis.
- **Delinquent loans.** Examiners should scan the delinquent loan list for unusual activity and review basic internal controls (consistent and timely collection efforts and charge off.) Reviewing larger and more recently granted loans may prove beneficial in correlating underlying problems of the delinquent loans with those of the current loan portfolio. Examiners should consider reviewing loans

that were seriously delinquent at the previous examination to assess their disposition.

- **Current loans.** Examiners should select a random sample of current loans to review for adherence to policies and regulations, as well as documentation, and underwriting quality.
- **Insider loans.** Examiners may select a sample of loans made since the last examination to officials, credit union employees, and their immediate family members.
- **Large loans and concentrations of credit.** Examiners should select samples of large loans and concentrations of credit. In a credit union with numerous routine mortgage loans, examiners may review a sample of non-routine large loans.
- **Member business loans and construction loans.** Examiners should select samples of member business and construction loans. Examiners should document the status of the member business loan portfolio if the member business loans exceed the regulatory limits of §723.16 of the *NCUA Rules and Regulations*, the credit union has received an exception from these regulatory limits (§723.17), or the credit union has received a waiver for a category of loans (§723.10.)
- **Other loan categories.** Examiners may select a sample of loans from the following categories, if they exist:

New programs	Line of credit
Real estate	Home equity
Insured-Guaranteed	Credit card
Participation	Agricultural
Floor plan	Paid-ahead
Open end	SBA
Risk-based	Lease
Non-amortizing loans	Repossessions
Foreclosures	Paperless loan systems
Indirect dealer financing program	

With an AIRES download, examiners can use standard or customized loan queries to pull specific loans meeting defined characteristics.

Part 2 of this chapter discusses delinquent loan control. Appendix 10A discusses the various loan types. Appendix 10B contains a glossary of loan terms and Appendix 10C contains specific financial ratios to analyze member business loans. Appendix 10D contains sample Indirect Dealer Financing Program (IDFP) agreements. Appendix 10E contains a documentation checklist for real estate loans.

Loan Documents

Credit unions must require adequate loan documentation for all loans. Weak documentation practices could adversely affect the ability to successfully collect the loans in a litigation action, and could lower the value of loans in merging or liquidating credit unions.

Adequate loan documentation includes the following:

- A completed loan application along with documented approval;
- Documented creditworthiness analysis including:
 - Verification of income;
 - Credit reports; and,
 - Debt ratio or disposable income analysis;
- Evidence of collateral value (e.g., purchase invoice, appraisals);
- Loan officer worksheets and notes;
- A completed note or security agreement; and
- A perfected collateral lien and adequate insurance.

Loan Exceptions

Through a review of the individual loan files, the examiner identifies as loan exceptions (1) documentation deficiencies, (2) loan processing exceptions, (3) violations of the *FCU Act* or *NCUA Rules and Regulations*, (4) violations of the credit union's lending policies, (5) violations of consumer compliance regulations, and (6) deficient credit practices. Examiners may use AIREs Loan Exceptions, or a self-designed workpaper, to detail their exception comments on the loan review.

When loans are missing from the files, and staff cannot locate the documents, examiners should provide the supervisory committee with a list of missing loans. Examiners should obtain an agreement that the supervisory committee will promptly contact the borrowers to confirm the loan's authenticity.

Examiners should treat chronic loan documentation and loan quality problems (e.g., the lack of establishing the creditworthiness of borrowers, recording titles, liens, UCC filings, obtaining real estate appraisals, verifying income, etc.) as a major area of concern.

Impermissible Loans

Loans made in violation of the *FCU Act* or *NCUA Rules and Regulations* are impermissible. Examiners should document these violations as loan exceptions, provide guidance to the officials regarding their responsibilities in connection with the violations, and make appropriate recommendations for corrective action. When examiners review only a portion of the loans, they should instruct the officials to review all similar loans for possible violations.

If the credit union made intentional or material impermissible loan disbursements, the board of directors must notify surety and request assurance that bond coverage will continue. The credit union must call the impermissible loan disbursement, unless the credit union made the loan to a "good faith" borrower. Since credit unions cannot legally compel good faith borrowers to return the money in terms other than those found in the original loan agreement, the credit union must honor the terms of the loan. If the credit union does not renegotiate or correct the loan and a loss occurs, the credit union should file a bond claim with surety for the balance of the impermissible disbursement.

The supervisory committee should determine the board has taken appropriate action to address impermissible loans and to file a claim or protect the right to file a claim with the surety company. The examiner should make certain the committee members, as well as directors and appropriate employees, familiarize themselves with their exact duties regarding impermissible loans.

Loan Programs and Policies

Section 701.21(c)(2) of the *NCUA Rules and Regulations* and sound business practices require that credit unions develop written loan policies. The following financial considerations apply:

- Member needs. Each credit union serves a different field of membership with somewhat differing needs. Credit unions should consider this when developing their loan policies;

- Availability of funds. Credit unions should consider sources for their funding of loans;
- Competition. A credit union should price its loans competitively by remaining aware of the rates national and local lenders offer their members and customers;
- Cash flow. Credit unions must tie their loan policies into their overall funds management program and must provide for cash flow, as well as, profitable return. As such, they should carefully weigh single payment loans and balloon notes in terms of the likelihood of repayment and the negative effect on liquidity. Credit unions should also exercise care in establishing a real estate loan program in which repayment terms of 15 years or more can affect cash flow and income, particularly if real estate loans make up a large portion of the loan portfolio; and
- Pricing. Credit unions should establish and continuously monitor their loan rates to ensure an adequate spread for the cost of funds, operating expenses, reserve requirements, and profitability goals. Other pricing considerations include market competition, loan demand, and asset liability management strategies.

The following credit evaluation considerations apply:

- Adequate borrower information. Credit unions should obtain complete credit information on borrowers. A complete and accurate application enables the credit committee or loan officer to assess the applicant's willingness and ability to repay. This information also helps the collection staff, if needed.
- Completed loan application. The loan application should document the applicants' income source and stability, as well as their current obligations. Staff can better determine the applicant's "capacity to repay" by verifying the monthly obligations through credit reports, and reported income using one of the following:
 - A copy of a recent pay stub. This will verify employment, as well as income. The loan processor should review hourly

wages, salary, or year-to-date income, as stated on the pay stub. They should also alert themselves to any wage garnishments;

- A documented phone contact or written verification to the employer or credit union sponsor (the sponsor may have income information or pay scale based on position and length of service);
- A complete copy of the most recent signed tax return or independently prepared and audited financial statement, for self-employed borrowers. By obtaining two years' tax returns, the credit union can develop a trend analysis to better analyze self-employed borrowers' cash flows and income levels over time; and
- A copy of the lease or rental agreement, tax return, or pay stub, when the applicant lists "other income" (e.g., rental, investment, or second job.)

Many credit unions with stable fields of membership and one primary sponsor may know their borrowers' relative income levels and past payment histories. Examiners should consider such factors in conjunction with loan loss and delinquency levels when evaluating the issue of income verification. Many competing lenders do not verify income. Competition and member service could override documentation considerations in credit unions with good lending performance.

- Terms of repayment. Credit unions should base loan repayment terms on the purpose of the loan, the collateral, and policy constraints. The terms also must coincide with the provisions of the *FCU Act* and *NCUA Rules and Regulations*.
- Collateral. The principles regarding collateral and the actions required by the officials when accepting collateral for various types of loans include:
 - Sufficient equity in the collateral to diminish the applicants' willingness to lose their investment;

- Repayment schedules that reduce the loan balance as the collateral depreciates;
 - Collateral that can readily convert to cash; and
 - Collateral that has a known value. For some types of collateral, such as vehicles, the credit union can determine the value from publications designed for that purpose. Other types of collateral, such as boats and real property, should have a written assessment or appraisal to document value.
-
- Extension agreements and refinanced loans. The principles of credit also apply to extension agreements and refinanced loans. Credit unions should not use them as devices to cover up delinquency problems. Generally, once a member with a previously unsatisfactory repayment history has demonstrated the ability to make three to six consecutive monthly scheduled payments without added collection work, the credit union may consider extending or refinancing that member's delinquent loan. The credit union should have a written extension policy and the ability to identify or track the performance of delinquent loans it extends or refinances.
 - Chattel lien instruments. Management decides whether a credit union files chattel lien instruments or purchases chattel lien non-filing insurance. It is management's responsibility to protect the credit union and comply with the provisions of state and local laws.

Lending Practices

Examiners may evaluate lending practices by reviewing policies, board minutes, credit committee/loan officer minutes, and the loan files. When assessing practices, the examiner determines the following:

- The board establishes reasonable written policies to manage delinquency and loan losses;
- The credit committee or loan officers act within their written authority;
- The board establishes realistic loan limits and pricing, to the extent of available funds;
- The board establishes reasonable collateral requirements that provide adequate protection to the credit union; and

- The board establishes written policies implementing an internal loan review and grading system (if applicable) to identify credit risk in the loan portfolio.

Credit Report Analysis

Most credit unions use credit reports when evaluating a borrower's creditworthiness. Occasionally, small credit unions use oral credit reports but these can result in misinterpretation. Credit unions must keep documentation of the oral credit report in the borrower's loan file.

Credit reports help determine the applicant's "character" and verify outstanding debts. Credit unions should place a strong reliance on the credit report and the member's payment history. A poor repayment history and adverse credit report provide strong indications of whether the member will repay the credit union. In general, credit unions should pull a new credit report if the most recent credit report is more than twelve months old.

When reviewing credit reports, loan officers should determine that:

- Borrowers have listed all their debts on the application. Reconciling the credit report to the application can identify debts not listed. Credit reports do not include debts to institutions that do not report to the credit bureau (e.g., some small credit unions, sub-prime lenders.) To determine the member's "capacity to repay," staff should consider all the obligations including the new loan.
- The credit ratings indicate a good, slow, or poor past payment history. Some credit reporting agencies (Experian, Equifax, and Trans Union) quantify payment histories into risk scores. The risk scores indicate the probability of loan default and the member's probability of filing for bankruptcy in the future. If credit unions use a risk score rating system as part of their loan underwriting process, they should understand the system well enough to explain it.
- Excessive numbers of inquiries over the past year (which may indicate financial problems or excessive pending new credit) are explained.

The credit union should not automatically deny a loan because of a member's adverse credit history. A member having experienced a layoff or serious medical condition could have a poor prior record. If the credit union approves a loan to a member with an adverse credit history, the credit union should adequately document the reasons for the approval and show the member has resolved the reasons for the adverse ratings.

Members can have problems "below the surface" even if all ratings show positive. Many revolving lines of credit at or near the maximum limits can signal potential over extension or "pyramiding." Reviews of bankruptcies indicate many members were current prior to filing bankruptcy. Comparing past credit reports to present credit reports can identify pyramiding debt. Characteristics of pyramiding debt include:

- Using new credit to pay old debt, especially the use of unsecured credit to consolidate credit card debt;
- Escalating debt outpaces income; and
- Increasing numbers of recent credit report inquiries, which can indicate either lender denials or unreported new debt, as some lenders report inquiries but do not report new loans.

Capacity to Repay

A major consideration in granting loans is the analysis of the member's capacity to repay. Calculation of a debt ratio (monthly obligations to income) remains a standard method of analyzing the ability to repay.

Credit unions must also consider the member's level of income when making loan decisions. For example, members with higher levels of income can often handle higher debt ratios. This type of review, referred to as a Net Disposable Income Analysis, can help determine the members' capacity to repay. All loans granted to members with limited capacity to repay should have an overriding reason noted in the file.

Credit Scoring

Credit scoring systems attempt to statistically predict the likelihood of a member defaulting on a loan. Regulation B requires statistically derived and empirically sound credit scoring. Fair, Isaac and Company,

Incorporated, a financial service organization, pioneered credit scoring and provides many of today's credit scoring tools. Other sources of credit scoring include a credit union's custom model or a score obtained from one of several credit reporting agencies. Credit reporting agencies also offer preapproval screenings based on "canned" prescreens or individually developed queries. In general, credit unions outsource the development of a credit-scoring model to minimize costs, while taking advantage of the marketplace expertise.

Advantages of credit scoring include (1) quick loan turnaround, (2) consistency in lending, and (3) basis for risk pricing. Many credit unions use credit-scoring models to market loan products, such as pre-approved auto and credit card loans. Credit scoring allows these credit unions to send out pre-approved mass mailings to targeted groups. Credit unions use credit scoring as the basis either for loan decisions or as a loan officer's tool in a judgmental loan decision. Credit unions manage the volume of loans and level of risk assumed by setting credit score ranges loans must meet.

When a credit union uses credit scoring, loan policies and procedures must outline how the credit union will do the following:

- Apply them consistently;
- Validate them. At a minimum, the credit union should test and validate the credit scoring model at least every two years; and
- Track their results. For example, if unexpected delinquency results from credit scoring, the credit union should consider modifying the underlying parameters of the scoring model.

Some credit unions contract with third parties to perform credit scoring. The contract must set forth the responsibilities of the parties, including who assumes responsibility for ensuring that the credit scoring meets applicable regulations. The credit union should ensure that:

- Staff receive adequate training and understand the credit-scoring model. Loan officers should understand the system, its components, and its limitations;

- Management obtained a written legal opinion that states the credit union has met all applicable regulations and has adequately protected itself;
- Management tracks credit scored loans and recalibrates the credit scoring model when necessary; and
- Indirect lenders can only authorize approval for loans to members. The third party contract must exclude loans to non-members.

Paperless Lending

Credit unions constantly search for ways to deliver services more efficiently to members. Credit unions have systems to take loan applications via audio response systems, fax, and the Internet. Often, credit unions using these paperless systems order credit reports and compare the application information entered by the member with that on the credit report. Simple logic programs analyze the member's debt ratio, credit history, disposable income, etc., and either approve the loan request, or refer it to the staff for further action. Some systems may even complete and disburse the loan electronically.

Examiner Guidance

When reviewing a paperless loan system, the examiner should determine the credit union addressed the following areas:

- Data integrity. Credit unions must secure application information collected by the system, protect it from access by unauthorized parties, and provide it in a form that users can readily access;
- Regulatory compliance. The application should comply with applicable consumer regulations (e.g., give the member the opportunity to apply for the loan individually or jointly, properly address community property issues, and meet *Equal Credit Opportunity Act* (ECOA) criteria.) Further, the credit union should have an attorney's opinion stating that the paperless application constitutes a legal loan application;
- Collectibility. If the system completes and disburses the loan, the credit union should retain an attorney's opinion stating that the loan represents an enforceable debt or security interest and addresses the ECOA issues as to enforceability against co-applicants, co-makers, or guarantors;

- **Internal Controls.** The credit union must maintain a record of all loans approved or referred by the system. Loan officers (or the credit committee) must properly act upon system-approved and referred loans. The internal control manager, assigned staff person, or outside auditor, who has no involvement in lending, should review this record and management's documented inspection to affirm the credit union makes no unauthorized loans; and,
- **Documentation.** Examiners should review the adequacy of the documentation and disclosures the paperless loan system generates for the credit union and the member. Some systems may only generate an information summary showing the data entered by the member. Credit unions may compensate by taking a master application before allowing a member to use the "paperless loan" system, in order to meet application disclosure requirements.

Risk-Based Lending

NCUA Letter to Credit Unions 99-CU-5 and 174 address risk-based lending. Risk-based lending involves setting a tiered-pricing structure that assigns loan rates based on an individual's credit risk. Profitable risk-based lending requires the surcharge rates charged by the credit union cover the loan loss rates and overhead costs related to underwriting, servicing, and collecting these loans. Credit unions that cannot justify and support pricing differences based on risk will face heightened compliance and reputation risks if pricing decisions appear to result in disparate treatment under consumer protection regulations (e.g., ECOA.)

Credit unions that engage in risk-based lending should have in place:

- Strategic and business plans that acknowledge the additional inherent risks and provide for the necessary resources, including specialized management and staff expertise, to manage the risks;
- Policies and procedures approved by the board that define the parameters of the risks assumed and internal controls necessary to ensure acceptable portfolio quality;

- Information systems capable of providing monitoring information sufficient to analyze the results of underwriting, operations, and pricing decisions;
- Quality control systems that provide feedback on the adequacy of and adherence to underwriting, operating, pricing, and accounting guidelines;
- Compliance management programs that identify, monitor, and control consumer protection problems associated with risk-based lending; and,
- The level of net worth needed to support the additional risks incurred. Examiners may review the credit union’s documentation of its method used to determine the amount of capital necessary, and may evaluate the overall capital adequacy on a case-by-case basis.

Large Loans and Concentrations

Examiners can often evaluate concentration risk by measuring concentrations as a percentage of total loans or total equity. (Smaller credit unions may find this more appropriate than larger credit unions.) Examiners may also find the pre-built queries in AIRES beneficial for identifying large loans and concentrations of credit. In both large and small credit unions, examiners may benefit from developing continuing workpapers for tracking large loans and concentrations of credit from one examination to the next.

AIRES

The AIRES Questionnaire workbook contains various loan questionnaires. These checklists further document the examiner’s review of various loan types. Use of the questionnaires can also assist the examiner in reviewing unfamiliar loan types. Depending on the credit union’s services offered, optional questionnaires may address controls in the following lending areas:

- Real Estate
- Line of Credit
- Leasing
- Indirect Lending

- Home Equity
- Credit Cards
- Construction
- Collections
- Adjustable Rate Mortgages
- Agricultural
- Member Business Loans

**Workpapers
and
References**

- AIREs Workpapers, Documents and Questionnaires
 - Review Considerations
 - Loan Analysis
 - Loan Exceptions Document
 - Loan Review
 - Key Ratios
 - Critical Loan Input
 - Real Estate Lending Controls
 - Adjustable Rate Mortgage Lending Controls
 - Construction Lending Controls
 - Business Lending Controls
 - Agricultural Lending Controls
 - Line of Credit Lending Controls
 - Credit Card Lending Controls
 - Automated Teller Machine Controls
 - Regulation M - Consumer Leasing
 - Regulation Z – Truth in Lending
 - Regulation Z – Variable Rate Loans
 - Allowance for Loan and Lease Losses Module
 - Manual Loan Classification
 - References
 - *Federal Credit Union Act*
 - 107(5) – Authority to Make Loans
 - 107(11) – Statutory Liens
 - 107(13) – Purchase of Eligible Obligations
 - 114 – Credit Committee
 - *Federal Credit Union Bylaws*
 - Article IX – Credit Committee
 - Article XII – Loans to Members and Lines of Credit

- *NCUA Rules and Regulations*
 - 701.21 – Loans to Members and Lines of Credit to Members
 - 701.22 – Loan Participation
 - 701.23 – Purchase, Sale, and Pledge of Eligible Obligations
 - 702.402 – Full and Fair Disclosure Required
 - 722 – Appraisals
 - 723 – Member Business Loans
- *Accounting Manual for Federal Credit Unions*
- IRPS 83-3 – Financing Leases
- *Chartering and Field of Membership Manual*
- NCUA Letter No.119
- NCUA Letter No. 174
- NCUA Letter No.99-CU-5

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Chapter 10 – Part 2

LOANS – CREDIT RISK, DELINQUENCY, & CHARGE OFFS

Examination Objectives

- Determine the credit risk within the loan portfolio
- Determine if the credit union reports delinquency accurately and in a timely manner
- Determine if the credit union has appropriate and adequate collection policies and procedures
- Determine if the credit union makes appropriate and adequate collection efforts
- Determine if the credit union has implemented reasonable extension and refinancing policies and procedures
- Determine reasonableness of the charge-off policy

Associated Risks

- Credit risk occurs when the borrower cannot repay according to the terms of the loan;
- Liquidity risk occurs when the failure to collect problem loans affects available funding sources;
- Transaction risk occurs when delinquent loans are not properly aged; and
- Reputation risk occurs when delinquency or collection efforts (or lack thereof) affect the credit union's image.

Overview

Management's responsibility includes identifying and monitoring credit risk, delinquency, and charged-off loans on an ongoing basis.

Evaluating Credit Risk

There are two purposes for reviewing the loan portfolio:

- Assessing the level and direction of credit risk, and
- Determining the potential risk to the NCUSIF.

Adequate funding of the ALLL and/or low delinquency and loan loss ratios do not necessarily mean the credit union properly mitigates its credit risk. Credit unions should also have a quality control process by which they review the loan portfolio or components of the loan

portfolio to determine if risk factors exist that, if left unattended, could adversely affect the overall quality of the loan portfolio.

Examiners may review the credit union's quality control process. The goal is to ensure management can assess the risk in its portfolio and monitor potential future exposure. The credit union may prepare lists to monitor and assess delinquent loans, other problem credits, and special mention loans. The preparation and maintenance of these reports vary among credit unions and largely depend on the credit union's resources and sophistication. Tracking the information on these lists enables management to assess the performance of the loan portfolio and act to mitigate risk therein through changes in policies and/or procedures. If the credit union has an adequate process for evaluating credit risk, examiners need not perform a detailed review of the loan portfolio.

Other problem credits usually include past due loans, leases, and accounts receivable; however, they may also include non-delinquent loans of members experiencing a recent layoff, loans especially affected by a downturn in economic conditions, and loans that circumstances indicate may become delinquent in the near future.

Special mention loans usually include loans that require special monitoring by the credit union. These may include loans in new loan programs, loans the credit union officials chose to grant that fall outside the credit union's loan policy, loans for which the credit union has no prior experience, loans previously classified as problem credits, and any other loan that requires additional attention.

If the credit union does not have an adequate quality control review process, the examiner should review a sample of loans to assess the level and direction of credit risk. This may involve creating a list of loans that exhibit specific risk characteristics, to review from one examination to the next. The Query Report Loan Watch List in AIRES provides a tool that may assist examiners in tracking loans containing significant existing or potential risk. In addition, the examiner may review and track loans meeting certain criteria such as the following:

LOANS – CREDIT RISK, DELINQUENCY, PROBLEM CREDITS, & CHARGE OFFS

- Loans having weaknesses that jeopardize full collection of the debt, including the distinct possibility the credit union will sustain some loss if it does not correct the deficiencies;
- Loans where, even if collected, the credit union would incur collection costs, which could be substantial;
- Loans, both open-end and closed-end, past due 90 days from the contractual due date;
- Loans where it appears the credit union will not collect a substantial portion, even though the borrower makes partial or irregular payments;
- Loans with inadequate documentation;
- Loans that are current but represent potential losses to the credit union due to questionable security;
- Loans, that are current according to their terms, but represent potential losses because of the payment terms or past practices. This category might include single payment loans and "balloon" loans that the credit union has repeatedly refinanced or extended;
- Workout loans in which the credit union permanently amended the original terms of the note to lower payments or reduce interest rates. Workout loans generally allow the borrower to continue a reasonable payment stream thus avoiding default; and
- Any other loan as warranted.

Based on this review, the examiner may make recommendations to management that would enhance the quality of their loan portfolio. Examiners should direct their review toward determining the level and direction of credit risk and the potential risk to the NCUSIF.

Delinquency Control

Examiners should verify the credit union accurately reports delinquency each month for all loan types. Credit unions must report the total delinquent amount when reporting delinquency statistics,

including loans handled by a third party (e.g., bankruptcy loans, participation loans, student loans, credit card loans, and first mortgage real estate loans.) An accurate list of delinquent loans enables the examiner to evaluate collection policies and practices, and identify delinquent loans for possible charge off.

Examiners may test a sufficient number of loans to determine the reasonableness of the delinquent loan schedule. Examiners can perform manual calculations and testing using a calculator, or they can test electronically using AIRES or other computer programs (e.g., Excel.) If the loan sample tested reveals loans improperly categorized or omitted from the delinquent loan schedule, the examiner should design a workpaper to reflect the correct categories for these loans.

If no current, complete, or accurate delinquent loan schedule exists, the examiner should establish appropriate plans with officials to develop one. Examiners may retain a schedule of the delinquent loans in the field file for reference.

NCUA does not require a credit union to use a particular loan delinquency calculation method. Examiners may use one of the traditional methods (in AIRES) as a simple measure for comparison with a credit union's calculated delinquency estimate. However, examiners must understand the intent of these methods is to provide a "reasonableness test." Generally, credit unions must calculate loan delinquency consistent with loan contract terms, which can vary widely.

The delinquent loan schedule can serve as the basis for a loan review sample. For example, a review of recently granted delinquent loans might provide insight as to reasons for increasing delinquencies. The Loan Exceptions workpaper can aid officials in revising policies and practices to reverse an increasing delinquent loan trend.

During the delinquent loan review, the examiner may:

- Determine whether staff follows the collection policies and procedures;
- Identify weaknesses within the collection policy or process;

- Identify underwriting trends and weaknesses, and determine what changes in procedures could have prevented the delinquency;
- Determine if the credit union develops and properly monitors a watch list of loans that require special attention; and
- Review repossession, bankruptcy and foreclosure logs to evaluate credit union control.

Based on a review of the Scope Workbook, the credit union's 5300 risk parameters, and loan queries, examiners should determine the level of risk posed by delinquency. An initial review of loans may suggest understated delinquency and deserve a closer look.

Collection Procedures

Examiners should review the loan loss ratio and the delinquent loan ratio when evaluating collection procedures. These ratios show the credit union's past loss experience and its current potential loss position. The adequacy of the collection program and the credit union's level of compliance with it provide an indication of the future direction of delinquency. The composition of delinquency can also indicate whether problems are recent or older.

Each credit union should develop a collection program appropriate for its size, complexity, field of membership, and area. The program should have definite, measurable goals (e.g., follow up on missed promise to pay within 24 hours.) Collection programs usually share the following common characteristics:

- Prompt action. Early collection effort enhances the success rate of collecting delinquent loans (e.g., within a few days of the first missed payment, long before the loan appears on the monthly delinquent loan list);
- Repeated contacts. A collection effort should consist of a series of payment requests, beginning with a gentle reminder and ending with a firm demand for repayment. Collection staff should record all collection contacts, and the results of those contacts, on a collection card or computer system collection-working file;
- Varied action. A collection program that combines letters and personal telephone calls can prove quite effective. Collection staff

should determine the "intent" of the delinquent member as early as possible. If delinquent members cannot make full loan payments, they should reach agreement with the credit union to make regular, partial payments. As a minimum, the borrower should initiate and maintain regular contacts with the credit union. If the borrower does not establish "good faith" or "good intent," the credit union should take stronger collection action;

- Prompt follow up on failed promises. If borrowers do not follow through with their promise to pay, the credit union should follow up within a maximum of 48 hours;
- Follow through. If the credit union does not follow through with its threatened action, delinquent borrowers may believe they can ignore the credit union; and
- Proper paperwork. Although not considered part of a collection program, staff must properly complete paperwork to reduce the likelihood of legal action against the credit union.

Examiners should discuss deficiencies in the collection program, policies, or practices with the appropriate officials. When encountering weak collection procedures, examiners may document their review by completing the Collection Program questionnaire in AIREs.

Examiners may also review previously charged-off loans. Often, credit unions assign these loans to outside collectors. These outside collectors should issue periodic status reports to the credit union. If these reports indicate a lack of follow up, officials must take appropriate action.

An "inverted" delinquency (more delinquent loans in the 6 to 12 and 12 months and over range than in the 2 to 6 months range) may indicate a problem in the collection program. The examiner should review the reasons for the inversions and, if necessary, reach agreements with the board to improve the collection practices. Inversion can also indicate the credit union does not charge off loans in a timely manner.

In a "normal" delinquency condition, more loans exist in the 2 to 6 months range than in the 6 to 12 months and 12 months and over ranges. Examiners may analyze the loans 1 to 2 months past due to determine if a weakness in the collection program is beginning to surface.

Erratic trends in delinquency, such as increasing delinquency followed by a sudden decrease that does not relate to loan charge-offs, can indicate potential abuse (e.g., due date bumping or fictitious loans.) Examiners may expand the review if they note unusual trends.

Extension and Refinancing

Examiners may review extension and refinancing policies and procedures for reasonableness. At times, credit unions can effectively use extension agreements or refinancing of delinquent loans as collection tools; however, excessive extension agreements or refinancing can mask delinquency. Credit unions should use extension agreements or refinancing of delinquent loans only to help borrowers overcome temporary difficulties, and after the borrower demonstrates renewed willingness and ability to repay the loan.

Generally, credit unions grant extension agreements to delinquent borrowers who have demonstrated their commitment to repay their obligations by making substantial payments for at least three months prior to approval. (Examiners should note that delayed disability insurance payments for illness or circumstances such as recalls after a layoff may justify extension agreements without the member demonstrating three months of good faith payments.) The collection department can prepare extension agreements; however, a loan officer or credit committee must approve the transaction to assure segregation of duties and avoid a conflict of interest.

Credit unions should refinance delinquent loans only after the borrower has demonstrated a consistent effort and ability to repay. Refinancing of delinquent borrowers that do not make consistent payments could warn examiners of hidden delinquency.

As a general rule, credit unions should not extend or refinance a loan more than once within a twelve-month period, or two times within a five-year period. If the credit union has a history of frequently

extending or refinancing loans, the examiner should carefully review the underlying reasons.

**Credit Card
Collection
Program**

The examiner may need to review the credit union's in-house procedures for delinquent credit card loans to ensure proper aging and limited losses. Some processors only report delinquency up to 210 days, in which case the credit union must calculate and report the past due months over 210 days.

Examiners should consider the following items when analyzing the credit union's credit card collection program:

- Procedures for listing delinquent, over limit, lost, or stolen cards in a warning bulletin;
- Procedures for blocking cards;
- Procedures for reviewing over limit cards; and
- Adequacy of bond coverage and deductible for fraud losses.

Bankruptcy

Examiners should familiarize themselves with the basic terms and concepts of federal bankruptcy law (Title 11, U.S. Code) in order to make informed judgments concerning the likelihood of collection from bankrupt members or member businesses (called "debtors" under the bankruptcy law.) The following paragraphs present only an overview of bankruptcy.

Complex situations may arise where examiners need more in-depth consideration of the bankruptcy provisions that warrant consultation with the credit union's counsel, regional office, or Office of General Counsel. For the most part, however, knowledge of the following information, when coupled with review of credit file data and discussion with credit union management, should enable examiners to reach sound conclusions regarding the eventual repayment of the credit union's loans.

**Forms of
Bankruptcy
Relief**

Liquidation and reorganization comprise the two basic types of bankruptcy proceedings. Liquidation, pursued under Chapter 7 of the law, involves the bankruptcy trustee collecting all of the debtor's non-

exempt property, converting it into cash and distributing the proceeds among the debtor's creditors according to a priority prescribed by statute. In return, the debtor obtains a discharge of all debts outstanding at the filing of the petition, thus releasing the debtor from all liability for those pre-bankruptcy debts.

Chapter 11 or Chapter 13 of the law addresses reorganization and, in essence, provides satisfaction of the creditor's claims from the debtor's future earnings, rather than through liquidation of the debtor's assets. That is, debtors may retain their assets, but the court restructures their obligations and implements a plan to pay the creditors.

All debtors (whether individuals, corporations, or partnerships), may use Chapter 11 bankruptcy, regardless of the amount of their debts. On the other hand, only individuals with regular incomes and unsecured debts under \$269,500 and secured debts less than \$807,750 may use Chapter 13.

The Chapter 13 reorganization plan represents essentially a contract between the debtor and the creditors. Before confirming the plan, the bankruptcy court must find that it was proposed in good faith and that creditors will receive an amount at least equal to what they would have received in Chapter 7 liquidation.

In Chapter 11 reorganization, all creditors may vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, creditors may object to the proposed repayment plan only on the following grounds: (1) they will not receive an amount at least equal to what they would have received in a straight liquidation (the "best interest of creditors" test); (2) the debtor is not required to pay all disposable income (i.e., income after payment of reasonable, current expenses) into the plan for at least three years (the "best efforts" test); or (3) the plan is not proposed in good faith (the "good faith" test.) The debtor may choose to convert a Chapter 13 bankruptcy to a Chapter 7 bankruptcy.

Most cases in bankruptcy courts involve Chapter 7 proceedings. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. The courts tailor reorganization plans to the facts and circumstances applicable to each debtor's situation, which mean they vary

considerably, and the amount that the creditor recovers may similarly fluctuate from nominal to virtually complete recovery.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to cease or "stay" further action to collect their claims or enforce their liens or judgments (12 U.S.C. §362.) Once filed, the petition prohibits actions to accelerate, set-off, enforce a statutory lien (*NCUA Rules and Regulations* §701.39), or otherwise collect the debt. The petition also prohibits post-bankruptcy contacts with the debtor (i.e., "dunning" letters.) The stay remains in effect until the bankruptcy court releases the debtor's property from the estate, dismisses the bankruptcy case, approves a creditor's request for termination of the stay, or the debtor obtains or is denied a discharge. Two of the more important grounds applicable to secured creditors for seeking relief from the automatic "stay" follow:

- The debtor has no equity in the encumbered property and the property is not necessary to an effective reorganization plan; or
- The court is not adequately protecting the creditor's interest in the secured property.

In the latter case, the law provides three methods by which to adequately protect the creditor's interests: (1) the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; or (2) the creditor may obtain an additional or substitute lien on other property; or (3) the court arranges some other protection (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in adequate protection for the secured creditor, relief from the automatic stay will not be warranted. If the creditor obtains relief from the stay, creditors may resume pressing their claims upon the debtor's property free from interference by the debtor or the bankruptcy court.

**Discharge –
Objections and
Exceptions**

The discharge protects the debtor from further liability on the debts discharged. In some instances, however, bankruptcy does not discharge debtors at all (i.e., the creditor successfully obtains an "objection to discharge"), or discharges them only as regards a specific

creditor and a specific debt (an action known as "exception to discharge.") In general, most unsecured debt is dischargeable, while most secured debt survives bankruptcy as a charge on the property to which it attaches. The debtor obviously remains liable for all obligations not discharged, and creditors may use customary collection procedures to collect these obligations.

"Objections to Discharge." The grounds justifying an "objection to discharge" include any of the following actions of the bankrupt debtor (this list is not all-inclusive) occurring within twelve months preceding filing of the bankruptcy petition: (1) transfer, removal, destruction, mutilation, or concealment of property of the debtor or the estate, with intent to hinder, delay, or defraud; (2) concealment, destruction, mutilation, falsification, or unjustifiable failure to preserve records of debtor's financial condition and business transactions; (3) making a false oath or account, or presentation of a false claim to the bankruptcy estate; (4) withholding of books or records from the trustee; (5) failure to satisfactorily explain any loss or deficiency of assets; and (6) refusal to obey a lawful court order or to testify when legally required to do so. In addition, the debtor's receipt of a discharge in bankruptcy within six years preceding filing of the present bankruptcy petition is a valid ground for objection (11 U.S.C. §727(a)).

"Exceptions to Discharge." The grounds justifying an "exception to discharge" include: (1) pre-bankruptcy income taxes; (2) money, property, or services obtained through fraud, false pretenses, or false representation; (3) debts not scheduled on the bankruptcy petition and for which the creditor had no notice; (4) alimony or child support payments (only the debtor's spouse or children may assert this exception, property settlements are dischargeable); and (5) submission of false or incomplete financial statements.

If a credit union attempts to seek an exception on the basis of false financial information, it must prove (1) the written financial statement was materially false, (2) it reasonably relied on the statement, and (3) the debtor intended to deceive the credit union. The credit union may find these assertions difficult to prove. Corporations and partnerships cannot avail themselves of discharges; therefore, bankruptcy often causes corporations and partnerships to dissolve or become defunct.

Reaffirmation

Despite a bankruptcy discharge, debtors may sometimes promise their creditors they will repay a discharged debt. A common example involves an unsecured loan with the credit union that the borrower wants to reaffirm after discharge. This process of reaffirmation is voluntary, but judicially enforceable agreement (11 U.S.C. §524(c); Fed. R. Bankr. 4008.) The principal requirements for a reaffirmation agreement are:

- The agreement between the debtor and the creditor must be made (i.e., executed and dated) before the discharge is granted;
- The agreement must inform the debtor that there is no legal requirement to reaffirm (i.e., that reaffirmation is voluntary);
- The court must reiterate that reaffirmation is voluntary and explain the obligations imposed by the agreement and the legal consequences if the debtor defaults; and
- The agreement must give notice of the debtor's right to rescind the reaffirmation agreement at any time before the discharge is granted, or within 60 days after the agreement is filed in court, whichever is later.

Transfers Not Promptly Perfected or Recorded

Under most circumstances, a credit union that fails to promptly perfect its security interest runs great risk of losing its security. This is a complex area of the law, but prudence clearly dictates that the credit union properly obtain liens and promptly file them to eliminate the possibility of losing the protection provided by collateral.

Statutory Lien

Federal credit unions can take advantage of a statutory lien authorized by the *Federal Credit Union Act* §107(11) and interpreted by IRPS 82-5. Under this authority a federal credit union may (1) impress a lien when granting a loan, by noting the existence of the lien in its records at the same time it grants the loan, by stating in the loan documents that borrowers pledge their shares and dividends to satisfy the lien or to secure the loan, or by adopting a bylaw or board policy to the same effect; and (2) enforce the lien by applying the shares and dividends directly to the amount due on the loan (including the unpaid loan balance together with interest, fees, and other charges) without obtaining a court judgment, even if the credit union has allowed the

member to make withdrawals and even if state law requires a court judgment before enforcing a statutory lien.

Three exceptions apply:

1. Regulation Z generally prohibits a federal credit union from offsetting a borrower's indebtedness arising from a consumer credit transaction under a credit card plan against funds that the credit union holds (12 C.F.R. §226.12(d));
2. As concerns individual retirement accounts (IRAs), the Internal Revenue Code (26 U.S.C. §408(a)(4)) requires that the "interest of an individual in the balance in his account is nonforfeitable." NCUA takes the position that federal credit unions should not impress a statutory lien against an IRA without first obtaining advice of either a tax advisor or counsel; and
3. The automatic stay of a bankruptcy court can stay the use of the statutory lien, which, if impressed within the preference transfer reversion period, could be an illegal preference and thus voided.

Examiners should also note two caveats regarding the statutory lien:

1. The credit union may only impress the statutory lien against the debtor-member's accounts (e.g., in a tenancy-in-common account, deemed to be a 50-50 split in the absence of other evidence, a federal credit union could not place the lien against more than the debtor's 50 percent interest; it cannot impress the lien against a parent's account for debts of an emancipated minor); and
2. The statutory lien only applies in the loan context; a federal credit union must adopt a nonstandard bylaw amendment or bylaw resolution in order to debit a member's account for losses resulting from another account (e.g., unpaid fees or service charges or returned checks.)

**Loan Loss Ratio
(Net Charge-Offs
To Average
Loans)**

The Financial Performance Report (FPR) computes an annual loss ratio termed net charge-offs to average loans, and provides a peer-group comparison (the amount of loss is shown per \$1,000 of loans

outstanding.) It also provides a historical trend of the net charge-off ratio. The Key Ratios workpaper displays the loan loss ratio for prior periods and the current ratio. The examiner should use this information for both comparisons between credit unions and to supplement the trend analysis. However, this ratio can be misleading.

For example, a low loss ratio could result from a board's reluctance to recognize losses, which would be evidenced by a high delinquent loan ratio. The examiner should compare the loss ratios over the periods to detect trends. A high but declining ratio might indicate that the credit union is correcting past problems. On the other hand, a credit union might have a low but rapidly increasing loss ratio, which might indicate an emerging problem.

The examiner should determine whether the credit union has a reasonable and timely method of charging off loans. Moreover, the examiner must verify the accuracy of the information on the NCUA 5300 report.

**Charge Off of
Problem
Credits**

Credit unions should establish a policy for the regular charge off of uncollectible loans to avoid an intentional or unintentional misstatement of their net worth position. The Query Report Charge Offs in AIREs provides a tool that may assist examiners in identifying charge off loans, when necessary.

The board may adopt a policy that delegates to the manager the authority to charge off loans. The board should approve the extent of the delegation (i.e., the dollar amount and loan type), reflect the approval in board minutes, and note the parameters in the written collection policy or, more appropriately, written loan charge-off policy. The manager refers loans that do not meet the established criteria to the board. The policy should specifically prohibit the manager from charging off loans when such charge off may constitute a conflict of interest, such as loans to family members.

Management reports loans charged off under the delegated authority to the board of directors at the next regularly scheduled meeting. NCUA recommends that the board ratify all delegated charge offs.

The board of directors must periodically review compliance with the charge-off policy. This policy may require the manager to comply with IRS rules to report certain discharges of indebtedness.

When the credit union deems the loan a loss, it must charge off the loan to the ALLL account. Loans that exhibit the following characteristics present a high degree of credit risk, and the credit union should consider them for charge off:

- A non-performing loan more than six months past due without a payment of at least 75 percent of a regular monthly installment within the last 90 days. Transfers from shares and proceeds from the sale of collateral do not constitute "payments";
- A delinquent loan in the hands of an attorney or collection agency, unless there are extenuating circumstances to indicate the credit union will collect the loan;
- A "skip," where the credit union has had no contact for 90 days;
- An estimated loan loss, where the credit union has the repossessed, but not yet sold, collateral on hand;
- An account in bankruptcy, where the credit union has received notification of filing from the bankruptcy court (e.g., loans discharged in Chapter 7 bankruptcy within 60 days of receipt of notification of filing from the bankruptcy court);
- A loan under the protection of Chapters 11, 12, or 13 bankruptcy, where the credit union has received no payments for six consecutive months;
- A fraudulent loan, when the loss is determinable;
- A loan of a deceased person, when the loss is determinable;
- A loan, where the remaining balance is a deficiency balance after the sale of repossessed collateral and where the credit union has received no payment and has no apparent course of action; and

- A loan deemed uncollectible, where additional collection efforts are non-productive regardless of the number of months delinquent.

Note: In Chapter 11 and 13 bankruptcy proceedings, if the court lowers the amount that the borrower must pay, the credit union should immediately charge-off that portion of the debt, which the court has discharged. Examiners should note that the court frequently revises the amount and terms of the debtor's obligations. If the court changes the terms of the debtor's obligation, the credit union must also change the terms of the obligation on the records (e.g., if the court changes the interest rate from 12 percent to 9 percent, the credit union must lower the rate to 9 percent as determined by the court.)

If the credit union does not maintain the ALLL account balance at a sufficient level to permit the necessary charge offs, the credit union must re-evaluate its ALLL funding methodology. Determining the adequacy of the ALLL is not a by-product of the loan portfolio review. Please see the ALLL chapter for a detailed discussion.

Collateral in Process of Liquidation

When a credit union possesses loan collateral that is in the process of being sold, the examiner may evaluate the collateral for recoverable value. The examiner may document the evaluation on an examiner-designed workpaper or on the list of collection problem loans. Misuse of collateral in the process of liquidation can occur in credit unions. The supervisory committee, in carrying out its auditing function, should review this account and the collateral.

Other Real Estate Owned (OREO)

OREO (other real estate owned) consists of foreclosed property where ownership has passed to the credit union. A credit union often acquires OREO through loan foreclosure. Generally, the credit union intends to sell the real estate to partially or totally satisfy the loan obligation.

The following definitions refer to OREO:

- **Cost** - fair value at the date of foreclosure plus cash payments for capital additions and improvements to the asset and, if applicable, related capitalized interest subsequent to the date of foreclosure.

- **Fair value** - the amount that the creditor could reasonably expect to receive in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Market value (if an active market exists) determines the fair value of assets. If no active market exists for the assets transferred but exists for similar assets, the credit union may use the selling prices in that market in estimating the fair value of the assets transferred. If the credit union has no market price available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may aid in estimating the fair value of assets.

**Accounting for
OREO**

Credit unions should account for and value foreclosed assets acquired by the credit union as OREO as follows:

- Presume OREO is "held-for-sale". The credit union should obtain appraisals or broker price opinions and onsite inspections as warranted to support the value of the property in question. (Note: generally, federal credit unions cannot hold OREO for the production of income. Therefore, this discussion of the accounting rules for OREO is limited to OREO-held-for-sale.)
- Record OREO at foreclosure at fair value less estimated cost to sell. After foreclosure, the credit union should account for OREO held-for-sale at the lower of fair value minus estimated costs to sell, or at cost. Credit unions should periodically evaluate the property for impairment and write down its carrying value if warranted. Often foreclosures need substantial refurbishments, such as new paint and carpeting, to make them marketable. Credit unions should factor estimated refurbishment costs into the carrying value.
- Report as a liability the principal amount of any debt to which the OREO is subject, and not deduct it from the carrying amount of the asset (e.g., tax lien, mechanic's lien.)

**Workpapers
and
References**

- AIRES Workpapers, Documents and Questionnaires
 - Supplementary Facts
 - Review Considerations
 - Loan Analysis
 - Loan Exceptions Document
 - Loan Review

- Key Ratios
- Critical Allowance for Loan and Lease Losses Input
- Critical Loan Input
- Collection Controls Questionnaire
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 - *Accounting Manual for Federal Credit Unions*
 - IRPS 83-3 – Financing Leases
 - *Chartering and Field of Membership Manual*
 - NCUA Letter No. 119
 - NCUA Letter No. 174
 - NCUA Letter No. 99-CU-5

LOAN TYPES - APPENDIX 10A

The *FCU Act* and *NCUA Rules and Regulations* permit credit unions to grant many types of loans. This appendix details the various types of loans offered by credit unions.

Loans to Insiders

Insiders include officers, directors, committee members, employees, and members of their immediate families. Loans to insiders must comply with §107(5) of the *FCU Act*, §701.21 of the *NCUA Rules and Regulations*, the *FCU Bylaws*, and sound principles of internal control.

Review procedures for insider loans could include the following steps:

- Tracing loans to officials back to the approval in the board minutes;
- Ensuring insider loans comply with §701.21(d) regarding preferential treatment; and,
- Reviewing statements for:
 - Negative balance activity;
 - Consistent application of fees and charges (e.g., officials' fees should mirror those of the other members); and
 - Numerous or unusual transactions.

Co-makers and Co-signers

The terms co-maker, co-borrower, co-signer, guarantor, and joint applicant sometimes create a degree of confusion. In general, these terms refer to one of two possible parties, either a co-maker or a co-signer.

A co-maker shares equal responsibility with the borrower for payment of the loan and receives an equal benefit in the loan proceeds, or access to future advances in an open-end loan. Regulation B (202.7(d)(1)) identifies a co-maker as a joint applicant and the resulting loan as joint credit.

A co-signer takes on liability for the obligation of another person without receiving goods, services, or money in return or, in an open-

end credit obligation, without receiving the contractual right to obtain extensions of credit under the obligation. Credit unions request a co-signer's signature as a condition for granting a member credit or as a condition for forbearance on collection of a member's obligation in default. A spouse who must sign a credit obligation to perfect a security interest pursuant to state law may not serve as a co-signer (refer to §706.1(h) of *NCUA Rules and Regulations*.) §706.3(a)(2) requires that co-signers receive specific written disclosures before obligating themselves on a debt. Guarantor and endorser are terms that also identify a co-signer.

The *FCU Act* §107(5) requires that co-makers be credit union members (see legal opinion dated February 20, 1992.) The co-maker shares in the loan proceeds and bears joint liability for repayment. Thus, a credit union cannot make a loan to a nonmember co-maker. However, a credit union may permit a nonmember to sign a loan, provided the nonmember does so in the capacity of a guarantor (co-signer), rather than a loan recipient (co-maker.)

Policies and Procedures

Anyone of legal age (according to state law) to enter into a contract can assume the responsibility of a co-signer. The credit union's policy or practice cannot require the co-signer be a member of the credit union or a family member of the primary borrower (e.g., spouse or parent.)

The same credit principles used to determine an applicant's ability to repay also apply to co-signers and co-makers. For example, credit unions should obtain a co-signer's credit report and perform a debt ratio analysis that includes the new payment. Credit unions may not change loan terms or the security pledged without the co-signer's consent.

Effective collection programs include notification to both co-signers and co-makers upon initial default of the obligation. If the member cannot or will not pay, the credit union should pursue repayment from the co-signer or co-maker, just as if they had received the proceeds of the original loan.

Bankruptcy cases require different procedures. If the primary debtor files under Chapter 13, the credit union must cease all collection

efforts against both co-signers and co-makers. If the primary debtor filed Chapter 7, the credit union should continue collection efforts against both co-signers and co-makers.

Credit unions should remain aware of groups of members who co-sign each other's loans. This practice, called "round-robin" co-signing can quickly result in an unsafe and unsound situation. Some data processing systems track co-signer obligations, but many cannot. Credit unions should institute a tickler system to track the member's co-signer obligations.

Lines of Credit

A line of credit is a preapproved fixed amount a member may draw on and replenish by repayment of amounts previously drawn. The agreement specifies the amount the borrower may access and the conditions of the agreement. Cancellation may occur upon notice by either party.

Some ways to access a line of credit include:

- Check or cash disbursements. Many credit unions accept telephone or mail requests. The check used with these transactions should bear a restrictive endorsement similar to the following:

Endorsement of this check by member acknowledges receipt of proceeds resulting from the transaction and agreements set forth on the detachable portion of this check and constitutes acceptance of the conditions of the agreements, which are hereby incorporated by reference.

- Automated Teller Machines (ATM.) The ATM verifies the card and requests an advance amount. The machine processes the request and provides the funds, a receipt, and a record of the transaction.
- Share draft overdraft loans. The line of credit agreement is separate from the share draft agreement. The share draft agreement must specify the authorized amount and include authorization for the credit union to transfer the amount of loan advance to the share draft account.

- Loan drafts. The drafts are similar to a bank check. Encoding allows the draft to travel through the check clearing system to the credit union's bank for payment.
- Credit cards. A credit union either issues credit cards itself or enters into an agreement with a credit card processor to issue credit cards, such as "VISA" or "MasterCard" to its members for processing against the members' lines of credit.

**Internal
Controls for
Plastic Cards**

Failure to protect plastic card programs represents a significant safety and soundness concern. A credit union should assess the adequacy of the loss prevention measures in its plastic card programs. Loss prevention measures, such as the following, reduce or prevent fraud losses:

- Card Activation. Processors should send new plastic cards to legitimate cardholders in an inactive mode. Before using the card, legitimate cardholders activate the card by going through customer verification procedures. Card activation programs can significantly reduce the loss of plastic cards in the mail.
- CVV/CVC (Card Verification Value/Card Validation Code.) VISA's Card Verification Value (CVV) and MasterCard's Card Validation Code (CVC) combat counterfeit fraud by using numbers encoded on the magnetic stripe of credit and debit cards. When the merchant passes the card through the point of sale reader, the transaction will be rejected and not receive authorization if the special code on the card does not exist or does not match the code maintained by the processor. However, for CVV/CVC to work, a credit union must have its authorization mode set to decline the authorization. Credit unions should confirm:
 - Their processor implemented CVV/CVC coding;
 - The CVV/CVC is fully operational and being read on all cards; and
 - The settings on its authorization response codes will decline the authorization for all credit and debit transactions.

- Neural Network. Neural networks track spending patterns of both cardholders and typical fraud type transactions. Effective systems monitor transactions 24 hours a day, seven days a week.

**Monitoring
Lines of Credit**

The credit union should periodically obtain information concerning the borrowers' current income and their repayment records on other debts. Industry norms require updated credit reports for lines of credit every two years. This review of a borrower's financial condition could help management determine whether to increase, decrease, or terminate a borrower's credit line.

**Open-End
Loans**

An open-end loan is similar to a line of credit plan. The primary difference is that a line of credit plan has preapproved advances, whereas, each open-end loan advance must receive loan officer or credit committee approval.

A member applying for an open-end loan completes a personal and credit information sheet, similar to a loan application except it usually does not ask for an amount or purpose. The applicant also completes an "open-end" note combined with the consumer credit disclosure.

Request vouchers document loan advances, which include an amount, purpose, and terms of repayment. If the applicant's signature does not appear on the request voucher, the check must contain a restrictive endorsement, acknowledging the advance under the open-end loan plan. The credit union may request updated financial information or credit reports every few years to ensure the member's creditworthiness has not deteriorated.

**Variable Rate
Loans**

Variable rate loans have interest rates tied to an index and margin. These loans pass some of the interest rate risk to the borrower. Movement in the index causes a change in the interest rate, which in turn causes a change in the monthly payment, the loan maturity, or a combination of these. While indices fluctuate over time, the margin (e.g., 100 basis points) remains fixed over the life of the loan. The index plus the margin equals the rate charged on the loan.

Following are some of the more common indices:

- Treasury Indices:
 - One-Year Constant Maturity U.S. Treasury (CMT) Securities (most common of the Treasury-based ARM indices);
 - Six-Month U.S. Treasury Bills; and,
 - Three-Year CMT Securities.

- London Interbank Offered Rate (LIBOR) indices:
 - Six-Month LIBOR as published in The Wall Street Journal; and,
 - Six-Month LIBOR as posted by Fannie Mae.

- Cost of Funds indices:
 - 11th District Cost of Funds index (COFi);
 - Federal Home Loan Bank Board (FHLBB) Monthly COFi;
 - National Monthly Median COF Ratio; and,
 - National Contract Rate.

- Prime Rate as published in The Wall Street Journal (most common index for Home Equity Lines of Credit.)

Laws governing Home Equity Lines of Credit (HELOCs) prohibit use of an internal cost of funds. Regulation Z also requires credit unions to prepare disclosures for variable rate loans showing the following:

- Circumstances under which the rate may increase;
- Any limitation on the increase;
- The effect of an increase, which refers to an increase in the number or amounts of payments or an increase in the final payment; and,
- An example of the payment terms that would result from an increase.

Variable rate loan review procedures include these additional steps:

- Determine the adequacy of policies, procedures, and internal controls for ensuring accurate rate change adjustments;
- Verify the credit union determined the borrower's ability to make the higher payment if interest rates increase;

- Review the variable rate log book or the computer program to verify the credit union has made accurate changes;
- Review the rate change notification sent to the member to verify the notification conformed to the terms of the note;
- Determine whether internal or external auditors or other staff periodically test the loan servicing system for accuracy; and,
- Determine the accuracy of the rate change adjustments.

Guaranteed Student Loans

Credit unions may offer guaranteed student loans that are part of the Federal Family Education Loan Program (FFELP.) Credit unions must receive approval to participate in FFELP and have strict monitoring procedures in place to maintain the program. Under FFELP, administered by the Department of Education (DOE), private lenders provide the loan principal and the federal government guarantees through a state agency the loan's principal and interest up to 98 percent. If the student or parent borrower defaults on the loan, the government reimburses the lender.

Granting and processing student loans differs from most other types of loans. Student loans are normally granted to nonworking students who attend school at least half time. The borrower's current ability to repay does not serve as the basis for the granting of student loans. This type of loan requires less credit risk analysis.

Most credit unions offering student loans accept and process the application, disburse the funds, and portfolio the loan while the student is in school. When the student graduates, the credit union may sell the loan on the secondary market. Credit unions may receive interest from the guarantor while the student is in school, then they may transfer the time consuming and extensive due diligence process to another entity when the student graduates.

Due Diligence on Student Loans

The credit union must perform due diligence on outstanding student loans. On subsidized student loans, the credit union must complete and send a billing report to DOE quarterly to receive interest due. The credit union also must update the status of the student borrowers at least annually (normally through a mailing) to obtain current school information and addresses.

Maintaining federal insurance on student loans requires that credit unions comply with all due diligence requirements, especially during the repayment process. Credit unions must make specific minimum telephone and written contacts to meet DOE's due diligence regulations. Violations occur when a credit union misses a contact or does not comply with the regulations. Violations of the DOE's regulations can result in loss of the government guarantee. Numerous violations may result in loss of the guarantee on the entire portfolio. The DOE may also levy fines for noncompliance. In addition, each state involved in the student loan process has its own required regulations and procedures. Credit unions often sell the student loan servicing to avoid the extensive due diligence requirements.

If the credit union appears to have significant risks associated with the student loan portfolio, examiners should determine the credit union has the following:

- Documented, comprehensive policies and procedures that adequately address the requirements of DOE, the secondary market, the guarantor, and the servicer;
- Adequate tracking methods for student loans;
- Delinquent loan list that includes delinquent student loans (even though they are guaranteed);
- Timely interest claims;
- Adequate training for management and employees that includes familiarity with DOE regulations;
- Well-documented and complete loan files;
- Adherence to the 50-50 rule (i.e., the credit union cannot have more than 50 percent of total loans in student loans); and,
- Additions to the collection policy that address specific requirements of DOE.

**Real Estate
Loans**

NCUA Rules and Regulations §701.21 addresses real estate lending. Well-planned and well-executed mortgage lending can offer advantages to the credit union including member loyalty, opportunity for cross-selling, good return and dependable cash flow. Credit unions should underwrite loans to ensure their eligibility for sale in the secondary market, unless they fit a specific exception created in the credit union's real estate policies.

Review procedures for these loans could determine the existence of the following potential higher risk loans:

- Loans over \$50,000 which meet the requirements of §723.1 are considered member business loans; and,
- Loans made to a “blind trust” (a trust whose beneficiaries’ identities are hidden) are high risk and can cause significant losses when members use these trusts to avoid restrictions on concentrations of loans.

Real estate loan review procedures could include these additional steps:

- Assess interest rate and liquidity risks associated with the terms and rates offered;
- Determine if policies and procedures address credit and collateral risk;
- Determine sufficiency of controls to ensure compliance with internal policies and minimum documentation requirements;
- Ensure the mortgage program is part of a well-planned and well-executed strategic plan;
- Evaluate reputation risk involving service to members and dealings with outside vendors; and,
- Ascertain compliance with the *NCUA Rules and Regulations*, individual state statutes, and other applicable consumer compliance laws and regulations.

The Secondary Market

After originating mortgages in the primary market, buying and selling of mortgages take place in the secondary market. The two biggest purchasers of mortgages are the Federal National Mortgage Association (FNMA or "Fannie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac.") Using their experience in the mortgage market, FNMA and FHLMC have determined an appropriate level of credit risk and established standards to control this risk.

NCUA Letter to Credit Unions Nos. 124 (June 1991) and 99-CU-12 (August 1999) provided credit unions with real estate lending guidelines. Credit unions should originate their loans in conformity

with secondary market standards; however, not all of a credit union's loans must necessarily meet this standard. Credit unions should also account for real estate loans, especially first mortgages, based on industry standards of 30-day month/360-day year, with a 15-day grace period and explicitly defined penalties. Departure from industry standards incurs additional risk.

Appraisals

Lenders use appraisals to determine the value of the collateral. Part 722 of the *NCUA Rules and Regulations* specifies the following:

- Identifies which real estate-related financial transactions require the services of an appraiser;
- Prescribes which categories of federally related transactions a state-certified appraiser shall appraise and which a state-licensed appraiser shall appraise; and,
- Prescribes minimum standards for the performance of real estate appraisals.

Appraisers normally use various valuation approaches. The valuation section of the appraisal provides the appraiser's support for the market value based on the cost approach, the sales comparison approach (market data approach), and the income approach. The appraiser usually places more weight on the sales comparison approach in the case of owner-occupied homes. The appraiser must report a minimum of three comparable sales as part of this approach.

FNMA and FHLMC have established guidelines for net and gross percentage adjustments. Generally, the dollar amount of net adjustments for each comparable sale should not exceed 15 percent of the comparable's sales price. The dollar amount of the gross adjustments, without regard to the positive and negative signs, for each comparable should not exceed 25 percent of the comparable's sales price. The appraiser should also use comparable sales settled or closed within the last 12 months. When the adjustments fall outside the 15/25 guidelines, comparable sales are more than six months old, or comparables are not in close proximity to the subject property, the appraiser should provide a written explanation. Ultimately, credit unions must accept sole accountability for the appraisal's accuracy.

Loans meeting the following criteria may not require a full appraisal:

- The loan is under \$250,000;
- The loan is for less than 50 percent of the property's value;
- The loan was planned to fit a specific exception created in the credit union's real estate policies; therefore, the credit union does not plan to sell the loan in the secondary market; and,
- The loan does not meet the requirements for an appraisal in Part 722 of the *NCUA Rules and Regulations*.

In these restricted circumstances, §722.3(d) requires the credit union to obtain a written estimate of market value, "performed by an individual having no direct or indirect interest in the property, and qualified to perform such estimates of value for the type and amount of credit being considered."

Evaluating Appraisers

When selecting an appraiser, credit unions must follow the specific requirements and restrictions outlined in Part 722 of the *NCUA Rules and Regulations*. In addition, the credit union should consider the following standards for selecting an appraiser:

- A minimum of two years of appraisal practice;
- A license or certification from the appropriate state; and,
- Insurance for errors and omissions.

Holding versus Selling Loans

Theoretically, lenders can sell any loan or portion of a loan. However, poorly documented or poorly underwritten loans may sell at reduced prices. Once a borrower has established a payment history (i.e., the loan is "seasoned"), buyers may relax documentation and underwriting requirements. Sometimes the credit union may find it advantageous to hold loans and sell them later as "seasoned" loans.

Credit unions may sell loans with or without recourse. The credit union must repurchase loans sold with recourse if the borrower defaults, even if it meets standard representations and warranties.

**Servicing
Mortgage
Loans**

Servicing constitutes all actions necessary to ensure proper handling of mortgage loans from the time of disbursement until finalization, by payoff, or charge-off. Servicing mortgages carries a significant amount of transaction risk. Credit unions must have all related practices in writing and follow them carefully. The required procedures include the following:

- Escrow accounts for the payment of taxes and insurance;
- Calculation of changes in payment for adjustable rate loans; and,
- Collection efforts regarding delinquent loans.

**Servicing
Rights: Sell or
Keep**

When a credit union sells a loan, it has three servicing options: (1) perform servicing itself, (2) sell its servicing rights to a second party, or (3) contract for servicing activities from a second party while maintaining control and ownership of those rights. Credit unions that sell or contract their servicing duties must ensure they deal with a reputable servicer.

Loan servicing can generate profit. Annual income may range up to one-half of one percent of the outstanding balance of the payments collected. At the same time, credit unions considering servicing loans must understand the labor-intensive nature of this activity and the importance of economies of scale. Credit unions that do not generate a large volume of loans may find it expensive. Generally, a servicing portfolio requires \$50 million or more to breakeven.

**Selling of
Servicing
Rights**

If the credit union sells the servicing rights, it must ensure the servicer can meet the standards for servicing required by the secondary market. The following list, while not all inclusive, addresses the most important items:

- The purchaser/servicer is reputable. The credit union should investigate the financial soundness and business history of the servicer.
- The credit union has a contract with the purchaser/servicer that addresses the following:

- Timeframes for remittance of payments. The member sends the required monthly payment to the servicer. The contract should determine when and under what conditions the servicer remits the principal and interest portion to the credit union;
- Information system. The servicer must have adequate information system processing capability to maintain accurate accounting and mortgage payment records. The credit union should maintain the right, by contract, to examine the records pertaining to the mortgages the servicer handles;
- Delinquency control. The servicer must perform collection activities mandated by the secondary market, including counseling procedures used with the borrower when trying to avoid or cure delinquency;
- Collection needs. The servicer should have established collection policies and procedures. Policies should address:
 - i. Actions taken by the servicer if the property requires repairs and the owner either cannot, or will not, pay for them;
 - ii. Procedures to control and monitor bankruptcy proceedings; and
 - iii. Guidelines addressing when to use an attorney and who will pay attorney's fees and associated costs;
- Foreclosure responsibilities. Servicer must familiarize themselves with the local and state requirements for all loans in its possession. In addition, some secondary market investors and insurers have specific foreclosure requirements;
- Filing of IRS forms. An important servicer responsibility involves timely filing of all IRS forms;
- Submission of periodic financial information. Credit union officials should periodically review the servicer's financial condition to ensure it operates safely and soundly;

- Servicer's insurance and bond protection requirements. Insurance policies must indemnify the servicer against losses resulting from dishonesty or fraudulent acts committed by the servicer's personnel and employees of outside firms that provide information systems and technology services for the servicer. Servicers must also have an errors and omissions policy to protect them against negligence, errors, and omissions in meeting the legal paperwork requirements;
- Accounting Records. Accounting records must identify the application of payments received on all loans. The servicer should provide the loan owner a monthly breakdown of the payment applications, based on the distribution of funds received;
- Onsite inspection requirements. The need and frequency of onsite inspections vary with the loan type, the payment history of the borrower, and the requirements of secondary market purchasers;
- ARM adjustment calculation. The agreement should provide a description of conditions governing when the servicer will calculate and notify the borrower of adjustments to the loan and payments per the contractual agreements of the note;
- Repurchase of rights. Written documentation should exist describing the terms and conditions with which the credit union can cancel or buy back the servicing rights;
- Resale of rights to a third party. If the credit union sells loans to a secondary market investor, the contract will contain a provision of approval for the sale of servicing rights to a third party. This protects the credit union's interest in the loan from involvement by inadequate servicers; and
- Penalty provisions for noncompliance. Noncompliance with any of the above provisions should trigger penalties outlined in the servicing agreement.

**Escrow
Accounts**

Escrow accounts accumulate funds to pay taxes, assessments, insurance premiums, and other charges that could affect the credit union's first lien position. The servicer's responsibility involves maintaining escrow accounts and adequate records to document (1) each account, its activity and current balance, (2) the prompt payment of bills, and (3) required reporting to appropriate government and non-government agencies. Regulation Z contains specific guidelines for escrow accounts.

Foreclosures

Once the credit union determines the member either cannot or will not bring the loan current and make the required payments, it should consider foreclosure. Servicers' policies should comply with secondary market requirements. Policies and procedures should consider provisions of the mortgage, applicable state or local laws, requirements of a loan insurer, and the best interests of the credit union.

Policies and procedures should address the following:

- Onsite inspections. Property location, crime rate in the area, occupancy status, and loan owner requirements determine the frequency and extent of onsite inspections;
- Property maintenance. The policies and procedures should ensure the property physically remains in salable condition. This can include lawn mowing, trash removal, snow removal, winterizing, etc.;
- Acceptable timeframes for foreclosure action. Legal counsel should address this issue. Generally, servicers should start foreclosure promptly after three full payments are past due on a first mortgage and after two full payments are past due on a second mortgage. They should immediately start foreclosure of abandoned or empty property;
- Insurance. Filing of needed claims with a mortgage insurer, if appropriate (e.g., PMI) and ensuring the credit union obtains insurance on foreclosed property; and,

- Pursuing deficiency judgments. The credit union must consider local laws restricting such action, the costs involved, potential delay in foreclosure procedures, collectibility of judgment, and the requirements of the secondary market.

A credit union foreclosing on secured contaminated property should determine if a liability exists under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA.) CERCLA facilitates the cleanup of hazardous waste sites. The mere threat of a hazardous substance release can invoke liability under CERCLA, which covers environmental hazards in the air, water, and soil. Legal guidance should help them determine the appropriate course of action.

Once the credit union completes foreclosure, it should account for the property as other real estate owned (OREOs) in accordance with generally accepted accounting principles (GAAP.)

Internal Controls, Segregation of Duties

A major purpose of internal controls is to avoid fraud and embezzlement. Separation of duties in the three phases of the mortgage lending process (taking the application, processing, and underwriting) decreases the risk of fraud. If the credit union cannot provide for adequate segregation of duties using its own staff, it should consider contracting out enough of the activities so that proper separation of duties occurs. A contractor can perform any or all of the three phases.

Independent Quality Control

A quality control program uses a sample of loans selected randomly by the quality control department. The quality control department audits the sample to determine proper collateralization according to the policies and procedures of the credit union and the regulatory authorities. Servicers must correct deficiencies uncovered during these reviews. Credit unions that sell loans to the secondary market must ensure their quality control program meets secondary market requirements.

Asset/Liability Management

The asset/liability management (ALM) program must address liquidity and ALM to maximize the gross spread and control interest rate risk

(IRR.) The Asset/Liability Management chapter provides additional information.

**Adjustable
Rate Real
Estate Loans**

Credit unions can reduce interest rate risk associated with mortgage lending by offering adjustable rate loans. However, adjustable rate loans carry their own problems, including:

- Lower yields, caused by market rates materially lower than those of fixed rate mortgages;
- Low "teaser" rates to attract borrowers (caution: the secondary market will not accept rates discounted more than 300 basis points below market);
- Index adjustments too far apart. The longer the adjustment period, the greater the lag;
- Adjustment caps too low. A low cap may keep the rate too low for the market, and too low to cover the credit union's costs;
- No floor rate. The credit union should establish a floor rate that will cover their costs;
- Use of an inappropriate index. Nonstandard indices affect salability and may result in poorer performance;
- Default among borrowers when rates adjust upward. Inability of borrowers to afford the higher payments may lead to more defaults; and,
- Penalties. Mistakes in calculating adjustments to rates may result in penalties.

**Subordinate
(Second)
Mortgages**

Subordinate, often second, mortgages allow borrowers to use a portion of the equity in their homes to secure borrowed funds. The *NCUA Rules and Regulations* do not prohibit third or fourth mortgages, but credit unions must carefully evaluate these for increased risk.

Tax laws allow borrowers to deduct interest on loans secured by their homes under certain conditions, so obtaining a mortgage loan often offers a tax advantage over a consumer loan.

Second mortgages, also marketed as "Home Equity Loans," include the following types:

- **Open-end/closed-end.** An open-end loan is either a line of credit (in which the credit union pre-approves advances at the time of application) or a loan where each additional advance requires reapplication and approval. Closed-end refers to the common type of standard second mortgage with set principal and term.
- **Fixed rate/adjustable rate.** Either open-end or closed-end second mortgages can have a fixed or an adjustable interest rate. Adjustable rate second mortgage loans can have all the features of an adjustable rate first mortgage: index, premium above index (e.g., "index plus two percentage points"), annual and lifetime caps, floors, etc.

A well-established market for second mortgages exists, so credit unions should use the standard documentation and practices in setting their own requirements.

Home Equity Lines of Credit

A Home Equity Line of Credit (HELOC) is a mortgage that does not require reapplication and approval for each advance. A HELOC carries an adjustable interest rate, usually adjustable monthly (with Prime Rate changes) or quarterly (per contract terms.)

In general, credit unions process and underwrite HELOCs in the same way as second or subordinate mortgages, with the following differences:

- **Note and mortgage.** Credit unions use special note and mortgage instruments for HELOCs. Standard secondary market documents for applicable parts of a HELOC loan file (e.g., mortgage, deed, title opinions) are recommended.
- **Consumer regulations.** The credit union must comply with all applicable consumer regulations. See the Consumer Compliance chapter for further information.
- **Legal considerations.** Legal opinions specifying the documents used to comply with applicable state and federal regulations should remain on file in the credit union.

- Creditworthiness. Credit union staff must analyze the borrower's creditworthiness periodically throughout the life of the loan.
- Loan-to-value (LTV) ratio limits. Credit unions should establish LTV limits. For conventional loans, the maximum LTV permissible should not exceed 80 percent of the lower of the appraised value or sales price unless the borrower obtained private mortgage insurance (PMI.) Credit unions should require borrowers to obtain the PMI from a company acceptable to the credit union and to established secondary markets. The LTV for government insured loans may not exceed the applicable FHA or VA guidelines. In declining real estate value markets, credit unions may require periodic appraisals for some properties. Ideally, credit unions should have the ability to trace property value statistics. Falling market values may require a reassessment of loan limits and the invoking of "Escape Clauses" allowed by the Federal Reserve Board to reduce the line of credit.
- Title insurance. As with other second mortgages, if the borrower can demonstrate title insurance outstanding, the credit union may choose to waive title insurance. However, without evidence of first mortgage title insurance, credit unions should require title insurance on home equity loans (assuming a sufficient loan amount.) The home equity loan should have a higher priority lien than an existing line of credit.
- Cash advances. The credit union's internal control programs should include tests of abuses of the equity line of credit. Equity lines of credit should not pay other in-house obligations. Establishing cash advance minimums discourages borrowers from using the line of credit for daily living expenses.
- Interest rate index. Credit unions must use publicly disclosed indices to establish the borrowing rate, not an internal cost of funds index. The index should be specific, such as the Prime Rate as published in the Wall Street Journal on a specific day.

**Loans Secured
by Mobile
Homes and
Real Estate**

Mobile home loans secured by property may qualify as a real estate or consumer loan, according to each state's laws. Credit unions should familiarize themselves with their applicable state laws. In many cases, title insurance companies will not include the value of the mobile home in their policy unless the borrower removes the wheels and tongue and places it on a permanent foundation. Also, some states require the same to qualify for homeowner's insurance.

**Insured -
Guaranteed
Loans**

§701.21(e) of the *NCUA Rules and Regulations* permits credit unions to grant loans secured by the insurance or guarantee of, or with an advance commitment to purchase the loan by, the federal government, a state government, or any agency of either. The law, regulations, or program under which the insurance, guarantee, or commitment is provided specifies the maturity, the terms, and conditions, including rate of interest, for making these loans.

Loans insured by the Federal Housing Administration (FHA) and loans guaranteed by the Veterans Administration (VA) are the most common types of loans that credit unions grant under this authority. Both types of loans help reduce the credit risk.

Only credit unions designated as "FHA-approved mortgagors" may originate loans under an FHA insurance program, and those functioning as "supervised lenders" may originate VA loans. Most credit unions should qualify.

These programs usually allow a borrower to purchase a home with little or no down payment. While the insurance or guarantee does not prevent a loss to the credit union, it usually provides the same protection that a large down payment from the borrower provides.

FHA/VA loans are more liquid than conventional mortgages, since both real estate and the government insurance or guarantee contract secure the loans. Additionally, credit unions may pool FHA and VA loans into Government National Mortgage Association (GNMA) pass-through securities. This pooling ability helps lower potential liquidity risk.

**Auto-Equity
Loans**

Changes in the tax laws severely restricted the deductibility of consumer loan interest paid by taxpayers. Lenders responded to these changes by creating "auto-equity" loans. Credit unions offering these consumer-purpose loans (generally for automobile purchases) take title to the automobile and place a lien on the member's real property. This action may make the loan interest tax deductible for the member (credit unions should provide members with a notice to consult a tax professional regarding deductibility of interest paid on the loan.)

Most credit unions underwrite these loans using consumer loan guidelines, rates, and terms. Credit unions take the real property lien purely as an abundance of caution and to possibly make the interest paid on the loan tax deductible for the members. The credit unions must comply with the applicable disclosure requirements for real estate loans, including rescission requirements.

**Construction
Loans**

Construction loans are high-risk loans that require sophisticated underwriting and administration. Construction loan policies should establish limits compatible with the credit union's size. The limits should integrate construction lending into the overall ALM plan. Credit unions should hire or contract with loan processors and underwriters trained and experienced in construction lending. NCUA Letter to Credit Unions No. 124 (June 1991) provides credit unions with real estate lending guidelines, which included information on residential construction loans. Generally, there are four types of construction loans:

- Loans to a developer to complete a commercial building such as a shopping center, office building, hotel, or apartment building;
- Loans to a developer to finance residential construction made on a speculative or "spec" basis (i.e., homes built to sell later in the general market);
- Loans to a general contractor to finance single homes to persons who may or may not have obtained prearranged permanent financing; and,
- Loans to an owner for financing the construction of the owner's primary residence (whether or not the owner acts as the general contractor.)

The first three loan types are member business loans if they exceed \$50,000. When owners act as general contractor, the credit unions must have tight controls to ensure construction progresses as planned. The major concerns involved in construction lending are:

- Failure of the builder to produce the anticipated product as contracted;
- Threat of prior or intervening liens placed on the mortgaged property;
- Unreliable market analysis resulting in either an unmarketable or difficult-to-market project; and,
- Inadequate funding for completing construction.

The following are possible unsafe and unsound operating practices:

- Disbursing funds in advance of construction progress. This could result in the credit union not having sufficient undisbursed funds to ensure project completion;
- Approving loan agreements, which do not include precautionary measures, to avoid the filing of mechanics' liens or stop notices. Mechanics' liens precede mortgage liens and stop notices can cause costly delays in construction;
- Approving loans for speculative or investment projects without (1) evaluating and approving feasibility studies, or (2) obtaining an independent appraisal of land value;
- Approving loans to investment borrowers without considering (1) their past performance records on similar projects, and (2) the proposed marketing program for the planned project;
- Approving loan agreements that do not include provisions for inspecting the construction's progress. Credit unions should disburse funds for labor and material according to progress of the project;
- Approving construction loans without prior review of builder's cost estimates to determine the accuracy and reasonableness of the estimates;

- Disbursing construction funds without supporting inspection reports;
- Approving loan agreements that do not require prior approval for changes in plans and specifications;
- Failing to segregate construction loan appraisal, inspection, and disbursement functions; and
- Granting loans to builders or developers with insufficient equity in the project. §723.3(b) of the *NCUA Rules and Regulations* requires 35 percent equity.

Land Loans

Loans collateralized by either raw acreage or improved property (having sewers, utilities, curbs, etc.) often contain high risk because of volatile land values and limited marketability compared to other real estate. Land loans usually require the following additional documents:

- **Appraisal, Survey, and Zoning Requirements.** When determining the soundness of the loan, the appraisal should consider the size of the property, the zoning requirements, the stated highest and best use of the land, access to highways, etc. A credit union should limit the LTV to no more than 60 - 70 percent of the appraised value of the land. Some experts limit the LTV to 50 percent. This will depend on the quality of the land, planned use of the land, and how soon owners plan to develop it;
- **Agreement that parties require credit union approval before making any improvements to the property; and,**
- **Title search and insurance.** Credit unions should periodically inspect unimproved property to ensure the borrower does not make changes without the credit union's knowledge.

Member Business Loans

A member business loan includes any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for a commercial, corporate, other business investment

property or venture, or agricultural purpose. *NCUA Rules and Regulations* §723.1(b) lists the exceptions to this general rule.

Credit unions must separately identify member business loans in their records and in the aggregate on their financial reports and 5300 Call Report. Many credit unions do not properly identify their member business loans. A review of the loan collateral and purpose codes can help identify potential member business loans. Reviewing reports on amortization, new funds advanced, extensions and loans granted in excess of \$50,000 may also assist in identifying these loans.

Policies and Procedures

Member business lending requires special skills in underwriting, servicing, and collecting. Credit unions engaged in member business lending must use the services of an individual with at least two years experience in business lending. Credit unions must have the expertise to monitor the financial condition of member-borrowers through periodic receipt and analysis of financial data, when appropriate and necessary (e.g., open-end member business loans.)

Member business lending programs often affect liquidity and interest rate risk. Credit unions involved in this type of lending must have adequate ALM policies and procedures before the credit union starts making these loans. The commitment to the borrower may involve a long-term business relationship, even though the actual loan term is short. For example, an agricultural operating loan generally involves a long-term commitment to fund the annual operations, while the individual loan may mature in one year or less.

To adequately address transaction and compliance risks, credit unions must document internal controls, policies, practices, and procedures. This documentation should include the types of loans granted, copies of forms used, and any other pertinent information.

Underwriting

The underwriting process should include an evaluation of the character and integrity of the borrower, including the borrower's ability to manage the business, repay debt, and accumulate capital in the business. The credit union should also assess the condition of the

industry in which the borrower operates, particularly as it affects the ability to repay.

The emphasis in underwriting member business loans shifts from the individual to the financial soundness of both the business and the member requesting the loan. To support their analysis of businesses, credit unions can use (1) commercial credit reports (e.g., Dun and Bradstreet), (2) individual credit reports, (3) balance sheet and income and expense statements, (4) cash flow statements, and (5) ratio analysis. Whenever a credit union requires a personal guarantee on a loan, it must evaluate the guarantor's financial strength. Some tools for the analysis include:

- Cash flow analysis. A credit union should only make the loan if the borrower has cash flow projections based on actual cash flow data. Many small businesses have trouble obtaining adequate and reliable cash flow information. Credit unions should not accept cash flow assumptions without data to show they are realistic. Borrowers must provide evidence they have sufficient funds available to service the debt.

The credit union should obtain tax returns and financial schedules of both the member and the business to properly analyze the cash flow statement. A quick test for cash flow is to add back to the profit-and-loss data of the business (net income) any non-cash expenditures (such as depreciation, adjustments to accounts receivable, etc.) and relate a positive resulting figure to the member's ability to cover loan payments.

- Net worth analysis. In addition to reviewing cash flow, the credit union should evaluate the strength of the business. One method of measuring profitability is to divide net profit by net worth, which results in the owner's return on investment.

Net worth is the equity or retained earnings of the business and represents the borrower's cushion before bankruptcy or insolvency occurs. Borrowers can distort net worth by overstating assets or understating liabilities. While borrowers often overvalue their assets, they can also understate liabilities both on their personal

and business financial statements. A borrower must supply supportable financial data to the credit union.

- Collateral analysis. The underwriting process must include a determination of the value, liquidity, and lien status of the collateral. Prudent lending requires the borrower to have equity in the assets securing the loan. The credit union's member business loan policy must establish guidelines for the maximum LTV the credit union permits for various types of collateral, while meeting the minimum regulatory requirements. When establishing these values, the credit union must keep in mind the forced sale of collateral generally brings a minimal return in relation to the value of the assets of a viable business.

Considering the high percentage of new businesses that fail, the credit union must carefully analyze collateral and cash flow. If the borrower uses inventory as collateral, all the procedures discussed later in this chapter concerning floor plan loans apply. However, the forced sale value of inventory in process may cover only a fraction of the value of the finished product.

- Financial analysis ratios. Credit unions should analyze at least three years worth of data from financial statements before granting a loan. They should perform ongoing analysis after granting the loan. Forward, as well as historical projections are critical to sound financial analysis. Examples of basic capital and liquidity ratios can be found in Appendix 10C - Member Business Loan Financial Ratios. Credit unions should use these ratios and, if necessary, establish additional ratios to analyze loans.

Credit unions may use published ratios relating to various industries as a standard for comparison (e.g., the Robert Morris ratios.) The credit union should maintain copies of the particular industry's standard ratios.

**Documenta-
tion**

Documentation for a member business loan also must include proper signatures from the parties to the transaction (those individuals permitted to borrow under the *FCU Act*, *FCU Bylaws*, and the *NCUA Rules and Regulations*.) §723.7 of the Regulations require the credit

union not grant member business loans without the personal liability and guarantee of the principals, except where the borrower is a not-for-profit organization, as defined by the IRS (26 U.S.C. 501.)

Lien filings often require the use of UCC documents. The credit union must file the necessary documents with appropriate local or state agencies, perform and document their search for prior liens, and keep their liens current, as required by their local or state agencies. Business assets also require proper insurance with appropriate loss payable clauses to the credit union.

Loan covenants documenting specific conditions of the loan are part of the member business loan note. Examples of loan covenants include (1) frequency of providing financial reports, (2) insurance renewal periods, (3) working capital requirements, (4) limits on owner draws, (5) permission for periodic onsite business inspections, and (6) call options, if the financial performance of the business deteriorates. An attorney experienced in loan covenants should prepare the loan agreement. Credit unions willing to take the risk of making a member business loan must recognize they need to pay for the expertise needed to document the loan agreements.

The credit union should know that too many covenants can expose the credit union to possible "lender liability", if the borrower defaults. Lender liability can also occur when a borrower becomes dependent on a lender for a constant supply of funds.

**Environmental
Protection
Agency (EPA)
Concerns**

A credit union foreclosing on secured contaminated property should determine if a liability exists under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA.) CERCLA facilitates the cleanup of hazardous waste sites. The mere threat of a hazardous substance release can invoke liability under CERCLA, which covers environmental hazards in the air, water, and soil.

Technically, when the credit union forecloses on the collateral, it becomes the "owner" of the property and the EPA can hold lenders liable for hazardous waste cleanup. However, CERCLA can exempt parties that hold ownership primarily to protect their security interest,

even when foreclosure leads to actual ownership. Legal guidance should help them determine the appropriate course of action.

Types of Member Business Loans

Examples of member business loans include investment property loans, working capital advances, term business loans, agricultural credit, and loans to individuals for business purposes. Some credit unions also grant letters of credit, which examiners may find particularly difficult to identify since they are an off-balance sheet contingent liability.

Rental Property Loans

The most common type of business loan is for rental property where the member obtains a credit union loan secured by an apartment building or a house, which the member then rents out. While real estate securing a member business loan may meet the requirements for exclusion from Part 723 of the *NCUA Rules and Regulations*, the examiner should treat the loan as a member business loan for review purposes.

When credit unions use rental income to qualify a borrower for a loan, the credit union should include the gross rental income as part of the borrower's gross income (after factoring in a reasonable vacancy rate), and the borrower's debt should include expenses related to the property.

Credit unions should support credit-granting decisions for rental property by determining the property's cash flow. For example, adding back depreciation to net rental income provides a good estimate of cash flow from rental property. Loan officers making rental property loans should have sufficient expertise in the rental property area, including a full understanding of Schedule E of the member's tax return.

Working Capital Loans

Working capital is the difference between current assets and current liabilities. This type of loan provides temporary capital in excess of normal needs. Working capital loans provide short-term funds that borrowers repay at the end of the cycle by converting inventory and accounts receivable into cash. Businesses engaged in manufacturing,

distribution, retailing, and service-oriented operations use short-term working capital loans.

Regulatory requirements and sound business practices govern the collateral securing this type of loan. Usually, the credit union takes the borrower's accounts receivable or inventory as collateral. If the credit union takes inventory as collateral, the lien should include the phrase "and proceeds thereof" since inventory converts to cash or accounts receivable, as it is sold.

Since this type of loan is high-risk, a credit union must set financing limits. For example, since accounts receivable collateral will rarely bring 100 cents on the dollar in a forced sale, the credit union should limit the loan to an amount less than the book value (e.g., 50 percent.) In addition, credit unions should review the accounts receivable discount terms and aging records to determine collection activity of the business.

If the credit union takes accounts receivable as security, the loan covenants should require the borrower to regularly check the credit rating of the major debtors on the receivable list. The credit union should receive a monthly aging of the accounts receivable past due and make periodic onsite inspections to determine the accuracy of the borrower's aging and reporting records. The credit union should also determine if the borrower has pledged inventory against another loan (e.g., a UCC filing search.)

When taking inventory as collateral, the credit union must perform periodic onsite inspections to ensure the borrower maintains a reliable inventory control system. The credit union should perform test checks on the inventory control system to ensure the accuracy of the total amount of reported inventory.

In all cases, credit unions should obtain quarterly profit and loss statements (including past statements, preferably for two or more years) from the borrower to evaluate the continued viability of the business.

Term Business Loans

Normally, members use term business loans to acquire capital assets such as plant and equipment. Regulatory requirements govern the collateral securing this type of loan. Due to the extended loan period, term loans contain more interest rate risk than do short-term advances. Because of the greater risk, credit unions should require amortization payments. Loan agreements will also contain restrictive covenants (conditions agreed to by the borrower) for the life of the loan.

Agricultural Loans

Agricultural loans range from mortgages on real estate to equipment, livestock, growing crops, operating loans, or personal loans. A credit union making farm real estate loans must take into account various factors that may not occur in other real estate loans. For example, credit unions making farm loans should (1) value not only acreage, but the productivity of those acres; (2) consider erosion and wastage along with fertility, since repayment may occur over an extended amount of time; and (3) look to the farm's productivity over a series of years as the source of repayment. Changes in price levels affect net worth.

To ensure repayment of the loan, credit unions should determine the agricultural operation earns sufficient income to pay taxes, personal living expenses (if applicable), operating expenses (including crop and herd insurance, if required), and reasonable allowances to maintain the productivity of the land and income flows. A farmer or rancher must demonstrate managerial efficiency by maintaining operating costs consistent with the productive unit type the borrower offers as security. Some owners, or farm or ranch managers, operate farms or ranches inefficiently because they economize too much in the use of labor-saving machinery, while others invest in more mechanization than the farm income can support.

If the amount of agriculture loans represents a significant risk to the credit union examiners can use the following questions as guidelines when evaluating internal controls for agriculture loans:

- Livestock loans:
 - Does the credit union require inspections at the time it makes livestock loans? Does the credit union require the borrower to provide proof of ownership at that time?

- Does the credit union require inspectors to properly date and sign the inspection report?
 - Does the inspection report note the condition of the animals?
 - Does the credit union require periodic inspections when appropriate for the type of livestock loan?
 - Has the credit union made proper notification to and reviewed with appropriate brand inspection or recording offices to ensure the borrower has proper title to the livestock?
 - Is the brand registered with the appropriate local or state agencies?
 - Is the brand registered in the borrower's name?
 - Has the credit union established a tickler file to ensure the borrower reregisters the brand every nth year as required by local or state agencies?
 - Does the credit union file security agreements with appropriate local and state authorities?
 - Does the credit union require assignment of milk check agreements on dairy loans?
- Crop loans:
 - Does the credit union require inspections of growing crops before it advances funds?
 - Does the credit union require borrowers to obtain crop insurance, where appropriate?
 - Does the credit union closely monitor disbursements to ensure the borrower channels loan proceeds into the farm operation and uses the proceeds as intended?
 - Are disbursement checks made out jointly to the borrower and vendor?

Letters of Credit

A letter of credit substitutes the creditworthiness of the credit union for that of the individual or corporation. Credit unions may earn a fee for issuing a letter of credit. Most credit unions do not offer them.

Credit unions disclose letters of credit, which are off-balance sheet contingent liabilities, using footnotes to the financial statements. When credit unions fail to disclose letters of credit, examiners may detect them through fee income spikes occurring in a single month.

Although the credit union disburses no funds when it approves a letter of credit, sound internal controls for member business loans require lenders to treat a letter of credit like a funded loan (i.e., if the member cannot service the debt, the collateral must be liquid.)

Two types of letters of credit are (1) the commercial letter of credit, and (2) the standby letter of credit. Often, a commercial letter of credit finances the sale of goods between a buyer and seller. The seller ships the goods to the buyer and submits an invoice. To avoid risk of nonpayment for the goods, the seller may require the buyer to obtain a letter of credit. Commercial letters of credit, secured by cash deposits, pose little risk to an institution as long as the credit union receives proper documentation from the beneficiary (seller.)

A standby letter of credit represents an irrevocable commitment to pay if the member defaults on an obligation. When issuing standby letters of credit, credit unions should determine that adequate collateral secures these letters of credit. Application forms should automatically convert to collateralized notes when members draw upon their letters of credit. Standby letters of credit have many uses. A request for a demand for payment of a standby letter usually signals something is wrong. Nonperformance or default that triggers payment of a standby letter of credit signals financial weakness, whereas payment under a commercial letter of credit suggests a normal business transaction.

Floor Plan Loans

Floor plan lending, a form of wholesale or inventory financing, finances items for dealers, including automobiles, mobile homes, boats, large home appliances, furniture, television, and stereo equipment. Under a written contract between the credit union and the dealer, a specific piece of equipment collateralizes each loan advanced. As the dealer sells a piece of collateral, the contract requires the dealer to repay those funds advanced for that collateral sold. A common policy requires dealers to invest 10 to 20 percent of their own funds.

Credit unions rarely engage in floor plan lending, which is specialized lending with above-normal risks. Loan officers working in the area of floor plan lending require special expertise.

This type of financing usually involves the use of a trust receipt. The written contract between the credit union and the dealer specifies the credit union will release to the dealer title to a specific piece of collateral sold with the stipulation the credit union will hold title to such collateral in trust until time of sale. The contract usually gives the dealer the right to sell the inventory, but normally at not less than the "release price." The credit union should request the dealer to authorize the credit union to periodically inspect the inventory, examine the dealer's records, and upon any default by the dealer to declare a forfeiture of the dealer's interest in the inventory. The credit union can verify inventory for reasonableness against tax forms.

To reduce the risk involved in this type of financing, the credit union should ensure prompt repayment by frequently inspecting the dealer's inventory (to determine exactly which units the dealer has sold), record inspection dates, the name of the inspector, and an itemized list of collateral.

Floor plan financing contracts should also provide for partial repayments on unsold inventory. For example, contracts frequently require the dealer to pay down the invoice price by 10 percent after 90 days and then make a 5 percent partial payment each month thereafter. Under such a plan, the credit union would require the dealer pay in full the note financing any units not sold after one year. This plan encourages inventory turnover and helps the credit union avoid financing out-of-date inventory.

Credit unions should require periodic financial statements from the dealers, monitor the dealers' financial position, and address any over-leveraging that may occur. Problems result when a dealer floor plans inventory with several lenders and uses the proceeds from the sale of the inventory for purposes other than to repay the floor plan loan.

**Examination
Guidance**

The review of the member business loan portfolio could document the credit unions compliance with:

- Member business loan requirements of Part 723; and,
- Loan maturity limits of §701.21(c)(4).

Examiners may complete the Business Loan questionnaire, which documents (1) whether the credit union complies with the *NCUA Rules and Regulations*, and (2) whether safety and soundness concerns exist in the credit union's member business lending practices. Examiners may also benefit from developing continuing workpapers for tracking member business loans from one examination to the next.

Examiners should report on the status of member business lending in credit unions whose member business loans exceed regulatory limits specified in §723.16 (the aggregate of member business loans plus unfunded commitments equal the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets.)

SBA Loans

The Small Business Administration (SBA), an independent agency of the federal government, guarantees up to 90 percent of the principal and interest on loans made by credit unions to small businesses meeting prescribed eligibility standards. In determining the \$50,000 member business loan threshold, credit unions should consider only the amount of the loan not guaranteed by SBA.

Participation Loans

Federal credit unions may participate with others in loans to credit union members, subject to the provisions of §701.22 of the *NCUA Rules and Regulations*. Participation loans may provide additional security to an investor, since the credit union would share in a portion of any loss.

The contract between the investor and the credit union may require the credit union to assume the majority of the risks in the event of a default. Such a contract may affect the adequacy of the Allowance for Loan and Lease Losses account. Sometimes credit unions enter into such transactions to avoid booking losses on a sale. If a third party with whom the credit union participates receives a higher rate of return on its investment than the credit union, examiners should carefully review the transaction to determine the credit union properly accounts for the transaction.

Following are possible unsafe and unsound operating policies and practices in loan participations:

- Purchase of loans without investigation of borrowers' credit positions, the condition of security properties, and the adequacy of appraisal reports;
- Purchase of unacceptably high risk loans to obtain purchase discounts or net yields above current market averages;
- Sales of high-yield loans and replacement of these loans with lower-yield loans;
- Sales of loans at a time when no current or projected demand for loanable funds exists; and,
- Participation sales only for creating income from a yield differential, a particularly risky practice under the condition described immediately above.

**Purchase,
Sale and
Pledge of
Eligible
Obligations**

Credit unions may purchase, sell, or pledge, in whole or in part, eligible obligations and loans in accordance with §701.23 of the *NCUA Rules and Regulations*.

Review procedures could include these additional steps:

- Conformance with all applicable parts and established limits of §701.23;
- Conformance of accounting procedures with GAAP, as applicable;
- Adequacy of reporting and collection practices and procedures;
- Existence and proper endorsement of notes and collateral documents; and
- Soundness of the loans' value.

**Stock
Secured
Loans**

Credit unions sometimes offer loans collateralized by stock, often in conjunction with a sponsor company, to facilitate sponsor-employee stock programs. Securities listed on the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or NASDAQ usually have a ready market. In most instances, credit unions should not make loans secured by stocks not listed on a national exchange, since these

loans can substantially increase credit, transactional, liquidity, and reputation risk.

The Federal Reserve Board's Regulation U (12 C.F.R. §221.2) provides an in-depth definition of a margin stock. In general, a margin stock is an equity security. Credit unions must adhere to both the margin and reporting requirements set by Regulation U. Credit unions that make loans to purchase securities (purpose loans) or make loans secured by securities must familiarize themselves with the requirements of Regulation U. Credit unions must also advise members about Regulation X, which requires borrowers in securities transactions to comply with margin regulations. These regulations help curb excessive credit in the securities market.

Regulation U stipulates, in part, that if a credit union extends credit of \$200,000 or more during a quarter (or has total credit outstanding at any time during the quarter of \$500,000 or more), secured by collateral that includes any margin security (regardless of the purpose of such loans), it must register by filing Federal Reserve Form FR G-1 with the district federal reserve bank. Regulation U also requires all registrants file an annual summary recap, FR G-4. The Federal Reserve forms are located at the FRB website:

www.federalreserve.gov/boarddocs/reportforms/

A currently registered credit union that has not extended any credit secured by margin securities during any six month period and that does not have more than \$200,000 of such credit outstanding during that period is eligible for deregistration (using form FR G-2, Deregistration Request.)

**Loan Policy
and Procedure**

Credit unions should cover the following areas in their stock secured loan policy:

- Types of acceptable stocks the credit union will accept for collateral (e.g., stock in the sponsoring company only, or stock listed on one or all of the major exchanges);

- Evaluation of the stock price, at the date of the loan disbursement, as well as periodic evaluations of the stock value;
- Loan to value limitations (margin.) Since stock values can fluctuate, credit unions should allow some margin in case of a reduction in stock value (e.g., 60 percent of current value); and,
- Stop loss provisions. The credit union should adopt procedures to liquidate the stock to satisfy the loan in the event the value of the underlying stock declines below an established loan-to-value ratio.

Required Documents

Credit unions making stock secured loans should have the following documentation:

- Note and security agreement. Consumer loan documents generally do not suffice for perfecting stock security interest. Credit unions often use a special note and security agreement designed for stock secured loans. If applicable, the co-owner of the stock must sign a third-party pledge agreement when the pledge is not part of the security agreement;
- Stock assignment forms. A stock assignment form giving the credit union the right to sell the stock, if necessary, must identify the name as it appears on the stock certificate and the stock certificate number. A credit union employee must witness the assignment. Sound internal controls require that stocks and assignments remain under dual control;
- Purpose statement, Form FR G-3. Credit unions must execute this form on all loans secured by margin securities extended after the credit union becomes subject to the registration requirements. The form, which the borrower and credit union must sign, prevents borrowers from using a false purpose statement to obtain funds for purchasing margin securities. The credit union must retain the form for at least three years after the borrower pays off the loan;
- Collateral tracking. The credit union must document and verify the number of shares and, as applicable, certificate numbers for stock received. Credit unions must implement an audit procedure to

periodically audit stock loans, their current balance, and the adequacy of the collateral's value as follows:

- Safekeeping receipts. Credit unions should issue a safekeeping receipt to the member to document receipt of the actual stock certificates. If the stock is in two names, the credit union should issue only one receipt to prevent one party from claiming the certificate without the knowledge of the other;
- Book-entry stock registration. In some cases, the member may not physically possess the stock, but a trustee may hold the stock in book-entry electronic format. Procedures must state what documentation the trustee must maintain to identify the stocks pledged as collateral for a loan; and
- Stock ownership. The credit union must assure the physical stock certificates exist in the member's name, not some other or street name. However, book entry stock registrations are held in street name;
- Default sale. Credit unions must adopt procedures to specify the conditions that would result in liquidation of stock collateral (e.g., default for past due payments or when the stock value declines.) When the value of stock falls below an established loan to value, the credit union must contact the member in writing and inform the member of the options available to address the collateral deficiency (e.g., paying down the loan or providing more collateral.)

**NCUA
Guaranteed
Loans**

Some credit unions purchase loans from liquidating credit unions under the terms of a contract with the NCUA Board on behalf of the National Credit Union Share Insurance Fund (NCUSIF.) Some contracts state the share insurance fund will repurchase a specified amount of loans within a specified time if the credit union cannot recover from the borrowers. The examiner should review the terms of the contract to determine the credit union complies with those terms, giving special attention to the credit union's accounting for payments received on the loans since contract provisions often differ.

The examiner also may need to evaluate the loans for the feasibility of an early settlement of the loan guaranty when both NCUA and the credit union would benefit from an early settlement (e.g., in cases of poor performing loans where the credit union needs more flexibility to develop a specific workout strategy.)

Indirect Dealer Financing Programs

Indirect Dealer Financing Programs (IDFPs) allow borrowers to make a purchase and obtain financing at the same location. IDFPs often apply to new and late model automobile loans; however, the concepts discussed apply to all types of indirect financing or point of sale lending.

A credit union should evaluate the stability of the dealership before entering into an IDFP business relationship. A credit union should investigate dealerships by (1) obtaining a Dun and Bradstreet report on the dealership, (2) contacting the applicable department of motor vehicles and the Better Business Bureau, and (3) analyzing the dealership's audited financial statements. Even after establishing the program, the credit union should cautiously select dealers and continue to review dealer selection.

In an IDFP, the automobile dealership realizes additional profit by charging a flat fee for referring loans to the credit union, or by charging the buyer-borrower an interest rate higher than the credit union's lobby rate (rate differential.) Rate differentials in excess of three percent indicate the dealership may be taking advantage of the credit union's members.

While the dealer initially determines the existence of credit union membership or eligibility for membership for a prospective borrower, responsibility for membership eligibility is the credit union's first consideration before beginning the loan approval process.

Before initiating an IDFP, the credit union should have in place:

- A written business plan that incorporates the aspects of the IDFP into appropriate areas of the credit union's operation;
- A sound overall lending program;

- Documentation of management's due diligence, including a formal cost/benefit analysis, for the proposed IDFP;
- An asset-liability management strategy that includes specific provisions for the IDFP;
- Detailed IDFP lending policies and procedures;
- Experienced IDFP lending management and staff;
- A comprehensive "dealership agreement" that delineates the rights, duties, and obligations of both the dealer and the credit union;
- A legal opinion on file that addresses the IDFP in general and specifically (1) the legality of the dealership agreement and loan documentation, and (2) applicable state and federal consumer compliance laws (Truth in Lending Act, Credit Practices Rule, Fair Credit Reporting Act, etc.);
- A strong internal control program that safeguards against contracts that may take advantage of members. The rapid growth and competitive pace of IDFPs may result in dealers using undue pressure tactics; and,
- A strong collection department with expertise in repossessing and disposing of vehicles.

Policies and Procedures

Formal IDFP policies and procedures should, at a minimum, address:

- Membership eligibility;
- Definition of terms;
- Lending requirements, including:
 - Obtaining legal opinions on loan documents and applicable consumer laws;
 - Qualifications for the lending staff; and
 - Limitations on aggregate amounts loaned through the IDFP;

- Dependable line of credit to avoid discontinuing the program during times of tight liquidity;
- Qualifications of dealerships (e.g., financial, experience, longevity, and ongoing analysis of dealer profitability);
- Limitations on dealers and dealerships;
- Internal controls;
- Monitoring procedures, to review by dealer:
 - Number of applications processed;
 - Number and amount of loans approved, conditioned, and rejected;
 - Number and amount of loans booked; and
 - Delinquency, repossessions, and charge offs;
- Method of determining rate differential or flat fee (credit unions should amortize rate differentials over the life of the loan or when the loan is paid off, whichever is sooner);
- Dealer contracts, including a legal opinion on such contracts;
- Auditing procedures for the dealer's reserve accounts and payouts; and,
- Marketing strategies aimed at maintaining a good relationship with the dealers.

Potential Problems

The following are a few of the problems credit unions may encounter in an IDFP:

- Unless the credit union has a competitive rate differential (or flat fee) structure, dealers may only forward high-risk loans, thereby increasing credit and transaction risk;
- Without adequate preparation and control, the increased loan volume could overrun the loan department resulting in unsound

underwriting decisions, again increasing credit risk and possibly liquidity risk;

- The increase in automobile loans could overtax the collection department with increased delinquencies and repossessions, thus increasing transaction and credit risks;
- The dealer's involvement may increase the credit union's potential for making a loan to a non-member or ineligible member, thus increasing reputation risk;
- The Holder-in-Due-Course provision, which creates a contingent liability to the credit union, applies due to the business relationship between the credit union and dealership. Since the degree of risk to the credit union depends on the financial stability and business reputation of the dealers involved, the credit union should ensure that the dealership agreement includes a recourse (or indemnification) agreement, which limits the credit union's losses in the event of a claim under the Holder-in-Due-Course provision;
- The dealer's buy rate or the flat fee paid to the dealer diminishes the credit union's profit margin. Constant monitoring of the cost/benefit relationship provides the board with important information for determining the IDFP's viability;
- Credit unions may lose fee income when the dealer sells loan protection, disability, and other types of insurance to members. The cost/benefit analysis should include the effect of lost opportunity fees;
- Credit unions with IDFPs that take members or business away from other area credit unions may experience strained relations with those credit unions, affecting reputation risk;
- Some members may become disgruntled to learn they are paying higher interest rates or insurance prices through an IDFP than other members pay who deal directly with the credit union. The credit union's marketing program should keep the membership informed of current lobby rates; and,

- The endeavor could result in a loss to the credit union if a substantial number of IDFPs fail; however, the credit union can minimize the risk of loss or failure if it takes appropriate initial steps before getting involved in an IDFP.

Warning Signs

The following items may evidence the credit union's lack of control over the program:

- The credit union approves more than 75 percent of the loans processed;
- The credit union places full reliance on the dealer to obtain credit checks and credit reports;
- The dealer, not the credit union, accepts the borrower's loan payments;
- The dealer makes payments on behalf of the borrower, a practice that could potentially disguise past due accounts;
- The member-borrower may apply for the title, which could result in an improperly recorded lien;
- The dealer finances the down payment (through dealer incentive, inflated or fraudulent trade-in, or purchase price, etc.) resulting in the member having no equity in the collateral;
- The credit union initiates or permits continuous overdrafts in the dealer reserve or holdback accounts;
- The IDFP operates outside of the credit union's normal trade area; or,
- The credit union does a majority of their business with one dealership or one finance and insurance (F&I) person.

Regulatory Issues

Federal credit unions may participate in IDFPs under both the authority to make loans to members (see §107(5) of the *FCU Act* and §701.21 of

the *NCUA Rules and Regulations*) and the authority to purchase eligible obligations of members (see §107(13) of the *FCU Act* and §701.23 of *NCUA Rules and Regulations*.) Participation under the loan authority requires the following:

- The federal credit union must make the final underwriting decision. That is, before the dealer and member sign the sales contract, the credit union must actually review the application and other documents and determine that the transaction conforms to its lending policies (federal credit unions may not delegate their lending authority to a third party); and
- The dealer must assign the sales contract to the federal credit union very soon after the member and dealer sign it. An indirect loan is a loan to a member (within the meaning of §107(5) of the *FCU Act* and §701.21 of the *NCUA Rules and Regulations*) only if the formation of a sales contract, the assignment of the loan to the credit union, the transmittal of funds to the dealer, and the establishment of a debtor-creditor relationship between the credit union and the member occur in a very short time frame.

When dealers do not assign contracts within a short time frame or when the credit union does not review the application and other documents prior to agreeing to fund them, NCUA considers them to be purchases of eligible obligations and, as such, limits them to five percent of the credit union's unimpaired capital and surplus.

**Direct versus
Indirect Point
of Sale
Programs**

Many credit unions, through arrangements with local retailers (auto dealerships, appliances and electronic equipment stores, etc.), have direct dealer financing programs (DDFP.) While the majority of the items pertaining to IDFPs can apply to DDFPs, the major differences between the two programs are as follows:

- In most cases, DDFPs do not involve signing up new members (i.e., borrowers must already belong to the credit union);
- Credit unions write loans with the same rates and terms for all members, leaving no room for the dealer to negotiate terms;

- Credit unions do not process non-member loans when dealers mistakenly submit them;
- Credit unions have the right of first refusal of their members' loans (i.e., the dealer does not shop the sales contract until the credit union rejects the loan); and
- Credit unions issue the "adverse action notice" if they do not grant the loan.

Leasing

Part 714 of the *NCUA Rules and Regulations* addresses permissible leasing activities for credit unions. Credit unions may engage in:

- Direct leasing, whereby the credit union purchases the property and leases it back to the member;
- Indirect leasing, whereby the member has a lease and the credit union purchases the lease from a third party (subject to §714.3);
- Open-end leasing, where the member assumes the risk for any difference in the estimated residual value and actual value at lease end; and
- Closed-end leasing, where the credit union assumes the risk for any difference in the estimated residual value and actual value at lease end.

Part 714 further specifies:

- Credit unions can only finance leases to their members;
- Credit unions may only offer a net, full payout lease. In a net lease, the member assumes all the burdens of ownership (maintenance, repair, licensing, registration, taxes, and insurance.) In a full payout lease, the credit union expects to recoup its entire investment in the leased property (amount financed), plus the cost of financing;

- The amount of the estimated residual value cannot exceed 25 percent of the original cost of the leased property (unless the excess is guaranteed);
- Credit unions must retain salvage powers over the leased property. The credit union must retain the power to take action to protect the value of the property if there is a change in conditions that threatens their financial position (such as failing to maintain insurance); and
- Credit unions must maintain a contingent liability insurance policy with an endorsement for leasing (or be named a co-insurer for indirect leasing) from an insurance company rated B+ or better.

Residual Value Insurance

Most automobile lease arrangements use residual value insurance coverage. Industry experts publish price guides showing residual values (e.g., Automobile Leasing Guide or Black Book.) Residual value insurance protects the credit union from errors in value estimation.

The credit union must determine the financial strength and reputation of the insurance company before purchasing residual value insurance coverage. The insurance company will only pay a claim for losses due to excessive devaluation of a vehicle at the end of the lease term. If, for any reason, the lease terminates early, this insurance does not apply.

Auto Insurance

Every member must carry normal liability and property insurance on the leased property. The member must name the credit union as an additional insured on the liability insurance policy and as the loss payee on the property insurance policy.

Regulation "M"

Regulation M implements the consumer leasing portions of the Truth in Lending Act to assure member-lessees receive accurate disclosures that allow members to compare various lease terms. The regulation also places limits on the size of balloon payments and specifies some advertising requirements. The credit union need not disclose "interest"

rates to the member, and usury laws do not apply. Lease contracts refer to fees rather than interest.

The regulation applies to leases that have the following characteristics:

- Term longer than four months;
- Leased property valued at no more than \$25,000;
- Purchases personal property for personal, family, or household use; and
- Natural person lessee.

Following are the required disclosures for Regulation M:

- Description of the leased property;
- Amount due at lease signing;
- Payment schedule and total amount of periodic payments;
- Other charges (i.e., the amount of any liability the lease imposes upon the lessee at the end of the lease term);
- Total of payments;
- Payment calculation:
 - Gross capitalized cost;
 - Capitalized cost reduction;
 - Adjusted capitalized cost;
 - Residual value;
 - Depreciation and any amortized amounts;
 - Rent charges;
 - Total of base periodic payments;
 - Lease term;
 - Base periodic payment;
 - Itemization of other charges; and
 - Total periodic payment;
- Early termination:
 - Conditions and disclosure of charges; and
 - Early-termination notice;
- Maintenance responsibilities:
 - Statement of responsibilities;
 - Wear and use standard; and
 - Notice of wear and use standard;
- Purchase option:
 - End of lease term; and

- During lease term;
- Statement referencing nonsegregated disclosures;
- Liability between residual and realized values;
- Right of appraisal;
- Liability at end of lease term:
 - Rent and other charges,;
 - Excess liability; and
 - Mutually agreeable final adjustment;
- Fees and taxes;
- Insurance:
 - Through the lessor; or
 - Through a third party;
- Warranties or guarantees;
- Penalties and other charges for delinquency;
- Security interest; and
- Limitations on rate information.

Failure to comply with the Consumer Leasing Act increases compliance risk and may result in criminal and civil penalties. Lessors must retain evidence (paper copies are not required) documenting their compliance with the Consumer Leasing Act regarding actions they performed and the required disclosures they made. The lessor must retain, for at least two years, enough information to reconstruct the required disclosures or other records. The Compliance chapter discusses Regulation M in more detail.

Income on Leases

Lease contracts refer to income on leases as "fee income" rather than "interest income". Therefore, lease contracts do not disclose an "interest rate" to the member. The credit union must know the costs of the lease and their overhead costs in order to determine the lease program's profitability. A well-managed lease program should identify the profit margin on leases.

Because a portion of each lease payment contains some principal return to the credit union, the credit union should use an effective interest method of recording income consistent with GAAP. This "interest rate" must be consistent with the "fees" disclosed in the lease agreement, but the credit union need not disclose the rate itself to the member, although some credit unions voluntarily disclose this rate.

**Leasing
Program
Problems**

The credit union should implement internal controls to mitigate the following problems posed by a leasing program:

- The credit union bears responsibility for credit risk. Residual value insurance does not benefit the credit union if a lease becomes delinquent. The member does not own the vehicle, usually makes no down payment on it, and therefore, does not have a vested interest in the vehicle. If the member defaults on payments and if the credit union repossesses the vehicle, the credit union would have to dispose of it and bear the depreciation expense. Credit unions must not view all of the insurance policies associated with auto lease programs as a substitute for quality underwriting procedures. Credit unions should take prompt action to limit losses on leases.
- Intense competition in the leasing area may tempt credit unions to offer lower lease payments by increasing the residual values. Manipulating and inflating residual values can result in significant losses to the credit union.
- Vehicles depreciate rapidly when they are new and gap insurance may not cover losses due to theft of the vehicle. Members will not continue paying on a wrecked or stolen vehicle, and the insurance company probably will not give the credit union book value (per the credit union's books) for the vehicle.
- If the credit union is the owner of the vehicle, a contingent liability may exist relative to the operation of the automobile.
- Although the member must properly maintain the vehicle, the incentive to maintain it lessens if the member intends to turn it in at the conclusion of the contract term. Poor or no maintenance may decrease the value of the vehicle at the conclusion of the lease. The credit union can penalize the member for a breach of the contract and impose a fee. However, the credit union may have difficulty collecting those fees the member feels are unwarranted.
- In closed-end leasing, losses resulting from depreciation and the credit union's inability to sell the vehicle for the loan balance at the end of the lease contract are the sole liability of the credit union,

unless it obtains appropriate insurance coverage. Closed-end leasing contains a level of risk that the credit union should understand and carefully evaluate.

- Using an outside party presents some risks. The benefits of using the services of a CUSO or leasing company include minimizing the credit union's administrative burdens and liability. However, if a credit union invests in or lends to a CUSO, and the CUSO fails, it can lose its investment in the CUSO, its loan to the CUSO, and the services that the leasing company CUSO provide. Since the credit union relies on the services of the CUSO, it should monitor the CUSO's financial condition and operations. Further, if the CUSO or leasing company files bankruptcy, the credit union may encounter difficulty obtaining title to the vehicles if the titles are in the name of the CUSO or leasing company at the time of bankruptcy. A participating credit union must monitor the financial condition of CUSOs or leasing companies.
- The credit union should have on file an attorney's opinion acknowledging that, in the event of bankruptcy, the leased vehicles are the credit union's assets, not assets of the CUSO or leasing company.
- Additional burdens could fall on the credit union if, at the end of the lease term, members return the vehicles to the credit union. The credit union must have written agreements for vehicle disposition at the time of lease termination to reduce the possibility of its becoming a used auto sales company. It should enter into written automobile disposal agreements with the residual value insurance company or local used auto dealers or auctions to reduce the potential of incurring a loss on the value of the vehicle. If a credit union uses a CUSO for leasing, this normally becomes the CUSO's responsibility.
- The potential for fraud exists in any program. Credit unions should check with their surety company and determine whether they need special bond coverage for lease financing.
- Interest rate risk exists with auto leasing as with any "loan" portfolio. When analyzing the profitability of a leasing portfolio,

the credit union must consider several factors, including the cost of CUSO service, the cost of insurance (usually included in the fee to the CUSO), the cost of credit risk, and the opportunity cost of the money invested.

- The credit union must consider service to members. Longer-term leases usually generate more profit to the credit union than short-term leases. Short-term leases may generate less profit than conventional loans. Some leases have marginal income spreads. If so, examiners should ensure that the credit union understands this condition and determine the profitability of the overall portfolio.

Balloon Notes

Balloon loans are loans with large final payments. The following inherent risks exist:

- The credit union may not contact the borrower frequently enough to learn of new financial problems of the borrower;
- The contracted balloon payment may exceed the borrower's ability to pay (borrower's expectations failed to materialize);
- The borrower may be unable to make final payment or obtain affordable financing elsewhere, when the contracted balloon payment comes due. When collateral depreciates faster than the loan balance amortizes, the collateral may no longer adequately secure the loan; and,
- The credit union may have liquidity problems due to a lack of cash flow.

Balloon notes present significant problems to management in establishing a sound asset-liability management (ALM) program. The credit union's ALM policies must clearly address how the credit union manages the risks inherent in balloon loans. Ideally, credit unions should match balloon note assets with equal maturity liabilities.

Boat Loans

Boats come in multiple shapes and sizes with costs ranging from less than \$500 to over \$1 million. There are two recognized categories of

boats based on displacement size, each with different requirements for perfection of liens.

- Boats with net displacement under five tons. This category contains mostly mass-manufactured recreational boats. While displacement differs for various hull types and shapes, generally boats under 32 feet fall into this category. Credit unions can determine the value of boats in this category from NADA (see nada.com) and Blue Book publications; similar to the way they determine the value of automobiles. Lenders can request independent appraisals if they cannot determine the value of a specific craft or its condition. In general, well-maintained boats hold their values much longer than automobiles or other recreational equipment.

Requirements for perfecting lien interests in small boats vary from one state to another. Most states title boats the same way they title automobiles. In some states, lien perfection requires filing a UCC-1. The credit union should familiarize itself with the requirements of the applicable states.

- Boats with net displacements over five tons. The U.S. Coast Guard regulates boats in this category, which generally operate in the open ocean, Great Lakes, and other large bodies of water (often as commercial fishing vessels.) Thus, loans for this type of boat may require business loan documentation. Credit unions should use caution when granting loans where the payments depend on income from a commercial fishing venture, since the cash flow is often seasonal (e.g., the limited Alaskan halibut season.) With the limited number of prospective buyers, high deficiency balances can result from defaults.

Many boats in this category have a mass manufactured hull, but the remainder of the boat is often custom built for an individual buyer. Equipment and quality of fit and finish vary widely. Before extending credit on boats in this category, credit unions should obtain a marine survey and an appraisal, especially important when the credit union grants a loan on a used vessel. A marine survey is a detailed report on the boat, its equipment, condition, seaworthiness, and compliance with Coast Guard fire and safety

regulations. Appraisers often require the completed survey before providing a firm value.

Perfection of a lien on a boat in this category requires a preferred marine mortgage filed with the U.S. Coast Guard.

GLOSSARY OF LOAN TERMS - APPENDIX 10B

Glossary of Auto Leasing Terms

Capitalized Cost: the amount financed or the final capitalized cost (cap cost) to the lessee.

Closed-End Lease: most consumer leases are closed-end leases. In a closed-end lease, the credit union assumes responsibility for any deficit between the agreed upon residual value and the vehicle's actual value at the end of the lease. This type of lease is often referred to as a "walk-away" lease.

Direct Lease: a lease where the credit union becomes the owner of the property at the request of the member and leases the property to the member.

Excess Mileage: the residual value is based on the leased vehicle having an exact number of contracted miles over the term of the lease. This mileage criteria is a major consideration in establishing the residual value. If the lessee anticipates additional miles at the beginning of the lease, the residual value can be lowered to account for the usage. If the mileage at lease end exceeds the amount contracted for, the excess mileage is billed at a predetermined cost per mile.

GAP Insurance: at any time during a loan's life, a payoff can be requested to determine the balance if paid in full before the scheduled end of the loan. This is often referred to as the net payoff. When a vehicle is stolen or considered a total collision loss, the insurance company negotiates a final settlement for the insured. In many cases, the settlement amount is less than the net payoff leaving a deficiency for which the borrower is still liable. GAP insurance pays the difference between the net payoff and the insurance settlement less the insurance deductible, thus eliminating the loss or deficiency.

Indirect Lease: a lease where the credit union purchases the lease and the leased property (or is assigned the lease and has a lien on the leased property) after the lease has been executed between a leasing company and the member.

IRPS 83-3: the NCUA's Interpretive Ruling and Policy Statement (IRPS) 83-3 authorizes federal credit unions to become involved in either direct or indirect, and in either open-end or closed-end financing of leased property. The personal property financed must secure the loan. All requirements and limitations established in the Federal Credit Union Act, the NCUA Rules and Regulations (particularly Sections 701.21 and 701.23), Regulations B and M, and local state laws must be followed.

Lessee: the party who actually uses the vehicle. The credit union member is the lessee.

Lessor: the party that enters into the lease with the credit union member. This may be the credit union, leasing company, or CUSO.

Open-End Lease: in an open-end lease agreement, the credit union member would take responsibility for any deficit between the agreed upon residual value of the property and its actual value at the end of the lease. This type of lease would be rare because the residual value would have to be less than 25 percent of the price of the vehicle and the member would have to accept this depreciation risk. These factors would make a lease agreement very unattractive to the member.

**Glossary of
Indirect
Dealer
Finance
Paper (IDFP)
Terms**

Residual Value: the projected future value of the leased vehicle. The value will vary based on the term of the lease, type of vehicle, and contracted mileage. Residual value is usually expressed as a percentage of the vehicle's MSRP (manufacturer's suggested retail price).

Buy Down Rate: a lower rate than the dealer's "buy rate." The dealer will pay the credit union the difference in the amount of the finance charges between the dealer's buy rate and buy down rate. This provides a lower rate to the dealer's customer (lower payments) allowing the dealer to complete the sale.

Conditional Sales Contract: agreement between the dealer and purchaser describing the merchandise with add-ons, agreed upon price, etc.

Captive Financiers: General Motors Acceptance Corporation, Toyota Motor Credit, Ford Motor Credit, etc.

Dealer's Buy Rate: the loan rate charged the dealer by the credit union. The rate offered to the dealer is usually between 0.25 and 1.00 percent less than the rate offered to members (lobby rate).

Dealer's Invoice: factory invoice describing the vehicle and the amount the dealer paid for the vehicle.

Dealer's Reserve: general ledger account balance owed to the dealer. It may represent an amount that must be retained in the dealer's reserve under the control of the credit union to assist in refunding interest on prepaid contracts, and to offset losses on contracts for which the dealer is obligated but has not performed.

F&I: an automobile dealership's Finance and Insurance Department.

Hold-Back Reserve: similar to dealer's reserve account, but usually represents a stipulated portion of the rate differential on a contract that the credit union believes represents a greater risk than normally accepted from the dealer.

Holder-in-Due Course: a liability situation created for the lender when the lender establishes a business relationship (e.g., IDFP) with the seller of a product (dealer). This area should be addressed in the Dealership Agreement to limit the loss exposure to the credit union.

Indirect Dealer Financing: financing arrangement whereby the dealer facilitates loans made by the credit union to members. The credit union is responsible for making the underwriting decision and the loan is assigned to the credit union immediately after being made.

Lobby Rate: rate charged members for direct financing with the credit union.

Post Purchase Audit: a detailed review of the paper submitted by the dealer to ensure the faxed application and sales contract agrees with the final paperwork submitted by the dealer, and the merchandise, add-ons, and insurances are appropriately priced. Usually performed for all new dealerships and periodically through the business relationship.

**Glossary of
Real Estate
Lending
Terms**

Quality Rating System: any number of loan rating methods designed to determine the risk assigned to a particular loan. (If the credit union is using some type of quality rating system, the amount and maturity of the hold back reserve should be adjusted in relation to the risk involved.)

Rate Differential: difference between the dealer's buy rate and the rate charged the customer. The higher the rate the customer will pay the more the dealer's profit on the financing.

Recourse Agreements: affects the lender's ultimate collectibility should the loan become delinquent. There are three types of recourse: 1) under "full recourse" the dealer must purchase the loan at the credit union's demand; 2) "limited recourse" would require the dealer to buy back the loan or repossess the goods if the credit union fulfills certain obligations; and 3) with "no recourse" (the most common), the dealer has no obligation on the loan unless fraud or misrepresentation was involved.

Retail Verification: also referred to as "after-purchase survey," this process serves as an internal control and quality control function (and, incidentally, presents an opportunity for the credit union to cross sell other loans and services.) An individual, other than the loan officer, calls the borrower after the loan is processed to ensure the dealer did not misrepresent the deal to the credit union or the member (APR, trade-in, out of pocket down-payment, accessories, insurance, etc.) This process should be completed for all new dealerships and F&I persons for the first 25 deals and then randomly thereafter (20 percent to eventually 10 percent of deals) as the relationship matures. The credit union considers a newly hired F&I person a new relationship.

Actual/Actual Remittance Type: a method of sending monthly mortgage payments to the loan owner that requires the lender (servicer) to remit only the interest and principal payment it actually receives from mortgagors.

Adjustable-Rate Mortgage Loan (ARM): a mortgage that allows the lender to adjust the interest rate periodically based on the movement of a specified index.

ALTA - American Land Title Association: a national association of title insurance companies, abstractors, and attorneys specializing in real property law. The association establishes standard procedures and title policy forms.

Amenity: an aspect of a property that enhances its value, e.g., off-street parking, availability of good public transportation, tennis courts, or a swimming pool.

Amortization: gradual reduction of the debt through periodic payments scheduled over the mortgage (debt) term. A loan payment schedule characterized by equal periodic payments calculated to meet current interest payments and retire the principal at the end of a fixed period.

Appraisal: a written report by a qualified person that sets forth an estimate or opinion of value. The term also refers to the process by which this estimate is obtained.

Arms-Length Transaction: a transaction between a willing buyer and a willing seller with no undue influence imposed on either party, and where there is no relationship between the parties except that of the specific transaction.

Assumption: a method of selling real estate wherein the property purchaser agrees to take over the primary liability for payment of an existing mortgage.

Balloon Mortgage: a mortgage that has level monthly payments that would fully amortize it over a stated term, but which provides for a balloon payment to be due at the end of an earlier specified time, e.g., 30-year amortization, with balloon payment due in five years.

Balloon Payment: the remaining balance of a mortgage that must be paid in a lump sum at the end of the mortgage term. The amount represents more than a monthly payment and is generally substantial, e.g., the balloon payment on a \$50,000 mortgage with a five-year term and 30-year amortization at 8.75 percent is scheduled to be \$47,800.

Bankruptcy: a proceeding in a federal court in which debtors who owe more than their assets can relieve the debts by transferring their assets to a trustee. This affects the borrower's personal liability for a mortgage debt but not the lien of the mortgage.

Basis Point: 1/100 of one percent.

Biweekly Mortgage: a mortgage that requires payments to reduce the debt every two weeks.

Blanket Lien: a lien on more than one parcel or unit of land, frequently incurred by subdividers or developers who have purchased a single tract of land for the purpose of dividing it into smaller parcels for sale or development.

Bridge Loan: a temporary loan generally made to borrowers who need financing between the purchase of a new home and the sale of an old home. Also called a "swing loan."

Cash-out Refinance: a refinance transaction in which the amount of money received from the new loan exceeds the total of the money needed to repay the existing first mortgage, closing costs, points, and the amount required to satisfy any outstanding subordinate mortgage liens.

Closing: the completion of a real estate transaction that transfers rights of ownership to the buyer. Also called "settlement."

Closing Costs: money paid by the borrower to enact the closing of a mortgage loan. This normally includes an origination fee, title insurance, survey, attorney's fees, and such prepaid items as taxes and insurance escrow payments.

Common Areas: those portions of a building, land and amenities owned by a Planned Unit Development (PUD) or condominium project's owners' association (or a cooperative project's cooperative corporation) that are used by all of the unit owners. Common areas could include swimming pools, tennis courts, and other recreational facilities, as well as common corridors of buildings, parking areas, etc.

Common Area Assessments: levies against individual unit owners in a condominium or PUD project for additional capital to defray the owner's association's costs and expenses to repair, replace, maintain, improve or operate the common areas of the project.

Comparables: in appraising, properties of reasonably the same size and location with similar amenities as the subject property. These are properties that have been sold recently, thereby indicating the approximate fair market value of the subject property.

Completion Bond: an insurance policy taken out for the lender that assures completion of the construction project if the builder or contractor cannot complete it.

Condominium: a real estate project where each unit owner has title to a unit, an undivided interest in the common areas of the project, and sometimes the exclusive use of certain limited common areas. Fannie Mae does not purchase condominium projects, but does purchase mortgages on individual units in the project.

Conforming Loan: a loan, the amount of which is less than or equal to the FNMA or FHLMC maximum loan limit (with the exception of loans securing property in Alaska or Hawaii which have higher limits).

Conventional Mortgage: a mortgage that is not insured or guaranteed by the federal government.

Cooperative Mortgages: mortgages related to a cooperative project. They may be multi-family mortgages covering the entire project or single-family mortgages covering individual units (share loans).

Cooperative Project: a multi-family residential building that has multiple ownership wherein a corporation holds title to the property and conveys units to individuals by issuing shares of stock and occupancy agreements.

Cost Approach to Value: a method of measuring the value of a property based on the cost of producing a substitute residence that has the same use and features as the property being appraised.

Covenant: refers to the various conditions (both positive and negative) associated with business loan and condominium promissory notes that the borrower or lender must meet during the life of the contract.

Credit Report: a report from an independent agency that verifies (last reported/known) a loan applicant's current employment and income, and provides information on previous debts and liabilities.

Credit Risk: the risk that a borrower will default (often associated with mortgage loans in view of their long-term nature.)

Credit Union Conforming Mortgage: a FNMA product that allows simplified documentation (credit reporting, income and employment verification, and application requirements) to facilitate FNMA's purchase of credit union-originated loans.

Deed in Lieu: a deed given by a borrower to a lender to satisfy a debt and avoid foreclosure.

Deed of Trust: in some states the document used in place of a mortgage; a type of security instrument conveying title in trust to a third party covering a particular piece of property; used to secure the payment of a note; a conveyance of the title land to a

trustee as collateral security for the payment of a debt with the condition that the trustee shall re-convey the title upon the payment of the debt, and with power of the trustee to sell the land and pay the debt in the event of a default on the part of the debtor.

Default: the failure of a borrower to make a mortgage payment when due. A delinquent loan is said to be in default.

Delinquency Advance: the deposit of a servicer's corporate funds into its custodial account to assure that the full monthly remittance due the secondary market will be available on the remittance due date, even though the servicer has not collected the actual funds from a delinquent borrower. A servicer may reimburse himself for delinquency advances from subsequent collections.

Discount: the amount by which the face value of a mortgage exceeds its selling price.

Discount Point: A percentage (usually one percent) of the loan amount (not the purchase price) of the property. Discount points paid by the borrower or seller when a loan is originated in order to increase the lender's actual yield.

Documentation: the use of FNMA/FHLMC Uniform Instruments ensures that the documentation associated with mortgage loans is complete and consistent with secondary market standards.

Due-on-sale Provision: a covenant in a conventional mortgage that allows the lender to call the mortgage due and payable if ownership of the mortgaged property is transferred without their permission.

Endorsement: additional coverage added to title insurance.

Errors and Omissions Coverage: a type of indirect loss insurance used to cover losses that occur because of error or neglect on the part of an employee to whom a specific responsibility has been assigned.

Escrow Account: the account holding that portion of the mortgagor's monthly payment, held by the lender, used for the payment of taxes, hazard insurance, mortgage insurance, and any other specified items as they become due.

Federal National Mortgage Association (Fannie Mae or FNMA): a major purchaser of mortgage loans on the secondary market. A privately owned corporation created by Congress to support the mortgage industry. It purchases and sells residential mortgages insured by FHA or guaranteed by VA as well as conventional home mortgages.

Federal Housing Administration (FHA): part of HUD whose main activity is to insure residential mortgage loans made by private lenders. It sets standards for construction and underwriting, but does not lend money or plan construction directly.

Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC): a private corporation authorized by Congress to provide secondary mortgage market support for conventional mortgages.

Fee Simple: the basic form of ownership, which conveys the largest bundle of ownership rights, including air rights above and mineral rights below the property.

Fee Simple Estate: an unconditional, unlimited estate of inheritance that represents the greatest estate and most extensive interest in land that can be enjoyed. It is of perpetual duration. In a condominium, the owner owns only his/her unit in fee simple and is an owner in common with respect to the land and other common portions of the property.

FHA Mortgage: a mortgage insured by the Federal Housing Administration; may be referred to as a "government" mortgage.

First Mortgage: a real estate loan that is the first lien against a property. First refers to the order in time that the lien is filed.

First Right of Refusal: lien that allows a prospective buyer the chance to buy the property before it goes on the market.

Fixed-rate Mortgage: a mortgage that provides for only one interest rate for the entire term of the mortgage. If the interest rate changes because of enforcement of the due-on-sale provision, the mortgage is still considered a fixed-rate mortgage.

Foreclosure: the legal process by which a borrower in default under a mortgage is deprived of his or her interest in the mortgaged property. This usually involves a forced sale of the property at public auction with the proceeds of the sale applied to the mortgage debt.

Ginnie Mae (GNMA), Government National Mortgage Association: a government-owned corporation within the US Department of Housing and Urban Development (HUD) that issues mortgage-backed securities in exchange for FHA/VA mortgages.

Hazard Insurance: insurance coverage that compensates for physical damage to the property (e.g., by fire, wind, or other natural disasters).

Home-Equity-Line-of-Credit (HELOC) Loan: a mortgage loan, usually in a junior lien position, that allows the borrower to obtain multiple advances of the loan proceeds at his or her discretion, up to a stated amount that represents a specified percentage of the borrower's equity in a property.

Home Mortgage: a residential mortgage on a one-to-four-family property.

HUD, Department of Housing and Urban Development: department responsible for the implementation and administration of government housing and urban development programs, including community planning and development, housing production and mortgage credit, and equal opportunity in housing.

Improvements: those additions to raw land that normally increase its value, e.g., buildings, streets, and sewers. Off-site improvements are improvements outside the boundaries of a property, e.g., sidewalks, curbs and gutters. On-site improvements include construction of buildings or other improvements within the property's boundaries.

Income Approach-to-Value: a method of measuring the value of a property, which is based on market rent or income that the property can be expected to earn.

Index Rate: a number that determines interest rate changes on adjustable-rate mortgages, e.g., LIBOR, 11 COFI.

Installment Debt: borrowed money that is repaid in several successive payments, usually at regular intervals, for a specific amount and term, e.g., automobile or furniture loan.

Insured Closing: settlement performed at the title company, not the credit union.

Interest Rate Risk: the risk that interest rates could increase or decrease significantly from the rates on loans held in a loan portfolio.

Junior Lien: any lien that is filed after the claims of the holder of a prior (senior) lien.

Lease: a written agreement between the property owner and tenant that stipulates the conditions under which the tenant may possess the real estate for a specified period of time and rent.

Leasehold Estate: a way of holding title to a property wherein the mortgagor does not actually own the property but rather has recorded a long-term lease on it.

Letter of Credit: a letter addressed by a financial institution, on behalf of a borrower, to a third party, authorizing the third party to draw drafts up to a stipulated amount under specified terms.

Lien: a legal hold or claim of one person on the property of another as security for a debt or charge.

Liquidity Risk: the risk of having inadequate cash on hand to meet member needs. A credit union in this position would be forced to borrow money or sell assets on what may be unfavorable terms to raise cash.

Loan-to-Value (LTV) Ratio: the relationship between the unpaid principal balance of the mortgage and the property's appraised value (or the sales price, whichever is lower).

Market Conditions: lending in any area requires a thorough knowledge of the local market, laws, customs and pricing.

Margin: a fixed-rate added to an index for determining the overall interest rate that will be charged on adjustable-rate loans. The margin is usually stated in terms of basis points, such as 100 BP, or as an interest rate, such as one percent.

Monthly Fixed Installment: that portion of the total monthly payment that is applied toward principal and interest.

Mortgage: conveyance of an interest in real property given as security for the payment of a debt. The deed by which such a transaction is effected. Collectively, the security instrument, the note, the title evidence, and all other documents and papers that evidence a lien on property as security for payment of a debt.

Mortgagee: a person or company to whom property is mortgaged.

Mortgagor (also Mortgager): a person who mortgages property (borrower, homeowner).

Negative Amortization: a gradual increase in the mortgage debt that occurs when the monthly installment is insufficient to cover interest. The interest shortage is added to the unpaid principal balance to create negative amortization - an increase in the principal amount owed.

Net Worth: the value of all assets, including cash, less total liabilities; often used to indicate creditworthiness and financial strength.

No Cash-Out Refinance: a refinance transaction in which the mortgage amount is limited to the sum of the unpaid principal balance of the existing first mortgage, closing costs (including prepaid items), points, the amount required to satisfy any liens that are more than one-year old (if the borrower chooses to satisfy them), and cash to the borrower of up to one percent of the loan amount.

Non-assumption Agreement: a provision whereby if the loan is sold the buyer cannot assume the debt.

Nonconforming Loan: a loan that FNMA or FHLMC will not buy because it exceeds their maximum loan limits (with the exception of loans securing property in Alaska or Hawaii which have higher limits.)

Nonstandard Loan: either a conforming or nonconforming loan supported by nonstandard documentation, e.g., a TRW credit report rather than a Residential Mortgage Credit Report.

Notice of Default: rider attached to title insurance for credit unions in a second lien position. Requires the first lienholder to notify the second lienholder before foreclosure.

Occupancy Status: Fannie Mae uses three definitions of ownership to determine conventional mortgage eligibility:

- **Principal Residence** - the borrower's primary residence. At least one borrower must occupy and take title to the property and execute the note and mortgage.
- **Second Home** - a single family property that the borrower occupies in addition to the principal residence (a two- to four-family residence is not eligible for second home status). When the property is classified as a second home, rental income may not be used to qualify the borrower.
- **Investment Property** - a property that the borrower does not occupy. This definition is used whether or not the property produces revenue.

Origination Fees: the fees charged by a lender to prepare loan documents, make credit checks, inspect, and sometimes to appraise a property. The fees usually are computed as a percentage of the face value of the loan.

Operating Loan: a current liability. It funds the operations of the business/farm for the cycle or period is due and payable within the operating cycle. Generally, used for the acquisition and financing of inputs for the production cycle.

P & I (Principal and Interest): that portion of a homebuyer's monthly payments to the lender that composes the debt service on the mortgage.

Power of Attorney: transfer right (interest) in property to another person to act in owner's behalf.

Private Mortgage Insurance (PMI): insurance written by a private company, protecting the lender against loss resulting from a mortgage default.

Promissory Note: borrower's promise to repay a loan; used in all types of borrowing. Contains the terms and conditions of the loan, including covenants necessary in commercial lending. All promissory notes contain the amount borrowed and the agreed upon interest rate - either fixed or variable.

Planned Unit Development (PUD): a real estate project in which each unit owner has title to a residential lot and building and a nonexclusive easement on the common areas of the project. The owner may have an exclusive easement over some parts of the common areas (e.g., a parking space). Fannie Mae does not purchase PUD projects but does purchase individual units in such projects.

Purchase-Money Transaction: the borrower obtains the mortgage to purchase the property.

Quality Control: development of regular loan monitoring that addresses the credit, collateral, and interest rate risk within a real estate loan portfolio. A system of safeguards and checkpoints to ensure that all loans are originated, processed, underwritten, closed, and serviced according to the lender's and/or secondary market's requirements.

Quit Claim Deed: transfers a portion or all interest to another.

Reconveyance: to transfer lien back to previous position or owner

Recourse: a financial institution's acceptance, assumption, or retention of some or all risk of loss generally associated with ownership of an asset, whether or not the institution owns or has ever owned the asset.

Red Lining: making home mortgage loans only in specified areas of towns or municipalities.

Refinance Transaction: the repayment of a debt from the proceeds of a new loan using the same property as security. Fannie Mae also considers the current owner's placement of financing on a property not financed as a refinance transaction.

RMCR, Residential Mortgage Credit Report: a detailed account of the credit, employment, and residential history (as well as public records information) of a borrower.

Sales Comparison Approach-to-Value: a method of measuring the value of a property based on an analysis of comparable sales, contract offerings, and listings of properties that are the most comparable to the property being appraised. (Also called "market data approach".)

Scheduled/Actual Remittance Type: a method of sending monthly mortgage payments which requires the lender to remit the scheduled interest due (whether or not it is collected from mortgagors) and the actual principal payments that it collects from mortgagors.

Scheduled/Scheduled Remittance Type: a method of sending monthly mortgage payments that requires the lender to remit the scheduled interest due and the scheduled principal due (whether or not payments are collected from mortgagors.)

Second Mortgage: a mortgage that has a lien position subordinate to the first mortgage because it was recorded later.

Secondary Market Lending Standards: participation in the secondary market requires strict adherence to established industry mortgage lending standards.

Secondary Mortgage Market: the market in which existing mortgages and mortgage-backed securities are bought and sold.

Servicing: the tasks performed to protect the mortgage investment including collecting the monthly payments, managing the escrow accounts, monitoring and dealing with delinquencies, and overseeing foreclosures and payoffs.

Servicing Compensation: the income that a servicer receives for the collection of payments and management of operational procedures related to a mortgage, e.g., base servicing fee, plus late fees charged for special services, yield differential adjustments or excess yield, and, sometimes, a share in prepayment charges.

Servicing Released: sale of a mortgage loan along with the rights to service that loan when the loan is sold in the secondary market.

Servicing Retained: retention of the rights to service a loan when the loan is sold in the secondary market.

Subordinate Financing: any mortgage or other lien that has priority lower than that of the first mortgage.

Subservicer: party under contract to the original lender to perform the on-going servicing activities for the mortgage or pool. A qualified party acceptable to the purchaser must service loans sold on the secondary market.

Subservicing Arrangement: an arrangement wherein the contractually responsible servicer of a mortgage or pool of mortgages hires another servicer to perform its servicing functions.

T & I (Taxes and Insurance): that portion of a home buyer's monthly payments to the lender transferred into an escrow fund to pay property taxes, the homeowner's insurance premiums, and mortgage insurance, if applicable.

Title Insurance: insures against defects in title that were not listed in the title report or abstract.

Trade Area: the area, as defined by the credit union's policies, where a stated type of loan will be considered. The area must be such that the credit union will be able to perform adequate monitoring of market conditions and of loans granted.

**Glossary of
Student Loan
Terms**

UCC, (Uniform Commercial Code): a comprehensive codification and modernization of commercial law (excluding law dealing with real property). Each state has adopted its own provisions to this codification.

VA Mortgage: a mortgage that is guaranteed by the Department of Veterans Affairs; may be referred to as "government" mortgage.

Warranty Deed: contains a covenant of warranty whereby the coventor will defend against the claims of all persons.

Wraparound Mortgage: a mortgage that includes the remaining balance on an existing first mortgage plus an additional amount requested by the mortgagor. Full payment of both mortgages is made to the wraparound mortgagee, who then forwards the payments on the first mortgage to the first mortgagee.

Deferment: time interval of postponement of principal payments on a Stafford Loan during which the federal government makes the interest payments (excluding unsubsidized). Lender/servicer determines the deferments, which are authorized for borrowers who meet the following criteria:

- Study at least half-time at an eligible school;
- Study in an eligible graduate fellowship program;
- Are seeking but are unable to find full-time employment;
- Will suffer economic hardship from repayment (as determined by the lender using Department of Education regulations);
- Serve in an eligible internship program

Federal Family Education Loan Program (FFELP): formerly called the Guaranteed Student Loan (GSL) program. Loans granted under this program are insured. Qualified students and parents can borrow money for education. This program includes Federal Stafford Loans (subsidized and unsubsidized), Federal Parent Loans for Students (PLUS), and Federal Consolidation loans.

Federal PLUS Loans: unsubsidized loans to parents who are assisting their dependent student. The parent is responsible for the loan repayment. Interest accrues from the date of origination and is the responsibility of the parent borrower. The loans have no grace period and repayment begins while the student is still in school.

Grace Period: the period of time between when a student ceases to attend school at least halftime and when the loan repayment must begin (usually 6 months).

Guarantee Agencies: agencies designated by the US Department of Education to guarantee loans made under the FFELP. The guarantee agency will reimburse the lender for an eligible loan in case of default, borrower's death, bankruptcy, or total and permanent disability. Each state has its own guarantee agency.

Insurance Premium: a fee, usually a percentage of the loan amount (up to 3 percent), deducted from the loan proceeds by the lender and transferred to the guarantor agency. The guarantee agency establishes the premium amount.

Interest Benefits: payments made by the Department of Education to lenders. The lender receives the full amount of the actual interest as long as the borrower remains eligible.

Secondary Market: purchases student loans from lenders and is the holder of the loan after purchase. Includes institutions such as SLMA (Sallie Mae - Student Loan Marketing Association) and CHELA/USA (California Higher Education Loan Authority).

Servicers: companies (e.g., EduServe and Academic Financial Services Association) that provide day-to-day management of student loans. The level of service can be negotiated with the individual companies (e.g., payment processing and collections).

Special Allowance: payments made by the Department of Education to the lender allowing lenders to offer FFELP loans at a reduced interest rate. Based on a mathematical formula established by the Department of Education, the special allowance depends on the average 91-day T-Bill rate, interest rate on the student loan, and a "special allowance factor" set by law. The special allowance compensates the lenders for what they could be earning if the funds were in consumer loans rather than student loans.

Subsidized Federal Stafford Loans: loans to undergraduate, graduate, vocational, or professional students who meet specific financial need and income criteria. These loans require no repayment when borrower is in school at least half time and during grace and deferment periods, at which times the government subsidizes these loans by paying interest to the lender. Monthly payments begin 6 months after the student graduates, drops below half-time status, or withdraws from school. The maximum payback period is 10 years from the date of the first payment.

Unsubsidized Federal Stafford Loans: loans to undergraduate, graduate, vocational, or professional students who do not meet specific financial need and income criteria. Interest payments begin immediately after the loan is disbursed. The interest can either be paid by the borrower or capitalized and added to the principal. The government does not subsidize these loans and therefore does not pay interest. Monthly payments begin 6 months after the student graduates, drops below half-time status, or withdraws from school.

MEMBER BUSINESS LOAN FINANCIAL RATIOS - APPENDIX 10C

Member Business Loan Ratios

Credit unions should establish specific ratios to analyze their member business loans. The following are intended to aid examiners in understanding the information presented during the loan review.

- **Acid Test Ratio (or Quick Assets):**

$$\frac{\text{Cash} + \text{Cash Equivalents} + \text{Accounts Receivable}}{\text{Current Liabilities}}$$

Tests the company's short-term debt paying abilities. Only the current assets that are readily converted into cash are used. Highlights potential liquidity problems attributable to an inadequate mix of current assets.

- **Current Ratio:**

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Most common indicator of a firm's short-run liquidity. Shows the relationship between current resources and short-term debt. Puts the dollar amount of the Working Capital calculation into ratio format for comparison purposes.

- **Days Sales in Accounts Receivable (Collection Period):**

$$\frac{\text{Accounts Receivable (Year-End)}}{(\text{Credit Sales} / 360)}$$

- **Earnings Per Share:**

$$\frac{\text{Net Income}}{\text{Average Common Stock Outstanding}}$$

Shows the amount of earnings attributable to each share of common stock held by the stockholders (owners).

- **Earnings Yield:**

$$\frac{\text{Earnings Per Share}}{\text{Market Price}}$$

- **Gross Margin Ratio:**

$$\frac{\text{Gross Profit}}{\text{Sales}}$$

- **Interest Burden:**

$$\frac{\text{Interest Expense}}{\text{Total Assets}}$$

- **Inventory Turnover:**

$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Indicates the number of times the firm's inventory is turned over or sold during a period. Generally, the higher the inventory turnover, the more effective the firm is in its operations, the lesser the amount that must be tied up in inventories, and the shorter the operating cycle necessary to replenish cash. Too high a ratio may indicate lost sales as a result of insufficient inventory on hand.

- **Long-Term Debt to Equity Capital:**

$$\frac{\text{Long-Term Liabilities}}{\text{Equity Capital}}$$

- **Net Income to Sales, or Profit Margin:**

$$\frac{\text{Net Income}}{\text{Sales}}$$

The relationship of net income to sales can evaluate the company's efficiency in controlling costs and expenses in relation to sales. Does not, however, consider the owner's investment necessary to generate the sales and income. A return on investment ratio will overcome this.

- **Operating Margin:**

$$\frac{\text{Operating Income} - \text{Depreciation}}{\text{Sales}}$$

- **Operating Profits to Sales:**

$$\frac{\text{Operating Profit}}{\text{Sales}}$$

- **Pretax Income to Sales:**

$$\frac{\text{Pretax Income}}{\text{Sales}}$$

- **Receivables Turnover:**

$$\frac{\text{Net Credit Sales}}{\text{Average Net Receivables}}$$

Indicates how many times receivables are turned over or collected each period. Shows the efficiency with which the firm collects its receivables and converts them to cash.

Generally, the higher the turnover, the better, as the firm will have fewer resources tied up in receivables, collects at a faster pace, and usually will have fewer uncollectible accounts. Receivable turnover is often divided into the number of days in the business year to show the average collection period in days. Comparing the company's average collection period to the days in its typical credit terms gives an indication of how aggressively the company's credit department collects overdue accounts.

- **Return on Equity Capital or Return on Stockholders' Equity:**

$$\frac{\text{Net Income}}{\text{Average Equity Capital}}$$

Reflects the residual return on the owners' equity.

- **Return on Total Assets:**

$$\frac{\text{Net Income} + \text{Interest Expense (Net of Tax)}}{\text{Average Total Assets}}$$

The amount of net income earned in relation to total assets; an indicator of a firm's efficiency in the use of its economic resources. The ratio can be mildly distorted depending on the age of the company and its assets. Average assets (beginning period assets plus ending period assets divided by 2) are used as net income is earned over the time period.

- **Sales to Cash:**

$$\frac{\text{Sales}}{\text{Cash}}$$

- **Sales to Accounts Receivable:**

$$\frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

Accounts receivable turnover ratio.

- **Sales to Inventory:**

$$\frac{\text{Sales}}{\text{Inventory}}$$

- **Sales to Working Capital:**

$$\frac{\text{Sales}}{\text{Working Capital}}$$

- **Sales to Fixed Assets:**

$$\frac{\text{Sales}}{\text{Fixed Assets}}$$

- **Sales to Total Assets:**

$$\frac{\text{Sales}}{\text{Total Assets}}$$

The ability of the company to minimize the level of assets (current and fixed) to support its level of sales.

- **Times Interest Earned:**

$$\frac{\text{Operating Income Before Interest and Taxes}}{\text{Interest Expense}}$$

An indicator of the firm's ability to cover its interest obligation through its annual earnings. It is a measure of the safety of the creditors' (particularly long-term) investments in the firm.

- **Total Debt to Total Capital (Debt Ratio):**

$$\frac{\text{Current Liabilities and Long-Term Liabilities}}{\text{Equity Capital and Total Liabilities}}$$

or

$$\frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Indicates the percentage of total assets contributed by creditors. Subtracting the ratio from 100 is the percentage of total assets (or equity ratio) contributed by stockholders (owners).

- **Working Capital Calculation:**

$$\text{Current Assets} - \text{Current Liabilities}$$

Shows the dollar amount by which current assets exceed current liabilities. Changes in the amount from one period to another is a useful indicator of the businesses' short-term debt-paying ability.

**Simplified
Cash Flow
Analysis**

Net Income	XX
Add: Depreciation	XX
Increase (decrease) deferred tax	XX
Increase (decrease) working capital (see below)	XX

Cash from operations

Increase (decrease) from investing activities (i.e., fixed asset purchase)	XX
---	----

Increase (decrease) from financing activities (i.e., notes payable, long-term debt)	XX
--	----

Net Increase (decrease) to cash	XX
---------------------------------	----

* * * * *

Increase (Decrease) to Working Capital

Add:

- Increase (decrease) to receivables
- Increase (decrease) to inventory
- (Increase) decrease to accounts payable
- (Increase) decrease to interest payable

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SAMPLE IDFP AGREEMENTS - APPENDIX 10D

Sample Dealer Purchase Agreement

This sample agreement is intended for use as a training aid for NCUA examiners and should not be considered an all inclusive legal document to be shared with, copied, or used by any other person or entity in whole or in part.

The XYZ Federal Credit Union ("Credit Union") agrees to purchase and the undersigned Dealer ("Dealer") agrees to sell, from time to time, loans entered into by Dealer and Dealer's customers ("Buyer"), pursuant to the terms of this agreement.

1. All loans offered by Dealer to Credit Union for purchase shall be secured by a first lien on the vehicles sold by Dealer to Buyer (hereafter the "Collateral").
2. All loans offered by Dealer to Credit Union for purchase shall be documented by standard form installment agreement, together with documentation necessary to perfect a first lien in the Collateral to secure the indebtedness (said documentation collectively to be known as "Dealer Paper").
3. Dealer may provide Credit Union with a copy of Buyer's loan application via facsimile transmission and obtain an approval of the loan and the terms that are acceptable to Credit Union, or a disapproval of the loan. In the event Dealer tenders Dealer Paper relating to a pre-approved application, Credit Union shall use all efforts to promptly review said Dealer Paper and verify it complies with the terms and conditions of the pre-approved application, before purchasing said Dealer Paper. Credit Union is under no obligation to purchase any Dealer Paper which does not comply with the terms of this Agreement as well as the terms provided by Credit Union when pre-approving a loan.
4. All Dealer Paper tendered by Dealer to Credit Union shall be completed by Dealer in a form acceptable to Credit Union and shall include, but not be limited to:
 - a. Original Loan Application;
 - b. Original Sales Contract;
 - c. Original Dealer's Invoice;
 - d. Note and Disclosure;
 - e. Title Work;
 - f. Insurance Verification; and
 - g. Income Verification.
5. Dealer shall assign to Credit Union all Dealer Paper purchased by the Credit Union and shall notify the appropriate authorities (including, but not limited to, the Department of Transportation) of the assignment of the lien securing the indebtedness to the Credit Union.
6. Credit Union has the option but not the obligation of purchasing any loan tendered by Dealer, except Credit Union shall purchase any loan from Dealer that complies with the terms of a pre-approved application.

7. For each loan purchased from Dealer, Credit Union shall promptly pay Dealer (after receiving all required documentation) the amount of the loan (which may include the cost of life and/or disability insurance and/or extended warranties sold to Buyer), together with an incentive fee as set forth on a schedule provided to Dealer by Credit Union from time to time.

8. As to all loans purchased by Credit Union, Dealer warrants:

(a) Dealer is authorized to sell said Dealer Paper; and

(b) The Dealer Paper is genuine and legally enforceable according to its terms; and

(c) No buyer was a minor or incompetent when the Dealer Paper was executed; and

(d) All statements contained in the Dealer Paper are true; Dealer has no notice of any matters not disclosed to Credit Union which might impair the credit of buyers; the disclosed cash down payment and trade-in were actually received by Dealer; Dealer has not made and will not make any advance to Buyer; and Dealer has no agreement with Buyer to separately finance or impose finance charges on Buyer or defer payment of a portion of the down payment; and

(e) Within ten (10) days of delivery of the vehicle sold to Buyer, Dealer perfected or will perfect a first security interest in the vehicle, time being of the essence; and

(f) The Dealer Paper and the transactions out of which it arose comply with all applicable laws and regulation; and

(g) Dealer has performed or will perform all of its obligations to Buyer, and no Buyer has asserted any defense, set-off, or counterclaim to Buyer's liability under the Dealer Paper; and

(h) At the time of sale, Dealer had authority to sell the goods to Buyer free of any security interest or other encumbrance and the goods have been delivered to and accepted by the Buyer within ten (10) days of the date of the Dealer Paper.

9. Dealer shall provide Credit Union with at least one bank reference and authorizes Credit Union to investigate Dealer's financial position from time to time as determined in Credit Union's sole discretion. Upon request, Dealer agrees to provide Credit Union with sworn current financial statements.

10. Dealer agrees, with respect to any Dealer Paper sold to Credit Union, that:

(a) If Dealer places insurance on the Collateral or obtains credit life or credit disability insurance for the Buyer, Dealer shall promptly pay to Buyer any premium refunds or other amounts it receives regarding such insurance to which the Buyer is entitled; and

(b) Dealer shall indemnify, defend, and hold Credit Union harmless from any loss, liability, penalty, claim, damage, or expense claimed or incurred due to any act or omission or commission of Dealer with respect to the Dealer Paper or the Collateral (including, but not limited to, violation of any applicable Federal or State

law or the breach of any of the provisions of this Agreement) which indemnification shall include any costs and attorneys' fees of credit union.

11. Credit Union may, without notice and without impairing Credit Union's rights against Dealer, in the name of Dealer or otherwise, take all actions and legal proceedings deemed advisable by Credit Union with respect to the Dealer Paper or the Collateral including, without limitation, modifying, extending, or compromising any terms, discharging or releasing any person liable, or releasing any security; Credit Union has no duty to perfect any security interest in the Collateral, to enforce any rights of Dealer, or to preserve rights under this agreement against prior parties.

12. If any warranties or covenants of Dealer shall be false or breached with respect to certain Dealer Paper, Dealer shall, upon request, repurchase the Dealer Paper from Credit Union for the full amount unpaid thereon (less credit union's unearned interest) plus expenses incurred by Credit Union in endeavoring to collect or enforce the Dealer Paper. Upon repurchase of the Dealer Paper, Credit Union will assign it to Dealer without any recourse or warranties whatever.

13. Dealer covenants that it has performed and will continue to perform in a timely manner all of its obligations to the Buyer, including its obligations which arise by virtue of the contract and all agreements between the Buyer and Dealer and all obligations which may arise by operation of law or otherwise. Dealer will advise Credit Union in writing within ten (10) days if the Buyer notifies Dealer that Buyer intends to assert any claim or defense against the Credit Union which arises out of the relationship between Buyer and Dealer. In such case, Dealer shall within thirty (30) days of receiving notice from the Buyer use its best efforts to resolve the claim to the mutual satisfaction of the Credit Union and Dealer. If the Credit Union receives notice from the Buyer of a claim or defense to be asserted against it, the Dealer shall within thirty (30) days of receiving written notice of the claim from the Credit Union use its best efforts to resolve the claim to the mutual satisfaction of the Credit Union and Dealer. In the event Dealer cannot satisfactorily resolve the issue within the 30-day period, Credit Union may demand Dealer to repurchase the Dealer Paper for said loan, which Dealer shall purchase. The purchase price shall be the amount of principal remaining due on said loan, together with any unpaid accrued interest due as of the date of the sale by Credit Union to Dealer. Said sale shall be without recourse to Credit Union.

14. This agreement is to be interpreted under the laws of the State of _____.

15. Upon execution, this Agreement shall bind the parties and their successors and assigns. This Agreement shall continue to be in effect for one year unless terminated by either party upon at least 60 days prior written notice. Unless so terminated, this Agreement shall automatically renew itself on its anniversary date. Any termination of this Agreement shall not affect the rights and duties of the parties regarding any Dealer Paper sold to Credit Union by Dealer prior to the effective date of the termination of this Agreement.

Dated this _____ day of _____, 19_____.

DEALER:

XYZ FEDERAL CREDIT UNION:

By: _____

By: _____

**Sample
Dealer
Reserve
Agreement**

This sample agreement is intended for use as a training aid for NCUA examiners and should not be considered an all inclusive legal document to be shared with, copied, or used by any other person or entity in whole or in part.

AGREEMENT between ABC Credit Union (credit union) and XYZ Rolls Royce Inc. (Dealer).

FOR CONSIDERATION, and intending to be legally bound, the Credit Union and Dealer Agree:

1. Definitions.

- (a) "Amount Financed" means the amount financed as stated in a Contract.
- (b) "Buy Rate" means the minimum annual interest rate which the Credit Union is willing to accept from time to time, as determined by the Credit Union in its sole discretion. The Credit Union shall quote its current Buy Rate to Dealer at any time upon request.
- (c) "Buyer" means a person who purchases a product from Dealer.
- (d) "Collateral" means a product sold by Dealer to a Buyer under a Contract.
- (e) "Contract" means an installment sale and security agreement evidencing the sale of Collateral from Dealer to Buyer.
- (f) "Contract Interest Rate" means the interest rate specified to apply under a Contract before default. The Contract Interest Rate shall not exceed maximum rates quoted by the Credit Union to Dealer from time to time. In no event shall the Contract Interest Rate exceed the rate allowed by applicable law.
- (g) "Paper" means one or more of Dealer's Contracts.
- (h) "Reserve" for each Contract means the excess of (i) the total interest payable in accordance with the terms of the Contract calculated at the Contract Interest Rate, over (ii) the total interest payable in accordance with the terms of the Contract calculated at the Buy Rate in effect at the time the Credit Union purchases the Contract.

2. Purchase. Dealer will from time to time offer to sell Paper to the Credit Union under the terms of this Agreement. The Credit Union may refuse to purchase any Paper offered by Dealer.

3. Purchase Price. The purchase price for a Contract shall be the Amount Financed stated in the Contract plus the Reserve for the Contract. If Contract is prepaid before scheduled full term, the Credit Union shall have the right to keep or be compensated for part of the Reserve, as provided in paragraph 5.

4. Reserve. At the time of each purchase of a Contract, the Credit Union shall compute the Reserve for the Contract and deposit the amount of the Reserve, together with the Amount Financed, into the Dealer's share draft account. Dealer agrees to make an initial minimum deposit into an interest bearing share savings account. Dealer may withdraw from the share savings account from time to time, but not below a minimum balance determined by the Credit Union taking into account the volume of the Credit Union's purchases of Paper from Dealer and the Credit Union's experience with that Paper. The initial minimum balance required is \$500. Dealer grants the Credit Union a security interest and lien in any credit balance in that

account or in any other money or subsequently owed Dealer by the Credit Union. In addition to all other remedies, the Credit Union may at any time, without notice or demand, set off against any such credit balance or other money owed the Credit Union by Dealer. Upon full payment or other liquidation of all Paper purchased by the Credit Union from Dealer, and Dealer's full payment of all amounts owed the Credit Union, the Credit Union shall pay the balance of the account to Dealer.

5. The Credit Union's Right to Reserve. If a Buyer prepays a Contract, if Buyer defaults and collateral is repossessed, or if Dealer repurchases a Contract, Dealer shall pay Credit Union a fractional portion of the Reserve for the Contract. The numerator of the fraction shall be the excess of the scheduled term of the Contract in months over the time in months the Contract was held by the Credit Union. (In the case of repossession, the numerator shall be equal to the number of unpaid full monthly payments remaining to fulfill the contract's original term.) The denominator shall be the scheduled term of the Contract in months. In determining months for this purpose, partial months of 14 days or less shall be ignored, and partial months of 15 days or more shall be counted as one full month. For example, two months and ten days shall be counted as two months; and two months and fifteen days shall be counted as three months.

6. Term: Additional Terms. Upon the Credit Union's acceptance, this document shall constitute an agreement between parties which shall inure to and bind the parties, successors and assigns. It shall continue in effect until terminated by either party upon at least 60 days prior written notice to the other. In addition, the Credit Union may terminate this agreement immediately upon notice to Dealer if Dealer defaults or becomes the subject of bankruptcy or other insolvency proceedings. Termination shall not effect the respective rights and obligations of the parties as to Paper purchased prior to the effective date of termination. Waiver of any default shall not constitute a waiver of any other default. This agreement shall be construed according to the laws of the State of _____.

7. Notice. Any notices given in connection with this agreement shall be in writing and shall be either personally delivered or mailed in the first class United States mail, postage prepaid, addressed to the last known address of the recipient. Notice by mail shall be effective one day after such mailing.

REAL ESTATE DOCUMENTATION CHECKLIST - APPENDIX 10E

Real Estate Loans - General

- Loan Application
- Contract of Sale
- Verification of Employment
- Verification of Deposits
- Residential Mortgage Credit Report
- Uniform Residential Appraisals Report
 - Property Survey
 - Zoning Requirements
- Flood Insurance Statement/Coverage
- Debt Ratio Computation Page
- Title Insurance
- Title Binder/Title Policy
- FNMA/FHLMC Mortgage or Deed of Trust
- FNMA/FHLMC Note
- FNMA/FHLMC Deed
- Private Mortgage Insurance, if applicable
- RESPA Settlement Statement
- Current Hazard Insurance
- Notice of Recision, if nonpurchase mortgage on residence
- Termite Inspection, if applicable
- General Home Inspection, if applicable
- Radon Inspection, if applicable
- Adjustable Rate/Variable Rate Rider
- Loan to Value Ratio Computation
- Verification of the Balance of the First Trust Deed
- Other Documents, as necessary

Real Estate with Mobile Home

Add to General list:

- Deed to Real Estate with Title to Mobile Home
- Documentation Whether Wheels Have Been Removed
- Purchase Order or NADA Value
- Sewage Permits or System, as needed
- Water Availability
- UCC Lien for Tongue and Wheels

**Construction
Loans**

Add to General list:

- Title Insurance Binder, with
 - Periodic Insurance
 - Adjustments/Notifications
- Take-Out Commitment
- Construction Loan Agreement
- Identification of Contractor
- Borrower's Risk Insurance on Builder
- Architect's Plans
- Builder's Cost Estimates and Line Item Budget
- Completion Bond, if required
- Periodic Inspection Reports Based on Phase Completions
- Photos of Inspection Phases and the Completed Project
- Schedule of Disbursements
- Building Permits
- Environmental Considerations
- Sewage Permits or System, as needed
- Feasibility Study
- Change Order Documentation

**Unimproved
Property**

- Agreement that Improvements Cannot be Made to the Property without Credit Union Consent

Chapter 11

ALLOWANCE FOR LOAN AND LEASE LOSSES

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Chapter 11

ALLOWANCE FOR LOAN AND LEASE LOSSES

Examination Objectives

- Determine if management has a sound methodology, with supporting documentation, for estimating the amount of probable existing losses in its loan and lease portfolio
- Assess the overall adequacy of the Allowance for Loan and Lease Losses (ALLL)
- Ensure management understands the purpose of the ALLL

Associated Risks

- Compliance risk – Includes the risk that the credit union does not present ALLL in compliance with the laws and regulations.
- Transaction risk – Includes the risk that internal controls do not sufficiently deter or detect errors, omissions or material misstatements.
- Reputation risk – Includes the risk that management did not meet its fiduciary duty to properly reserve for probable existing losses, resulting in poor publicity or administrative action.

Overview

The boards of directors of federally-insured credit unions bear responsibility for ensuring their credit unions have controls in place to consistently maintain the ALLL in accordance with the credit union's stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance. They should instruct management to develop and maintain appropriate, systematic, and consistently applied procedures to determine the amounts of the ALLL and provisions for loan losses.

The ALLL provides an estimate of probable but unconfirmed losses in the loan portfolio as of the financial statement date; it is not a reserve for future anticipated losses. GAAP has as a primary objective for the ALLL to ensure a credit union recognizes and measures loan impairment in the period the impairment occurs and in the amount of that impairment. This applies to all credit unions, regardless of size.

If the credit union obtains a certified public accountant (CPA) opinion audit, examiners can place reliance on the CPA's review of the ALLL. The Supervisory Committee chapter contains additional guidance.

Definitions

Following are definitions used in this chapter:

- **ALLL:** A contra asset account established and maintained by periodic charges to operating expense to provide a credit union's best estimate of the probable amount of loans it will be unable to collect based on current information and events and the amount of the loss can be reasonably estimated.
- **Homogenous:** Of the same kind or nature; having similar parts or elements.
- **Impairment of loans:** A loan is impaired when it is probable that a creditor (credit union) will be unable to collect all amounts due, including principal and interest, according to the contractual terms and schedules of the loan agreement.
- **Layering:** The inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.
- **Loan Segmentation:** Presentation of information about certain parts of a loan portfolio, in contrast to information about the entire loan portfolio.
- **Migration Analysis:** A method to determine the adequacy of valuation allowances by tracking movements (or migration) of a classified asset to a worse classification in order to estimate a loss percentage likely to be incurred from different categories of assets within the current portfolio.
- **Probable:** Higher level of likelihood than "more likely than not."
- **Non-homogenous:** Not of the same kind or nature.

Documenting the ALLL

The examiner should ensure the credit union has appropriate documentation to support the ALLL process and reported amounts. The credit union should document the relationships between the results of the credit union's detailed review of the loan portfolio, the amount of the ALLL, and the provision for loan and lease losses reported in each period. Examiners should review the supporting documentation over the following decisions, strategies, and processes:

- Policies and procedures over the systems and controls that maintain an appropriate ALLL, and over the ALLL methodology;
- Loan grading system or process (if applicable);
- Summary or consolidation of the ALLL components;
- Validation of the ALLL methodology; and
- Periodic adjustments to the ALLL process.

Analysis of ALLL

The following sections of this chapter provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, this chapter addresses:

- Application of GAAP,
- Policies and procedures,
- Methodology,
- Summarizing components and consolidating the loss estimates forming the amount required in the ALLL, and
- Validating the ALLL methodology.

Application of GAAP

GAAP-recorded ALLL quantifies a credit union's best estimate of the probable uncollectible amount of loans and leases based on current information and events. Estimating the amount of the ALLL involves management judgment and is inevitably imprecise.

Two GAAP rules primarily govern valuation of the ALLL. One covers large balance non-homogeneous loans (FAS 114), usually business and agriculture loans. The other rule deals with groups of homogeneous pools of loans (FAS 5) such as credit card, residential mortgage and consumer installment loans. The following further details those rules:

- Business and agricultural loans. GAAP provides guidance on the acceptable methods for measuring impairment for larger-balance loans individually evaluated. Specifically, GAAP states that if impairment of such a loan exists, a credit union should measure impairment based on the following:
 - The present value of expected future principal and interest cash flows discounted at the loan's effective interest rate;

- A loan's observable market price; or
- The fair value of collateral, if applicable.

When developing the estimate of expected future cash flows for a loan, a credit union should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors.

- Credit Card, Residential Mortgage, and Consumer Installment Loans. Credit unions collectively evaluate large pools of smaller-balance homogeneous loans for impairment rather than evaluating these pools on an individual basis. The pools may include individually evaluated loans (business and agricultural above) that the credit union does not consider individually impaired.

According to GAAP, a credit union should increase the ALLL when it has incurred a probable loss and it can reasonably estimate the amount. A credit union may determine that the amount of loss falls within a range and may record its best estimate within the range of loan losses.

Examiners should ensure credit unions do not layer their loan loss allowances. Layering occurs when the credit union inappropriately records in the ALLL more than one amount for the same probable loan loss. It can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or in a pool, and then includes the loan in another pool, which receives an additional ALLL amount.

Policies and Procedures

The ALLL process requires a wide range of policies, procedures, and control systems. Credit unions should tailor their policies to the size and complexity of the credit union and its loan portfolio.

The effectiveness of a credit union's ALLL methodology requires written policies and procedures that, at a minimum, should address the following:

- The roles and responsibilities of the credit union's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, board of directors,

and others, as applicable) who determine, or review the ALLL they will report in the financial statements;

- The credit union's accounting policies for loans and loan losses, including the policies for charge-offs, recoveries, and estimating the fair value of collateral (if any);
- The description of the credit union's methodology, which should maintain consistency with the credit union's accounting policies for determining its ALLL; and
- The system of internal controls used to ensure that the ALLL process adheres to GAAP and supervisory guidance.

An internal control system for the ALLL estimation process should:

- Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- Reasonably ensure that the credit union's financial statements (including regulatory reports) follow GAAP and ALLL supervisory guidance;
- Include a well-defined loan review process containing:
 - An effective, consistently-applied loan grading system that accurately, and in a timely manner, identifies differing risk characteristics and loan quality problems, and prompts appropriate corrective actions;
 - Internal controls that ensure consideration of all relevant loan review information in estimating losses. This includes maintaining appropriate reports and details of reviews performed, and identifying personnel involved; and
 - Clear, formal communication and coordination between the board of directors, management, and others involved in the ALLL determination or review (e.g., written policies and

procedures, management reports, audit programs, and committee minutes.)

Methodology

An ALLL methodology is a system designed and implemented by the credit union to reasonably estimate loan and lease losses as of the financial statement date. ALLL methodologies should incorporate management's current judgment about the loan portfolio's credit quality through a disciplined and consistently applied process.

A credit union's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan procedures, field of membership, and management information systems influence its ALLL methodology. While credit unions may use different methods, certain common elements should exist in any ALLL methodology. Generally, a credit union's methodology should:

- Include a regularly performed analysis of the loan portfolio detailing delinquency, loan losses, extensions, etc., by loan type and/or category;
- Consider all loans (whether on an individual or pool basis);
- Identify loans for impairment evaluation on an individual basis under FAS 114 and segment the remainder of the portfolio into pools of loans with similar risk characteristics for evaluation and analysis under FAS 5 (discussion of FAS 114 and FAS 5 occurs later in this chapter);
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Apply factors affecting collectibility consistently (but modify for new factors);
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;

- Require performance of analyses, estimates, reviews, and other ALLL methodology functions by well-trained personnel;
- Base methodology on current and reliable data;
- Require thorough documentation with clear explanations of the supporting analyses and rationale; and
- Include a systematic and logical method to summarize the balances determined under the various methodologies and ensure the credit union follows GAAP when recording the ALLL balance.

A properly designed and implemented methodology should provide a credit union's best estimate of the ALLL balance. Each dividend period, credit unions should make necessary adjustments to the ALLL account.

**Documenting
ALLL
Methodology**

A credit union's written policies and procedures should describe the primary elements of its ALLL methodology, including portfolio segmentation and impairment measurement. Effective policies and procedures should describe the methodology:

- For segmenting the portfolio:
 - The credit union's segmentation process (i.e., by loan type, industry, credit scoring, etc.),
 - The loan grading system used to segment the portfolio, if applicable, including:
 - i. Definitions of each loan grade,
 - ii. Reconciliation of the credit union's internal loan grades to examiners' concerns, and
 - iii. Delineation of responsibilities for the loan grading system.
- For determining and measuring impairment for business and agriculture loans (FAS 114):

- The methods used to identify loans for individual analysis;
- The methods by which the credit union determines and measures the amount of impairment for individually reviewed impaired loans, including:
 - i. Procedures describing available impairment measurement techniques, and
 - ii. Steps performed to determine which technique most appropriately fits a given situation.
- The methods used to determine whether and how the credit union should pool business and agriculture loans deemed individually evaluated, but not individually impaired, with other loans that share common characteristics for impairment evaluation under pools (FAS 5.)
- For determining and measuring impairment for groups of consumer and mortgage loans (FAS 5):
 - Criteria for pooling loans with similar characteristics to evaluate them for collectibility (such as loan type, past-due status, and risk);
 - Criteria for determining loss rates (e.g., historical loss rates adjusted for environmental factors or migration analysis) and time frames to evaluate loss experience; and
 - Descriptions of qualitative factors (e.g., industry, geographical, economic and political factors) that may affect loss rates or other loss measurements.

The credit union may integrate supporting documents for the ALLL in its credit files, loan review reports or worksheets, board of directors and committee meeting minutes, computer reports, or other appropriate documents and files.

Management should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date.

Management's current judgments about the credit quality of the loan portfolio should determine the amounts of the ALLL and provisions for loan and lease losses and should include the following:

- The board should review and approve the ALLL and provision for loan and lease losses reported each period;
- The board should periodically validate and, when necessary, revise the methodology to ensure it remains appropriate for the credit union;
- The supervisory committee should oversee and monitor the internal controls over the ALLL determination process;
- The officials should adjust the allowance for loan and lease losses through current earnings in accordance with GAAP; and
- The officials should understand that they must meet the full and fair disclosure requirements in §702.402 of *NCUA Rules and Regulations* before distributing dividends.

Allowance for Individual Impairment of Large Balance, Non-Homogeneous Loans (FAS 114)

In applying its ALLL methodology for business and agriculture loans, the credit union begins with its normal loan review procedures to identify whether impairment of a loan exists. The credit union must document its method for identifying and analyzing impaired loans and must retain that documentation. The analysis must include the determination of which of the following measurement methods it used:

- Present value of expected future cash flows, including:
 - The amount and timing of cash flows,
 - The effective interest rate used to discount the cash flows, and
 - The basis for determining cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- Fair value of collateral less costs to sell, including:
 - Criteria for determining fair value, including the use of appraisals, valuation assumptions, and calculations,
 - Supporting rationale for any adjustments to appraised values,
 - Determination of costs to sell, if applicable, and
 - Appraisal quality, and the expertise and independence of the appraiser.

- Observable market price:
 - The amount, source, and date of the observable market price of the loan.

Examiners should understand that fully collateralized loans may require no ALLL.

Documenting an ALLL for Individually Impaired Large Balance Non-Homogeneous Loans (e.g., Business and Agricultural)

Comprehensive worksheet for the impairment measurement process

A small credit union uses a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Illustration 11-A

Allowance for Small Balance Homogeneous Pools of Loans (FAS 5)

When evaluating loans on a pool basis under GAAP, management should segment the loan portfolio by identifying risk characteristics common to various pools of loans. Credit unions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Credit unions typically segment their portfolios as follows:

- Credit unions involved in less complex activities and offering a narrow range of loan products often segment the portfolio into broad loan categories.
- Credit unions offering a more diverse and complex mix of loan products may segment the portfolio into major loan types but typically maintain more detailed information. This allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment.

Changes in economic and other business conditions often require credit unions to modify their business strategies. This may result in

adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses.

Regardless of the segmentation method used, a credit union should maintain written documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

Credit unions use a variety of documents to support the segmentation of their portfolios, including:

- Loan trial balances by categories and types of loans;
- Management reports about the mix of loans in the portfolio;
- Delinquency and non-accrual reports; and
- A summary presentation of the results of an internal or external loan grading review.

Credit unions may find reports generated to assess the profitability of a loan product line useful in identifying areas in which to further segment the portfolio.

Documenting Segmentation Practices

Documenting a refinement in a segmentation method.

A credit union with a significant portfolio of consumer loans performed a review of its ALLL methodology. The credit union had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge offs) for the past two years to the estimated loss rates. During this process, the credit union decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans.) This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Illustration 11-B

Estimating Loss on Pools of Loans

After segmenting the portfolio and using a systematic and consistently applied approach to select the most appropriate loss measurement methods, a credit union should estimate the required ALLL for each segment (pool.) For those segments that require an ALLL, the credit

New

union should estimate the loan and lease losses, each dividend period, based on its ongoing loan review process and loan performance analysis.

One method of estimating loan and lease losses for pools of loans is by applying loss rates to the pools' aggregate loan balances. Such loss rates typically reflect historical loan loss experience for each pool of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time.

If a credit union does not have loss experience of its own, it may reference the loss experience of other credit unions. To do so, it must demonstrate similarity between the attributes of the loans in its portfolio to those of the loans included in the portfolio of the credit union providing the loss experience.

Documenting the Loss Measurement Method

Comprehensive loss analysis in a small credit union

A small credit union determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge offs and recoveries in determining the loss rate. The credit union also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The credit union maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

A credit union develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on business real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The credit union generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The credit union maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Illustration 11-C

Credit unions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which they incurred the losses. If credit unions use a range of

loss, they should maintain documentation to support the identified range and the rationale used for determining the best estimate within the range of loan losses.

Before employing a loss measurement method, a credit union should evaluate and modify, as needed, the method's assumptions to ensure consistency of the resulting loss estimate with GAAP. Credit unions can demonstrate consistency with GAAP by documenting the evaluation, the conclusions regarding the appropriateness of the loss measurement method or other loss estimation tool, and the support for adjustments to the method or its results.

In developing loss measurements, credit unions should consider the impact of current environmental factors and document which factors they used in the analysis and how those factors affect the loss measurements. Credit unions should consider the following factors when developing loss measurements:

- Levels of and trends in delinquencies and impaired loans;
- Levels of and trends in charge-offs and recoveries;
- Trends in volume and terms of loans;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- Experience, ability, and depth of lending management and other relevant staff;
- National and local economic trends and conditions;
- Industry conditions; and
- Effects of changes in credit concentrations.

Adjustments of loss measurements for environmental factors require that the credit union maintain sufficient, objective evidence to support the amount of the adjustment. The documentation must relate the need for the adjustment to current information, events, circumstances, and conditions.

**Summarizing
Components
and
Consolidating
the Amount
of the ALLL**

Management should prepare a summary document supporting the amount of ALLL it reports on the credit union's financial statements. This will verify that the ALLL is fairly presented in accordance with GAAP and is auditable. The credit union board should review and approve this summary. Common elements in such summaries include:

- An estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other pools of loans collectively evaluated for impairment);
- The aggregate probable loss estimated using the credit union's methodology;
- A summary of the current ALLL balance;
- The amount, if any, of the necessary ALLL adjustment; and
- Detailed sub-schedules of loss estimates that reconcile to the summary schedule, if so warranted by the level of detail supporting the ALLL analysis.

Generally, a credit union's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. However, instances may exist whereby individuals or committees that review the ALLL methodology and allowance balance identify needed adjustments to provide a better estimate of loan losses. These changes may result from information not known at the time of the initial loss estimate.

Management should (1) document the nature of any adjustments and the underlying rationale for making the changes, (2) ensure these adjustments remain consistent with GAAP, and (3) make certain the adjustments receive the review and approval of appropriate personnel. They should provide this documentation to those making the final determination of the ALLL amount. The summary should give each subsequent reviewer an understanding of the support behind the adjustments.

**Validating
ALLL
Methodology**

A valid ALLL methodology accurately estimates the amount of loss contained in the portfolio. Thus, the credit union's methodology should include procedures that adjust loss estimation methods to

reduce differences between estimated losses and actual subsequent charge offs, as necessary.

To verify the validity of the ALLL methodology and its conformance with GAAP and necessary supervisory guidance, the board should establish internal control policies, appropriate for the size of the credit union and the type and complexity of its loan products. These policies should include procedures for a review, by a party independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, credit unions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether deficiencies exist in their overall methodology or loan grading process. Validation procedures include the following:

- A review of trends in loan volume, delinquencies, restructurings, and concentrations;
- A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- A review, on a test basis by a party independent of the ALLL estimation process, of source documents and underlying assumptions to determine that the established methodology results in reasonable loss estimates; and
- An evaluation of the appraisal process of the underlying collateral, by periodically comparing the appraised value to the actual sales price on selected properties sold.

**Supporting
Documentation
for the Validation
Process**

Usually, management supports the validation process with the working papers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The credit union's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the officials change the methodology based upon the findings of the validation process, they should maintain documentation that describes and supports the changes.

When a Document of Resolution is Required

If required, a Document of Resolution (DOR) should focus on the methodology (deficiencies noted, improvements needed) rather than a specific dollar amount of over- or under-statement in the ALLL. However, if the examiners detect a material misstatement, they should require an appropriate dollar amount of funding.

Workpapers and References

- Workpapers
 - ALLL
 - Loan Analysis
 - Query Report Loans Impaired
 - Allowance for Loan and Lease Losses Classification
 - Allowance Summary
- References
 - *NCUA Rules and Regulations*
§ 702.402 -- Full and Fair Disclosure

ALL FACTS, QUESTIONS, and ANSWERS - APPENDIX 11A

Measuring and Documenting Impairment Under FAS 114

Facts: Approximately one-third of Credit Union A's business loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Credit Union A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Credit Union A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the business loans reviewed under FAS 114 that are individually impaired, how should Credit Union A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Credit Union A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Credit Union A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its business loans for the past five years.

Credit Union A should maintain written documentation to support its measurement of loan impairment under FAS 114. If Credit Union A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions. When Credit Union A uses the fair value of collateral to measure impairment,

Credit Union A should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Credit Union A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

**Measuring
Impairment
for a
Collateral
Dependent
Loan Under
FAS 114**

Facts: Credit Union B has a \$750,000 loan outstanding to Member X that is secured by real estate, which Credit Union B, according to their current policy, individually evaluates under FAS 114 due to the loan's size. Member X is delinquent under the terms of the loan agreement. Accordingly, Credit Union B determines that its loan to Member X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Credit Union B measures impairment of the loan based on the fair value of the collateral. Credit Union B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$900,000.

Credit Union B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, personnel at Credit Union B adjust the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral. After adjusting the collateral valuation assumptions, the loan review department determines that the current estimated fair value of the collateral, less costs to sell, is \$575,000. Considering the loan balance is \$750,000, Credit Union B concludes that the loan is impaired by \$175,000 and records an ALLL adjustment of \$175,000.

Question: What type of documentation should Credit Union B maintain to support its ALLL adjustment of \$175,000 for the loan to Member X?

Interpretive Response: Credit Union B should document that it measured impairment of the loan to Member X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$575,000. This documentation should include the credit union's rationale and basis for the \$575,000 valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Credit Union B arrived at the valuation of \$575,000 by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$900,000 eighteen months ago to \$575,000 in the current period.

**Fully
Collateralized
Loans Under
FAS 114**

Facts: Credit Union C has \$500,000 in business loans that are fully collateralized by purchased business equipment. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to fully secure each loan. The member borrowers have physical control of the collateral. Credit Union C perfected its security interest in the collateral when the funds were originally distributed. On an annual basis, Credit Union C determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. Semiannually, or more frequently as needed, Credit Union C physically inspects the equipment. If there are any collateral deficiencies, Credit Union C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Credit Union C has historically not incurred any material losses on these loans. Credit Union C believes these loans are fully collateralized and therefore does not maintain any ALLL reserve for these loans.

Question: What documentation does Credit Union C maintain to adequately support its determination that no allowance is needed for this group of loans?

Interpretive Response: Credit Union C's management summary of the ALLL includes documentation indicating that, in accordance with the credit union's ALLL policy, the collateral protection on these loans has been verified by the credit union, no probable loss has been incurred, and no ALLL is necessary. Documentation in Credit Union C's loan files includes the two independent market quotes obtained annually for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Credit Union C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Credit Union C's policy requires the following factors to be considered and the credit union's findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral;
- Recency and reliability of the appraisal or other valuation;
- Recency of the credit union or other third party inspection of the collateral;
- Historical losses on similar loans;
- Confidence in the credit union's lien or security position including appropriate:
 - Type of security perfection (e.g., physical possession of collateral or secured filing);
 - Filing of security perfection (i.e., correct documents and with the appropriate officials), and
 - Relationship to other liens.
- Documentation indicating adequate and up to date insurance is in effect for the secured collateral.
- Other factors as appropriate for the loan type.

**Adjusting
Loss Rates
Under FAS 5**

Facts: Credit Union D's field of membership (lending area) includes a metropolitan area that is financially dependent upon the profitability of a number of sponsor manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these sponsor manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the sponsor

manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the sponsor manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Credit Union D has yet to confirm an increase in its loss experience as a result of these events, management knows that the credit union lends to a significant number of member's for business and individual purposes whose repayment ability depends upon the long-term viability of the sponsor manufacturing businesses. Credit Union D's management has identified particular segments of its business and consumer member bases that include member borrowers highly dependent upon sales or salary from the sponsor manufacturing businesses. Credit Union D's management performs an analysis of the affected portfolio segments to adjust its loss rates used to determine the ALLL. In this particular case, Credit Union D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How should Credit Union D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Credit Union D should document its identification of the particular segments of its business and consumer loan portfolio for which it is probable that the sponsor manufacturing business' financial downturn may result in loan losses. In addition, Credit Union D should support adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Credit Union D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data, and notes from discussions with individual member borrowers. Because in this case Credit Union D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Credit Union D creates a summary of the amount and rationale for the adjustment factor, which

management presents to the supervisory committee and board for their review and approval prior to the issuance of the financial statements.

**Estimating
Losses under
FAS 5 for
Loans First
Reviewed but
Not
Considered
Impaired
Under FAS
114**

Facts: Credit Union E has outstanding loans of \$875,000 to Member Y and \$725,000 to Member Z, both of which are paying as agreed upon in the loan documents. The credit union's ALLL policy specifies that all loans greater than \$700,000 must be individually reviewed for impairment under FAS 114. Member Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Member Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the credit union's loan grading system. Despite its concern, management believes Member Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Credit Union E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Member Y has risk characteristics similar to the loans included in Segment 1 and the loan to Member Z has risk characteristics similar to the loans included in Segment 2.

In its determination of the ALLL under FAS 5, Credit Union E includes its loans to Member Y and Member Z in the groups of loans with similar characteristics (i.e., Segment 1 for Member Y's loan and Segment 2 for Member Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the credit union's probable loan losses in these segments.

Question: How does Credit Union E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: As part of Credit Union E's effective ALLL methodology, it documents the decision to include its loans to Member Y and Member Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Credit Union E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The credit union also maintains copies of the economic and other reports that provided source data.

**Consolidating
the Loss
Estimates –
Documenting
the Reported
ALLL**

Facts: Credit Union F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Credit Union F's documentation practices related to its ALLL balance appropriate?

Interpretive Response: No. A credit union must maintain supporting documentation for the ALLL amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For credit unions subject to external audit, this documentation should also be made available to the supervisory committee and its independent accountants. If changes frequently occur during management or committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the credit union uses.

Chapter 12

INVESTMENT ANALYSIS

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Chapter 12

INVESTMENT ANALYSIS

Examination Objectives

- Determine adequacy of the credit union's investment policy, procedures, and internal controls
- Assess legality of investments and compliance with related regulations, accounting procedures, and other guidelines
- Evaluate suitability of the investment portfolio in relation to the credit union's business plan, asset-liability management (ALM) strategies, liquidity, and net worth position
- Determine fair value of the investment portfolio and the effect of realized or potential losses from investment transactions on the credit union's earnings and capital position
- Review correction of investment-related problems by management

Associated Risks

The investment area affects all seven risks found in credit union operations – credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. (The Risk-Focused Program chapter contains a description of the seven risks faced by credit unions.) This chapter specifically addresses credit, interest rate, liquidity, transaction, compliance, and other operational risks; however, if credit unions suffer significant losses due to investment decisions, the credit union could also face reputation risk. Examiner's judgment plays an important role in identifying both the type and extent of risks as well as deciding on appropriate examination procedures.

Overview

The investment portfolio serves as an important source of liquidity and can represent a substantial portion of a credit union's assets. Likewise, investment income can serve as an important source for meeting a credit union's operating expenses, dividend payments, and reserve requirements (if applicable.) Thus, the examiner's assessment of management's ability to invest prudently is an important part of the examination.

The extent of the examiners' investment reviews will depend on the following:

- The results of reviews of investment policies, procedures, practices, and internal controls;
- The adequacy of management's risk monitoring system for investments;
- The condition of investment records;
- The volume and materiality of investment transactions; and
- The degree of problems disclosed by previous audits or examinations.

Examiners record the extent of the investment analysis (if they perform such an analysis) in the Scope Workbook. They should also complete applicable investment questionnaires or reports.

Examiner Resources

The key investment references for this chapter are *NCUA Rules and Regulations* §703, IRPS 98-02, and related Guidance Papers. Other resources that may assist examiners in their analysis of complex investment portfolios include:

- Regional capital market specialists (RCMS) in each regional office provide technical assistance;
- Bloomberg terminal, an information vendor system available through each RCMS, provides investment characteristics and analysis;
- Office of Strategic Program Support and Planning (OSPSP) in the Central Office provides additional assistance (examiners should follow regional procedures);
- The NCUA Investment Hotline (1-800-755-5999) provides examiners and credit unions a resource to call and discuss investment questions.

Policies

The board of directors must (1) adopt a written investment policy consistent with the *Federal Credit Union Act*, *NCUA Rules and Regulations*, and other applicable laws; and (2) review and update the investment policy at least annually. A monitoring and reporting program helps ensure the credit union's investment process adheres to the written policy. If the investment review discloses exceptions to sound investment policies or procedures, the examiner will recommend appropriate changes to resolve the concerns.

The credit union's size and asset mix determine the scope of the investment policy. At a minimum, the policy must address the following:

- **Purpose and objectives.** The credit union must document its intentions (purpose) at the time it purchases investment securities, and must classify each security as one of the following: held-to-maturity, available-for-sale, or trading. SFAS 115 contains additional guidance.

Investment objectives should reflect the relative importance of investments to the credit union's overall goals and objectives. Generally, credit unions attempt to balance the need for safety and liquidity against the need for yield, while maintaining enough flexibility to respond to rapid changes in market interest rates. Thus, investment objectives should closely coincide with internal asset-liability goals and the short- and long-term business plan.

- **Characteristics of investments.** Investment characteristics describe the permissible investments and explain their pros and cons. The board of directors must specify in the investment policy the types and characteristics of investments permitted for the credit union. Characteristics may include the issuer, maturity, coupon rate, index, cap, floor, coupon formula, call provisions, average life, and interest rate risk (e.g., duration.) For example, a board policy specifying permissible interest rate risk (IRR) of an investment communicates to management the board's tolerance for risk at the instrument level. The policy should ensure management considers the effect of investment characteristics on the marketability and resale value of the investment and the credit union's ability to achieve established liquidity objectives.
- **IRR.** IRR is the potential for change in the value of a security as market interest rates change (also referred to as market risk.) Changes in interest rates can reduce the investment's value. Managing IRR on a total balance sheet basis, which includes monitoring the price sensitivity of the investment portfolio and long-term loans, is a sound business practice. A credit union may consider whether it should specify institution-wide IRR limits (generally for net economic value or earnings exposures) in light of

its long-term investment and lending activities and its level of capital.

Credit unions, especially those that do not establish institution-wide IRR limits, may choose to establish price sensitivity limits on their investment portfolio or individual investments. The officials must understand that, while many investments have good marketability, the selling price of an investment may be sensitive to changes in interest rates. For example, although Treasury securities usually have ready marketability, longer-term fixed-rate Treasury securities generally will experience greater price volatility than shorter-term fixed-rate Treasury securities.

Management must prepare a risk report at least quarterly if the fair value of all securities with (1) embedded options, (2) maturities greater than three years, or (3) complex coupon formulas exceeding net capital. The risk report must document potential effects of interest rate shifts of plus and minus three percent (300 basis points) on each security's fair value and the cumulative effect of those shifts on capital (§703.90.)

- **Liquidity risk.** An investment's liquidity or marketability risk is the risk that inadequate market depth could impede the credit union's ability to promptly sell the investment at a reasonable or fair market price. Generally, Treasury securities have greater liquidity than other securities. Wide bid-ask spreads characterize illiquid securities. Current examples of illiquid securities include Small Business Administration (SBA) loan participation certificates and smaller or older mortgage-backed securities (MBS.) Additionally, negotiable CD investments in financially weak depository institutions often are less liquid than investments in strong depository institutions.

A credit union must have sufficient liquid assets to meet immediate cash demands. The board should consider current and future liquidity needs based on its business plan (including budget) and asset-liability management strategy. The board should structure the investment portfolio to help meet normal liquidity needs, as well as any unexpected cash outflows.

Proper classification of held-to-maturity, available-for-sale, and trading securities can enable a credit union to meet its liquidity needs without an accounting reclassification. The examiner may question a credit union's assertion that it has the intent and ability to hold securities to maturity if the credit union has had to sell or transfer held-to-maturity securities to meet a liquidity need, especially in instances of a material sale or transfer.

- **Credit risk.** Credit risk is the possible loss that could occur if the issuer of an investment defaults or if the market value of an investment declines because the market perceives an increased probability of default. Credit risk appears most often in uninsured deposits with other (correspondent) financial institutions (e.g., Fed Funds sold.)

Credit unions should address credit risk in their investment policies as follows:

- List specific permissible institutions, issuers, and counterparties or specify criteria for their selection, and
- Specify limits on the dollar amounts the credit union may invest in each.

Before making investments that exceed an insured limit, are not insured, or not fully guaranteed as to principal and interest by the U.S. Government or its agencies, enterprises, or corporations, management must perform and document a credit analysis of the investments. Management must update the analysis at least annually as long as the credit union holds the investment. Smaller credit unions that cannot perform a detailed credit analysis should invest funds in appropriate alternatives (e.g., corporate credit unions), albeit, they still must perform due diligence.

- **Concentration risk.** Concentration risk results when the credit union does not properly address diversification in the investment portfolio. Concentration risk can occur when the investments in a portfolio have similar characteristics, such as identical call dates and provisions, the same or related issuers, or the same geographic distribution. Concentrations in investments can increase a credit union's exposure to interest rate, credit, and liquidity risk. The

investment policy should specify dollar limits for holdings of obligations with similar characteristics (e.g., fixed vs. variable, type of floating rate index, geographical distribution, etc.)

- **Delegation of authority to officials or employees.** The credit union board of directors may delegate the authority, but not the responsibility, for making investment decisions. The board must retain ultimate responsibility. The board may authorize an official of the credit union (normally the president or an investment officer) to invest or divest funds according to the investment policy on a continuing basis. For example, the policy may authorize the manager to transfer funds to an overnight investment account whenever the checking account cash balance exceeds a specified amount or average daily balance. Board policy must state explicitly the authority it has delegated to the manager; §703.30(g) requires professional qualifications by education or experience for individuals given investment authority.

In other situations, the board may delegate only limited authority to a credit union employee (e.g., complete and sign the necessary papers related to investment transactions.) The board should sufficiently define the delegation of authority so the individual receiving the investment instructions cannot exercise discretionary powers. This individual should report all transactions to the board, investment committee, or executive committee at least monthly. Board policies and procedures should address how the credit union will comply with §703.120 (e.g., the prohibition on acceptance of cash bonuses, merchandise premiums, etc., from broker-dealers.)

- **Delegation of authority to a third-party.** §703.40(c) permits the board to delegate its authority for investing credit union funds to a third party. However, the credit union must ensure that the third party is an investment adviser registered with the Securities and Exchange Commission (SEC), and limit the aggregate amount of such delegations (e.g., dollar amount of investments) to 100 percent of net worth. This restriction does not apply to investments in mutual funds. Also, the 100 percent limitation does not apply to credit unions meeting the Reg Flex requirements of Part 742.

- The board should exercise caution when delegating investment decision authority to SEC-registered investment advisers. The board should perform the following additional procedures:
 - Investigate the integrity and financial condition of any investment adviser before delegating investment authority;
 - Reduce the delegation of authority to writing and explicitly state in board policy the authority delegated to the investment adviser; and
 - Understand that the board must set policy limits, approve procedures, understand the overall risks associated with the investments, and receive reports assessing whether the portfolio has remained within established limits.

- **Broker-dealer.** A federal credit union may use a third party (i.e., a broker-dealer) to purchase and sell investments if the broker-dealer holds a current registration as a broker-dealer with (1) the SEC or (2) a depository institution for which a federal regulatory agency regulates the broker-dealer activities. CUSOs that provide broker-dealer services to credit unions must meet the requirements of §703.50.

A credit union making an investment in a certificate of deposit (CD) must either send funds directly to the issuing depository institution or use a broker-dealer. A federal credit union may use a third party (i.e., a CD finder) to locate institutions offering high CD rates, and may compensate the finder for that service, but it must send the funds directly to the depository institution offering the CD and not through the finder. (Refer to the section of this chapter on Broker-Dealer Analysis; Letter to Credit Unions No. 157, September 1994; and Letter to Credit Unions No. 00-CU-05, September 2000 for additional guidance.)

- **Safekeeping.** Either the SEC or a federal or state depository institution regulatory agency must regulate and supervise any safekeeping institution that a federal credit union uses for custody of purchased investments. Actual or opportunity losses can result from inappropriate safekeeping arrangements for investments. (Refer to the section of this chapter on Safekeeping for guidance.)

- **Surveillance and divestiture.** For investments that fail to meet the requirements of the *FCU Act, NCUA Rules and Regulations*, or board policy, the policy must address how the credit union will handle these investments. The policy should include provisions for monitoring and reporting of high-risk investments.

- **Trading account.** Federal credit unions engaging in investment trading must adopt expanded policies that address the trading issue, and sufficient resources, knowledge, systems, and procedures to manage the risks. The policy should address size limitations of the trading account, stop loss or sale provisions, and limits on the length of time the credit union may hold an investment in the trading account.

- **Operational risks.** In addition to the requirements above, credit unions' investment policies should address the various types of risks inherent in the investment process, including:
 - Management risk. Management risk is the loss potential resulting from lack of knowledge about various characteristics of the intended investment instrument. Before making any investment, management must thoroughly understand the intended security and ensure that the investment's risk characteristics are consistent with the credit union's overall investment objectives and business goals. Management's unfamiliarity with the pricing of an investment or terms of the investment transaction can result in losses if the price management paid exceeds the fair value. Therefore, management must understand how the investment instrument reacts to changes in market interest rates.

 - Transactional or operational risk. This risk arises from deficiencies in information systems or internal controls that can result in unexpected loss. Sources of operational risk include inadequate procedures, human error, system failure, and fraud. The first line of defense in controlling operating risks is effective internal controls, including separation of duties and supervision of persons executing investment transactions from those responsible for processing transactions and accounting for investments; and

- Compliance or legal risk. Federal credit unions must ensure that investments comply with the *FCU Act, NCUA Rules and Regulations*, and other applicable laws. Legal risk includes the risk that contracts, such as custodial agreements and repurchase agreements, are not legally enforceable or properly documented. Federal credit unions should adequately evaluate agreements before entering into a contract to ensure (1) compliance with applicable laws, and (2) inclusion of all bargained for duties and provisions, such as the ordinary duty of care for a safekeeper, or the requirement for a perfected first priority security interest in repurchase collateral.

During the review of the board and the executive committee minutes, examiners should determine that the board fulfills its responsibilities and that any individual to whom the board has delegated its authority submits the proper reports. Board minutes should clearly outline to whom the board has delegated authority and the extent of that authority. Examiners should review such delegations during each examination.

In summary, credit unions can reduce investment risks by:

- Fully evaluating each type of investment before purchase, including the creditworthiness and/or the financial condition of the issuer and the potential IRR of the proposed investment;
- Analyzing the financial condition and reputation of any intermediary to the transaction, such as a broker-dealer; and
- Diversifying the investment portfolio by type, maturity, geographical location, guarantor, etc.

Examination Guidance

Examiners should complete the “Investment Controls” questionnaire before determining the extent of investment risk. The examiner may decide to expand the review if (1) the credit union has changed its investment policies since the last examination, (2) the examiner or auditor noted investment internal control or other weaknesses, (3) the credit union changed substantially its investment mix, or (4) the credit union has material amounts of complex investments in its investment portfolio.

If the examiner and supervisory examiner determine the necessity of reviewing investments, the examiners should sample each investment type. For example, if the credit union has 100 CDs, the examiner may review a sample of five CDs. If problems exist, examiners should expand their analysis to the point of determining the severity of the problems and developing plans for correction.

Examiners may review broker/dealer activity, when applicable, to determine the existence and extent of any resulting problems. Examiners may also review a sample of investments made through a new broker/dealer.

**Classification
of Securities
SFAS 115**

Federal credit unions must report securities in accordance with generally accepted accounting principles (GAAP), which require categorizing a security in one of three classifications:

- **Trading securities** - debt and equity securities that the credit union bought and holds primarily for the purpose of selling in the near term (held for only a short period of time.) The credit union reports trading securities at fair value through the income statement;
- **Held-To-Maturity securities** - debt securities that the credit union has the positive intent and ability to hold to maturity. The credit union reports held-to-maturity securities at amortized cost; and
- **Available-For-Sale securities** - debt and equity securities not classified as either trading or held-to-maturity securities. Credit unions report available-for-sale securities at fair value through a separate component of equity on the balance sheet, Accumulated Unrealized Gains/Losses on Available-for-Sale Securities.

Absent evidence to the contrary, examiners normally should accept the credit union's designations, especially if the examiner considers the external audit adequate and does not take exception. (Contradictory evidence could include a pattern of intermittent sales or transfers of held-to-maturity securities, suggesting that the securities are actually available-for-sale.) The examiner should focus on evaluating the risks

in the securities holdings and activities and on the credit union's management of these risks, and should not micro manage the classification of securities under SFAS No. 115. (Refer to SFAS 115 for further information.)

Broker-Dealer Analysis

Following are recommended guidelines for credit unions to analyze and select a broker-dealer:

- **Use only established, well-capitalized, registered broker-dealers.** The board should use established, well-capitalized, and reputable national and regional firms, and should establish minimum capital standards for each broker-dealer. If available, the credit union should consider reports and credit ratings from one or more of the nationally recognized statistical rating organizations (e.g., Moody's, Standard & Poor's, or Fitch.)

Management should ensure the broker-dealer is either (1) registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934 or (2) is a depository institution whose broker-dealer activities are regulated by a federal regulatory agency. For unregulated firms, the examiner should determine that the credit union only obtains information from the unregulated firms (e.g., a CD finder), but does not send funds through such firms.

Management should regularly review the financial strength of the broker using the broker's latest audited financial statements, paying particular attention to the capital and leverage positions, such as notes payable and securities purchased on margin (see Letter to Credit Unions No. 157.)

- **Check references and complaints against the firm and broker.** Management should perform a background and reputation check on broker-dealers with whom the credit union does business (see Letter to Credit Unions, No. 157, dated September 1994.) A background check includes requesting and reviewing three to five references from the salesperson and the firm, and inquiring of other credit unions, chapters, and leagues about the broker-dealer and firm.

For each firm with which the credit union does or plans to do business, the board should specifically request and obtain a written response confirming or denying if the SEC, the National Association of Securities Dealers (NASD), or a state securities regulator has sanctioned either the firm or its salespeople in the last five years. The board should perform the same due diligence on each salesperson and confirm the responses with the SEC or NASD (www.nasdr.com) and the applicable state securities regulator. The credit union should obtain a broker-dealer registration statement from NASD before doing business with any individual.

NASD Regulation (NASDR) provides an online Public Disclosure Program. Using the NASDR's Central Registration Depository (CRD) the credit union can access broker-related background information. Each broker-dealer firm and registered representative has a unique CRD number, which it must provide upon request. Credit unions can use the CRD number to reference background information from NASDR.

- **Ascertain information about the knowledge, experience, and performance of the broker.** Management should inquire about the salesperson's knowledge and skills, obtain a resume, and determine what training the firm provides its salespeople. Most reputable firms have schools or require periodic training.

On a continuing basis, management should analyze the overall performance of the broker (e.g., review the number of times the broker provided the lowest cost offer on securities purchased.) The credit union should not do business with salespeople who do not explain in depth the type of security they are offering for sale. Most reputable firms provide salespeople with research and analysis reports that explain the investment products.

- **Obtain competitive bids and offers.** Credit unions should obtain competitive bids and offers from more than one broker. Before purchasing or selling a security, management must procure either (1) price quotations on the security from at least two broker-dealers or (2) a price quotation on the security from an industry-recognized information provider (e.g., Bloomberg, Reuters, etc.) This

information is not required for new issues either purchased at par or at an original issue discount (e.g., a U.S. Treasury Note purchased at a discount at auction.) To ensure the credit union receives a fair market price, management should consider obtaining three independent quotations before purchasing or selling a security.

If management cannot procure multiple offers from different brokers to sell a security to the credit union, they should determine the liquidity of the investment (e.g., will other brokers provide a bid on the security) and whether the offer represents fair value before committing to purchase it. The lack of multiple bids from brokers to purchase a security from a credit union may indicate an illiquid security (e.g., often, only the originating dealer bids on a privately placed collateralized mortgage obligation (CMO)). The credit union should try to confirm that the sole bid represents fair value. For example, the credit union may request bids on comparable securities (those with substantially similar characteristics), retaining reasonable and appropriate documentation (e.g., dated telephone note with quote from broker or dated *Wall Street Journal* quote on specific comparable security.) Brokers generally do not provide written bids.

- **Prepare a board resolution and list of limitations.** The board must maintain an internal list of board-approved broker-dealers, including a list of limitations on the amount of funds and types of securities that management or staff may place or invest with each firm. In addition, the board should possess a written agreement with each broker-dealer that specifies the type of securities, transactions approved, and the approved amount for each firm and individual broker. The board should acquire and maintain a basic understanding of the business structure of the broker-dealer including the primary emphasis of the firm (e.g., government securities, agency securities, CMOs, retail, etc.)
- **Use a recorded phone line.** Examiners should encourage credit unions with active or very large investment portfolios to maintain a separate, recorded phone line to document trading instructions and retain a record of conversations with the broker-dealer. Before the officials record conversations with a broker-dealer, they should

exercise due diligence by addressing relevant legal and contractual issues.

A credit union's reliance on Securities Investor Protection Corp. (SIPC) insurance does not substitute for a thorough review of the broker-dealer. If available, SIPC insurance covers only the first \$500,000 of covered securities and cash. Many broker-dealers and custodians obtain private insurance to cover losses in excess of the SIPC limit. However, record keeping problems, fraud, disputed amounts, or ineligible investments (e.g., repo agreements) may prevent collection in full from the SIPC or private insurer.

Letter to Credit Unions, No. 157, contains additional information on broker-dealer analysis. See also, §703.50 and the investment guidance paper.

Audit

Examiners should review the supervisory committee audit to determine whether the auditor verified investments and if material deficiencies were present in the investment area. The auditor bases the extent of the verification of investments on the audit scope and computed materiality level. Examiners should review the scope and computed materiality level for reasonableness. Verification of investments requires the auditor to either physically inspect the investments or send confirmation letters. If the auditor did not verify investments, the examiner should arrange to have the committee perform the verification within a reasonable period, usually 60 days. Examiners should not make a physical inspection or send verification letters unless they suspect a problem and need the inspection or the verification to support an examiner's finding. Examiners should consult with the supervisory examiner before sending out confirmations.

Safekeeping

The credit union should have a procedure to ensure safekeeping of its investments, as well as a board-approved list of safekeeping facilities. Examiners should emphasize to the officials the importance of safekeeping investments off the credit union's premises and enforcing necessary internal controls to minimize the possibility of loss. Investment losses can materially affect the credit union's financial

condition. While some credit unions eventually recover part or all of such losses, the legal process can make recovery very time consuming.

The credit union must retain a written custodial agreement with third parties that act to safekeep the credit union's investments (§703.60.) As custodians, these third-party institutions safekeep the credit union's securities and will deliver them only after receiving the credit union's instruction.

Under §703.60, the custodial agreement is a contract in which a third party agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers. Ordinary care, often called reasonable or due care, holds the custodians responsible for losses from their acts or omissions such as willful misconduct, bad faith, or negligence. A custodial agreement must not specify a duty of care less than ordinary (e.g., an agreement is insufficient if it holds the custodian responsible for losses only from gross negligence.) If the custodial agreement specifies no standard of care, credit unions may assume the default of due care under the model Uniform Commercial Code §§8-504-506.

The regulations require a custodial agreement for most securities. The credit union must obtain monthly statements from the custodian to verify its investments and repurchase collateral. The custodial agreement should not restrict or alter the negotiability of any investment. For example, the agreement should not restrict a negotiable CD to safekeeping with a single custodian.

There are two situations that do not require a custodial agreement: (1) investments that the credit union holds (possesses) in physical form (most issuers now issue securities in book-entry form only) and (2) book-entry investments recorded directly in the credit union's name through the Federal Reserve Book-Entry System. However, most credit unions use a custodian to hold their investments recorded in the custodian's name through the Federal Reserve Book-Entry System. Book-entry investments may include Treasury and Agency securities, as well as mortgage derivative products such as agency CMOs. Finally, as with other book-entry or physical securities, professional third-party control minimizes the possibility of loss.

Credit unions should ensure that at least two people approve the transfer of any of its investments. Both delivery versus payment (DVP) transactions and free deliveries (i.e., a transfer of a security without payment) require this dual control measure. Two common uses for free delivery include (1) transfer of securities from a primary custodian to a third-party custodian in a tri-party repurchase agreement and (2) transfer of securities from an old to a new custodian.

When a broker-dealer serves as safekeeper of the credit union's investments, the written custodial agreement should assure the credit union that the broker-dealer has segregated the credit union's securities from the broker-dealer's investments and that the broker-dealer maintains separate records for the credit union's investments. Officials should review the custodial agreement (sometimes part of the account agreement) to determine that it prohibits the broker-dealer from lending the credit union's securities in the marketplace (e.g., hypothecation.) The credit union should carefully review the reputation and financial stability of a broker-dealer serving as custodian.

Officials must verify these custodial provisions. Credit unions can sustain losses in securities held by broker-dealers. For example, a brokerage firm could use a credit union's securities as collateral on its own loans and later enter bankruptcy. A properly executed third-party custodial agreement could prevent losses resulting from a credit union forwarding funds to a broker but the broker failing to purchase the security.

A safekeeping receipt must evidence each investment held by a third-party custodian. The receipt generally contains the following information, as it applies to the type of investment:

- Name and CUSIP (Committee on Uniform Securities Identification Procedures) identification of the security,
- Par value,
- Date of issue,
- Date of maturity and call date (if applicable),
- Coupon or interest rate,
- Coupon or interest payment dates,

- Trade and settlement date, and
- Name of beneficial owner.

The credit union can determine evidence of safekeeping with a broker-dealer by reviewing the monthly broker statement. The last item on the statement, often referred to as “inventory” or “position”, generally lists the securities that the broker-dealer holds for the account.

Regardless of the methods the credit union uses to control its evidence of beneficial ownership of investments or physical investment documents, the credit union must have procedures in place to periodically inspect and reconcile the actual documents, statements, and safekeeping receipts to its records. When the credit union is the beneficial owner of securities held by a custodian, the credit union’s name does not appear on the book-entry system or on a physical security. Thus, the credit union must verify records received from the safekeeper with the credit union’s own records (§703.60.)

The credit union must require the selling broker to settle investment transactions delivery versus payment (DVP.) DVP (also termed “cash on delivery” and “delivery against cash”) provides for the simultaneous transfer of funds and securities, ensuring that the credit union (or its custodial agent) possesses either the securities or funds.

If the credit union requires the selling broker to settle investment transactions at a third-party custodial agent, it may eliminate some of the risk associated with settling and safekeeping securities. Delivery to a third-party custodian may reduce problems with non-delivery of securities, delivery of the wrong securities, purchase of nonexistent securities, purchase of CDs based on inaccurate or partial disclosure of terms, and other problems.

Records

While all credit unions must maintain adequate investment records, the sophistication of these records will depend on the level of activity and the types of investments involved. For example, a credit union that invests only in a common trust fund account could maintain this account without a subsidiary ledger. However, credit unions that do substantial investment activity or have a substantial portion of their assets in investments should maintain adequate subsidiary ledgers.

The subsidiary ledger contains all transactions involving that security. The credit union should record the following information on each subsidiary investment record, as applicable:

- Name, type, and CUSIP identification;
- Par value and any premium/discounts (purchase price);
- Date of issue;
- Date of maturity and call dates;
- Date of purchase and sale;
- Book value;
- Interest or coupon rate, and floating-rate formula and index;
- Timing of interest rate adjustments;
- Interest rate caps and floors;
- Coupon or registered status;
- Interest payment dates;
- Current fair value (as of each month-end);
- Location or safekeeping custodian;
- Amortization of premiums or accretion of discount, if applicable;
- Current par value (CPV) of pass-through type investments;
- Name of broker, if used for purchase; and
- SFAS 115 classification.

The credit union should also retain and have available for verification the original investment confirmations. The examiner should determine that the credit union maintains current, in balance subsidiary ledgers that provide sufficient information for managing the investment portfolios.

Investment Valuation

Quotes on securities may show both a bid and an ask quote. To determine a security's fair value, examiners should apply the bid quote to the current par value or face value of the security. After determining the fair value, examiners use the book value to compute market appreciation or depreciation.

Example: A credit union owns a U.S. Treasury Bond with a face value of \$1,000,000 and a book value of \$898,000. The bid is 91.125. Therefore, the fair value of the security is \$911,250 ($\$1,000,000 \times .91125$.) The market appreciation or depreciation is: \$911,250 fair value minus \$898,000 book value equals \$13,250 appreciation.

In determining the fair value of the investment portfolio, examiners may use data supplied by the institution, if available, as of the examination's effective date. The examiner should determine that the credit union uses the same pricing service consistently from period to period to prevent management from choosing the most favorable valuation at the end of each period. Examiners should refer to SFAS 115, and to the Mutual Funds, Common Trusts, Unit Trusts and Investment Trading sections, respectively, for specific guidance. Footnotes to the credit union's balance sheet should separately disclose differences between the total fair value and book value of the held-to-maturity and available-for-sale investments.

If examiners doubt the accuracy of the data, they should test it to determine the accuracy of the stated fair value and book value. This may include reviewing the broker-dealer's market valuation data, examining the business section of a newspaper, or seeking a third-party review (e.g., corporate credit union, Office of Strategic Program Support and Planning, RCMS, etc.) Material miscalculations or inaccurate disclosures of the fair value of the investment portfolio resulting from weak internal controls will require appropriate correction.

Examiners may complete the Amortizing Investments Review and Certificate Review workpapers in AIREs to assist in the valuation and trend analysis of investments. Examiners must consult their supervisory examiners before requesting the credit union to obtain a third-party review.

Bond Basics

A security called a bond represents a debt obligation of the issuer. The issuer will pay principal and interest to the investor according to the terms of the bond. A Treasury note is a U.S. Government debt obligation with an original maturity of 10 years or less. A Treasury bond has an original maturity greater than 10 years. Debt obligations of the issuer generally refer to note and bond obligations. Credit unions often use the terms "notes" and "bonds" interchangeably when discussing investments.

Principal

The issuer must pay to the investor the principal of a bond, also called the par or face amount. Bonds may have the following characteristics:

- Due at maturity or amortizing. A bullet bond has the entire amount of the principal due at maturity. An amortizing bond has periodically scheduled principal repayments.
- Straight or callable. The issuer of an option free bond (with respect to principal repayments) must pay the principal amount on the scheduled due dates. Conversely, the issuer of a callable bond has the right to accelerate repayment of principal. A callable bond typically refers to a bond callable in total; however, a mortgage-backed security (MBS) typically is callable in part (in addition to the scheduled amortization of principal.) The term “prepayments” refers to partial calls on an MBS.
- MBS and CMO factors. Amortization or prepayments reduce the original principal amount of a mortgage-backed security or collateralized mortgage obligation over time. Computing the outstanding face or outstanding principal balance requires use of the portion of the original principal outstanding, shown as a factor in decimal form. For example, a \$250,000 original face MBS with a factor of 0.80000000 has a \$200,000 outstanding principal balance ($\$250,000 \times 0.80000000$.)

Coupon Rate

The borrower periodically pays the coupon rate or the stated rate of interest on a bond. The bond may have the following interest rate characteristics:

- Coupon or zero coupon. Zero coupon bonds, sold at a discount from the par amount due at maturity, do not pay interest periodically. The discount represents future interest earned over the term of the investment.
- Fixed or floating rate. A fixed-rate bond has a coupon determined by the interest rate at the time of issuance. A floating-rate bond has an interest rate index (to which a fixed margin typically is added) that will reset the interest rate periodically according to the terms

of the bond. The formula for a floating rate bond should specify the interest rate index and any margin.

- Unrestricted or capped floating rate. An unrestricted floating rate note (bond) has no restriction on the upper limit in the resetting of the interest rate. However, a floating rate note may state a maximum rate of interest, termed a cap (also called a life cap or ceiling.)

Day Count Basis

Calculating a coupon payment amount from a coupon rate requires knowledge of the day count basis of a bond. The day count basis defines the method of counting the days in a month and in a year for the coupon period. The notation to express a day count basis is (days in month)/(days in year.) Following are the four fundamental day counts used for domestic investments:

- Actual/Actual. The number of days in a month (numerator) is the actual number. The number of days in the year (denominator) also is the actual number. Treasury notes use this basis;
- 30/360. The number of days in each month is counted as 30 days, therefore, each year has 360 days (12 x 30.) MBS, many CMOs, and some agency and municipal bonds use this method;
- Actual/360. This method counts the actual number of days in a month, but counts the basis for a year as 360 days. Money market securities, including Treasury bills, typically use this method; and
- Actual/365. This method counts the actual number of days in a month, and counts each year to have 365 days. The quoted rate on a CD may use this computation.

Accrued Interest

Accrued interest is the amount of interest that has accrued on a bond from the prior coupon payment date (or from issuance for most newly issued securities) to the accounting statement date or settlement date. Buyers must pay to sellers any accrued interest, or fraction of the amount payable on the security's next coupon payment date. The

Securities Industry Association typically uses the following formula to compute accrued interest on periodic coupon paying investments:

$\text{Accrued Interest} = \text{Principal Amount} \times (\text{Coupon Rate as a decimal} / \text{Number of Coupon Periods per Year}) \times (\text{Number of Accrued Days according to the day count basis from beginning of period to settlement date} / \text{Number of Days in Interest or Coupon Period.})$

Price Quotations

The secondary market (after issuance) typically quotes bonds on a dollar price basis. Quotes for Treasury securities typically reflect a yield basis at the auction.

- Dollar price per \$100 par. Bond quotes typically reflect a dollar price per \$100 of principal, without accrued interest. A “clean price” does not include accrued interest. For example, a \$250,000 Agency note quoted at a price of 102 would cost \$255,000 ($\$250,000 \times 102/100$) plus accrued interest. However, a \$250,000 original face MBS at a price of 102 with a factor of 0.80000000 would cost \$204,000 ($\$250,000 \times 0.80000000 = \$200,000$ remaining face; $\$200,000 \times 102/100 = \$204,000$ cost) plus accrued interest. Coupon bearing securities typically do not use the dirty price quotes (equal to the clean price plus accrued interest.)
- Discount or premium. A bond quoted at a price of less than 100 reflects a discount to par, while a bond quoted at a price of greater than 100 reflects a premium.
- Quotations in fractions. Some publications and broker-dealers may quote the prices of fixed-income securities in whole dollars and in 32^{nds} of a dollar per \$100 dollars par. For example, an offer price of 100-12 makes that security available for purchase at a price of \$100 and 12/32 (that is, \$100.375) per \$100 dollars par, plus accrued interest to the settlement date. Occasionally, a quotation will include a “+” (plus), which is ½ of one 32nd, or 1/64th. The following table converts 32^{nds} to decimal form:

32 nd	Decimal	32 nd	Decimal	32 nd	Decimal	32 nd	Decimal
1	0.03125	9	0.28125	17	0.53125	25	0.78125
2	0.06250	10	0.31250	18	0.56250	26	0.81250
3	0.09375	11	0.34375	19	0.59375	27	0.84375
4	0.12500	12	0.37500	20	0.62500	28	0.87500
5	0.15625	13	0.40625	21	0.65625	29	0.90625
6	0.18750	14	0.43750	22	0.68750	30	0.93750
7	0.21875	15	0.46875	23	0.71875	31	0.96875
8	0.25000	16	0.50000	24	0.75000	32	1.00000

**Yield
Quotations**

The yield on an investment is a function of the coupon rate, the purchase price, and the term to maturity. Users should take care to recognize the days basis used for the yield quotation. Common methods to quote yields include:

- **Bond-equivalent yield (BEY.)** The Securities Industry Association calls this semi-annual compounding yield the universally comparable yield. Quotes for the yield on a security with a term to maturity of greater than one year typically reflect a bond-equivalent basis. BEY is the industry standard for quoting yield.
- **Annual percentage yield (APY.)** Annual compounding forms the basis for computing APY. Credit unions must disclose this yield to members, but the institutional fixed-income investment market does not use it.
- **Money market (or discount) yield.** Calculating this simple interest return on an investment uses price as the basis (also used for investments with a maturity of less than one year.)
- **Discount rate.** Calculating this simple interest rate of return on an investment uses redemption value (e.g., the face amount of a Treasury bill due at maturity) as the basis (also used for investments with a maturity of less than one year.)

**Investment
Products**

§107(7)(B) of the *FCU Act* authorizes a federal credit union to invest in the obligations of the United States of America, or in securities fully guaranteed as to principal and interest.

US Treasury Securities

U.S. Treasury securities, which are fully guaranteed obligations of the United States government, include bills, notes and bonds currently issued only as book-entry securities in the Federal Reserve book-entry system. Credit unions may purchase Treasury securities directly at Federal Reserve auctions through either a competitive or a noncompetitive bid. They may submit competitive bids on a yield basis for a specified amount of Treasury securities. Treasury accepts the bidders with the lowest yields (i.e., highest prices for the Treasury securities.) The Federal Reserve awards Treasury securities purchased by a noncompetitive bid, generally for up to \$5 million face amount, at a price equal to the average of the competitive bids accepted by the Treasury.

Credit unions may also purchase Treasury securities in the secondary market from a securities dealer or financial institution. Purchasing Treasury securities does not require a primary dealer. Large volumes and narrow bid-ask spreads characterize the highly liquid Treasury securities' secondary market.

A safekeeping receipt typically evidences a credit union's Treasury securities. Alternatively, a statement of holdings from the Federal Reserve evidences ownership of Treasury securities held directly by the credit union in the book-entry system.

Treasury Bills

Treasury bills issued by Treasury consist of discount securities auctioned and quoted on a discount rate basis, with an original maturity of 91 days, 182 days, or 52 weeks. Occasionally, Treasury will issue special maturity Treasury bills in the form of cash management or tax anticipation bills. Treasury bills have a face value that reflects the return of a single cash flow (also called a redemption amount) to the investor at maturity. The dollar discount, calculated by multiplying the discount rate (as a decimal) times the face value times the number of days remaining to maturity divided by 360 days (the days basis), represents the difference between the purchase price and the face value (i.e., the amount of interest the investor receives at maturity.) The dollar purchase price reflects the difference between the face value and the dollar discount.

Comparing the Treasury bill interest rate to a coupon security (e.g., a Treasury note) requires calculation of the Treasury bill's bond-equivalent yield (BEY), a universally comparable semi-annual yield (i.e., a nominal annual yield assuming semi-annual compounding.) Credit unions cannot compare in a meaningful way the discount rate to the BEY on a Treasury note or bond. The discount rate, based on the face value of the investment rather than the dollar purchase price, uses a 360-day, rather than a 365-day basis for its calculation. Alternatively, calculation of the money market yield facilitates comparison of the interest rate on a Treasury bill to another money market instrument.

**Treasury
Notes and
Bonds**

Treasury notes and bonds represent coupon-bearing securities. The U.S. Treasury auctions Treasury notes on a BEY basis and quotes them on a price basis in the secondary market. Treasury notes and bonds pay interest semi-annually and return the principal amount (face value) to the investor at maturity. The U.S. Treasury issues Treasury notes with an original maturity of 2, 5, or 10 years and Treasury bonds with an original maturity of 30 years. Occasionally, Treasury will reopen a previously issued security and auction additional amounts.

**Treasury
Zeros or
STRIPS**

§703.110(d) prohibits the purchase of a zero coupon investment with a maturity date more than 10 years from the settlement date, unless the credit union is exempt under the Reg Flex provisions of Part 742. Treasury prices a zero-coupon or "stripped" security at a discount to face value before maturity. A "corpus strip" reflects a claim to the principal portion of a Treasury security, as contrasted with a stripped coupon's claim to an interest payment.

STRIPS (Separate Trading of Registered Interest and Principal of Securities) is the U.S. Treasury program that permits separate trading and ownership of the interest and principal payments on 10-year and longer term original maturity Treasury notes and bonds maintained in the book-entry system operated by the Federal Reserve Banks. STRIPS reflect direct obligations of the U.S. Government.

For example, a 10-year, 6 percent coupon, \$1,000,000 Treasury note may be separated into 20 different coupon STRIPS (one for each of 20 semi-annual payments of about \$30,000 each) and one corpus STRIPS

(the \$1,000,000 principal due at maturity.) STRIPS also can be reconstituted into the original Treasury note or bond.

**Other US
Guaranteed
Securities**

In addition to Treasury securities, the U.S. Government fully guarantees the principal and interest of certain other securities, such as Government National Mortgage Association (GNMA or Ginnie Mae) securities and Government of Israel notes.

**Federal
Agency
Securities**

In the bond market, the term “federal agency securities” generally applies to two different types of securities: (1) a security issued by a Government corporation (wholly or partially owned by the Government), usually with an unconditional guarantee of the U.S. Government; and (2) a security issued by a government sponsored enterprise (GSE), often explicitly guaranteed only by the issuer.

Permissible investments for federal credit unions include the obligations, participations or other instruments issued by federal agencies as authorized in §107(7)(E) of the *FCU Act*, wholly-owned Government corporations designated in §101 of the Government Corporation Control Act (31 U.S.C. §9101(3)), and other securities as authorized in §107(7)(E) and §107(7)(F) of the *FCU Act*. Most wholly owned Government corporations no longer issue their own securities.

**Government
Corporations**

The Federal Financing Corporation generally provides funds to Government corporations and borrows those funds from the Department of the Treasury that, in turn, issues Treasury securities. Recently issued securities of Government National Mortgage Association, Small Business Administration, and Tennessee Valley Authority commonly fall within this category.

Wholly owned Government corporations include:

- Government National Mortgage Association (GNMA or Ginnie Mae); and
- Tennessee Valley Authority (TVA.) The full faith and credit of the US government do not back these Tennessee Valley Authority securities.

- Entities formed to assist with problems in the savings and loan industry include:
- Financing Corporation (FICO);
- Resolution Trust Corporation (RTC); and
- Resolution Finance Corporation (RefCorp.)

These mixed-ownership Government corporations have issued, directly or indirectly, certain securities in which federal credit unions may invest including certain mortgage-backed or mortgage-collateralized securities.

Government Sponsored Enterprises

Government Sponsored Enterprises (GSEs) are privately owned, Congressionally chartered corporations. The government establishes a GSE to provide funding to a sector of the economy otherwise underserved by purely private financial intermediaries. Because GSEs play an important role in sectors of the economy, GSEs are instrumentalities of the U.S. Government for specific purposes. SEC registration requirements exempt GSE debt obligations. However, GSEs do not carry an explicit guarantee of the U.S. Government.

GSEs that issue securities include:

- Federal National Mortgage Association (FNMA or Fannie Mae);
- Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac);
- Farm Credit System (including Federal Farm Credit Bank (FFCB) and Farm Credit System Financial Assistance Corporation (FACO));
- Federal Home Loan Bank System (FHLB);
- Federal Agricultural Mortgage Corporation (FAMC or Farmer Mac); and
- Student Loan Marketing Association (SLMA or Sallie Mae.)
SLMA formed a holding company for the purpose of giving up its GSE status. Securities issued by SLMA with final maturities not to extend beyond September 30, 2008 remain permissible investments for federal credit unions. However, federal credit unions may not invest in securities issued by SLM Holding Corporation.

Permissible Investments for Federal Credit Unions

Issuer or Originator	Security Backed by US Government	Permissible for Federal Natural Person Credit Union - Provision of <i>FCU Act</i> (or other law)
FNMA (Fannie Mae)	NO	YES - 107(7)(E)
FHLMC (Freddie Mac)	NO	YES - 107(7)(E)
FFCB (Farm Credit)	NO	YES - 107(7)(E)
FACO	YES	YES - 107(7)(B)
FHLB	NO	YES - 107(7)(E)
FAMC (Farmer Mac)	NO	YES - 107(7)(E) (and 12 U.S.C. 2279aa-12(c))
SLMA (Sallie Mae)	NO	YES - 107(7)(E)
FICO	NO (principal backed by zero-coupon Treasuries)	YES - 107(7)(E) (and 12 U.S.C. 1441(e)(6))
RTC	NO	Certain trusts are permissible mortgage-related security investments
RefCorp	NO	YES - other agency 107(7)(E)

Obligations

Agency obligations include short-term notes, long-term debenture bonds, and structured notes, described as follows:

- Short-term notes - generally discount securities (similar to Treasury bills) with a single cash flow at maturity;
- Debenture bonds – also called consolidated bonds when issued by Farm Credit generally pay interest semi-annually
- Structured notes - typically contain call provisions or other embedded derivatives; credit unions that do not understand the risks of the embedded derivatives should not invest in these securities.

Participations

Participations differ from debenture bonds in that specific assets, typically mortgage loans, back participation bonds. Generally, the U.S. Government (for Ginnie Mae) or a GSE (for Fannie Mae and Freddie Mac) guarantee these securities.

One loan or a pool of loans may back participation certificates. To reduce prepayment risk on securities purchased at a premium, management should know the approximate number of loans in the participation pool and, if geographic diversification warrants, their location. For the more recent issues, the Bloomberg screens, offering circulars, or other external means provide characteristics of the participation pools.

Management should thoroughly analyze the risk of uncertain cash flows associated with mortgage pass-through certificates. As market interest rates rise, prepayments generally slow down. As rates move up and the repricing of investment cash flow diminishes, members increase pressure for higher dividend rates. Likewise, prepayments generally increase as rates move downward. If rates decrease, the credit union must then reinvest excess dollars at lower rates, further reducing asset yields. As such, standard prepayment models (e.g., those available through Bloomberg) often help project cash flow for mortgage pass-through securities. (For further guidance on standard prepayment models, refer to the section on CMOs in the Investment Guidance Papers located in the NCUA E-Library.)

Participation certificates may also consist of variable- or fixed-rate loans. From an asset-liability standpoint, management should know the correlation between the variable rate formula (e.g., the index plus the margin) used to determine the loans' interest rate and the credit union's cost of funds.

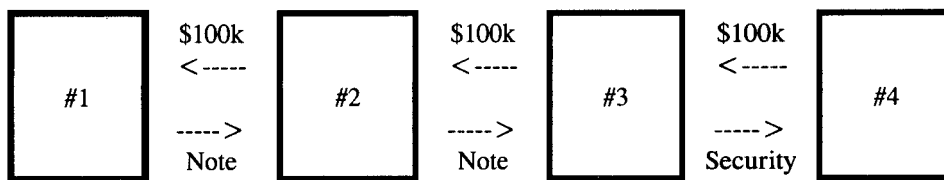
Usually, the participation certificate holder receives monthly payments of principal and interest directly from the servicer of the loan who, in turn, received those payments from the borrower, resulting in a "pass-through" security. A "modified pass-through" means that the agency guaranteeing the security ensures the timely payment of principal and interest. Following is Illustration 12-A, a secondary market flowchart for modified pass-through securities.

Basic securities are of two types:

- Pass-Throughs. Investors share in cash flow from the underlying mortgages on a "pro-rata" basis. Monthly payments and

prepayments of principal and interest are divided among the investors according to the relative size of their investment.

Secondary Market Flow Chart



#1 Individual wants \$100,000 to purchase or refinance a principal residence and usually requests a long-term fixed rate (high level of IRR.)

#2 Credit union wants to loan money, charge points and fees, and "service" the debt. If the credit union does not wish to assume the reduced liquidity or increased IRR associated with mortgage lending, it structures the loan to qualify for the secondary market. The credit union then has the option of selling the loan immediately or at a later date, thus enabling it to make additional loans.

#3 Intermediary (e.g., GNMA, FHLMC, and FHA) established to provide a ready source of housing funds. These agencies set secondary market standards based on historical records to ensure high quality loan underwriting and documentation, which allow the agency to "guarantee" loan principal and interest payments. The intermediary issues to individual investors certificates or securities collateralized (in whole or in part) by the mortgages purchased from the credit union.

#4 Individual investors willing to buy a security collateralized by the mortgages. They receive a guarantee of monthly principal and interest payments and a higher yield than they would receive if they invested in a Treasury security with a similar maturity. The investors, in turn, assume interest rate and prepayment risks resulting from uncertainty as to the repayment period of the principal and interest from the collateralized mortgages in the pool. For example, if individual homeowners refinance or move, they pay off the entire loan early rather than over their original mortgage periods (usually 15 or 30 years.)

Illustration 12-A

- CMO/REMIC. Investors share in cash flows on a "prioritized" basis by purchasing into a "tranche" or class. The prospectus provides details of when the investor will receive interest, principal, and/or prepayments.

Secondary Participations

Secondary participations usually do not have a timely payment guarantee. Insured student loans (other than those primarily guaranteed

by a state or private agency), Farmers Home Administration (FmHA) Business and Industrial Loans, and the guaranteed portion of loans guaranteed by the SBA fall into this category.

Credit unions holding secondary participations should file all appropriate forms with the insuring agency and retain written assurance that the secondary participation loans meet all requirements in the event that the borrower defaults and the credit union must file a claim. Officials should understand the credit union's collection responsibilities under the insuring clauses that support the investments in question.

The credit union should ensure that participation certificates and other secondary participations meet the requirements of §107(7)(E) or §107(7)(F) of the *FCU Act*, and that no obstructions exist that might invalidate the federal guarantee.

GNMAs

A pool of mortgages insured or guaranteed by the Federal Housing Administration (FHA), the FmHA, or the Veterans Administration (VA) backs a GNMA. GNMA guarantees the timely payment of principal and interest to the security holders. The credit union normally receives payment on the fifteenth of each month for GNMA I, or on the twentieth for GNMA II. This payment includes the scheduled principal payment, any prepayment of principal on the security, and coupon interest for the prior month.

Because GNMAs have the principal repayment feature, the credit union must know the pool factor to compute the principal outstanding. The Bond Market Association publishes a schedule for the factors (Prepayment Announcements.) For example, GNMA I factors are announced about the fifth business day of the month, and GNMA II factors a business day later.

The factor for a GNMA represents the amount of principal that remains outstanding as of the end of the previous month. When reconciling safekeeping statements, examiners should note that statements may show the factor for the current month, and report only the payment amounts for principal and interest from the previous month, not those scheduled for receipt in the current month.

Settlement on GNMA trades occurs once each month, according to a schedule published by The Bond Market Association. For example, most 30-year GNMA I securities have a settlement date of about the sixteenth business day of the month. To settle on the current month's settlement date, the credit union must make and report a transaction on or before the notice date, which is 48 hours before the settlement date.

A GNMA's principal balance as of the end of the previous month provides the basis for the settlement amount. Thus, while a transaction sets the dollar price per \$100 of outstanding principal, the credit union cannot compute the actual dollar amount due at settlement until it knows the pool factor for computing the outstanding principal.

A credit union should accurately record principal repayments and interest payments. Staff should properly reflect the security's outstanding balance by reviewing the statements received from either the servicer of the GNMA pool or the credit union's broker.

GNMA issues GNMA securities in book-entry form in the electronic book entry system of the Mortgage-Backed Security Division of the Depository Trust Company (DTC.)¹

Each month, credit unions registered as owners of GNMA's receive an Issuers Monthly Remittance Advice. This form usually accompanies the monthly payment and identifies the amount of principal repayment, interest income, and the outstanding balance of the security. The examiner may verify these figures with those on the credit union's books.

Most credit unions hold GNMA securities through a custodian that maintains a chain of custody through a participant in DTC. The credit union receives a statement from its custodian. Information contained on these statements may vary slightly from custodian to custodian. Examiners and credit union staff can verify the principal repayment, interest income, and the security's current par value from the custodian's statements against the figures in the credit union's books.

¹ Since December 11, 1990, investors holding older physical-form GNMA securities may convert them to book-entry form, with the exception of GNMA Serial Notes. Since December 1986, non-eligible securities and book-entry eligible securities that were not delivered according to good delivery guidelines remain in physical form.

If a custodian's statement does not provide the current par value of the security, the examiner may compute the balance as follows:

- Obtain the original par value of the security from the trade sheet (if available) or from the subsidiary ledgers;
- Obtain the GNMA pool factor. (The pool factor represents the percentage of principal still outstanding.);
- Multiply the original par value by the factor to determine the current par value (remaining principal balance); and
- Verify the computed value against the figures in the credit union's records.

Example: A credit union purchased a GNMA modified pass-through security with an original par value of \$1,007,008.33. The GNMA pool factor is .99703096.

Original par value	\$1,007,008.33
GNMA pool factor	<u>.99703096</u>
 Current par value (CPV)	 \$1,004,018.48

To determine reasonableness of the fair value of a recently issued GNMA, the examiner may look up the bid price for the stated interest rate and multiply the bid price by the outstanding principal balance of the investment to determine the fair value. A published bid price for a recently issued GNMA typically will not reflect fair value for a seasoned GNMA, that is, for a GNMA security with a shorter remaining maturity. (See the Mortgage Valuation workbook in AIREs for indication values for mortgage related securities.)

**SBA
Guaranteed
Loans**

Fixed-rate Small Business Association (SBA) guaranteed loans have appealed to some credit unions because of their relatively high yields. SBA also has a variable-rate participation loan, in which the loan rate generally adjusts quarterly and moves with the prime rate, thus reducing the IRR of the security.

However, the lack of an active secondary market for these loans limits their marketability, making them more suitable as a long-term

investment than as a liquid asset. Generally, SBA single loans contain more risk than SBA loan pools. Likewise, SBA loan pools that have a small number of loans carry more risk than do pools with larger numbers of SBA loans. In other words, the larger the number of loans in the pool, the more predictable is the pool's performance and the better its marketability.

SBA loans, whether fixed or variable rate, do not have a consistent average life and SBA can call them for immediate repayment, which could result in a loss if the credit union purchased the SBA at a premium. In addition, the "thin market" (i.e., not an actively traded secondary market and a limited number of brokers making a primary market in SBAs) restricts marketability of these instruments.

Example: A credit union purchased a \$100,000, 10 percent, 5-year SBA loan at 105. After one year, the balance of the loan was \$80,000 and the unamortized premium was \$4,000. The borrower repaid the loan in full at this point. Since SBA guarantees repayment only at par, SBA would not reimburse the credit union for the remaining \$4,000 unamortized premium and the credit union must absorb the loss during the current accounting period.

Credit unions should be aware of the dangers of purchasing SBA loans and other secondary participations at high premiums. However, the decision of whether or not to purchase SBAs remains with the officials.

Zero Coupon Bonds

As with Treasury securities, which can be stripped into zero coupon securities, agencies (e.g., TVA) and other financial institutions can offer zero coupon debt obligations.

The price of a zero coupon security exhibits more sensitivity to changes in interest rates than does the price of a similar maturity coupon bearing bond. In fact, prices of longer-term, zero coupon securities can react strongly to changes in interest rates. This price volatility can attract credit unions wishing to speculate in trading of zero coupon securities. As such, a credit union's investment in a zero coupon security may be legal, but not appropriate from an asset-liability standpoint.

A federal credit union may not purchase a zero coupon investment with a remaining maturity greater than 10 years from the settlement

date. A credit union may “grandfather” a zero coupon bond purchased before December 2, 1991, unless it poses a safety and soundness concern. If examiners determine that the investment poses a significant threat to the continued sound operation of the credit union, they should contact their supervisory examiner before further assessing the situation.

Examiners should determine that the credit union properly records the zero coupon securities. Management determines the present value of the single cash flow using the purchase interest rate, typically a bond-equivalent yield. Accounting for these securities requires accreting the discount using the interest method (also termed scientific or level yield.) Unlike the straight-line method, the interest method results in a lesser amount of income earned in early periods than in later periods.

Examiners should also ascertain whether the credit union purchased these securities for trading purposes. If the credit union trades these securities, the examiner should consult the supervisory examiner. The examiner should review the credit union's trading policies, operating procedures, and level of overall risk in the investment portfolio (also see the Investment Trading section.)

SMBS IOs and POs

Stripped mortgage backed securities (SMBS) or SPLITS, more commonly referred to as interest only securities (IOs) and principal only securities (POs), resemble zero coupon type instruments. However, they possess the additional characteristic of uncertain cash flow and the resulting uncertain returns. The issuer strips the principal and interest payments from the underlying mortgage-backed securities and SPLITS them into separate investments. Investors in a PO receive a pro rata portion of the principal payments on the underlying mortgages, while investors in an IO receive a pro rata portion of the interest payments on the underlying mortgages.

§703.110(c) prohibits the purchase of stripped mortgage backed securities (SMBS), residual interests in collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits

(REMICs), and mortgage servicing rights. Purchase of SMBS solely for reducing IRR is no longer permitted for new purchases.²

NCUA grandfathered investments in SMBS acquired before January 1, 1998, unless they posed a safety and soundness concern (see §703.130 for further guidance.) Credit unions holding grandfathered, stripped mortgage-backed securities to reduce IRR in accordance with NCUA's Rules and Regulations must report the security as a trading asset at fair value through income or as an available-for-sale asset at fair value through equity until its disposition.

Credit unions that purchased SMBS before December 2, 1991, should:

- Carry them at amortized cost if the credit union has both the intent and the ability to hold the SMBS to maturity. Amortized cost is original cost (present value of future cash flows) systematically adjusted to the amount that the credit union expects to realize through the maturity date;
- Use the interest method of amortization or accretion to record interest income over the life of the investment unless the straight-line method results in a materially equivalent amount;
- Retain a copy of the prospectus; and
- Provide reports and analysis documenting the reduction in risk at the time of purchase (since credit unions may only hold SMBS to reduce IRR) and periodically thereafter.

As with all mortgage-backed securities, credit unions may need to periodically adjust the carrying value of the SMBS through current period income to reflect significant changes in the prepayment rates of the underlying pool of mortgages. Effective yield calculations reflect a security's purchase price relative to expected future periodic cash flows, anticipating estimated mortgage pay-down speeds over the life of the security.

As the underlying mortgages pay down significantly faster or slower than originally anticipated, the carrying value of the SMBS may require adjusting. This adjustment involves recalculating the effective yield used in the amortization to reflect an effective yield based on

² Before January 1, 1998 but after December 1, 1991, NCUA's Rules and Regulations permitted credit unions to purchase SMBS solely for reducing IRR.

actual payments to date and anticipated future payments. As a result of the adjustment, the net investment in the loans reflects the amount that would have existed had application of the "revised" effective yield occurred since the acquisition of the loans. The adjustment to the new balance involves debiting or crediting the investment in loans with a corresponding charge or credit to interest income.

When reviewing SMBS, examiners should do the following:

- Determine that the officials understand the risk associated with SMBS (especially IOs) as outlined in the prospectus;
- Review for reasonableness the accounting treatment and its basis.

CMOs

Collateralized mortgage obligations (CMOs) are multi-class pass-through bonds; either general obligations of the issuer backed by mortgage collateral or limited obligations where the bondholders rely on the pledged collateral for payment. Each bond class, or tranche, has a stated maturity date and a fixed coupon or variable rate. The cash flows generated by the collateral relate to the cash flows of the bonds. After making interest payments, all available cash goes to repay principal on the "fastest" pay tranches. Principal payments go to one or more classes at a time, based on an order of priority determined at the bond issue date. Illustration 12-B shows a CMO where principal payments go to one class at a time.

In a simple sequential pay structure, following retirement of the first class, the next tranche in the sequence becomes the exclusive recipient of principal payments until its retirement. In more complex structures, the first class may be some form of "support tranche," created to protect the planned amortization classes (PACs) and target amortization classes (TACs) of the total offering. The support tranche will absorb any unanticipated cash flows with a paydown in principal, and will extend their maturities when prepayment speeds diminish.

The potential for increased certainty of cash flow patterns, faster return of principal over the mortgage pass-through type securities, and attractive yields have made CMOs popular investments. If their structure sufficiently protects them from prepayment and extension risk, CMOs can appropriately enhance yield for a credit union that

Collateralized Mortgage Obligation

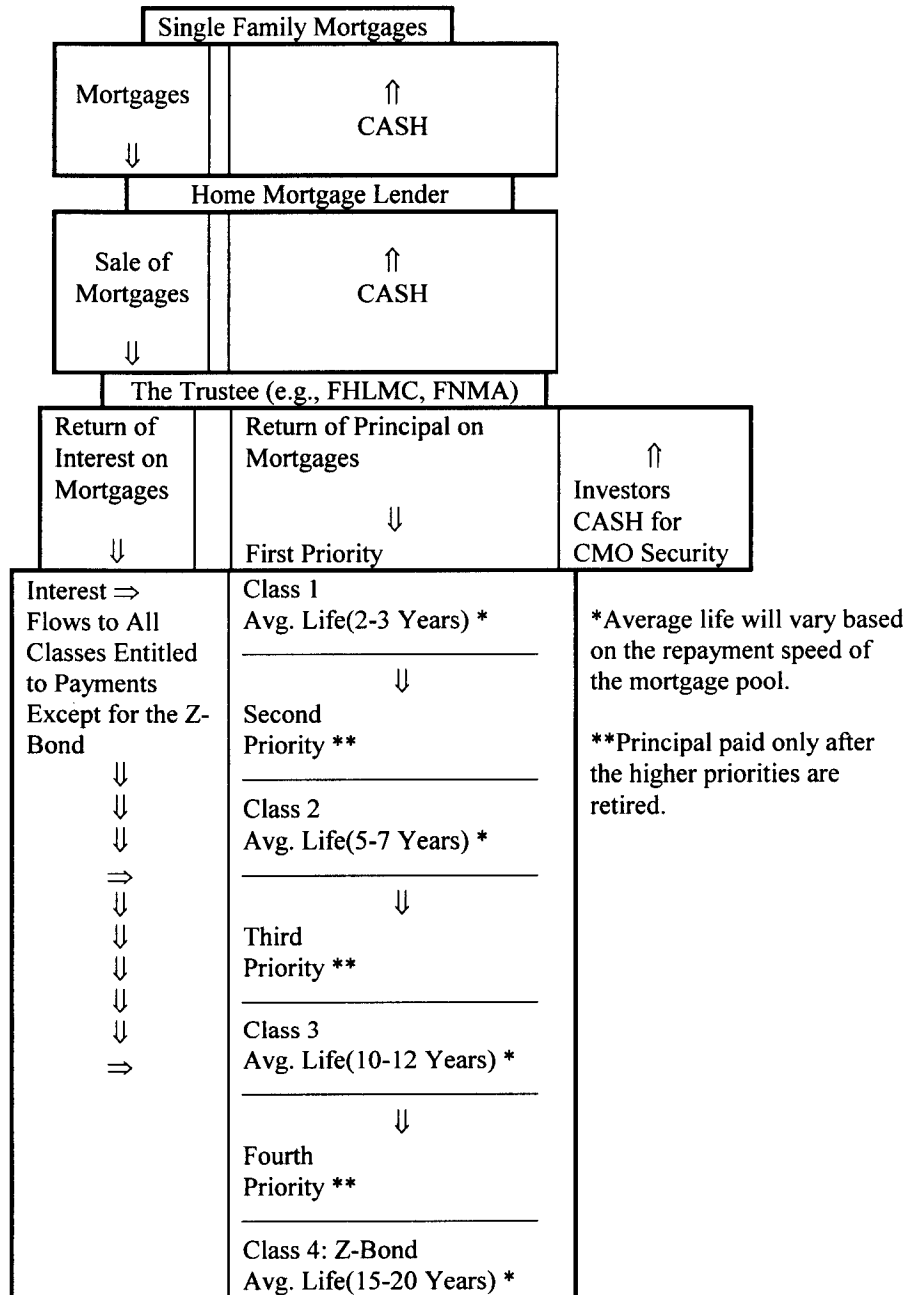


Illustration 12-B

thoroughly understands the product. However, a credit union must closely analyze a CMOs' characteristics before investing.

§107(7)(E) and §107(15) of the *FCU Act* authorize credit unions to invest in collateralized mortgage obligations (CMOs) issued by FHLMC, FNMA, and GNMA, and permissible private issuers. CMOs issued by FHLMC or FNMA carry little or no credit risk. Groups that offer privately issued CMOs include securities firms, savings and loans, mortgage bankers, home builders, and life insurance companies. Most privately issued CMOs are highly rated, however, a credit union that anticipates buying a privately issued CMO should ensure that the CMO's rating falls within one of the two highest categories by at least one nationally-recognized statistical rating organization.

CMOs can contain significant liquidity and IRR including the following:

- Unanticipated principal prepayments on the collateral could result in the issuer retiring the bonds substantially earlier than their final maturity date;
- In a declining interest rate environment, credit unions that reinvest excess dollars at lower rates usually experience reduced yields;
- If the credit union purchased the instrument at a premium, the effective rate of return decreases as prepayments increase in a declining rate environment; and
- As interest rates move upward, cash flow could decrease significantly and reduce the amount of funds available to reprice at the higher rates.

Complex CMO investment instruments require that credit union investors understand the potential cash flows and related yields. For example, a CMO issue may include numerous tranches ranging from PACs (I, II, and III) to TACs to very accurately defined maturities (VADM)s to Z-Bonds to companion or other support classes. Furthermore, the average life and final maturity of a CMO depends upon the payment priority of the CMO within the issue's deal structure, and often creates interdependencies with other classes within the same CMO issue. Examples of typical classes within a CMO issue and related risks include:

- **Planned amortization class (PAC.)** Generally, the PAC class of a typical CMO contains less risk and has a well-defined tranche that receives priority over other classes within the issue. While PAC CMOs exhibit less uncertainty in cash flow pattern, the certainty of its cash flow depends on a "range" (or "band" or "collar") of prepayment speeds. However, cash flow patterns could significantly change if the speed of the issue moves outside the PAC range.

A CMO issue may include one or more PACs, often referred to as PAC I, PAC II, or even PAC III. The first PAC may have a wider PAC band or level of protection than other PACs within the CMO issue, thus covering a wider range of prepayment speeds.

- **Very accurately defined maturity (VADM.)** The VADM class may contain the least risk of the various classes. VADMs tend to have relatively short stated final maturities, and typically have PAC bands covering upwards from "0" percent prepayment speed assumptions (PSA.) The higher the PSA, the shorter the time in which the credit union anticipates the return of its principal dollars. For example, a "0" PSA means no anticipated prepayments within the mortgage pool (an unlikely event.) A PSA of 100 means a repayment rate of 6 percent per year. A PSA of 200 means a repayment rate of 12 percent per year.

When interest rates rise, members generally repay their mortgages at a slower rate causing PSA rates to fall. The reverse is true in a declining interest rate environment. From a cash flow standpoint, the VADM may have a relatively short repayment window. Thus, the wide "band" coverage of a VADM, combined with the short and relatively stable stated maturities, makes this class a low risk category in contrast to others.

- **Targeted amortization class (TAC.)** The market typically refers to TACs as "half PACs". They are slightly more volatile than PACs or VADMs, but more stable than a Z-Bond or other support classes. TACs offer some protection against prepayment risk (falling interest rate environment), but not against extension risk (rising interest rate market.)

- **Companion or support class.** The companion or support classes, one of the more volatile classes within a CMO issue, receive principal payments only if other, higher priority classes (e.g., PACs, TAC, etc.) have received their scheduled payments. This may require the issuer to redirect cash flows within the pool to other higher priorities. As a result, the predictability of cash flow patterns often remains highly uncertain. A credit union investing in companion or support classes must fully understand the complexity of the CMO issue, the interrelationships within the CMO, and their likely effect on future cash flow projections.
- **Z-Bonds.** An accrual bond or Z-bond tranche does not receive any cash payments of principal or interest before retirement of all tranches preceding it. Many CMO issues include one or more accrual bond tranches. In effect, an accrual bond is a deferred interest obligation with a varying payment date, resembling a zero coupon bond before the retirement of the preceding tranches. With its long average life, the Z-Bond often has high price sensitivity to changes in interest rates. The Z-Bond tranche receives repayments last, which makes it one of the riskiest of the various classes.

REMIC

Generally, a real estate mortgage investment conduit (REMIC) is the tax-preferred method of issuing CMOs. To qualify as a REMIC, the interests in the REMIC fall within one or more classes of "regular" interests and a single class of "residual" interest. Regular interests are the classes of a CMO issue. The residual interest consists of the excess interest and reinvestment earnings that exist as a result of the differential between the income flow from the underlying mortgages and the income outflow to the regular interest holders.

IRPS 98-02

Examiners should ensure that credit union officials understand the sound principles and practices provided by IRPS-98-02, which recommends that credit unions having material positions in complex securities such as CMOs perform reasonable analysis both at time of purchase and periodically thereafter. After October 1, 1998, credit unions need not obtain the FFIEC high-risk securities test (HRST) for CMOs and real estate mortgage investment conduits (REMICs) in natural person credit unions.

IRPS 98-02 recommends analyses similar to that which underlies the HRST for credit unions having material positions in complex securities. The following three tests serve as a benchmark for a federal credit union's analysis:

- The average life sensitivity test - tests the average life of the security, assuming an immediate shift in the yield curve of plus 300 basis points, and a decline on the downside (-300 basis points);
- The average life test - reviews the CMO's expected average life for base case exposure; and
- The price sensitivity test - tests the estimated change in the CMO's price due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.

Assumptions for the analysis include market interest rates and prepayment speeds at the time of valuation, thus enabling the credit union to comply with the IRPS 98-02 requirement that it knows the value and price sensitivity of its investments. The credit union must maintain, and have available for examiner review, documentation supporting the analysis (§703.40.)

At a minimum, the credit union should obtain a prospectus (when available) and closely analyze the characteristics of the CMO issue using standard industry calculators (e.g., Bloomberg, etc.) before purchasing the security. Projecting future cash flows of CMOs under various interest rate conditions is a complex task; therefore, NCUA recommends using an acceptable standard prepayment model to analyze IRR under various prepayment assumptions. NCUA Letter No. 139 encourages credit unions to obtain prepayment forecasts from at least three different dealers before purchase.

An unreasonable PSA can produce inaccurate test results. A broker could manipulate the prepayment assumptions to make a CMO appear less risky (see example in the addendum.) Thus, the examiner should review the "source" of the prepayment assumptions for consistency. The industry uses a wide variety of "sources" for prepayment assumptions including Andrew Davidson, CMO Passport, First

Boston, UBS, DLJ, Paine Weber, JP Morgan, Bear Stearns, and Median, which is an average of the dealer estimates.

The *Investment Guidance Paper* for March 1997, Section D, Exhibits 1 to 17, includes an example and description of the HRST and other important Bloomberg screens. Bloomberg continues to support this screen as it provides detailed analytics for CMO/REMIC securities. The "Assumption and Source" area for the test specifies the PSA used in the analysis.

Examiners should watch for credit unions that rely on a "CUSTOM" prepayment model source, a customized set of prepayment assumptions. Unless management can fully support the assumptions used in a "CUSTOM" prepayment model, examiners should request additional tests using industry standards. Examiners may readily accept some "CUSTOM" prepayment models. For example, a brokerage firm may offer a "CUSTOM" prepayment speed derived from the median, average, or most conservative estimate from all of the models available (Bloomberg, etc.)

Stress analysis outcomes, based on inconsistent prepayment assumptions, can vary from model to model. Credit unions can comply with the IRPS by analyzing material positions in a CMO or REMIC using a single model; however, a conservative approach would rely on at least three different models. The credit union should ensure that the analysis of securities is reasonably within its limits.

Occasionally a CMO or REMIC could acceptably withstand a 300 basis point change, but present higher risk at some lesser shift in the yield curve. The credit union should understand the risk for all yield curve shifts, up to and including a 300 basis point shift. Acceptable testing at 100, 200 and 300 basis point shifts should sufficiently address these concerns.

Management should also consider the potential for decline in fair values of the investment portfolio over a variety of interest rate cycles and the likely effect on net worth. The "price sensitivity" analysis tool projects the potential effect on a CMO's fair value in various interest rate cycles.

Officials should demonstrate the CMO's suitability for the credit union from an ALM standpoint. While the CMO may be legal, its anticipated cash flow patterns or potential maturity in relationship to the share structure may render it unsuitable for the credit union. For example, a credit union investing a significant portion of its assets in CMO tranches with long average lives could raise safety and soundness concerns if its share base is short-term.

The credit union remains responsible for obtaining analysis information. However, the examiner may need to obtain an analysis through the Office of Strategic Program Support and Planning or the regional office under certain conditions:

- The examiner suspects the reasonableness of the broker's assumptions or other variables (e.g., PSA); or
- The credit union cannot get analysis information and the CMO could substantially affect the credit union's financial health.

Examiners should call the Investment Hotline (800-755-5999) or their RCMS to discuss CMO questions. Examiners may seek the orderly disposal of any CMO or REMIC if the investment poses a significant threat to the continued sound operation of the federal credit union under IRPS 98-02. Before requesting an onsite analysis or recommending divestiture, the examiner should discuss the credit union and its circumstances with the supervisory examiner and follow regional procedures.

Divestiture of Securities

Responsibility for assessing balance sheet risk lies with the credit union officials. If the examiner's analysis determines the credit union has a significant position in high-risk securities (e.g., CMOs, REMICs, or other complex securities that have excessive risk) or inconsistency with the credit union's investment, liquidity or asset-liability policies, the examiner may review management's analysis and determine whether the credit union can manage the risk of holding the high-risk CMOs or complex securities.

Some of the factors for examiners to consider in evaluating whether a credit union may safely hold high-risk investments include:

- Ability of the officials to explain the instrument's characteristics and risks to the examiner;
- Ability of the officials to obtain and adequately evaluate the instrument's market pricing, cash flows and test modeling;
- Ability of the officials to define, explain and document how the high-risk investments fit into the credit union's ALM strategy; and
- The effect that either holding or selling the high-risk bonds will have on earnings, liquidity and net worth in different interest rate environments.

After obtaining the concurrence of the supervisory examiner and regional office, examiners may seek divestiture if they believe continued ownership of high-risk securities represents an undue risk to the credit union. This risk can arise from the following:

- The size of a credit union's holdings of high-risk securities in relation to its capital and earnings;
- Management's inability to demonstrate an understanding of the nature of the risks inherent in the securities;
- The absence of internal monitoring systems and other internal controls to appropriately measure the market and IRR of these securities; or
- Management's inability to manage its overall IRR.

If the region considers the credit union's continued holding of the high-risk securities a safety and soundness concern, both the examiner and supervisory examiner will meet with the officials to reach agreement for divesting the securities or developing an acceptable plan to mitigate the risk. If they cannot reach an agreement with the officials, the examiner will prepare a preliminary warning letter or recommend other administrative action, following regional procedures. Examiners will document the agreements reached in the report. They also should follow-up with the credit union as necessary to ensure compliance with the agreements.

Federally insured state-chartered credit unions holding high risk CMOs or REMICs must record unrealized gains or losses under SFAS

115 (see §741.219); however, they need not establish a special reserve for non-conforming investments. Following regional working agreements with the SSA, examiners will discuss and coordinate divestiture of high risk CMOs that present safety and soundness concerns in state-chartered credit unions with the appropriate state regulator.

Residual Interests

A federal credit union may not purchase a residual interest in a CMO or REMIC. Management should provide reports and data to the examiner and the board on how it proposes to reduce IRR.

Fair Values

The credit union must determine the fair values of the securities at least monthly, in accordance with §703.90, unless the credit union is exempt under the RegFlex provisions of Part 742.

Investment in Mortgage Notes

§107(15)(A) of the *FCU Act* permits credit unions to purchase certain mortgage loans. A federal credit union may make these investments only if it has an ongoing program of making real estate-secured loans and needs comparable loans to complete the packaging of a pool of loans for sale or pledge on the secondary market (see §701.23.) Examiners may also refer to NCUA Letter to Credit Unions, No. 96, dated March 1988.

Mutual Funds, Common Trusts, Unit Trusts

Mutual funds. A mutual fund is an open-end investment company registered with the SEC to invest money from shareholders. A prospectus discloses the permissible investments and investment transactions for the fund. A money market mutual fund complies with SEC regulations limiting investments generally to short-term instruments.

The net asset value (NAV) represents the value of a share in a mutual fund. The financial sections of a number of local newspapers, the *Wall Street Journal*, or online services report NAVs for mutual fund shares. Money market funds typically maintain a stable NAV of \$1 per share.

The value of a credit union's investment in a mutual fund equals the number of shares it holds (found on the monthly statements of account activity provided by the trustee) multiplied by the NAV. Credit unions may redeem mutual fund shares with the open-end investment company for the NAV.

Each dividend period, the credit union must adjust its investment in mutual funds and common trusts to fair value. Credit unions must classify mutual funds having readily determinable fair values as either trading (if purchased with the intent of sale in the near term) or available-for-sale (if other than trading.) They cannot classify mutual funds as held-to-maturity (amortized cost) and should not carry mutual funds at the lower of cost or market, but at fair value, adjusted through income (if trading) or through equity (if available-for-sale.)

Common trust fund. A common trust fund is a collective investment fund maintained by a national bank (12 CFR Part 9.) A common trust fund that complies with Office of the Comptroller of the Currency (OCC) regulations limiting investments generally to short-term instruments is called a short-term investment fund ("STIF.")

OCC regulations requires disclosure of the value of a credit union's pro-rata interest in a common trust fund at least once every three months if the fund's assets are readily marketable. However, investors may contract for more frequent valuations. OCC regulations allows for STIFs valuation on a cost basis.

Legality of Fund

Credit unions must implement adequate procedures for determining each fund's legality. The examiner should review the following:

- The credit union's procedures:
 - To ensure they meet the needs of the credit union;
 - To ascertain that staff reconciles the book balances with the statement of account each month; and
 - To determine that the records are in balance; and

- The prospectus for each mutual fund investment:
 - To determine the investment's permissibility (i.e., that the fund invests or is authorized to invest only in investments permitted by the *FCU Act* and *NCUA Rules and Regulations*), and
 - The investment meets other requirements.

A number of mutual funds sometimes use hedging strategies to increase yield. Federal credit unions may not, however, use common techniques such as writing call options and futures contracts. Fund managers' use of such techniques would make the fund illegal.

**Character-
istics and
Risks**

The examiner should determine that management understands the nature of the investment in mutual funds. While a mutual fund investment has the same maturity as the weighted average maturity of the underlying investments, the NCUA 5300 (call report) and AIREs permit classification based on the maximum weighted average life disclosed in the prospectus. If the prospectus does not disclose the weighted average life, the credit union may use the three to ten year column. Examiners should take exception if the credit union does not adhere to its investment policies and internal asset-liability strategy regarding these investments.

Yield enhancement often motivates investment in long-term instruments, particularly in times of falling short-term rates. Examiners should explain to the officials the unsoundness of this practice unless the maturities and other characteristics of the investments coincide with the credit union's asset-liability strategy and liquidity expectations.

Investments in mutual funds can lose principal; therefore, examiners should ensure that the officials understand the risks and adopt limits by investment type that consider both the credit union's capital structure and asset size. Significant variance of mutual funds' net asset values over a range of interest rate environments may necessitate establishment of minimal stop-loss guidelines. An adequate monitoring system should minimize future investment losses.

Examiners should also determine that management considered the mutual fund's suitability from an asset-liability standpoint. For

example, several of the mutual fund net asset values may move inversely to market interest rate changes or may significantly lag the market. Credit unions with short-term and highly interest rate-sensitive share bases may find investments in mutual funds inappropriate.

Fees

Examiners should watch for marketing techniques that do not give a complete and accurate picture of a mutual fund. Even though the SEC requires certain disclosures, a credit union may incur significant costs to obtain, maintain, or divest an investment in a fund:

- Credit unions may incur front-end and back-end load fees, which are, in essence, sales commissions. The credit union must pay front-end load fees at the time of purchase. It pays back-end load fees if it redeems shares before holding periods specified in the prospectus.
- Credit unions may incur management and "12(b)-1" fees (back-end fees), which the mutual fund assesses shareholders for some of the promotional expenses. The mutual fund must specifically register the fee with the SEC and must disclose the levying of such charges. Such fees can reduce the actual return by 100 basis points or more.

Complex issues arise over the appropriateness and suitability of investments in mutual funds or other long-term investments. Management varies significantly in its understanding of these issues and in the sophistication of investment practices. Examiners should consult with their supervisory examiners if problems exist.

**Unit
Investment
Trusts**

A closed-end investment company called a Unit Investment Trust (UIT) repays principal and interest monthly as the underlying securities are repaid. At the trust's maturity date, UIT managers sell underlying investments, and return funds to investors. The cash flow from a UIT investment often resembles both a direct purchase of a GNMA and a mutual fund.

The examiner should determine the credit union properly reduces its investment balance and records interest income in a manner similar to

a direct GNMA purchase. However, the “units” represent ownership, not the Agency obligation. Therefore, the fair value approach must account for the value of the investment. The UIT’s market price determines its value; the closed-end investment company does not redeem UITs.

CUSOs

NCUA Rules and Regulations §712.2 specifies that a federal credit union may invest in shares, stocks or obligations of credit union service organizations (CUSOs) in amounts not exceeding, in the aggregate, one percent of the credit union’s paid-in and unimpaired capital and surplus (total of all shares and undivided earnings plus net income or minus net losses to date) as of its last calendar year-end financial report. The same section authorizes credit unions to make loans to CUSOs in amounts not exceeding, in the aggregate, one percent of its paid-in and unimpaired capital and surplus as of its last year-end financial report.

Credit unions frequently establish CUSOs to provide additional services to members or to other credit unions. Poorly structured or poorly managed CUSOs can become expensive liabilities and harm the credit union's financial condition. Therefore, during the examination, examiners may review the credit union’s investment in CUSOs. The CUSO chapter discusses examination procedures for CUSOs.

For purposes of measuring a credit union’s investment in and loans to a CUSO in financial statements, credit unions must follow generally accepted accounting principles (GAAP.) GAAP requires one of three measurement options (cost method, equity method, or consolidated financial statements) depending on the degree of ownership a credit union has in a CUSO.

Federal Funds

Federal funds are the excess reserves one bank has available to lend to another bank enabling it to meet its cash reserve requirements. Federal funds usually have a maturity of only one business day, although credit unions may negotiate term federal funds for a longer period. The federal funds rate represents the rate that the lending banks charge the borrowing banks for the use of the funds.

Compared to other money market rates, the federal funds rate is volatile. Investors closely watch the funds rate as an indicator of the money market, monetary policy, and general economic conditions because the federal funds market operates at the center of the money market and the commercial bank system.

§703.100 authorizes the sale of federal funds to any financial institution defined in §107(8) of the *FCU Act* under the deposit authority contained in that section.

Credit Risk

Federal funds are not insured; therefore, the credit union must review the bank's financial condition and set appropriate policy limits. The policy must address how the credit union will manage the credit risk of federal funds sold. (See §703.30(e)).

Besides selling Federal funds to a bank, a credit union can purchase Federal funds from the bank. Purchasing of funds constitutes a borrowing transaction by the credit union subject to the borrowing limitations of §107(9) of the *FCU Act*.

The examiner should pay particular attention to the method the credit union uses to transfer funds and record funds' transfers, especially the related income or expense. The examiner should review internal control procedures for placing funds, recording transactions, and reconciling transactions to the confirmation or statement.

**Corporate
Credit Unions**

§107(7)(G) of the *FCU Act* authorizes credit unions to invest in shares, deposits, and certificates in corporate credit unions. However, credit unions may not invest in a corporate credit union that does not operate in compliance with Part 704 of the *NCUA Rules and Regulations*.

As with its other investments, NCUA expects management to establish a process for evaluating the corporate's investments and operations, and to incorporate the amounts and maturities of all authorized investments in corporates into their written investment policies.

Corporate credit unions offer daily balance share accounts that earn dividends comparable to market rates offered by other financial

institutions. Many credit unions use this account for short-term investing because of the daily dividend feature. Most corporates also offer accounts for clearing share drafts, ATM transactions, money orders, ACH items, and credit card activity.

Corporate credit unions may offer two capital accounts, which NCUSIF does not insure: membership capital (MC) and paid-in capital (PIC), both member and nonmember. Both accounts have a degree of permanence. MCs have a minimum withdrawal notice of three years. PICs are callable at the corporate's option and have an initial maturity of at least twenty years. Credit unions must accept the risk of these uninsured accounts; therefore, credit unions investing in these accounts must perform the same due diligence as they perform for other at risk investments. Examiners should review the due diligence procedures.

Credit unions have available more diverse investment products, including those offered by corporates. In addition to daily balance share accounts and certificates accounts, some corporates offer structured investment products that mimic CMOs and other complex investments. The examiner should determine that the credit union consistently adheres to its ALM structure when investing in corporate credit union investments, as well as other investments. Examiners should also assure themselves that the directors and management understand the risks of the investment instruments.

Most corporate credit unions issue monthly or even weekly statements. The voluminous activity in these clearing accounts may require the examiner to determine that the credit union fully reconciles all transaction accounts at least monthly, regardless of the month-end balance. Examiners should note the lack of prompt reconcilements or continually carrying over outstanding items from one month to the next as an area of concern. The credit union can lose control over these high activity accounts if it does not implement adequate reconciliation procedures.

Most corporates also offer high-yielding, short-term CDs (30 days.) Many credit unions continuously roll over these accounts or purchase new ones. Corporates have reduced the paperwork burden by using electronic transfers instead of paper certificates; however, credit unions must reconcile their CD activity.

Other Credit Unions

§107(7)(H) of the *FCU Act* authorizes credit unions to invest in shares, deposits and certificates of federally insured credit unions. As with other institutional accounts, the examiner may find it necessary to review the credit union's process for evaluating the credit risk associated with such investments.

Other Shares, Deposits, and Certificates

§§107(7)(D) and 107(8) of the *FCU Act* authorize credit unions to invest in shares, deposits, and certificates in financial institutions other than credit unions.

Thrift Shares and Bank Deposits

Credit unions may invest in passbooks, certificates, or book entry confirmation receipts issued by federally insured thrifts, building and loan associations, and banks (and non-federally insured banks located in the state in which the credit union does business.) Credit unions must retain documentation of these investments.

§703.30 gives the board responsibility for determining the amount and the specific institutions in which a credit union may invest. If the credit union invests over the insured limit, the board should specify limits on the amounts the credit union may invest with each institution. Management often supports the limits with a credit evaluation that identifies specific financial criteria, such as capital requirements and earnings trends. Credit unions with large CD portfolios should obtain the institution's docket number (FDIC's equivalent to NCUA's charter number) to determine compliance with the credit union's exposure limit at each institution. FDIC's website (www.fdic.gov) can provide the docket number.

Credit unions, the officials, or employees sometimes receive cash bonuses or merchandise premiums from the institution for new investments or increases in investments. §703.120 prohibits credit union officials from accepting these bonuses or premiums on their own behalf. If examiners suspect the credit union earned a bonus dividend or premium but find no accounting for it, they should notify their supervisory examiner, send a positive confirmation letter to the institution concerned, and report the facts in the confidential section.

**Time
Certificates of
Deposit**

Credit unions may purchase either negotiable or non-negotiable time certificates of deposit (CDs.) If purchased from the issuing institution, the credit union normally contacts and negotiates with the institution and then transfers the funds directly. If the credit union uses a broker-dealer for CD purchases, it should reasonably protect itself against potential loss. These steps include entering into a written contract, dealing with reputable broker-dealers, evaluating the risk, and using a custodial agreement.

A large pool of funds, which the broker-dealer invests in a single block at a federally insured institution, could include the CD purchased. If so, a custodian normally holds the investment and the credit union should receive a depository receipt from the third-party custodian evidencing ownership. The insured institution should also document the fiduciary relationship between the broker-dealer and the issuer, and evidence insurability for individual investors of the pool. Part 330 of Title 12 of the Code of Federal Regulations outlines requirements for FDIC insurance in "pass-through" situations.

Credit unions should fully address and document insurability in pooling arrangements. They should not depend solely on the broker to analyze the soundness and insurability of issuing institutions, nor should they rely on the deposit insurance coverage as the only basis for the deposit.

Written investment policies should address criteria and the financial analysis necessary to ensure sound investment practices. If federal deposit insurance does not cover all, or a portion, of a deposit, the credit union should analyze the credit quality of the institution before making the deposit. Management may contract with a rating service to assist with this analysis.

Negotiable CDs. Federal credit unions may sell negotiable CDs to third parties before maturity, subject to the appropriate regulations governing the issuing institution. Conversely, a credit union could purchase a CD of an eligible institution in the secondary market. If the credit union purchased the CD at a premium (e.g., the purchase price exceeded the original (or accredited) issuer price), federal deposit insurance does not cover the amount of the premium. Thus, any

premium remaining on the credit union's books of an institution that failed before the CD's maturity date may require write off.

Loss of premium also could occur with longer-term investments (e.g., zero coupon CDs) that some credit unions purchased in the secondary market at a significant premium. The credit unions would also face reinvestment risks.

A credit union does not need to physically hold even a negotiable CD for safekeeping. However, a security dealer holding negotiable CDs or "bearer" securities poses risks:

- The security dealer can wrongfully transfer the instruments to a third party. A third party purchasing these instruments for value, in good faith, and without notice of any adverse claim, becomes a "bona fide purchaser" under the Uniform Commercial Code and can retain possession of the instruments.
- The security dealer could declare bankruptcy or insolvency. The credit union could "trace" and claim its securities or CDs by proving ownership of specific instruments. However, negotiable CDs registered in street name, rather than in the credit union's name, makes recourse more difficult, if not impossible. The key here is for the officials to (1) know their safekeeping custodian, (2) document the financial standing of the safekeeping custodian, and (3) ensure proper recordkeeping by reconciling monthly safekeeping reports.
- If the credit union experiences the loss of a negotiable CD or security due to a dealer's misappropriation or bankruptcy, surety will most likely not reimburse for the loss because surety does not consider the security dealer to be a credit union employee.

Credit unions should balance these risks against the advantages of having a security dealer hold negotiable CDs and securities in bearer form for safekeeping; namely, the credit union will have liquid investments that they can immediately redeem.

Deposit Notes Credit unions may invest in deposit note issues by a §107(8) institution (e.g., a national bank.) Deposit notes are unsecured obligations of §107(8) institutions. Federal deposit insurance (to \$100,000) covers a deposit note if the following exist:

- The bank, instrument, or offering circular states that the obligation is a deposit;
- The bank's call report reports it as a deposit; and
- The bank pays the FDIC insurance premium.

The issuing bank should state in writing the eligibility requirements in an offering circular or contract.

Bank Notes A bank note is an unsecured and uninsured obligation of the issuing bank. Credit unions may invest in bank notes issued by §107(8) institutions with maturities less than five years. (NCUA's Office of General Counsel has deemed them permissible as deposits under Regulation D.) However, credit unions may not invest in debt obligations of a bank holding company.

The credit union should closely review and document the financial status of the issuer of any bank note and any deposit note with an uninsured portion. As with CDs, a broker-dealer may invest a pool of funds in a §107(8) institution's deposit note. The risks previously specified for CD pooling apply equally to deposit notes.

Eurodollar Deposits A Eurodollar deposit is a dollar-denominated deposit in either a foreign branch or a foreign subsidiary of a United States bank, or in a foreign bank located outside the United States. Credit unions may invest only in foreign branches of parent U.S. depository institutions and only if the parent U.S. depository institution meets the requirements of §107(8) of the *FCU Act*. Federal deposit insurance does not cover Eurodollar certificate of deposits.

Yankee Deposits A Yankee Dollar deposit is a dollar-denominated deposit in a United States branch or subsidiary of a foreign financial institution. Credit unions may invest in these institutions pursuant to §107(8) of the *FCU*

Act if the branch or subsidiary has federal deposit insurance or operates in accordance with the laws of a state in which the federal credit union does business.

**Bankers'
Acceptances**

Federal deposit insurance does not cover time drafts drawn on a bank called bankers' acceptances. §703.100 authorizes investments in bankers' acceptances issued by §107(8) institutions. Bankers' acceptances represent irrevocable obligations of the bank that arise in a variety of ways, but generally, corporate customers of the bank use them initially to "pay" for goods and services. Often, recipients of banker's acceptances discount and trade them as money market instruments.

**Mutual
Savings
Banks, State
Banks, Trust
Companies**

Credit unions may make deposits or investments in shares or accounts of mutual savings banks, state banks and trust companies located in the state in which the credit union does business, or in financial institutions insured by the FDIC. Financial institutions located in the state where the credit union does business qualify as depositories even though they do not carry federal deposit insurance.

The credit union's board of directors must accept responsibility for selecting the mutual savings banks, state banks, and trust companies, and for determining the amount they will invest in each. Examiners may decide to discuss the advantages of placing funds in insured institutions. However, they should not take exception if the credit union invests in non-insured institutions in the state where the credit union does business, assuming that reasonable limits as to the amounts invested with each institution govern these investments. As with other uninsured investments, the credit union must fully analyze the credit quality of the institution. (See, §703.30(e)).

**Loans to
Other Credit
Unions**

Credit unions record loans to nonmember credit unions separately from loans made to their members. They must comply with the limitations and restrictions (not to exceed 25 percent of paid-in and unimpaired capital and surplus) set forth in §107(7) of the *FCU Act*.

The board, the executive committee, or the credit union's investment committee must properly authorize loans to nonmember credit unions. The aggregate of these loans may not exceed the legal limit, and a signed note must evidence the loan ((§107(7) of the *FCU Act*.) When the credit union has not met these requirements, the examiner should inform the officials, reach appropriate agreements, and comment in the examination report.

**State and
Municipal
Obligations**

Credit unions may invest in state and municipal securities authorized in §107(7)(k) of the *FCU Act*. Most municipal (muni) bonds receive a credit rating from a rating service (a nationally recognized statistical rating organization.) *NCUA Rules and Regulations* §703.100(f) permits investment only in those muni bonds rated in the top four ratings categories (e.g., BBB, A, AA, or AAA.) When evaluating credit risk, examiners should review bond ratings assigned to munis in the portfolio. Further, §107(7)(k) limits obligations of any one issuer, except general obligations of the issuer, to no greater than 10 percent of the credit union's unimpaired capital and surplus. This means revenue bonds, even when insured, are subject to the percent limit.

States and municipalities generally issue their obligations at lower interest rates because of the unique tax advantage to security holders. Since credit unions do not pay income taxes, there is no offset to the lower yield and, therefore, no financial advantage to investing in these tax-exempt securities. Taxable revenue bonds have no tax exemption, but generally carry greater credit risk than do general obligation bonds.

**Repurchase
Transactions**

In a repurchase transaction the credit union agrees to purchase a security from a counterparty and to resell the same or an identical security to that counterparty at a specified future date and at a specified price. §703.100(i) authorizes credit unions to enter into repurchase transactions within the following limitations:

- The repurchase securities consist of permissible investments for a federal credit union;
- The credit union receives a daily assessment of the market value of the repurchase securities, including accrued interest, and maintains

an adequate margin that reflects a risk assessment of the repurchase securities and the term of the transaction; and

- The credit union has entered into signed contracts with all approved counter parties.

The examiner may review the credit union's file to determine that it contains a written custodial agreement as well as copies of the safekeeping receipts. The Federal Reserve Book Entry System could record the credit union as the owner of the security. As with physical securities, third-party control further minimizes custodial risks.

The credit union entering into the repurchase transaction usually requires collateral with a security value in excess of the amount of cash delivered, an amount often called the "haircut." For example, for \$1,000,000 in cash, the credit union may require securities valued at \$1,020,000 to collateralize the transaction. This "haircut" generally ranges from two to five percent and protects the cash participant's collateral position if fair values change. The credit union must monitor the collateral's market value. If the value decreases relative to the cash outstanding, the credit union should request a margin call and require the securities lender to provide additional collateral. Responsibility for repaying the funds ultimately rests with the counter party to the transaction, making that party's reputation (ability to pay) important to others in the transaction. FDIC insurance does not cover repurchase agreements and a secondary market for repurchase agreements does not exist.

**Commitments
to Purchase
or Sell
Securities**

Under §703.100, credit unions may not invest in forward commitments to purchase or sell a security. Commitments to purchase or sell securities (forward commitments) represent contingent liabilities.

§703.100 permits the purchase or sale of a security as long as the delivery of the security is by regular-way settlement. Regular-way settlement means delivery of a security from a seller to a buyer within the time frame that the securities industry has established for that type of security.

For example, regular-way settlement of mortgage-backed securities occurs once a month according to a schedule of The Bond Market Association (PSA) settlement dates. While a regular-way settlement in a mortgage-backed security transaction is pending, the credit union should account for the transaction in accordance with GAAP.

**Standby
Commitment**

Generally, a standby commitment consists of an agreement to purchase or sell a security at a future date, whereby the purchaser must accept delivery of the security at the seller's option. To induce the purchaser to buy at the seller's option, the seller pays a non-refundable option premium called a "commitment fee." If the market price of the security on settlement date has increased, the seller would not exercise the option, but would sell the security elsewhere. The purchaser would then recognize the commitment fee as income.

Examiners should review documentation required by §701.21(i) for long positions in financial put option contracts. §703.110(a) prohibits all financial derivatives, except as provided under §701.21(i) for the purchase of certain financial put option contracts (also called standby commitments) to manage risk of loss through a decrease in value of its commitments to originate real estate loans.

**Cash Forward
Agreement**

A cash forward agreement represents a firm commitment for a purchaser to buy and a seller to sell an agreed-upon security on a specified settlement date. A commitment fee does not pass from the seller to the purchaser. A cash forward agreement extends beyond the term of a regular-way settlement; therefore, a federal credit union may not enter into a cash forward agreement for a security.

Short Sale

A short sale is a forward commitment to sell a security that the seller does not own. Short sales sellers speculate that market prices will decline before the settlement date. Thus, they can purchase a less expensive security to meet the commitment to sell and realize a gain. If, however, the market price increases, the seller incurs a loss in meeting the commitment. §703.110 prohibits a federal credit union from engaging in short sales.

Pair-Off Transactions

A pair-off transaction matches or nets the commitments to purchase and to sell securities. Participants in pair-off transactions often do not take delivery of the security purchased, but speculate that the market price will increase before settlement date resulting in a gain from its sale. Many times, participants make the commitment to sell and the commitment to purchase on the same day. §703.100(1) specifies requirements for a credit union to trade securities including when-issued trading and pair-off transactions. Credit unions must record these transactions at fair value on the trade date.

Reverse Repurchase Transactions

A reverse repurchase transaction (reverse repo) is a transaction by a credit union in which the credit union agrees to sell a security to a counter party and to repurchase the same or an identical security from that counter party at a specified future date and at a specified price. In effect, the credit union incurs a borrowing collateralized by a marketable security.

Credit unions may use funds generated by a reverse repo to (1) meet liquidity needs, such as share or loan demands, or (2) purchase other securities with a yield higher than the borrowing rate of the reverse repo (often called a spread trade or “arbitrage.”) When engaging in the latter, the credit union must comply with statutory limitations. Any security purchased with the funds obtained from the transaction or the securities collateralizing the transaction must have a maturity date not later than the maturity date for the reverse repo transaction and be permissible investments under Part 703. A reverse repo transaction is a borrowing transaction subject to the aggregate borrowing limit of 50 percent of a credit union's unimpaired capital and surplus specified in §107(9) of the *FCU Act*.

Example: A credit union owns a \$1,000,000 Treasury security with a 7 percent coupon rate, valued at par. The credit union enters into a reverse repo, borrowing \$1 million, collateralized by the Treasury security, at 5.5 percent for 90 days. The credit union also purchases a 90-day time certificate paying 6.0 percent, also maturing in 90 days. Thus, the credit union earns a 0.5 percent spread (the difference between the cost of the funds borrowed, 5.5 percent, and the income earned, 6.0 percent.)

If the examiner finds a credit union entering into reverse repo transactions with the intent of earning a positive spread by reinvesting

the funds, the examiner should determine if the credit union actually realizes a positive earnings spread.

The credit union must retain signed contracts with all approved counter parties. Examiners should encourage master contracts (i.e., The Bond Market Association (formerly called PSA) Agreements) covering the dates and responsibilities of each party. Confirmations under the master contract constitute evidence of individual reverse repo transactions. A trade sheet, rather than written agreements between a broker and the credit union, does not constitute acceptable evidence.

Since reverse repos represent borrowings by the credit union, credit unions must record them as notes payable and the board of directors or executive committee should approve them. The investment committee cannot authorize borrowing through a reverse repo.

The credit union must properly record reverse repos, the income applicable to the related investment, and the interest on the notes payable. GAAP provides guidance on the proper accounting treatment for repurchase transactions (SFAS No. 125 and 140.)

For examination analysis and CAMEL-rating purposes, examiners must use GAAP determined total assets. Examiners should note that the existence of reverse repos can (1) cause material changes in the asset size of the credit union, (2) affect any ratio that uses average assets or total assets, and (3) distort the trends and ratios of the most recent Financial Performance Report (FPR.)

During the period (usually a short duration of 90 to 120 days) of spread transactions, reverse repos will increase total assets by the committed amount. The investment, which may be material, remains on the credit union's books while, at the same time, the credit union establishes a notes payable account and an asset account for the amount of the transaction. At the end of the transaction term, the credit union will reduce the liability account and the asset account accordingly, while the investment account remains unchanged.

As an alternative, credit unions may engage in securities lending transactions (i.e., "bonds borrowed" agreements.) These generally

consist of very short-term lending activities in which the credit union releases control of investment grade securities in exchange for a promise for repayment, and receives a fee for the related risks. In some cases, the credit union must record a securities lending transaction in its financial statement, similar to a reverse repurchase transaction, as a notes receivable and a securities lending (“bonds borrowed”) credit. The examiner should ensure that the credit union adequately discloses any securities lending (“bonds borrowed”) transactions. In addition, credit union officials should review the borrower's financial condition.

Adjusted Trading

§703.110(b) prohibits credit unions from engaging in adjusted trading. Adjusted trading also may violate applicable statutory provisions because it does not (1) meet "full and fair disclosure" requirements, (2) record losses in a timely manner, or (3) fairly present the financial condition to members, creditors, and the regulator.

When reviewing investments, the examiner should look for indications that the credit union purchased or sold securities at other than “at market” prices, which could evidence adjusted trading. The examiner should test several purchases or sales if indications exist that a security transaction was not at market. Examiners can verify sales prices using the *Wall Street Journal* or another reliable paper as of the sales date, or by contacting a broker-dealer.

The examiner should analyze problems noted. In the past, problems in adjusted trading occurred with broker-dealers who were not regional or who did not have a reputation for knowing their customers.

The two most common methods of adjusted trading are:

- **Adjusted trading or overtrading.** When market prices decline, credit unions may face investment losses if (1) they must sell their securities or (2) must meet commitments to purchase securities without having available funds to do so. To avoid these losses, a credit union might enter into an agreement with its broker to transfer or to hide the loss in another transaction. Such an adjusted trade violates *NCUA Rules and Regulations*.

Example: The credit union owns Investment A with a book value of 97 and a market value of 95. The broker owns Investment B with a fair value of 91. Needing funds, the credit union decides to sell Security A, but does not wish to incur the loss of two points. The broker agrees to purchase the investment at book value; however, in return, the credit union agrees to purchase Security B using a forward commitment for 93; or two points over market. The credit union is speculating that the fair value of Security B will increase by the settlement date. If that happened, the credit union would sustain no loss and would not record the transaction.

- **Fee trading.** Fee trading, or reposition trading, represents a form of adjusted trading. Fee trading uses similar mechanics except the credit union pays a fee or "up front" money to the broker. Using the example above, the broker would purchase Security A at 97, but would require the credit union to forward a two-point fee. The fee ensures the credit union's purchase of Security B on settlement date. When the credit union purchases Security B, the broker returns the fee.

If the investment review discloses possible adjusted trading, the examiner should contact the supervisory examiner. In any case, the examiner should exercise additional scrutiny should there appear to be indications of adjusted trading.

Impermissible or Unsuitable Investments

The examiner may find that a credit union has investments not permitted by statutes or regulations. Examples include investments in commercial paper, a stock-based mutual fund, or loans to other credit unions in excess of the legal limit. The credit union should liquidate the investments as soon as possible. If the divestiture most likely will result in a material loss, the examiner should consider the investment's maturity and safety, as well as its effect on the credit union's financial condition. When examiners find impermissible investments, they should contact their supervisory examiner. Credit unions must also notify the surety company of the illegal investment.

In most cases, the examiner and officials can resolve the problem during the examination. If not, the examiner should address it with the officials and, if material, in the examination report. Examiners should reserve administrative action only for extreme cases where other supervisory efforts fail.

If the examiner determines that the credit union holds permissible, but not suitable, investments for the credit union's balance sheet, the examiner should contact the supervisory examiner before requiring the write-down or sale of the investments.

Investment Trading

The goal of trading securities is to take short-term trading profits from an increase in fair value. Investors may earn sizable trading gains as interest rates decline; however, rate increases typically result in losses.

NCUA Rules and Regulations §703.30(k) sets forth policy requirements and §703.100(l) sets forth other requirements for a federal credit union to trade securities. Credit unions should know the market risks associated with trading, and adopt policies and procedures to limit risk to an acceptable level. The board of directors must approve a written trading security policy that includes, at a minimum, the provisions listed in this section. Credit unions must maintain consistency with GAAP guidance in accounting for trading securities.

The examiner should review the credit union's investment activity and determine if the credit union is trading. This analysis should include a review of the following:

- The broker's monthly statement to determine proper booking of all activity;
- The month-end safekeeping statement and transaction reports;
- The source documents, such as the broker confirmations, to adequately analyze trading activity; and
- The cash and corporate credit union account transactions to determine the existence of large security purchases or sales.

Credit unions involved in trading must have adequate reserves to absorb potential trading losses and should establish loss parameters based on the level of reserves. If unsafe and unsound trading policies or procedures exist, the examiner should consult with the supervisory examiner to develop a plan for resolving the problems.

Before a credit union's board engages in trading securities, they must develop and adopt a written securities trading policy that at a minimum specifies the following:

- Internal controls, including appropriate segregation of duties;
- Individuals who have purchase and sale authority;
- Trading account size limits;
- Allocation of credit union's cash flow to trading accounts;
- Stop loss or sale provisions;
- Dollar limits for the purchasing of specific types, quantities, and maturities;
- Limits on the length of time an investment may remain in the trading account;
- Monthly reports for the board of all purchase and sale transactions, and the resulting individual transaction gain or loss (credit unions should report purchases and sales to trade date); and
- A requirement for recording at fair value on the trade date any security purchased for trading purposes.

See the Classification of Securities SFAS 115 section for transfers to or from the trading category.

**Workpapers
and
References**

- Workpapers
 - Critical Input tab
 - Statement of Income
 - Review Considerations
 - ALM Tab
 - Solvency Evaluation
 - Investment Trend
 - Investment Maturity
 - Investment Classification
 - Investment Controls Questionnaire
 - Credit Union Service Organization Controls Questionnaire
 - Certificate Review
 - Amortizing Investment
- References
 - *Federal Credit Union Act*
 - §§§107(7), 107(8), 107(9), and 107(15) - Powers
 - §§304 and 305, Central Liquidity Facility

- *NCUA Rules and Regulations*
 - §701.21(i), Put Options in Managing Increased Interest-Rate Risk for Real Estate Loans Produced for Sale on the Secondary Market
 - §712, Credit Union Service Organizations
 - Part 703 - Investment and Deposit Activities
 - Part 725 - Central Liquidity Facility
- *Federal Credit Union Bylaws*
- Accounting Bulletin 94-1
- SFAS 107
- SFAS 115
- SFAS 125
- SFAS 133
- SFAS 140 - Administrator's Letter No. 29, dated 4/17/79; Custodial/Safekeeping Accounts
- NCUA Letter No. 57, dated 6/24/81, Investment Risk
- NCUA Letter No. 79, dated 5/29/85, Mutual Funds
- NCUA Letter No. 130, dated February 1992, Risks of Long-Term Investments - Mortgage Derivative Products
- NCUA Letter No. 139, dated September 1992, Collateralized Mortgage Obligations
- NCUA Letter No. 146, dated August 1993, New Investment Products
- NCUA Letter No. 155, dated April 1994, Permissible Investments for Mutual Funds
- NCUA Letter No. 157, dated September 1994, Broker Selection, Security Safekeeping
- NCUA Letter No. 169, dated April 1995, Divestiture of CMOs and REMICs
- NCUA Letter No. 00-CU-05, dated September 2000, Investments in Brokered Certificates of Deposits
- IRPS 98-02, dated 1998, Supervisory Policy Statement on Securities Activities and End-User Derivatives Activities
- NCUA Investment Report No. 1, dated 1/31/89, Mortgage Pass-Through Securities
- NCUA Investment Report No. 2, dated 4/10/89, Broker Selection
- NCUA Investment Report No. 3, dated 7/19/89, Collateralized Mortgage Obligations (CMOs)

- NCUA Investment Report No. 4, dated 12/1/89, Stripped Mortgage-Backed Securities
- NCUA Investment Report No. 5, dated 4/1/90, Short-Term Investments for Federal Credit Unions
- NCUA Investment Report No. 6, dated 9/1/90, Treasury-Backed Stripped Securities
- NCUA Investment Report No. 7, dated February 1991, Deposit Notes
- NCUA Investment Report No. 8, dated July 1992, The New Investment Regulation
- NCUA Investment Hotline - 1-800-755-5999 (703-518-6620 Washington, DC area)
- Investment Guidance Paper(s), Developed by OSPSP and RCMS Staff
- Using the Regional Investment Specialist, dated February 1999

GLOSSARY OF INVESTMENT TERMS - APPENDIX 12A

This section contains definitions of financial terms commonly used in investments and asset-liability management. Standard dictionaries do not contain the definitions of many words and phrases used throughout the investment industry; therefore, this glossary was compiled to assist the examiner in understanding specialized industry-specific words.

Accretion of a Discount: the accounting recognition of earnings on a discount bond in anticipation of receipt of par at maturity.

Accrued Interest: the amount of coupon interest accumulated on a security between coupon payment dates, or between issuance and the first coupon payment date. The purchaser of the bond pays to the seller the market price plus accrued interest. Accrued interest is calculated using the accrued interest (day count) type for the security.

Accrued Interest Types: the day count used to calculate the accrued interest and the coupon period. A day count type is displayed as DD/YYY, where DD denotes the number of days per month elapsed in the coupon period and YYY denotes the number of days per year (for calculating the coupon period). The day count does not include the settlement day. Common day count types include:

- ACT/ACT: actual days for month and year (365 or 366 days).
- 30/ACT: each month has 30 days and the year has 365 or 366 days.
- 30/360: each month contains 30 days and a year has 360 days.
- 30/365: each month has 30 days and a year has 365 days.

Actuals: the physical or cash commodity, as distinguished from a commodity futures contract or derivative contract which has a value based upon an underlying commodity or index. Forward contracts with an immediate delivery date are called spot contracts. Actuals are also called spot commodities or cash commodities.

Adjusted Trading: a prohibited method of deferring or hiding a loss on the sale of a security. Generally, a security is sold at its book value, which is above the market value, and another security is purchased (or a commitment is made to purchase another security) at a price that also is above the market value.

Advance Commitment (Conditional): a written promise to make an investment at some time in the future if specified conditions are met.

Agent: a person or firm authorized by another (called a principal) to act on his/her behalf. An agent in an investment transaction does not own the security, but instead, represents the employer's interests and is subject to control by the employer. Purchase confirmations should state whether the broker acted as agent (representing the credit union) or as principal (acting at arms length from the credit union). See "Principal".

Amortization: a reduction in an investment due to periodic payments of part of the principal before final maturity, usually made in accordance with a predetermined schedule of installment payments. Compare "Prepayment".

Arbitrage: the simultaneous purchase in one market and sale in another of an investment. The arbitrageur hopes to profit from the price differences between different markets. Arbitrage has been used in the credit union industry to describe a position in a security that is funded by a reverse repurchase agreement (see, "Carry", "Positive Carry", "Negative Carry"); however, there is price risk in such a position when the term of the borrowing is shorter than the maturity of the investment. There may also be credit risk in such a position if the investment is not issued or guaranteed by the U.S. Government.

Ask Price: the lowest declared price at which a seller is willing to sell a security at a particular time. Opposite of "Bid". Same as "Offer".

Asset-Backed Security (ABS): a security that is collateralized, typically, by loans, leases, unsecured receivables, or installment contracts on personal property. Asset-backed securities are not permissible investments for federally chartered natural person credit unions.

Assignment: the transfer of ownership of a right or a contract from one party, the assignor, to another, the assignee.

At-the-Money: describes an option when the current trading price of the underlying security is the same as the option's strike price.

At Market: the going bid price of a security at any given time.

Auction: a competitive process by which an issuer sells its securities, rather than selling at a negotiated, or non-competitive, price.

Auction Stop Out: the lowest or cheapest price (corresponding to the highest yield) at which securities are awarded in a multi-price auction. The Treasury Department has used one-price auctions for two- and five-year Treasury Notes, resulting in the award of securities to each winning bidder at the stop-out yield (the highest yield).

Average Life: the weighted average time to principal repayment. It is useful to describe the life of an instrument as an approximation of a single maturity.

Backup Bid: see "Take Out Bid".

Bad Delivery: a delivery of securities that does not fulfill the requirements for good delivery.

Bailment for Hire: a obsolete name used for a custodial (or safekeeping) agreement between a custodian (or safekeeping institution) and its customer (or the beneficial owner of the security).

Balloon: a final payment at maturity on a security (or loan) that is much greater than the previous payments. For example, a 7-year balloon loan is amortized on a 30-year schedule to make the payments affordable, but has a large payment of the remaining principal balance (balloon) due at the end of the 7 years. A balloon feature is usually associated with real estate loans and mortgage-backed securities.

Band: see "PAC" (Planned Amortization Class).

Banker's Acceptance: a time draft or bill of exchange accepted by a bank. It represents an irrevocable obligation of the accepting bank to guarantee payment of the draft at maturity at the face value. These instruments are uninsured and are sold at a discount from face value prior to maturity.

Bank Deposit: an account with a bank, including a checking, time, interest or savings account. Bank deposits with certain institutions are authorized in the Federal Credit Union Act. Some deposits are insured up to \$100,000, while other deposits are not insured. For example, Federal funds, banker's acceptances and certain bank notes have been determined by general counsel to be bank deposits under the FCU Act and thus to be permissible, but not insured, investments.

Bank Note: an unsecured and uninsured obligation of the issuing bank. General counsel has determined that bank notes with maturities less than five years are deposits under Regulation D and thus are permissible investments.

Basis: 1) a price expressed in terms of yield-to-maturity or annual rate of return, or a term to describe the yield to expected maturity, as in the expression "GNMAs are trading on a 9-1/2% basis" or a 10 percent bond selling at 100 has a 10 percent basis; 2) the difference between the spot or cash price of a commodity and the price of the nearest futures contract for the same or a related commodity, e.g., basis is usually computed in relation to the futures contract next to expire and may reflect different time periods, product forms, qualities, or locations; 3) used in the phrase "long the basis" or "short the basis" to indicate a cash market position hedged with a futures contract. See "Long the Basis" and "Short the Basis".

Basis Point: a measurement of yield for fixed income securities. One basis point equals 1/100 of one percent. For example, the difference between 8.00 percent and 8.25 percent is 25 basis points.

Basis Risk: 1) the risk that rates on assets and liabilities will react differently to changes in interest rates, e.g., the investment coupon linked to the Federal Home Loan Bank's 11th District Cost of Funds (COFI) will not be perfectly correlated with the funding rate offered on a money market share account tied to the overnight Federal fund rate; 2) the risk associated with an unexpected widening or narrowing of the difference in rates or prices between the time a hedge position is established and the time that it is lifted.

Beneficial Owner: the entity that is entitled to receive some or all of the benefits of ownership, including the cash flow, even though title to the security may be in another name, e.g., a nominee name. Title is frequently held in a name other than that of the beneficial owner for safety or convenience of transfer.

Bid Price: the highest declared price at which a buyer is willing to purchase a security at a particular time. Opposite of "Ask" or "Offer".

Bid and Asked: usually refers to the inside bid/ask quotation, i.e., the best bid and best offer in the market. From a single dealer, the bid/ask represents the prices at which the dealer stands ready to purchase and to sell, often referred to as making a two-way market quotation. See also "Quotation" and "Take Out Bid".

Bloomberg: an information vendor system that provides financial market information and performs various analyses of securities. There are a number of private companies or publications that provide a source of basic information and analytic detail about securities.

Board of Trade: an exchange or an association of persons, whether incorporated or unincorporated, that is engaged in the business of buying and selling any commodity or receiving the same for sale on consignment.

Bond: a certificate or evidence of a debt on which the issuer promises to pay a specified amount of interest and to repay the principal on the maturity date. Examples include Treasury bills (original maturity under one year), Treasury notes, Treasury bonds (original maturity over 15 years), agency debt, and mortgage backed securities.

Bond-Equivalent Yield: a comparable measure of the return over the life of a bond or Treasury bill or other discount instrument, assuming it is purchased at the ask price and the return is computed using a semi-annual interest formula and an actual-day year. Other rates of return cannot be compared directly with the bond-equivalent yield; e.g., a discount rate of return is calculated by using the par amount rather than the purchase price, by using another formula, and by using a 360-day year rather than an actual-day year. The Securities Industry Association has published standard securities calculation methods for fixed income securities formulas.

Book Entry Security: a security that is not represented by a physical certificate. The beneficial owner (or the custodian) of the security is recorded on an electronic system on which the terms and conditions of the security exists. The method of computerized entries eliminates the need for physical certificates. For example, the Treasury and certain government sponsored enterprises use a book-entry system maintained in computerized records at the Federal Reserve Banks in the names of member banks. A member bank, in turn, keeps records of securities held for 1) beneficial owners with whom it has a direct custodian agreement and 2) other custodians that hold as nominees for others that, in turn, maintain records of beneficial ownership or other custodians.

Book Entry Transfer: a system of custody and transfer of securities through the electronic delivery and settlement of transactions.

Book Value: the value at which a held-to-maturity security is shown on the holder's balance sheet. Book value may differ significantly from market value.

Broker: an entity that engages in securities transactions for the account of others. A broker does not buy and sell securities for its own account, as contrasted to a dealer that trades for its own account. A broker charges a commission for the service which it provides.

Broker-Dealer: an entity engaged in securities transactions for its own account and for the account of others. A broker-dealer may act as agent (broker) or principal (dealer). The purchase confirmation will state whether the broker-dealer acted as broker (agent) or dealer (principal) for the transaction.

Bullet Bond: a debt security that returns 100 percent of principal on the maturity date.

Call: 1) an option contract granting the buyer the right but not the obligation to purchase (call) a specified quantity of a security at a specified price (the exercise or strike price) and time (the exercise style). Typical option terms provide for exercise a) at any time until the stated expiration date of the contract (American exercise style), or b) only at the stated expiration date (European exercise style). Such an option is bought in the expectation of a price rise above the strike price. If the price rise occurs, the purchaser will exercise the option. If the rise does not occur, the purchaser will let the option expire and will lose the purchase price of the option, that is, the option premium. 2) an embedded call in a security grants the issuer the right to retire or "call away" all or part of the security at a specific price (the call price) and at a specific time prior to its contractual maturity date. The ability to call the security is an "option" that belongs to the issuer of the bond. Common call features include a) callable only on specific call dates, or b) continuous, that is, callable anytime, usually after a lockout period, which is a time period when a call cannot occur.

Call Date: the date or dates on which a security may be redeemed by the issuer at a pre-specified price.

Call Feature: a provision on a bond which entitles the issuer to redeem the bond at face value or other price before the maturity date.

Call Loan: a short-term loan of temporarily liquid funds by banks to securities dealers and brokers.

Cap: 1) an embedded option in a floating-rate security that places a rate ceiling (specifying the highest interest rate that will be paid) on the floating rate coupon. 2) a stand-alone option contract (usually written as a swap) that pays the holder of the cap an amount equal to the notional principal amount times the excess of the market rate over the cap rate. A cap usually consists of a strip of caplets (that is, a series of options with sequential expiration dates). Each caplet is an option on rates for a single period of time. 3) for risk management purposes, the quantitative limit placed on the position that a participant in a funds or securities transfer system can incur during the business day.

Carry: the interest cost of financing securities positions, calculated by subtracting the cost of funds borrowed to finance the securities from the interest earned on the securities.

Cash Commodity: see "Actuals".

Cash Flow: 1) the stream of principal and interest payments on a security. 2) the amount of cash derived over a certain measured period of time from the operation of income-producing property after debt services and operating expenses, but before depreciation.

Cash Forward Agreement: a cash transaction in which a buyer and seller agree upon delivery of a specified amount of a security at a specified future date. Also known as a firm commitment. See "Commitment".

Cash Market: traditionally, denotes the market in which commodities are traded, for immediate delivery, against cash. The cash market in which securities trade for

immediate delivery is contrasted with the futures markets in which securities trade for future delivery.

Cash Price: a price quotation obtained or a price actually received in a cash market. Same as "Spot Price".

Cash Settlement: 1) money market securities purchased for delivery on the same day the trade is made. 2) a method of settling an option contract whereby the seller pays the buyer a cash amount determined according to a procedure specified in the contract based on the cash value of the underlying instrument at expiration. Futures contracts also may specify cash settlement in lieu of physical delivery at maturity.

CATS (Certificate of Accrual on Treasury Securities): an obsolete form of zero coupon Treasury security. See "STRIPS".

Certificate of Deposit (CD): a time deposit issued by a bank that pays interest periodically or at maturity. While principal may be paid according to a schedule, typically principal is repaid in a single payment on the maturity date. "Brokered CDs" are marketed through a deposit broker to investors. By way of comparison, a "direct CD" is purchased from the issuing financial institution without the use of a deposit broker. A negotiable CD can be sold by the holder to another party in the market prior to maturity. In contrast, a non-negotiable CD cannot be transferred, but may be redeemed with the issuer subject to any interest penalty.

Cheap: Wall Street vernacular for the relative value of one security to another in terms of its historical price relationship. If a security is cheap, it is underpriced relative to another security. See also "Rich".

Chicago Board of Trade (CBOT): an exchange which is designated as a contract market in various commodity futures and option contracts. The CBOT introduced GNMA futures contracts in 1975 (no longer traded) and now is an active contract market for futures contracts in Treasury securities.

Churning: excessive purchases and sales by a broker in the accounts of one or more customers for the purpose of generating commissions while disregarding the interests of the customers.

Clean-up Call: the redemption of the remaining outstanding principal of an asset-backed security that is triggered by the reduction in outstanding principal through amortization or prepayment to a specified percentage of the original principal.

Clearing/Clearance: the process of transmitting, reconciling and in some cases confirming payment orders or security transfer instructions prior to settlement. Sometimes the terms are used to include settlement.

Clearing Corporation: 1) any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities, generally serving to centralize and reduce the number of settlements of securities transactions. Major clearing corporations for fixed income securities include the Government Securities Clearing Corporation and the Mortgage-Backed Securities Clearing Corporation. 2) a corporation organized to function as the clearing house for an exchange, that may interpose itself as the buyer to every seller and the seller to every buyer.

Clearing Member: a brokerage concern entitled to use the services of a clearing corporation.

Clearing Organization: usually a brokerage concern which clears the transactions of another brokerage concern.

Closed Position: forward or futures contracts which have been offset in full are considered "closed" because the obligations cancel each other out.

Closing Price: the price (or price range) at which transactions are made just before the end of trading on a given day. See also "Settlement Price".

Collar: 1) a maximum and a minimum interest rate on a floating rate bond. This is comprised of two embedded option positions: a short cap on rates and a long floor on rates. See "Embedded Option", "Cap", and "Floor". 2) a swap contract that eliminates the downside risk below the floor price (or rate) and eliminates the upside participation above the cap price (or rate). This is comprised of a long floor on price (or rate) and a short cap on price (or rate).

Collateral: an asset pledged to a lender until a loan is repaid. If the borrower defaults, the lender has the right to seize the collateral and sell it to pay off the loan.

Collateralized Mortgage Obligation (CMO): a bond that represents a partitioned ownership of a mortgage pool. CMOs are issued by a trust which holds mortgage-backed securities as collateral. The trust issues several different classes of CMOs, called tranches. Tranches have different maturities, coupons, and risks. A common CMO structure separates pools into short-, medium-, and long-term classes, which divides the ownership of the MBS pools into sequential-pay tranches; principal is paid to the class with the highest priority claim on principal payments (the short-term class, often called the A tranche) until all bonds of that priority have been redeemed; then, principal is paid to the next highest priority class (the medium-term class, often called the B tranche) until all bonds of that priority have been redeemed; finally, principal is paid to the long-term class (often called the C tranche). This structuring creates a series of bonds of distinct expected maturities. There are many different structures that specify complex cash flow priorities of principal and interest. A CMO is also referred to as a REMIC (Real Estate Mortgage Investment Conduit).

Commercial Mortgage-Related Security: a mortgage related security where the mortgages are secured by real estate upon which a commercial structure is located.

Commercial Paper: a short-term unsecured promissory note issued by a corporation for a maturity specified by the buyer.

Commitment: an agreement to buy or sell a security at a future date, subject to compliance with stated conditions. Applies to mortgage-backed securities. See "Cash Forward Agreement", "Standby Commitment", and "Take-Out Commitment".

Commitment Fee: see Fee.

Commodity Futures Trading Commission (CFTC): a federal regulatory agency charged and empowered under the Commodity Exchange Act with regulation of futures trading in all commodities.

Common Trust: a collective investment fund maintained by a national bank under 12 CFR part 9.

Competitive Bid: 1) bid tendered in a Treasury auction for a specific amount of securities at a specific yield or price. 2) bids solicited from one or more syndicates by issuers such as municipalities and public utilities for new issues.

Conditional Prepayment Rate (CPR): same as "Constant Prepayment Rate".

Confirmation: the document (or process) whereby a market participant notifies its customers of the details of a trade and, typically, allows time to affirm or to question the trade which had previously been agreed to verbally.

Connie Mac: a colloquial term for securities collateralized by pools of conventional mortgages. See "Conventional Loan".

Constant Maturity Treasury (CMT): a construct to obtain a bond equivalent yield for a fixed maturity. Yield curves on U.S. Treasury securities are constructed daily by the Treasury Department. The curves are fitted based on the closing market bid yields of actively traded Treasury securities. Values are read (or interpolated using cubic spline fitting) from the yield curve for constant remaining maturities of 1, 2, 3, 5, 7, 10, and 20 years. The yield for one and three year CMT's are often used as indexes for variable rate securities.

Constant Percent Prepayment (CPP): an infrequently used term that expresses single monthly mortality (SMM) on an annualized basis without correcting for the effects of compounding. CPP is SMM multiplied by 12.

Constant Prepayment Rate (CPR): a measure of the prepayment rate at which mortgage collateral is expected to prepay, expressed as an annual percentage of the remaining collateral. Sometimes called "Conditional Prepayment Rate". CPR reflects the result of compounding on SMM. If a constant percent of the outstanding balance prepays each month, the dollar amount prepaid declines over time. Using a 4 percent SMM, on a \$100,000 mortgage, \$4,000 ($\$100,000 \times .04$) would prepay in the first month, but only \$3,840 ($\$96,000 \times .04$) would prepay in the second month. In the first year the CPR would be 38.73 percent, i.e., $[1 - (1 - .04)^{12}]$ and the remaining mortgage balance at the end of the first year would be \$61,270, i.e., $[(1 - .3873) \times 100,000]$.

Contract: 1) a bilateral agreement between buyer and seller. 2) a term of reference describing a unit of trading for a commodity for future delivery.

Contract Grades: those grades of a commodity which have been officially approved by an exchange as deliverable in settlement of a futures contract.

Contract Market: a board of trade designated by the Commodity Futures Trading Commission as a contract market under the Commodity Exchange Act. Contract markets include: 1) a futures contract in a specified commodity or financial instrument; 2) an option contract on a specified commodity or financial instrument (also called an option on a physical); and 3) an option contract on a futures contract (also called a futures option).

Contract Month: the month in which delivery is to be made in accordance with a futures contract.

Convertible: 1) a feature of an adjustable rate mortgage that permits a change to a fixed rate mortgage. 2) a bond containing a provision that permits conversion to the issuer's common stock at some fixed exchange ratio.

Convexity: 1) a measure of the curvature of the relationship between the change in bond price and the change in interest rates. A bond or note is said to have positive convexity if the instrument's value increases at least as much as duration predicts when rates drop, and decreases less than duration predicts when rates rise. Positive convexity is desirable to investors because it makes a position more valuable after an interest rate change than suggested by a duration estimate. Negative convexity refers to a position that loses value relative to duration's prediction when prices change in either direction. 2) a colloquial term for the gamma of an option, which practitioners may refer to as curvature. Practitioners also may use interchangeably the terms selling convexity and selling volatility; these terms refer to the pick up in yield for selling the call options that are embedded in bonds such as MBS and callable GSE bonds.

Corporate Bond Equivalent Yield: an upward adjustment to reflect monthly payment of interest rather than semiannual payment of interest which is the convention in the Corporate and Government bond markets.

Correspondent: a mortgage banker who services mortgage loans as a representative or an agent for the mortgage owner or investor. Also applies to the mortgage banker's role as originator of mortgage loans for an investor.

Cost of Funds Index (COFI): an index that reflects the cost of funds for all thrift institutions as reported by the Federal Home Loan Banks. Cost of funds is defined as the annualized average interest paid or accrued on deposits, on FHLB advances and other borrowed money during a reporting period. The most common COFI is the Federal Home Loan Bank's 11th District COFI, which is compiled from savings banks in California, Arizona, and Nevada.

Counterparty: the opposite party to a financial transaction or contract.

Coupon: 1) the stated annual interest rate on a debt instrument that the issuer promises to pay periodically to the holder until maturity. See "Coupon Rate". 2) that portion of the physical security which shows the interest due on the payable date (usually semiannually). Physical securities may have detachable coupons that must be presented by the holder for payment.

Coupon Date: the date the interest payment is due to the owner of the investment.

Coupon Income: the income received from the coupon rate on owned securities.

Coupon Rate: the interest rate on a debt instrument, expressed as a percentage of face value, paid periodically by the issuer, e.g., a bond with a 6% coupon will pay \$6 per \$100 of face amount per year, usually in installments every six months. Not synonymous with yield. See "Rate of Interest".

Cover: purchasing to offset a short position. Same as "Short Covering". See "Offset", "Liquidation", "Evening Up".

Covered Call Writer: a seller of a call option who owns the underlying security on which the option is written.

Cover Value: the monetary amount necessary to buy-in a short position at the current market value.

Credit Enhancement: 1) the backing of a debt instrument with collateral, a bank LOC, or some other device to achieve a higher rating for the debt instrument than would be obtained based solely on the issuer's credit risk. 2) any structural component of a transaction that increases creditworthiness.

Credit Risk: the risk of default as reflected by the financial and operating risks of the issuer.

Cross Hedge: a hedge with two transactions in different, but related, securities, usually in different markets; e.g., a long position in US Treasury Bonds in the futures market and a short position in the GNMA forward market.

Current Coupon: a newly issued or to-be-announced mortgage-backed security selling at or close to par. Other new issues are referred to as discounts or premiums.

Current Issue: the most recently auctioned issue, usually in Treasury securities. Also referred to as an on-the-run issue. Trading is more active in current issues than in off-the-run issues.

Current Market Value: the closing price of a security as of the preceding business day.

Current Maturity: current time to maturity on an outstanding note, bond, or other money market instrument, e.g., a 5-year note one year after issue has a current maturity of four years.

Current Yield: coupon payments on a security as a percentage of the security's market price. The market price should be gross of accrued interest, particularly on instruments where no coupon is left to be paid until maturity. Often referred to as current return.

Custodial Agreement: a contract in which a custodian agrees to exercise ordinary care in safekeeping and administration of securities and financial instruments on behalf of others. Regulation 703 prohibits a contract with a standard of care less than ordinary. Modern term for Bailment for Hire.

Custodian: an individual or organization responsible for safeguarding and administration of securities and financial instruments on behalf of others.

CUSIP Number (Committee on Uniform Securities Identification Procedures): an identifying number assigned to a publicly-traded security. It is a nine-digit code (alpha-numeric) that uniquely identifies an issue.

Dealer: any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise. Such an individual or firm is acting as principal rather than as agent. The dealer typically does not charge a commission, but makes a profit from the difference between its purchase price and its sale price. A dealer is not required to disclose its cost basis. Therefore, each party to a trade should establish whether the contra party will receive dealer status. The dealer's confirmation discloses to the customer that the dealer has acted as principal. At different times, the same individual or firm may function as either broker or dealer.

Dealers Association: see "Mortgage-Backed Securities Dealers Association".

Debenture: a bond secured only by the general credit of the issuer.

Debt securities: IOUs created through loan-type transactions-commercial paper, bank CDs, bills, bonds, and other instruments.

Decay: the rate at which a variable's value diminishes through time, e.g., if a variable is set equal to Ce^{-rt} , and C is greater than 0, r is positive, and t equals time, then the variable exhibits exponential decay. Where r is the continuously compounded interest rate, the formula computes the present value of the cash flow (C) that will occur at a time (t) in the future.

Deferred Futures: the most distant expirations of the listed futures contract months. Also called back months.

Delay: refers to the "stated" delay time elapsed to the first payment of principal and interest (GNMA I--45 days, GNMA II--50 days, FHLMC PC--75 days, FHLMC Gold--44 days, FNMA MBS--55 days, conventional pass-throughs--55 days). The "actual" delay, or penalty, is 30 days less than the "stated" delay.

Deliverable Grades: see "Contract Grades".

Delivery: 1) the tender of the securities to the purchaser against receipt of payment at the contract price in settlement of a cash or forward trade. 2) the tender and receipt of the actual commodity, the cash value of the commodity, or of a delivery instrument covering the commodity, e.g., warehouse receipts or shipping certificates, used to settle a futures contract.

Delivery Month: a specified period (not necessarily a calendar month) within which a futures contract can be settled by delivery.

Delivery Versus Payment (DVP): a security delivery method in which the buyer's payment for securities is due at the time of delivery (usually to a bank acting as agent for the buyer) upon receipt of the securities.

Delta: the expected change in an option's price for a given change in the price of the underlying instrument or security.

Department of Housing and Urban Development (HUD): a department of the US Government. GNMA is a corporate instrumentality within HUD.

Deposit Note: a term deposit in a bank. A deposit note is an obligation of a bank that is similar to a certificate of deposit but is rated.

Depository: a central facility for holding securities which enables securities transactions to be processed by book entry without physical delivery of securities certificates. In addition to safekeeping, a depository may incorporate comparison, clearing and settlement functions. Major depositories include the Depository Trust Company (DTC) and the Fedwire book-entry securities system. DTC has a separate MBS Division (formerly operating as the Participants Trust Company).

Discount: an amount, expressed as a percentage or dollar amount, that a security is trading below its par value. Some securities, e.g., Treasury Bills, are issued at a discount, without a coupon, and are redeemable at par when they reach maturity; the difference between the original discount and par provides the rate of return on the investment.

Discount Bond: a bond selling below par.

Discounted Cash Flow: an accounting technique used to estimate the present value of future cash flows by applying a discount rate to anticipated cash flows.

Discount Rate: 1) the interest rate charged by the Federal Reserve Banks for loans to member banks, using government securities or eligible paper as collateral. 2) a discount rate (as opposed to the Discount Rate) is an interest rate used in determining the present value of future cash flows.

Disintermediation: the phenomenon that occurs when there is a decline in the deposit and lending relationships between financial intermediaries and their customers and an increase in direct relationships between ultimate suppliers of funds and ultimate borrowers of funds. Caused, for example, when financial intermediaries cannot compete efficiently with the rates being paid by others. This results in a shrinkage in the amount of deposits held by those financial intermediaries which are unable to pay the higher (market) rates. See also "Intermediation".

Dollar Rolls: a special repurchase agreement transaction where the holder of a security agrees to sell the security to a second party and agrees to buy back a security with substantially similar characteristics at a specified price, on a specified date. It differs from a repurchase transaction in that the seller gives up the cash flows from the security during the roll period. The accounting profession may refer to this type of transaction as a Dollar Price Repurchase Agreement.

Domino Effect: the notion that a default by (or financial stress at) one organization will cause a default or financial stress at other firms in the securities industry because of interconnected obligations.

Don't Know (DK): denying knowledge of a trade and a refusal to settle a trade by a buyer when the buyer (or the buyer's receiving agent) does not recognize confirmation or the securities that the seller has delivered. The buyer's operations department may have no record of or instructions to complete the trade, or the buyer may "DK" the trade because it reflects an incorrect price or quantity.

Due Bill: a promissory note delivered in lieu of the security to a buyer by the seller which evidences the seller's obligation to deliver the security to the buyer at a later date. A due bill check is a post-dated check issued by the seller to the buyer that becomes payable to the buyer on a specified date in the amount of principal and interest due to the buyer. Prior to the payable date, the due bill check serves as a due bill.

Duration: a measure of the sensitivity of an instrument's price to changes in yields. It is calculated as a present value-weighted time to maturity of the cash flows from an instrument. Also termed "Macaulay Duration". See also "Modified Duration", which is slightly different but often used interchangeably with duration. For a bond with known cash flows, the percentage change in the security's price in response to a small change in yield is approximately equal to the negative of the product of the

security's modified duration and the rate shift. For mortgage-backed securities, such as CMOs, where cash flows are subject to uncertainty, the calculated duration is a poor indication of market risk, since it does not adjust for the impact of changing interest rates on prepayment and extension risks. In such a case "Effective Duration" is a better measure.

Effective Duration: a measure of the sensitivity of an instrument's price to changes in yields, taking into account the effect of embedded options and changes in prepayments. It is calculated typically as an average percentage change in a bond's value (price plus accrued interest) for shifts in the Treasury curve of +/- 100 basis points (that is, plus and minus one percent). Effective duration may also be calculated for other shifts (e.g., +/- 200 basis points) in the Treasury curve.

Embedded Option: an option that is an inseparable part of another instrument. Embedded options include caps, floors, calls, puts, and prepayment provisions. Typical embedded options grant early termination rights to the issuer, such as the call provision in many corporate bonds or the homeowner's prepayment option that permits the issuer to repay the mortgage-backed security earlier than the nominal maturity. While embedded options are not severable, in contrast, detachable options can be traded separately.

Endorsement: a signature, other than that of a signer as maker, drawer, or acceptor, that alone or accompanied by other words is made on an instrument for the purpose of 1) negotiating the instrument, 2) restricting payment of the instrument, or 3) incurring endorser's liability on the instrument. Spelled "indorsement" in the Uniform Commercial Code.

Equivalent Bond Yield: annual yield on a short-term, non-interest-bearing security calculated so as to be comparable to yields quoted on coupon securities. See "Bond-Equivalent Yield".

Escrow Agent: a third party, acting as an agent for the buyer and the seller, who carries out the instruction of both and assumes the responsibilities of handling the paperwork and the disbursement of funds.

Escrow Fees: fees charged by the escrow holder for services.

Eurodollars: U.S. dollars deposited in a financial institution located outside of the United States. Permissible Eurodollar deposits under Part 703 are deposits in foreign branches of United States depository institutions. These deposits are not covered by FDIC insurance.

Evening Up: buying or selling to offset an existing market position. See "Liquidation".

Exchange: an organization which maintains a market by bringing together members to execute trades in the commodities or securities listed on the exchange. Also called a "Board of Trade" in the commodities markets.

Exchange of Cash for Futures: a transaction in which the buyer of a cash commodity receives a short futures position in a corresponding amount and the seller of a cash commodity receives a long futures position in a corresponding amount, at a price difference from the cash commodity mutually agreed upon. These transactions allow ex-pit trading of futures to facilitate movement of the cash commodity and can

establish, transfer, or offset open interest. Also called Exchange for Physical, or Against Actuals.

Exempted Securities: securities exempt from registration under the Securities Act of 1933 (see section 3) or exempt from certain provisions of the Securities Exchange Act of 1934 (see section 3(a)(12)). Such securities include governments, agencies, municipal securities, and certain commercial paper and private placements.

Exercise: to elect to put into effect the right (but not the obligation) held by an option holder, e.g., to require the option writer to deliver a security at the strike price (call), or to require the option writer to purchase a security at the strike price (put).

Exercise Price: the price at which the option buyer may purchase (call) or sell (put) the underlying security. Also called "Strike Price".

Expiration Date: the final date on or before which an option may be exercised. If not exercised by the expiration date, the option is void and worthless.

Extension Risk: the potential that the principal of a mortgage-backed security will be paid later than expected, typically in response to rising interest rates. Since the expected prepayments will be slower in a higher interest rate environment, the result is a longer expected average life. Opposite of "Prepayment Risk".

Face Value: typically the value of a bond or financial instrument at maturity. Historically, all securities were issued in the physical form of a certificate; the face value appeared on the face of the certificate. Face value is not an indication of market value. For amortizing instruments such as mortgage-backed securities, face value typically refers to the original principal amount. Also called "Par Value".

Factor: the proportion of the outstanding principal balance of a security to its original principal balance expressed as a decimal. In mortgage backed securities (MBS), the principal amount of each outstanding certificate is reduced monthly by its pro rata share of the regular mortgage payments by the mortgagees of the underlying mortgages and any prepayments or foreclosures. The MBS issuer publishes a list of factors each month (e.g., .987654321). The MBS security holder can calculate the current amount of principal outstanding by multiplying the factor by the original principal amount (e.g., .987654321 factor times \$100,000 original principal balance = \$98,765 outstanding principal balance). The MBS security holder can calculate the amount of principal received in the current month by subtracting the prior month's outstanding principal balance from the current month's outstanding principal balance.

Fail: when the seller of a security does not make delivery on the agreed settlement date.

Fair Value: the amount at which an instrument could be exchanged in a current arms-length transaction between willing parties, other than in a forced liquidation sale. Market prices, if available, are the best evidence of the fair value of financial instruments. If market prices are not available, the best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (e.g., the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models.)

Fannie Mae: see “Federal National Mortgage Association (FNMA)”.

Farmers Home Administration (FmHA): a US Government agency established under the Farmers Home Administration Act of 1946 to provide financing to farmers and other qualified borrowers who are unable to obtain loans elsewhere. It makes, participates in, and insures loans for rural housing and other purposes.

Federal Agency Security: interest bearing debt securities issued by U.S. departments and agencies. Agency securities are backed by the full faith and credit of the U.S. government (e.g., GNMA pass throughs and participation certificates). Securities of Government Sponsored Enterprises (GSEs) often are referred to as agency securities, but typically are backed only by the issuer (e.g., FNMA debentures).

Federal Funds (Fed Funds): funds deposited at Federal Reserve Banks by financial institutions, including funds in excess of reserve requirements. Fed funds can be sold by a credit union to a Section 107(8) institution. Fed funds sold represents an uninsured investment by the credit union (a permitted borrowing by the bank). Although a credit union can also buy Fed funds, Fed funds purchased represents a borrowing by the credit union.

Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac): a private corporation authorized by Congress. FHLMC is a secondary-market facility of the FHLBB system. It primarily sells mortgage participation certificates secured by pools of conventional mortgage loans whose principal and interest are guaranteed through the FHLMC.

Federal Housing Administration (FHA): a division of HUD. Its main activity is the insuring of residential mortgage loans made by private lenders. It sets standards for construction and underwriting. FHA does not lend money or construct housing.

Federal National Mortgage Association (FNMA or Fannie Mae): a private corporate created by Congress to support the secondary mortgage market. It primarily purchases conventional residential mortgages and issues mortgage-backed securities.

Federal Open Market Committee (FOMC): the arm of the Federal Reserve System (Fed) that controls the purchase and sale of securities in the market for the Fed’s open market account. A purchase of securities by the Fed adds reserves to the banking system (increasing the money supply), while a sale of securities withdraws reserves. Open market operations serve as one of three basic tools the Fed uses to conduct monetary policy (the other two being changes in the discount rate and reserve requirements).

Fee: 1) a Commitment Fee is a payment to investors or prospective investors, which may or may not be refundable, for the purpose of obtaining a commitment to purchase or to sell securities. 2) a Standby Fee is a non refundable amount received or paid for the sale or purchase of a standby commitment. 3) an Up-front Fee is a commitment fee paid in advance of the settlement date to an investor for a future purchase.

Fee Trading: see “Adjusted Trading”.

FHA Experience: a statistical series, revised periodically, which represents the portion of mortgages that "survive" a given number of years from their origination.

Financial Accounting Standards Board (FASB): the professional quasi-regulatory organization that primarily establishes and reviews generally accepted accounting principles (GAAP), which are mainly delineated by Statements of Financial Accounting Standards (SFAS).

Financial Instruments: 1) any obligation or contract which can be negotiated, including stocks, bonds, commercial paper, forwards, and futures. 2) more generally, cash, evidence of an ownership interest in an equity, or a contract that establishes a right of one party to receive cash (or another financial instrument) or to exchange other financial instruments on potentially favorable terms with the counterparty.

Financial Intermediary: a financial institution which acts as an intermediary between savers and borrowers by accepting money from the public and, in turn, by lending the accumulated funds to borrowers. The classification includes savings associations, commercial banks, mutual savings banks, life insurance companies, and credit unions.

Firm Commitment: a commitment to buy or sell a security at a fixed price for a specified period of time.

Firm Price: a price at which a trader is willing to trade for a limited period of time, usually no longer than the length of the phone call. Opposite of indicative price or indication.

Floor: 1) an embedded option in a floating-rate security that places a rate minimum (specifying the lowest interest rate that will be paid) on the floating rate coupon. 2) a stand-alone option contract (usually written as a swap) that pays the holder of the floor an amount equal to the notional principal amount times the excess of the floor rate over the market rate. A floor usually consists of a strip of caplets, i.e., a series of options with sequential expiration dates. Each caplet is an option on rates for a single period of time.

Floor Broker: any person who, in or surrounding any pit, ring, post or other place provided by an exchange for the meeting of persons similarly engaged, executes for others any orders for the purchase or the sale of any commodity or security and receives a prescribed fee or commission.

Foreclosure Payment: a prepayment made to holders of mortgage-backed securities from proceeds of property liquidation after foreclosure. Amount of prepayment must equal the principal balance of the foreclosed mortgage.

Forward: a cash market transaction in which two parties agree to the purchase and the sale of a commodity at some future time under such conditions as the two agree. In contrast to futures contracts, the terms of forward contracts are not standardized. A forward contract usually is not transferable and can be canceled only with the consent of the other party, which often must be obtained for consideration and under penalty, and forward contracts are not traded in federally designated contract markets. Essentially, forward contract refers to any cash market purchase or sale agreement for which delivery is not made "on the spot." See "Commitment", "Cash Forward Agreement", and "Standby Commitment".

Forward Contract: see "Forward".

Forward Market: refers to informal (non exchange) trading of commodities to be delivered at a future date. Contracts for forward delivery are not standardized, e.g., delivery time and amount are as determined between seller and customer.

Forward Months: see "Deferred Futures".

Forward Roll: like "roll over," a term used to describe the action of selling an investment position and redeploying the proceeds into a new but similar position. A trader in the Government securities market may elect to sell a long position in the previously-issued 2-year note (the "current" 2-year) and use the proceeds to buy the newly-issued 2-year note (referred to as the "when issued" or "w.i." 2-year) prior to its settlement date. When this action is done with the forward settlement date, it is described as a "forward roll from the current to the w.i." In the futures and options markets, a forward roll is used to describe the extension of a position from one month (maturity) to a longer month. A trader may elect to shift from a March Eurodollar contract to a June Eurodollar contract to avoid the expiration date on the March contract.

Freddie Mac: see "Federal Home Loan Mortgage Corporation (FHLMC)".

Fully Modified Pass-Through: a security for which the timely payment of both principal and interest is guaranteed. Investors in the security will receive mortgage interest and principal payments on a certain date regardless of whether the mortgage borrowers have actually made those payments.

Funding Date: term used by mortgage bankers to denote the date on which the mortgage banker funds or finances a new issue of MBS. See "Settlement Date".

Fungibility: the characteristic of interchangeability. Treasury securities of the same maturity and coupon are interchangeable, as entries in the Fed's book-entry system. Futures contracts for the same commodity and delivery month are fungible due to their standardized specifications for quality, quantity, delivery date, and delivery locations. GNMA's bearing the same interest rate generally are treated as fungible until pool numbers are assigned. Subsequently, fungibility may decline or vanish.

Futures Commission Merchant: the CFTC's term for a futures broker. Any individual, association, partnership, corporation, or trust engaging in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on, or subject to, the rules of any futures exchange.

Futures Contract: an agreement to purchase or sell a commodity or financial instrument for delivery in the future: at a price determined at initiation of the contract, which obligates each party to the contract to fulfill the contract at the specified price, which is used to assume or shift price risk, and which may be satisfied by delivery or offset. Futures contracts are sold on an exchange or board of trade in which the terms are standardized. See "Contract Market".

Futures Exchange: see "Contract Market".

Futures Price: the price of a given commodity unit determined by public auction on a futures exchange.

Gamma: a measure of the rate of change of the option's delta with respect to a change in the price of the underlying asset.

Gap: mismatch between the earlier of maturity or repricing of a depository institution's assets and liabilities, prepared by scheduling the cash flows of all balance sheet items into time periods, or "buckets." A static gap reports the current balance sheet repricing mismatch. Dynamic gap a) typically refers to a gap report projected as of a future balance sheet date, but b) may refer to the use of estimated cash flows in the maturity or repricing buckets of a gap report.

General Obligation Bonds: municipal securities secured by the issuer's pledge of its full faith, credit, and taxing power.

Ginnie Mae Mortgage-Backed Security (Ginnie Mae or GNMA): a security issued and guaranteed by the U.S. Government. Cash flows on Ginnie Mae securities are based on the underlying FHA, VA, or FmHA mortgages. The term "pass-throughs" is often used to describe Ginnie Maes. See "Government National Mortgage Association", "GNMA I", "GNMA II".

GNMA I: a pass-through mortgage-backed security on which the registered holders receive on the 15th day of each month a separate principal and interest payment on each of their certificates. GNMA I securities are collateralized by a pool of mortgages from a single originator, such as a mortgage banker, commercial bank, savings and loan association, savings bank, credit union, or and other institution.

GNMA II: a pass-through mortgage-backed security on which registered holders receive on the 20th day of each month an aggregate principal and interest payment from a central paying agent on all of their GNMA II certificates. GNMA II securities are collateralized by multiple-issuer pools ("Jumbos") or custom pools (one originator but different interest rates that may vary within one percentage point).

Go-Around: the technique whereby the manager of the System Open Market Account purchases and sells securities for the Federal Reserve System.

Good Delivery: a term indicating that a security in proper form has been delivered timely in accordance with the terms of the transaction.

Government Agency: organizations established by Congress to serve many different purposes. Most agencies typically do not issue securities, but borrow indirectly through the US Treasury. Those securities issued directly by agencies typically are direct obligations of the US Government. Government Sponsored Enterprises, which are private corporations, often are called (loosely and erroneously) "agencies".

Government National Mortgage Association (GNMA or Ginnie Mae): a wholly-owned government corporation within the Department of Housing and Urban Development. GNMA supports a secondary market in government insured and guaranteed mortgages. GNMA securities are backed by pools of FHA-insured and VA-guaranteed mortgages. See "Ginnie Mae", "GNMA I", "GNMA II".

Government Sponsored Enterprise (GSEs): a financial intermediary established by Congress to provide funding to sectors of the economy that are in need of credit beyond that supplied by purely private intermediaries. GSEs are privately owned and operate with limited government direction. Obligations are not guaranteed by the full

faith and credit of the U.S. government. Examples include:

- Federal Home Loan Bank (FHLB)
- Federal Home Loan Mortgage Corporation (FHLMC - Freddie Mac)
- Farm Credit System
- Agriculture Mortgage Corporation (Farmer Mac)
- Student Loan Marketing Association (SLMA - Sallie Mae)
- Financing Corporation (FICO)

Graduated Payment Mortgage (GPM): a mortgage that features negative amortization in which early payments are scheduled to be insufficient to pay the interest accruing on the outstanding principal. After a period of low initial payments, there is a graduation period where the size of the payments increase for some number of years. The number, frequency, and rate of increases are specified in the original contract.

Gross Long: the total of open long (purchase) contracts, not reduced by any short positions (sales contracts) held at the same time.

Gross Short: the total of open short (sales) contracts, not reduced by any long positions (purchase contracts) held at the same time.

Guaranteed Loan Participation Certificate (GLPC): see "Small Business Administration Secondary Participation".

Guaranty: a promise by one party to pay a debt or to perform an obligation contracted by another party in the event that the original obligor fails to pay or perform as contracted.

Haircut: 1) deductions of specified percentages from the market value of assets solely for the purpose of computing regulatory net capital. 2) in computing the worth of assets deposited as collateral or margin, the difference between the actual market value of a security and the value assessed by the lending side of a transaction.

Hedge: 1) a position or combination of positions that reduces some type of risk, usually at the expense of expected return. A hedging transaction is a transaction or position in a swap, futures contract, or other financial instrument that reduces financial risks of a commercial enterprise. Typical hedges involve: entering into an opposite position (in a related security in the cash market or in a futures contract) to a position held in the cash market to minimize the risk from adverse price changes; and entering into a position in the futures market as a temporary substitute for a cash transaction that will occur later to guarantee today's price. 2) among traders and portfolio managers, a term used to describe a partially hedged position. 3) used erroneously to minimize the perceived risk in describing a risky position (or combination of positions) taken with the intent of profiting from an expected change in a spread (also termed a basis arbitrage) or value (also termed a risk arbitrage).

Hit: a dealer is "hit" when the bid side of a market which the dealer has made is accepted by the customer, that is, when the customer sells a security to the dealer. When bids are being "hit," the general response of the dealer is to lower the bid price.

HUD: the Department of Housing and Urban Development. Established by the Housing and Urban Development Act of 1965 to supersede the Housing and Home Finance Agency. Responsible for the implementation and administration of

government housing and urban development programs. HUD programs include community planning and development, housing production, the extension of mortgage credit (FHA), and ensuring equal opportunity in housing.

Impound: see “Escrow Payment”.

Indenture of a Bond: a legal statement spelling out the obligations of the bond issuer and the rights of the bondholder.

Index: the interest rate used in determining the coupon rate of a variable rate security or loan. A margin is usually added to the index.

Index Amortizing Note (IAN): a note that returns principal prior to final maturity. The amount and timing of the return of principal is linked to an index, such as three-month LIBOR or the prepayment speed of a mortgage-backed security. Typically, as the index rises, the scheduled return of principal payments slow down, exposing the owner to extension risk; as the index declines, the scheduled return of principal payments increase, exposing the owner to prepayment and reinvestment risk. Corporate credit unions have offered Amortizing Certificate Programs (ACPs) that behave in a similar manner. IANs are not mortgage backed, but they have similar market risk due to the uncertainty of payments.

Initial Margin: the amount of money or its equivalent that a customer must deposit with a broker when the customer buys or sells a security or futures contract on margin.

Institutional Lender: a financial institution that invests in mortgages and carries them in its own portfolio, e.g., mutual savings banks, life insurance companies, commercial banks, pension and trust funds, and savings and loan associations.

Insured Association: a savings association with savings accounts insured by FDIC.

Interest Rate Risk: the potential for change in the value of a security when the level of interest rates changes.

Interest Rate Swap: a contract to exchange streams of interest payments, e.g. fixed for floating, based upon a specified dollar amount (notional amount) at specified dates in the future.

Interest Trades: these transactions involve a) a purchase of securities for current settlement; b) a delayed settlement (forward) sale of these securities or the possession of a long standby; and c) a financing of a long position by a sale under an agreement to repurchase on or before the forward delivery date.

Intermediation: the phenomenon that occurs when rates paid by certain financial intermediaries can compete successfully with the rates being paid by others, e.g., the US Government on its Treasury Bills. This causes an expansion in the amount of deposits held by the intermediaries which are able to pay higher rates. See “Disintermediation”.

In-the-Money: a term to describe an option that has a positive value if exercised immediately. A call option is in-the-money if the underlying security's price is higher than the option's strike price. A put option is in-the-money if the underlying

security's price is below the option's strike price. An option that is in-the-money has intrinsic value.

Intrinsic Value: the value of an option if immediately exercised. A call option has intrinsic value when the price of the underlying security exceeds the option's exercise price. A put option has intrinsic value when the underlying security's price is less than the option's exercise price.

Inventory: the total issues, long and short, held by a dealer that comprise that dealer's inventory.

Inverted Market: a futures market in which the nearer months are selling at prices higher than the more distant months; hence, a market displaying inverse carrying charges. This is characteristic of markets in which supplies are currently in shortage.

Inverted Yield Curve: a graph illustrating the level of interest rates as a function of time to maturity, where shorter maturity investments have higher yields than longer maturity investments. Inverted Yield Curves generally occur during period when the Federal Reserve is attempting to fight inflation by restraining growth in economic activity and restricting growth in the money supply. Normally, the yield curve is upward sloping.

Issuer: the legal entity that is selling or has sold its security or other financial instrument. In mortgage banking, the entity who pools mortgages to back GNMA pass-through securities. See "Originator".

Junior/Senior Structure: a securities issuance with one class that is subordinated to a senior obligation.

Junk Bond: a bond with a credit rating that is low, below BBB (S&P) or equivalent.

Key Rate Duration: a duration analysis technique to determine the affect on an instrument's value of a rate change in part of the yield curve. The sum of the key rate durations for an investment provides a measure comparable to duration for parallel shifts in the yield curve.

Legal Eligibility: investments that life insurance companies, mutual savings banks, or other regulated investors may make under a state charter, law, or regulation.

Liquidation: 1) making a transaction that offsets or closes out a position. 2) closing out a defaulted transaction.

Liquidity Risk: 1) the potential loss when a security cannot be sold promptly at or near prevailing market prices. This may be the result of a general market disruption, uncertainty in the market place regarding the value of the security, or a large position relative to market trading volume. 2) in a financial institution, the costs incurred to attract new deposits or liquidate assets to meet the cash flow needs of unanticipated withdrawals.

Liquidity Support: in a structured securities transaction, a source of funds for the issuing trust to cover shortfalls in cash flow resulting from timing mismatches between payments received on trust assets and payments due to securities holders.

Load Fee: a fee charged to invest in a mutual fund. Load fees may be "up-front" fees charged at the time of purchase and/or "back-door" or "back-end" fees charged at the time of sale. These fees may be based on the amount of funds placed in the investment and the length of time the investment is held.

Long Bond: generally a bond that matures in more than ten years is a long bond. Wall Street refers to the 30-year U.S. Treasury bond as the "long bond."

LIBOR: the London Interbank Offered Rate. When not specified, usually the rate at which major banks offer to lend US dollars (i.e., to make a Eurodollar deposit, as opposed to a deposit denominated in some other currency such as the German mark). There is a different LIBOR rate quoted for each deposit maturity. Different banks may quote slightly different LIBOR rates, just as different banks in the US may have slightly different deposit rates. A popular interest rate survey of LIBOR is prepared each day by the British Bankers' Association (BBA). NCUA considers a US dollar-denominated LIBOR to be a domestic interest rate.

Long: one who owns an inventory of securities, commodities, or forward or futures contracts.

Long the Basis: a person or firm that has bought the spot commodity and hedged with a sale of futures is said to be long the basis.

Macaulay Duration: see "Duration".

Maintenance Margin: the minimum amount of money or collateral required to be maintained in a margin account in accordance with exchange regulations or broker requirements. If a customer's margin account drops below the required level, the broker issues a margin call to the customer for a payment sufficient to restore the account, often to the level of the initial margin. Maintenance Margin differs from Variation Margin or Payment, which is a cash payment made to the clearinghouse, usually at least daily, because of an adverse movement in price.

Maker: see "Writer".

Making a Market: a dealer makes a market when he stands ready to buy or sell at his bid and offered prices.

Margin: 1) a constant value added to an index to arrive at the fully indexed coupon, which is the interest rate paid on a variable rate loan or investment, in the absence of a teaser rate or binding cap rate. The cap rate will be paid on an investment while its fully indexed coupon is above the cap rate. 2) a deposit of cash or collateral by a client with a broker (or by a broker with a clearing house) which protects the broker (or clearing house). Margin in commodities is not a payment for equity or down payment on the commodity itself, but rather is in the nature of a performance bond. The difference is significant because a) both buyers and sellers post margin in commodities; b) the remainder of the position is not being borrowed from one's broker and does not require interest payments; and c) as price moves against one's position, the account is debited (termed Variation Margin at the clearing member level) and the protection represented by the Initial Margin may fall below the prescribed maintenance level, in which case the trader will be required to post additional margin. See "Initial Margin", "Maintenance Margin", "Original Margin", and "Variation Margin".

Margin Call: 1) a call from a brokerage firm to a customer to bring margin deposits up to minimum levels required by the broker, at least equal to exchange minimums. 2) a request by the clearing house to a clearing member to bring clearing margins back to minimum levels required by the clearing house rules.

Market Order: an order to buy or to sell a stated amount of a security at the most advantageous price obtainable after the order is entered.

Market Price: market price usually is indicated by the last reported price at which the security or financial instrument sold. For an inactive security that has not traded recently, the market price is the latest bid price.

Market Risk: the risk that an investment will vary in price as market conditions change.

Market Value: the current or prevailing price of a security, at which a security presumably could be sold.

Marketability: 1) the capacity of the market in a particular security to absorb a reasonable amount of buying and of selling at reasonable price changes. See "Liquidity Risk". 2) the degree of investment interest underlying a security.

Mark-to-Market: 1) to value a position or portfolio at current market prices. Marking to market is an effective way to monitor profit and loss. Trading accounts must be marked to market daily to provide management with a measure for control purposes. 2) a procedure whereby a brokerage concern has the right to demand funds or securities in the amount of unrealized loss on unsettled contracts to purchase or sell securities. The making of a mark to market payment restores original margin. 3) the accounting adjustment made to bring the book value of an investment to its market value. It is the accounting procedure that is applicable to a credit union's trading account securities.

Markup: the difference between what a dealer has paid for a security and the price at which the security is offered to another person. May be referred to loosely as Spread. Spread, however, usually refers to the difference in current bid and current offer prices, rather than the difference between the dealers cost and the current offer price.

Matched Repurchase Agreement (Matched REPO): matched repurchase agreements include transactions in which a dealer acquires a security on a reverse repurchase agreement or a collateral loan, only when the dealer has outstanding commitments both to repurchase and to resell the security on the same date. If the reverse repurchase agreement is made first in anticipation of a subsequent matching agreement, the transaction is not a matched agreement until the security is sold under a repurchase agreement. Matched agreements also include transactions in which a dealer is in any way subject to a contingent liability, as well as those where the dealer is acting as an agent in a transaction that involves the temporary exchange of cash for securities between two or more other parties but remains contingently liable for any losses incurred because of the failure of any of the other parties to fulfill their part of the agreement.

Matched Sale-Purchase Agreements: an agreement where the Federal Reserve sells a security outright for immediate delivery to a dealer or foreign central bank, with an agreement to buy the security back on a specific date (usually within seven

days). Matched Sale-Purchase Agreements are the reverse of repurchase agreements and allow the Federal Reserve to withdraw reserves on a temporary basis.

Maturity: the date on which the principal amount of the security is due and payable to the registered owner of the security. On such date, the accrual of interest typically terminates on a note, time draft, acceptance, bill of exchange, mortgage-backed security, or bond.

Medium-Term Notes (MTNs): plain corporate debt instruments with a fixed rate and fixed maturity (typically less than seven years), that often are continuously offered notes, ranging in maturity from nine months to 30 years. Bank Deposit Notes are a form of MTN.

Midgets: GNMA pass-through security with collateral of 15-year original maturity mortgages. It is similar in structure to a GNMA security backed by 30-year original maturity mortgages.

Modified Duration: a measure of the sensitivity of an instrument's price to changes in yields. It is calculated as Duration, discounted by a small factor noted below. See "Duration". Modified Duration often is used interchangeably with Duration, since many uses of duration are not sensitive to the small difference. For a bond with known cash flows, the percentage change in the security's price in response to a small change in yield is approximately equal to the negative of the product of the security's modified duration and the rate shift. For mortgage-backed securities, such as CMOs where cash flows are subject to uncertainty, the calculated duration is a poor indicator of market risk, since it does not adjust for the impact of changing interest rates on prepayment and extension risks. In such a case Effective Duration is a better measure.

$$D_{\text{mod}} = [1/(1 + [y/f])] D$$

where D_{mod} = modified duration; y = yield to maturity; f = frequency of coupon payment, and D = duration.

Modified Pass-Through: a security for which the timely payment of interest, but not principal, has been guaranteed by an institution or agency.

Money Market: the market for trading of short-term, high-grade financial instruments, such as banker's acceptances, certificates of deposit, and commercial paper.

Money Market Mutual Fund: a mutual fund that invests in highly liquid securities and pays money market rates of interest, in accordance with regulations of the SEC (17 CFR 240.2a-7). Some funds invest only in government-backed securities. Money market funds attempt to maintain a stable Net Asset Value (NAV) of \$1.00 per share. These funds are not insured by the government.

Mortgage-Backed Security Dealers' Association: a voluntary association of dealers in GNMA mortgage-backed securities. The association changed its name from the GNMA Mortgage-Backed Securities Dealers' Association.

Mortgage Banker: a party who originates, sells, and services mortgages. A mortgage banker retains servicing rights to loans and may service the loans it has sold. A mortgage banker also may sell servicing rights. As the local representative of

regional or national institutional lenders, it acts as a correspondent between lenders and borrowers.

Mortgage Bankers Association of America (MBA): an association of mortgage bankers. The association serves as the trade association for the mortgage banking industry.

Mortgage Bond: a bond secured by a lien on property, equipment, or other real assets.

Mortgage-Backed Bonds: a bond collateralized by mortgages. The cash flow of the bond need not be linked directly to the principal payments of the mortgages.

Mortgage-Backed Security: a term used broadly to refer to a security backed by mortgages, including pass-through securities, pools, mortgage-backed bonds, and CMOs.

Mortgage Pass-Through Security: a security representing an undivided ownership interest in a pool of mortgages. The mortgages are serviced by a financial institution which transfers the monthly payments by home owners of principal and interest (less a servicing fee and a guarantee fee, if any) to be received by the owner of the interest in the MBS. This process of transferring cash flow is termed a "pass through."

Mortgage Participation Certificates: similar to pass-through securities, representing an undivided interest in residential mortgages.

Mortgage Yield: an internal rate of return calculation. In the early days of mortgage-backed securities, the yield was calculated as if all principal were prepaid at the end of 12 years. Now, a reasonable and supportable estimate of the prepayment speed is used in calculating the estimated yield on a mortgage-backed security. See "Constant Prepayment Rate".

Municipal Securities Rulemaking Board (MSRB): a self regulatory organization established to propose and adopt rules for brokers and dealers in Municipal Securities. The SEC oversees the MSRB. The MSRB was created under §15B of the Securities Exchange Act of 1934.

Municipal Security (Muni): obligations of a state, and of a county, city, tax district, or other division of a state. Municipal securities include: a) General Obligation (GO) Bonds, which the municipality backs with its full faith and credit; b) Revenue Bonds, which are payable from specified revenues only, such as a property or facility financed by the revenue bond, but which do not bind the municipality; and c) short term notes issued by municipalities in anticipation of tax receipts (tax anticipation notes or TANs), proceeds from a bond issue (bond anticipation notes or BANs), or other revenues (revenue anticipation notes or RANs). Many municipal bonds are insured by municipal bond insurance typically issued by one of three leading triple-A rated municipal-bond insurers, AMBAC Indemnity corporation, FGIC (Financial Guarantee Insurance Corporation, or MBIA (Municipal Bond Insurance Association).

Mutual Fund: a fund operated by an investment company that raises money from shareholders. Funds offer professional management and diversification for a fee. The market price of a share is called its Net Asset Value (NAV), which reflects the market-to-market value of all securities held by the investment company. Also called open

end investment company. A mutual fund that invests in fixed income securities often is called a bond fund. See "Money Market Mutual Fund".

National Association of Securities Dealers, Inc. (NASD): the self-regulatory organization of the securities industry responsible for regulation of the Over-The-Counter securities market and the many products traded in it. The NASD administers qualifications tests to securities professionals and enforces compliance by its members with the securities laws, the rules of the Municipal Securities Rulemaking Board, and NASD rules. The NASD rules, in general, protect investors by preventing fraudulent and manipulative acts and practices, and promoting just and equitable principles of trade. The NASD was created under §15A of the Securities Exchange Act of 1934 (the Maloney Act). The SEC oversees the activities of the NASD. The NASD also owns and operates the NASDAQ market.

Negative Arbitrage: See "Arbitrage".

Negative (or Inverse) Yield Curve: See "Inverted Yield Curve".

Negotiable Security: under the Uniform Commercial Code (UCC), an instrument that meets certain legal requirements and can be transferred by endorsement or delivery.

Net Asset Value: the value of a mutual fund share determined by the fund on a daily basis based upon the market value of the underlying securities and the number of shares outstanding.

Net Capital: net worth of a brokerage concern, less certain items such as exchange memberships, carrying value of securities which are not readily marketable, "haircuts" on marketable securities in proprietary accounts, furniture and equipment, etc.

Net Long: a net position that is long.

Net Position: the difference between the open long contracts and open short contracts held by one trader in any one contract market or financial instrument. Trades which have been offset are removed from the net position.

Net Short: a net position that is short.

Net Yield: the part of gross yield that remains after the deduction of all costs, such as mortgage servicing expenses and guaranty fees. See also "Yield".

New Issue: 1) a security that is purchased at issuance. 2) a recently issued security.

No Load: a mutual fund sold without a load fee.

Normal Yield Curve: a graph illustrating the level of interest rates as a function of time to maturity, where shorter-maturity investments have lower yields than longer-maturity investments. The Normal Yield Curve is upward slopping.

Note: a written promise to pay a debt.

Notional Principal (or Notional Amount): in an interest rate swap agreement, the dollar amount to which interest rates are applied in order to calculate periodic

payment obligations. The notional amount is not exchanged by the parties to the interest rate swap agreement.

Odd Lot: a quantity of securities which is less than the typical cash market trading unit, e.g., an odd lot for a Treasury security is a par amount of less than one million dollars. The bid-ask spread on an Odd Lot is slightly wider than for a round lot.

Offer: the lowest declared price at which a seller is willing to sell a security at a particular time. Opposite of bid.

Offset: the liquidation of a purchase of futures through sale of an equal number of contracts of the same delivery month or the covering of a short sale of futures through the purchase of an equal number of contracts of the same delivery month. Either action cancels the obligation to make or take delivery of the commodity.

Open Interest: the total number of future contracts in a given commodity which have not yet been liquidated by offset or fulfilled by delivery; the total number of open contracts. Each open contract has a buyer and a seller; however, when calculating the open interest of an exchange, only one side of the contract is counted.

Open Position: a forward or futures contract is open if it has not been fulfilled by delivery or liquidated by offset. The open position includes open long and short contracts, including option contracts that have not been exercised.

Option: a contract that grants the option buyer the right or privilege, but not the obligation, to buy or sell a specified amount of a given financial instrument at a fixed price (the exercise price) before or on a designated date (the expiration date). A call option confers on the option buyer the right to buy the financial instrument. A put option confers on the option buyer the right to sell the financial instrument. The option writer has the obligation of performing if the option is exercised timely by the option buyer. See also "Standby Commitment", "Optional Commitment", "Exercise Price", "Expiration Date".

Option Adjusted Spread (OAS): represents an expected incremental return (spread) over Treasury rates, given the observed market price for a security. The OAS is normally positive and reflects the risks of the security, including option risk, relative to a Treasury security. A Treasury security will have an OAS of zero. A negative OAS means a security is expected to earn less than a Treasury security of comparable maturity.

OAS is calculated using an iterative modeling process. First, a large sample of potential Treasury interest-rate paths consistent with the current term structure and current level of volatility are generated; second, the cash flows of the security for each of those Treasury interest-rate paths are generated; third, the cash flows are discounted using the projected Treasury rates to compute an estimated model price. The estimated model price is then compared to the observed market price of the security. If the model price is greater than the market price, an increasingly larger spread is added to each of the Treasury rates and the process of discounting cash flows is repeated until the model price equals the market price. OAS is the spread that results in the estimated model price equaling the observed market price.

When OAS is calculated using Treasury rates as discount rates, the OAS includes both option spread and credit spread. Thus, occasionally OAS may be calculated

using a corporate interest-rate curve, such as LIBOR, to compute primarily the spread arising from the embedded optionality.

Given a reasonable estimate for OAS, a fair (model) value can be calculated for a security, using the current term structure of interest rates and the current level of volatility.

Option Buyer: the purchaser of a call or put option who pays a premium to receive the exercise right of the contract.

Option Writer: the seller of a call or put option who grants the exercise right to the buyer in exchange for receiving the premium.

Optional Commitment: a term for an over-the-counter option; an option to receive securities, exercisable at a future date. The buyer of the optional commitment has the option to receive the securities. A long optional commitment is an option to purchase securities. A short optional commitment is a commitment to sell. See also "Option and Call".

Optional Commitment Fee: amount paid for the purchase of an optional commitment. Also called a "Premium".

Original Margin: term applied to the initial deposit of performance bond or margin money required of clearing member firms by clearing house rules.

Origination: the process whereby a bond, such as a GNMA certificate, backed by approved mortgages in a pool, is issued. See "Issuer".

Originator: one whose function is to originate or issue mortgage-backed securities. Builders, brokers, and others are solicited to obtain applications for mortgage loans. The individual mortgage company which performs this function is also designated as the originator or issuer. See "Issuer".

Out-of-the-Money: an option that has no value if exercised under current market conditions (e.g., the option to purchase is at \$100, while the market price is below \$100). Such an option has no intrinsic value, but may have time value. A call option is out-of-the-money when the exercise price of the option is higher than the underlying security's price. A put option is out-of-the-money when the exercise price is lower than the underlying security's price.

Output: the volume of mortgage securities that a mortgage company can be expected to issue in a month. Also called "Production" or "Origination".

Overcollateralization: the value of the collateral for an asset-backed security exceeds the par amount of the asset-backed security. From the perspective of the issuing entity, the extent to which the value of the asset or the cash flow produced by the asset (collateral) exceeds the liability or the cash flow required to meet the liability obligations. It is usually expressed as a percentage of par amount of the liability.

Over-The-Counter (OTC): 1) non-exchange traded instruments, including Treasury securities, mortgage-backed securities, municipal securities, negotiable CDs, swaps, forwards, and certain options. 2) a market that is not part of an organized exchange.

Overtrading: see "Adjusted Trading" and "Fee Trading".

P&I: abbreviation for "principal and interest." This is customarily used to describe the regular monthly checks paid to the registered owner of mortgage-backed securities by the issuer. Payment of GNMA I P&I is scheduled to arrive by the fifteenth of each month and contains the interest, regular principal payments, and prepayments made on a pro rata basis by the entire pool for the previous calendar month.

PAC (Planned Amortization Class): a CMO tranche which is protected, to some degree, from both prepayment and extension risk. The CMO pays principal according to a predetermined schedule that is expected to be met if the collateral prepayment speed remains within the PAC band, that is, between the two specified prepayment speeds.

Pair Off: the matching or netting of contra transactions between two parties when delivery is due. Only the unmatched balance is delivered with a check for the difference between the purchase and sale prices of all transactions being received or delivered. This reduces the number of physical deliveries and redeliveries which otherwise would be required. A pair-off transaction is a security purchase transaction that is closed or sold at, or prior to the settlement or expiration date.

Papers: term sometimes given to put or call options.

Par Cap: a provision in the contract of sale for GNMA securities which restricts delivery only to pools which bear an interest rate sufficiently high so that the securities would trade at or below par when computed on the agreed-to yield.

Par Value: the face value of a security.

Participation Certificate: a type of mortgage-backed security which represents an undivided interest in certain real estate loans.

Pass-Through: a mortgage-backed security on which payment of interest and principal on the underlying mortgages are "passed through" to the security holder by an agent shortly after interest and principal payments are received from the mortgage borrowers.

Pay Down: when the dollar value of a new issue of Government securities is less than the maturing issue which it replaces, the difference is called the pay down.

Paying Agent: an agent, usually a commercial bank, engaged by an issuer to effect dividend or interest payments periodically.

Pay Up: when the dollar value of a new issue of Government securities is more than the maturing issue which it replaces, the difference is called the pay up.

Permanent Investor: one who provides permanent mortgage financing.

Physical/Definitive Security: a security for which there exists a physical paper document as a certificate of ownership identifying terms and conditions.

Plus (+): describes an additional 1/64th on quotations. For example, 98.4+ means 98 and 4/32nds, plus an additional 1/64th.

Point: 1) an amount equal to one percent of the face value or principal amount of an investment or note. 2) a mortgage loan discount point, which is a one-time charge assessed at closing by the lender to increase the yield on the mortgage loan to a market rate. 3) in the foreign-exchange market, the lowest digit at which the currency is quoted, e.g., "one point" is the difference between sterling prices of \$1.8080 and \$1.8081. Also called pips.

Pool: a collection of mortgages which are packaged and sold as a security. Holders of GNMA pass-through securities own a pro rata share of the outstanding balance of all mortgages in the same pool. Pools must be mortgages of the same kind (single family, mobile home, or projects), carrying the same or similar rate of interest, and must all be of the same or similar maturity (e.g., 30 years). All mortgages within a single pool are serviced by the same issuer and are usually from the same geographic area.

Position: an interest in the market, either long or short. Securities purchased and held are a long position. Securities sold short and not yet covered are a short position. Forward or futures contracts purchased are called a long position. Forward or futures contracts sold and not yet liquidated are called a short position. A call option purchased and a put option sold economically are equivalent to a long position. A put option purchased and a call option sold economically are equivalent to a short position. See also "Open Position" and "Net Position".

Position Limit: the maximum number of speculative futures contracts in one commodity that a person or group of persons acting in concert can hold as determined by the Commodity Futures Trading Commission or the exchange upon which the contract is traded.

Positive Yield Curve: See "Normal Yield Curve".

Premium: 1) the amount by which the current market price exceeds the security's face value, 2) the amount paid to purchase an option, 3) the amount by which the redemption price exceeds a callable security's face value, 4) loosely, refers to the higher yield demanded by the market for CDs and securities issued by a particular institution as a result of higher perceived credit risk of that institution relative to other similarly rated institutions (also referred to as "paying up for funds"), 5) in the case of federally insured zero-coupon CDs, the amount of the purchase price in excess of the original (or accredited) issue price charged by Broker-Dealers to secondary market investors, which is not FDIC-insured, 6) refers to a higher price charged for a security that is in short supply relative to other similar securities, as in the phrase, "the old 2- year is at a premium to the When Issued 2- year."

Prepayment: payment made ahead of the scheduled payment date.

Prepayment Model: an empirical method which produces a reasonable and supportable forecast of mortgage prepayments in particular interest rate scenarios. The estimated prepayment speeds from such models typically are available from securities broker-dealers and industry-recognized information providers. These estimated prepayment speeds are used in tests to forecast the weighted average life, change in weighted average life, and price sensitivity of CMOs and mortgage-backed securities. The estimated prepayment speeds usually are expressed in terms of a prepayment benchmark, either "Constant Prepayment Rate (CPR)" or "PSA".

Prepayment Risk: the potential that all or part of the principal of a security, such as a mortgage-backed security, will be paid earlier than expected, typically in response to falling interest rates.

Price Limits: the maximum price advance or decline from the previous day's settlement price permitted for a contract in one trading session by the regulations of a futures exchange.

Prime Rate: the interest rate at which preferred customers can borrow from commercial banks.

Primary Dealer: dealer in Treasury securities which reports its activities and resource commitments to the Federal Reserve Bank of New York and with whom the Federal Reserve conducts open market operations to expand or contract the money supply. To maintain their status with the Federal Reserve, primary dealers must maintain an active market-making role in Treasury securities.

Primary Market: offerings in a security at its issuance. See also "Secondary Market".

Principal: (as contrasted with Agent) a party who buys and sells for his or her own account in an arms-length transaction with another, and who is not required to disclose the price basis of a transaction.

Principal Balance: the actual balance of an obligation exclusive of accrued or unpaid interest.

Principal Transaction: a securities transfer wherein one or both of the parties acts as principal dealing for his/her own account.

Private Placement: a security issue offered only to a limited number of sophisticated investors, as opposed to being publicly offered. Subject to certain securities laws, a Prospectus for a Private Placement does not have to be registered with the SEC.

Production: the aggregate of mortgages assembled by a mortgage company, e.g., if a mortgage company generates \$1 million per day of new mortgages, it is said to be a \$5 million a week producer.

Prospectus: a detailed statement prepared by an issuer and filed with the SEC prior to the sale of a new issue. The prospectus gives detailed information on the issue and on the issuer's condition and prospects.

Proxy: when one person acts on behalf of another, the first person is acting as proxy for the second. Similarly, one instrument can be viewed as a proxy for another when the primary instrument is unavailable or too costly. Warehouse receipts or depository receipts may be used as proxies for commodities or securities.

PSA: a prepayment speed benchmark used for expressing estimated prepayment rates for CMOs. The PSA benchmark assumes slow, but rising, prepayments during the first thirty months, then level prepayments in subsequent months. Thirty months after issuance, a speed of 100% PSA is equal to a 6% CPR. The name derives from the Public Securities Association (now The Bond Market Association), which was an

association of dealers in government securities that served as the trade association for brokers and dealers in exempt securities.

Purchased Interest Receivable: interest due to the previous owner of an investment that is paid to the new owner. This accrued interest is part of the transaction's cost, but is not reflected in the investment's quoted price. The receivable is eliminated when the first coupon payment is received.

Put: 1) an option contract granting the buyer the right, but not the obligation, to sell (put) a specified quantity of a security at a specified price (the exercise or strike price) and time (the exercise style). Such an option is bought with the expectation of a price decline below the contract price. If the price decline occurs, the purchaser will exercise the option. If the decline does not occur, the purchaser will let the option expire and will lose the purchase price of the option, that is, option premium. 2) an embedded put in a security grants the holder the right to retire or "put back to the issuer" all or part of the security at a specific price (the put price) and at a specific time prior to its contractual maturity date. The ability to put the security is an "option" that belongs to the holder of the bond. See "Option"; compare with "Call".

Pyramiding: successive borrowing on securities to finance the purchase of additional securities.

Quality: a reference to the credit quality of a security. A security is said to be of high quality if the return on principal and the payment of interest are well secured or guaranteed.

Quotation: the bid to buy and the offer to sell a security in a given market at a given time. Often shortened to "quote." See also "Bid" and "Asked".

Range/Accrual Note: a note with a coupon determined by whether the underlying price or rate falls within a specified range, e.g., for a typical LIBOR-based range note, no interest is paid if the LIBOR rate is outside of the specified range.

Rate of Interest: the coupon rate of a security; the annual interest rate of a pool. Usually not equal to the yield. See "Bond Equivalent Yield".

Real Estate Syndicate: a group of investors who pool funds for investment in real property.

Refunding: the process of issuance of a new security to replace a security that was redeemed before maturity. Usually used in reference to a municipal security that was called.

Registered: 1) a security that is issued in the name of the owner or the owner's nominee. 2) opposite of exempt. A registered security may not be issued without the filing of a registration statement with the SEC.

Regular-way Settlement: 1) delivery of a security by a seller to a buyer within the number of days (between the trade date and the delivery date) that the securities industry has established for a particular type of security for normal settlement, e.g., regular-way settlement is three business days after the trade date for agency securities and once a month on the earliest scheduled date for mortgage-backed securities 2) delivery of a security for spot delivery, as opposed to forward delivery,

e.g., a US government security may settle for spot delivery on the same (cash), the next (regular), or the second (skip) day after the trade date.

Regulation T: the name for the Federal Reserve Board's regulation governing the amount of credit that brokers and dealers may extend to customers who buy securities.

Regulation U: the name for the Federal Reserve Board's regulation governing the amount of credit that banks may extend to customers who borrow money to buy securities on margin.

REMIC (Real Estate Mortgage Investment Conduit): a CMO issued after January 1, 1987, through a financing vehicle created by the Tax Reform Act of 1986. A pass-through entity that can hold mortgages secured by any type of real property and issue multiple classes of ownership interests to investors in the form of pass-through certificates, bonds or other legal forms. See "CMO".

Remote: 1) isolated, as in bankruptcy remote. 2) non-recurring. Per FASB, "isolated, nonrecurring, and unusual" encompasses the "extremely remote 'disaster scenarios' (such as a run on the credit union)." This type of event would not be anticipated by a credit union in deciding whether it has the positive intent and ability to hold a debt security to maturity. Other events, no matter how infrequent or remote, that are related to on-going business activities, such as the construction of a building or the payment of claims by an insurance company, are not considered "isolated, nonrecurring, and unusual" under SFAS 115.

Repurchase Agreement (Repo): a security sold subject to an agreement to repurchase at a specified price on an agreed forward date. From the broker's standpoint, this transaction occurs when a security is sold to a counterparty (e.g., credit union) with the obligation that the broker will repurchase the security at a later date. (Industry terminology uses the broker's standpoint.)

Residual: the difference between the cash flows originating from the collateral of a mortgage pool and the funds needed to fund the securities supported by the collateral. Among the CMOs issued by a REMIC, the residual has special tax consequences.

Revenue Bond: See "Municipal Security".

Reverse Repurchase Agreement (Reverse Repo): a security purchased subject to an agreement to resale at a specified price on an agreed forward date. From the broker's standpoint, this transaction occurs when a security is purchased from a counterparty (e.g., credit union) with the obligation that the counterparty will repurchase the security at a later date. (Industry terminology uses the broker's standpoint.)

Rich: Wall Street vernacular for a high value of one security relative to another in terms of its historical price relationship. If a security is said to be rich, it is believed to be overpriced relative to another security. See also "Cheap".

Roll Over: using funds received from a maturing security to reinvest in a similar new security.

Round-Lot: the usual minimum unit of trading (normally \$1,000,000 or more in Governments.)

Safekeeping: a term that refers to the storage and protection of securities provided as a service by a bank or institution acting as agent for the customer. Since ownership interests in most securities now are held as securities entitlements in book-entry form, the broader term is custodian.

Safety: an attribute of an investment. Safety is often associated with securities that have a short maturity and a low credit risk arising from insurance or government guarantee.

Seasoning: the aging of a mortgage. The amount of time that has elapsed since origination.

Secondary Market: the resale market for securities. See also "Primary Market".

Section 107(8) Institution: an institution in which a credit union may make a deposit as authorized under Section 107(8) of the Federal Credit Union Act (12 U S C 1757(8)), e.g., an institution that is insured by the FDIC or a state bank, trust company, or mutual savings bank operating in accordance with the laws of a state in which the credit union maintains a facility.

Securities and Exchange Commission (SEC): an agency established by Congress to regulate the corporate securities market. Brokers and dealers in securities are required to register with the SEC.

Securities Industry Association (SIA): a trade association of securities dealers.

Securities Investor Protection Corporation (SIPC): a federally chartered corporation that provides insurance for customer accounts carried by US broker-dealers. The insurance protects against safekeeping losses from failure of the broker-dealer up to \$500,000.

Securities Lending: lending a security to a counterparty, directly or through an agent, and receiving as collateral an amount of money or securities in return. The value of the collateral usually is greater than the value of the loaned security. A fee is earned by the lender. Similar to "Reverse Repurchase Agreement".

Security: a common or preferred stock, a bond, a US Government or agency issue, or a state or municipal obligation. See also "Negotiable Security".

Self-Regulatory Organization (SRO): any organization which develops regulations for its members and enforces the regulations. Typically, enforcement is obtained by expulsion of members who do not follow the regulations.

Seller-Servicer: an approved corporation that sells mortgages to, and services mortgages for, FNMA, GNMA, and/or FHLMC.

Seller's Option: the right of a seller to select, within the limits prescribed by a contract, the quality of the commodity delivered and the time and the place of delivery.

Selling Hedge: selling futures contracts to protect against possible decreased prices of commodities. Usually called short hedge. See "Hedge".

Sell Out: action taken by a broker or a dealer to liquidate an account or a transaction for failure to maintain proper margin or to make timely payment.

Serial Bonds: a multiple bond issue in which the maturities are staggered over a number of years.

Servicing: the duties of the mortgage banker as a loan correspondent, per specifications in the servicing agreement for which a fee is received. The collection for an investor of payments, interest, principal, and trust items (e.g., hazard insurance and taxes), on a note by the borrower in accordance with the terms of the note. Servicing also consists of operational procedures covering accounting, bookkeeping, insurance, tax records, loan payment follow-up, delinquent loan follow-up, and loan analysis.

Servicing Agreement: a written agreement between an investor and a mortgage loan correspondent stipulating the rights and obligations of each party.

Settlement: an act that discharges obligations in respect of funds or securities transfers between two or more parties, e.g., settlement of a security transaction typically is by delivery of securities in proper form to the buyer and delivery of funds in proper form to the seller on the settlement date.

Settlement Date: the date agreed upon by parties to a security transaction for the payment of funds and the transfer of the security. Trades that are not settled on the settlement date are said to fail.

Settlement Price: the price at which a security or a commodity is to be settled. Used primarily in connection with clearing house operations. In commodity trading, the settlement price is based on the closing price or the range of closing prices.

Short Covering: the purchase of securities so that securities previously sold to make delivery on a short sale may be returned. To close a short position.

Short Hedge: see "Selling Hedge".

Short Option: an option that has been sold.

Short Sale: the sale of a security not owned by the seller. The seller anticipates being able to purchase the security at a later time at a lower price. To make delivery on the short sale, the seller will obtain the security through borrowing (securities lending) or a reverse repurchase agreement.

Short the Basis: the purchase of futures as a hedge against a commitment to sell in the cash market.

Short (vs. Long) Bond: Wall Street refers to the short bond as a US Treasury security with a maturity of two years. See "Long Bond".

Short-Term Investment Fund (STIF): a collective investment fund maintained by a national bank under 12 CFR Part 9, that is restricted to a dollar-weighted average portfolio maturity of 90 days or less similar to a Money Market Mutual Fund.

Small Business Administration Secondary Participation: a security that represents the guaranteed portion of a SBA loan that is sold by a lending institution to a secondary participant. Also called a "Guaranteed Loan Participation Certificate (GLPC)".

Small Business Related Security: a security as defined in §3(a)(53) of the Securities and Exchange Act of 1934, i.e., a security, rated in one of the four highest rating categories by a nationally recognized statistical rating organization, that represents ownership of one or more promissory notes or leases of personal property which evidence the obligation of a small business concern. It does not mean a security issued or guaranteed by the Small Business Administration.

Slow-Pay Bonds: bonds in a low priority class compared with bonds in other classes with respect to the order of redemption, which may result in slow redemption when compared to other classes.

Speculate: to buy or sell securities, commodities, futures, or forward contracts without a natural hedge or a bona fide hedge, e.g., a natural hedge would be to buy a security funded by a deposit liability of similar duration. To trade (e.g., GNMA's) with the hope of quick profit by market movement as opposed to investment income. See "Speculator".

Speculator: one who trades with the objective of achieving profit through the successful anticipation of price movements. In commodity futures, a speculator is any person with a position that is not a bona fide hedge as defined by the Commodity Futures Trading Commission.

Spot: refers to the characteristic of being available for immediate or nearly immediate delivery. Cash market transactions usually are grouped into two kinds - spot and forward contracts. An outgrowth of the phrase "on the spot."

Spot Commodity: see "Actuals".

Spot Month: in futures trading, the nearby contract month, in which case delivery usually is possible at any time. However, such trading is in a futures contract.

Spot Price: the price at which a financial instrument or physical commodity is selling at a given time and place. Same as cash price.

Spread: the difference between yields on securities of different quality or different maturity. The difference between bid and ask price is also called the spread.

Spreading: the purchase of one futures contract and the sale of another, in the expectation that the price relationships between the two will change so that a subsequent offsetting sale and purchase will yield a net profit. Examples include: (a) the purchase of one delivery month and the sale of another in the same commodity on the same exchange, (b) the purchase and the sale of the same delivery month in the same commodity on different exchanges, (c) the purchase of one commodity and the sale of another (wheat vs. corn or GNMA's vs. long-term US Treasury Bonds), and (d) the purchase of one commodity and the sale of the products of that commodity (soybean vs. soybean oil and soybean meal). When the terms of the contract and all other relevant factors indicate that the price relationships between the contracts should be constant, but price discrepancies develop due to temporary supply-demand imbalances, spreading operations to take advantage of such

discrepancies are sometimes erroneously called arbitrage. Spreading generally involves the making of judgments about price relationships which are subject to gradual change due to economic factors which vary over a period of time and is, therefore, a form of speculation.

Standby Commitment: a commitment to either buy or sell a security, on or before a future date, at a predetermined price. The seller of the commitment is required to either accept delivery of a security (in the case of a commitment to buy) or make delivery of a security (in the case of a commitment to sell), in either case, at the option of the buyer of the commitment. See "Option".

Standby Fee: the fee charged by an investor for a standby commitment. The fee is earned upon issuance and acceptance of the commitment.

Stop-Loss: a method of limiting the amount of loss caused by a decline in the market value of an investment by establishing a "low" point at which an investment will be sold.

Street Name: a registered security which has been endorsed in blank or endorsed in favor of a recognized dealer is said to be in street name. A security may remain in the broker's name as long as the credit union is the beneficial owner of the security.

Strike Price: the price at which a security underlying a call (or put) option can be purchased (or sold) upon exercise during the period specified in the contract. Also called "Exercise Price".

Strips or Stripped Treasuries or STRIPS: see "Zero Coupon Treasury Bonds".

Stripped Mortgage-Backed Security: a mortgage-backed security that has been separated into principal and interest components. Stripped mortgage-backed securities are not permissible investments for natural person federal credit unions.

Structured Note: a security with a coupon, average life, or redemption value that is linked to a) changes in an underlying index; b) changes in the prepayment speed of a mortgage-backed security used as a reference for the structured note; or 3) other factors. A government sponsored enterprise may issue structured notes to reduce the agency's cost of funds. The risk of embedded options make some structured notes unsuitable investments for federal credit unions.

Stuffed Pig: a transaction initiated by a dealer for a client without authorization from the client. See also "Wooden Ticket".

Subordinated Debenture: an unsecured debt obligation that is junior in payment priority to other senior bonds. In the event of bankruptcy, the claims of the unsecured debt holders are paid after those of senior unsecured debt holders.

Swap: 1) a contract between two parties to exchange cash flows in the future based on an agreed formula. A swap is a bundle of forward contracts. Swaps are available in and between all active financial instruments. a) The "plain vanilla" interest rate swap agreement is an agreement to exchange fixed interest payments for floating-rate payments based on a notional principal amount. The notional principal amount is not exchanged in an interest rate swap. b) A generic currency swap is an agreement to exchange one currency for another, at the beginning and at the end of the swap, and to make fixed interest rate payments based on the currency obtained

during the life of the swap. c) A generic equity swap is an agreement to exchange the capital gains (and perhaps dividends) based on an equity index in return for payments based on a fixed or floating rate of interest. 2) the practice of exchanging one bond for another to improve yield, change credit exposure, reflect an interest rate view, or register a tax loss. More generally, the exchange of one asset or liability for a similar asset or liability for the purpose of lengthening or shortening maturities, or raising or lowering coupon rates, to maximize revenue or minimize financing costs. A bond swap is very different from a notional principal swap, but the term "swap" has been in use longer in the context of bond swaps. The different uses occasionally confuse new users of notional principal swaps.

Sweep Account: an account into which funds are transferred on a short-term basis. Cash or checking accounts may be swept into an overnight federal funds account through a sweep account arrangement.

Switch: liquidation of a position in one delivery month of a commodity and simultaneous initiation of a similar position in another delivery month of the same commodity. When used by hedgers, this tactic is referred to as rolling forward the hedge.

Systemic Risk: the risk that the failure of one participant in a transfer system, or in financial markets generally, to meet its required obligations will cause other participants or financial institutions to be unable to meet their obligations (including settlement obligations in a transfer system) when due. Such failure may cause significant liquidity or credit problems and, as a result, might threaten the stability of financial markets.

Systematic Risk: the risk associated with the movement of a market or market segment as opposed to distinct elements of risk associated with a specific security. Systematic risk cannot be diversified away; it can only be hedged.

TAC (Targeted Amortization Class): a CMO tranche which is protected, to some degree, from prepayment risk, but not extension risk. See "PAC", "CMO".

Take Out Bid: a GNMA dealer agrees to purchase GNMA securities at a specific price from a mortgage banker, subject to a successful bid for mortgages sold at auction. This take-out or backup bid allows mortgage bankers to bid on the purchase of mortgages, obtained from GNMA, to their servicing portfolios. This two-party agreement helps GNMA to implement its management and its liquidation functions. In net effect, the mortgage banker is purchasing the mortgage collateral and is financially backed by the GNMA dealer.

Taken (Lifted): a dealer is "taken" (lifted) when the offering side of a market which he has made to a customer is accepted.

Taking a Position: purchasing a security for inventory.

Term: 1) the period of time between the commencement date and the termination date of a note, mortgage, legal document, or other contract. 2) a provision in a contract.

Theta: a measure of the rate of change in the value of an option (or portfolio) as a result of the passage of time. The value of an option usually will decline with the passage of time with all else remaining constant. Also called time decay.

Tick: the typical minimum price increment in cash market quotations, e.g., one thirty-second of one percent, .03125% or .0003125, in US Treasury securities.

Time Value: the part of the option premium that reflects the remaining life of the option. The total option value is the sum of its intrinsic value and its time value. The more time that remains before the expiration date, generally the higher the premium, because more time is available for the value of the underlying security to move up or down.

To Be Announced (TBA): a delayed-delivery contract. A contract for the purchase or sale of a mortgage-backed security to be delivered at an agreed upon future date, but that does not specify an identified pool number and number of pools. Trading in these securities is often done on a yield basis.

Total Return: the sum of interest and principal payments, the income earned on the reinvestment of these cash flows, and the change in fair value over a specific holding period (horizon) for a specific security.

Trade: either a purchase or a sale of a security.

Trade Date: the date on which parties enter into an agreement, orally or in writing, for the purchase or sale of a security.

Trading: the act of entering into purchases or sales of a security.

Trading Income: income derived from the trading of a portfolio of securities.

Trading Profits or Losses: profits or losses resulting from the trading of a portfolio of securities.

Transfer: when a registered instrument is acquired, it is sent to the transfer agent for transfer. The transfer agent records that this certificate is no longer owned by the previous holder but is now owned in the name of the individual who has acquired it.

Transfer Agent: an entity appointed to maintain records of securities owners, to cancel and issue certificates and to address issues arising from lost, destroyed or stolen certificates.

Treasury/U.S. Government Obligations: negotiable debt obligations of the US Government secured by its full faith and credit.

Treasury Bill (T-Bill): a direct obligation of the US Government issued at regular auctions on a discount basis from face value for original maturity periods of 13 weeks to 52 weeks.

Treasury Bonds: a direct obligation of the US Government issued at regular auctions. Currently issued in original maturity of 30 years. Treasury bonds are coupon instruments with semi-annual interest payments.

Treasury Notes: Treasury notes have the same characteristics as Treasury bonds except that the original maturities range from one to ten years.

Twelve-Year Life: historically, an assumption that the cash flow associated with a mortgage will consist of level payments until the twelfth year, when the remaining principal balance is paid in full.

Uncovered Call Writer: a call writer who does not own the underlying financial instrument on which the option is written. Also called a naked call writer.

Underlying: the security, cash commodity, forward, futures, swap, or other contract or instrument that is the subject of a derivatives contract or instrument.

Underwriting: 1) any person who has purchased from an issuer with a view to distribute any security. Securities dealers use this term to designate the issue of origination of new securities. 2) the process used by a Mortgage Banker to analyze risk and the matching of risk to an appropriate rate and term.

Uniform Commercial Code (UCC): a comprehensive model statute to simplify and clarify the law governing commercial transactions, designed to make uniform the laws of the states. It has been adopted, with modification, by most states.

Unit Investment Trust: an investment company similar to a mutual fund, but which issues only redeemable securities (units), each of which represents an undivided interest in a portfolio of securities.

Up-Front Fee: see "Fee".

Variation Margin: in futures trading, a payment made on a daily or intraday basis by a clearing member to the clearing organization based on adverse price movement in positions carried by the clearing member. Variation margin is a cash payment, as opposed to maintenance margin, which is a value (in cash or eligible securities) which must be maintained on deposit as a performance bond. Individuals may be subject to a margin call to replenish the performance bond to the initial margin level in the event the value drops below the maintenance margin level.

Vega: a measure of the change in an option's price for a given change in the volatility of the underlying security.

Volatility: a measure of a security's actual or expected price movement over a specific time period. Usually this is the standard deviation of proportional changes in the asset's price.

Warehousing: the borrowing of funds by a mortgage banker on a short-term basis at a commercial bank, using permanent mortgage loans as collateral. This form of interim financing is used until the mortgages are sold to a permanent investor. It is a form of "line of credit" financing.

Weighted-Average Coupon (WAC): the arithmetic mean (dollar-weighted) of the coupon rate of the underlying mortgages that collateralize a security as of its issue date. This is the same calculation used for WAM except using the mortgage coupon.

Weighted Average Life: the arithmetic mean (dollar-weighted) of the time to principal repayment of a security. WALs for CMOs and mortgage pass-through securities are calculated under a prepayment assumption. The WAL is a commonly used maturity measure in the mortgage market. Since the weighted-average lives of Treasuries are equal to their maturities, the par yield curve for Treasuries provides a

natural benchmark for pricing mortgage-backed securities of various projected average lives.

Weighted-Average Maturity (WAM): the arithmetic mean (dollar-weighted) of the remaining term of the underlying mortgages that collateralize a security as of its issue date. This is the sum of the principal balance of each mortgage in the pool times its months to maturity divided by the total principal balance of the mortgages in the pool. Subsequent to issuance, estimates are made of the expected average remaining term assuming no prepayments.

When Issued (WI): short for when, as, and if issued. Transactions prior to issuance of a security are on a WI basis, because the transaction is conditional on issuance, although the security has been authorized. The when issued trading period in US Treasury securities is normally three to ten days. However, interest does not accrue during the when issued period, and payment is not required until the settlement date. When issued trading in Treasury securities occurs on a yield basis prior to the auction (sometimes denoted w.w.i.) and on a price basis following the auction (denoted w.i.).

Wooden Tickets: a transaction initiated by a dealer for a client without authorization. See 'Stuffed Pig'.

Writer: the grantor of an option contract. Also called the "Maker".

Yield: the yield on a bond is the annual percentage of return that it pays, typically based on a semi-annual coupon convention. By way of comparison, the annual percentage yield (APY) is based on an annual compounding convention. In real estate, the term refers to the current yield, that is, the effective annual amount of income which is being accrued on an investment, expressed as a percentage of the price originally paid. See also "Net Yield".

Yield Curve: a graph illustrating the level of interest rates as a function of time to maturity. The most common yield curve plots Treasury securities from the 3-month Treasury bill to the 30-year Treasury bond. Yield Curves may be described as a) a normal yield curve (short-term rates are lower than long-term rates); b) an inverted yield curve (short-term rates are higher than long-term rates); and 3) a flat yield curve (little difference between short-term and long-term rates).

Yield on Average Life: historically, GNMA yields were quoted from tables which calculated the yield on a single loan prepaid at the end of 12 years. It was assumed that such a yield calculation was fairly representative of a pool of loans wherein the average loan life was thought to be 12 years. No longer a basis of trading.

Yield Maintenance Contract: concurrent commitment to purchase a security via a cash forward agreement and to sell the same security on the same settlement date via a standby commitment. Also refers to a forward contract written with terms which maintain the yield at a fixed rate until the delivery date.

Yield to Call: the bond-equivalent yield that an investor would receive on his investment if he were to buy a particular security at the quoted asked price and the bond was called on the call date.

Yield to Maturity: the bond-equivalent yield that an investor would receive on his investment if he were to buy a particular security at the quoted asked price and hold to maturity.

Zero Coupon Bond: a security that makes no periodic interest payments and is sold at a discount from face value. Zero coupon bonds that mature more than ten years from settlement date are not permissible under Part 703.

Zero Coupon CMOs: CMO bonds that are either true zero coupon instruments or accrual bonds. An accrual bond (or compound interest bond) is a coupon bond that, during some part of its life, accumulates accrued interest as increased principal rather than as cash paid. This accumulation is called accretion.

Zero Coupon Treasury Bonds (STRIPS, Stripped Treasuries): a Treasury security with a single cash flow at maturity. These securities result from the separation of the principal (corpus) and interest (coupon) portions of US Government obligations. Most zero coupon Treasury securities are in the Federal Reserve book-entry system under the STRIPS program, Separate Trading of Registered Interest and Principal of Securities. The holder of a corpus strip has the right to receive the principal balance on the maturity date. The holder of a coupon strip has the right to receive the periodic interest payment on the coupon payment date. These instruments are sold at a discount from the value to be received on the due date. Prior to the STRIPS program, Wall Street firms issued ownership interests in trusts that stripped Treasury securities. As a transitional measure, the Federal Reserve registered stripped physical coupons as CUBES, Coupons Under Book-Entry System.

Chapter 13

ASSET LIABILITY MANAGEMENT (ALM)

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Chapter 13 – Part 1

ASSET LIABILITY MANAGEMENT (ALM)

Examination Objectives

- Determine safety and soundness of the credit union's Asset Liability Management (ALM) process
- Determine whether the credit union effectively manages its balance sheet
- Alert the officials to existing or potential weaknesses resulting from the ALM process

Associated Risks

- Interest rate risk (IRR) – the risk that changes in market rates will adversely affect a credit union's capital and earnings;
- Liquidity risk – the current and prospective risk to earnings or capital arising from a credit union's inability to meet its obligations when they come due;
- Strategic risk – the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes; and
- Reputation risk – the risk that the credit union cannot meet member loan and share funding requests, causing concerns about the credit union's solvency.

Overview

ALM is the process of evaluating balance sheet risk (interest rate and liquidity risk) and making prudent decisions, which enables a credit union to remain financially viable as economic conditions change. A sound ALM process integrates strategic, profitability, and net worth planning with risk management. This process often includes an Asset Liability Committee (ALCO), which has the central purpose of attaining goals established by the short- and long-term strategic plans without taking on undue risk. While smaller credit unions with simple balance sheets may not have or need an ALCO, an ALCO represents a sound business practice for larger institutions with more product offerings (e.g., real estate loans.)

Credit unions with effective ALM programs can better balance the demands of meeting their members' needs with the objectives of maintaining financial strength and flexibility. Credit unions with sound ALM processes recognize that ALM involves more than just an IRR measurement program; they retain a global view of the purpose of ALM. For example, ALM management includes activities such as marketing, product pricing, investment analysis, cash management, internal controls, and data processing, all while understanding how external factors (e.g., laws, economic conditions, sponsor support) affect the credit union.

Overall, successful ALM programs encompass the following practices:

- Identifying goals and objectives;
- Developing strategies;
- Creating policies and procedures;
- Managing product offerings and pricing;
- Identifying, measuring, monitoring, and controlling exposures to risk;
- Generating adequate income and net worth over varying economic conditions; and
- Maintaining financial flexibility.

Credit union boards have responsibility for overseeing the ALM process, and usually delegate the day-to-day implementation to management. Since ALM affects the entire scope of a credit union's operation (e.g., types of loans, loan rate structure, investments, sources of funding, share rate structure, profit expectations, level of risk, etc.), an effective ALM program requires an integrated process of coordinating, analyzing, and communicating that includes all operational units.

In larger credit unions, key players or operating units involved in the ALM process generally include the chief executive officer (CEO) and the chief financial officer (CFO), as well as management in the areas of finance (investments), lending (credit), shares, and marketing. Smaller credit unions may integrate the ALM process within one or two key persons (e.g., CEO or CFO.)

The primary objective of examiners' ALM review involves analyzing the credit union's approach to ALM and assessing the level of balance sheet risk exposure. Therefore, the examiner should ensure management performs its due diligence by regularly analyzing the structure of its assets (loan and investment products, rates, terms, etc.) and liabilities (share products, rates, terms, etc.) to determine the credit union's potential risk exposure.

To ensure they maintain adequate net worth over a broad range of possible economic conditions, credit unions should have in place a process for (1) identifying, measuring, monitoring, and controlling balance sheet risk; (2) monitoring financial performance; and (3) actively managing (limiting) short- and long-term earnings fluctuations. The officials should understand the reasons for any balance sheet risk exposure. They should adjust the plan when necessary to maintain positive earnings and sufficient net worth. In this regard, ALM represents a decision-making tool for helping credit unions realize stable earnings and appropriate net worth levels over time as economic conditions change.

Sound, flexible ALM processes, which can respond to changing market conditions, enable credit unions to make more prudent decisions about their balance sheet growth and product mix. This also enables the credit union to better serve their members' needs without incurring excessive or unreasonable levels of risk.

While the term ALM can encompass the broad area of balance sheet risk, this chapter will focus on interest rate and liquidity risks because they represent the most prominent risks affecting credit unions. Part 2 of this chapter addresses Interest Rate Risk and Part 3, Liquidity Risk. Although this chapter separately addresses each of these risks, in reality, they interrelate with each other. That is, actions that will affect a credit union's IRR exposure will also likely influence the liquidity risk exposure to some degree, and vice versa.

Reference

- IRPS 98-02, dated 1998, *Supervisory Policy Statement on Securities Activities and End-User Derivative Activities*

Chapter 13 – Part 2

ALM – INTEREST RATE RISK

Examination Objectives

- Determine the credit union's exposure to interest rate risk (IRR)
- Evaluate how effectively management manages IRR exposure
- Communicate necessary concerns with management
- Develop agreements for corrective action, as necessary

Associated Risks

- Interest rate risk (IRR) – the risk that changes in market rates will adversely affect a credit union's capital and earnings;
- Strategic risk – the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes; and
- Reputation risk – the risks that the credit union cannot meet member loan and share funding requests, causing concerns about the credit union's solvency.

Overview

IRR is the potential decline in earnings and net worth arising from changes in interest rates. This risk generally occurs because a credit union may have a disproportionate amount of fixed and variable rate instruments on either side of the balance sheet. Thus, as interest rates change, the earnings stream or dividend expense on variable rate balances will change while fixed rate balances will remain the same. Accordingly, net income may rise or fall depending on the direction of rate changes and whether the credit union is asset or liability sensitive.¹

Credit unions with sound interest rate risk management processes can often avoid wide swings in net earnings (see Illustration 13-A.)

¹ Asset sensitive means that the credit union has more assets that will reprice than shares. Liability sensitive means that a credit union has more liabilities that will reprice than assets. Repricing can occur due to maturities or resetting variable instruments interest rates.

Illustration 13-A shows how the asset yield (interest income) of a credit union can decline over time in response to falling market interest rates. The graph depicts how this credit union adjusted its cost of shares (interest expense) and thereby maintained a relatively constant net interest income (NII) over time. Finally, the graph shows net operating expenses as relatively constant and net income positive over the period, with only a slight variance despite the falling market interest rates.

Margin Analysis

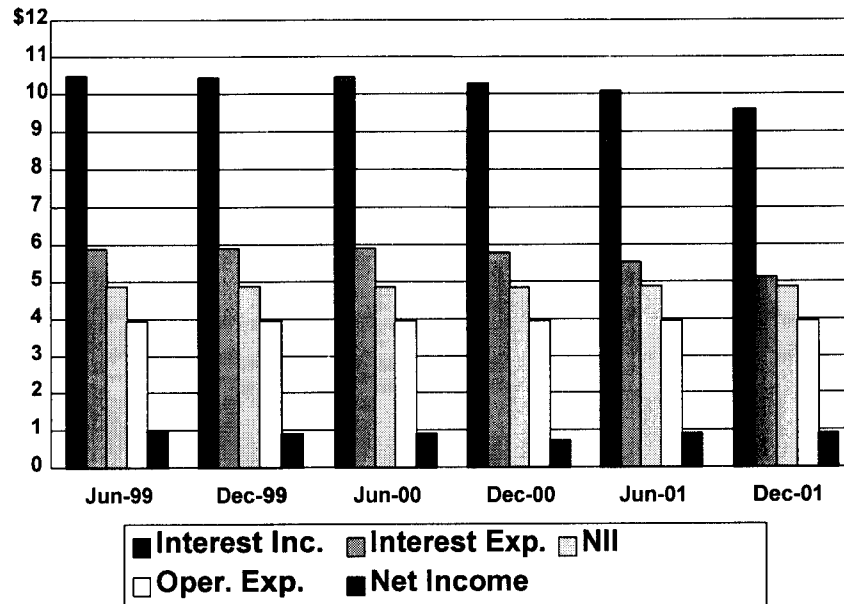


Illustration 13-A

Small and basic service credit unions may have fairly simple IRR processes. These may incorporate awareness of the members' share and loan needs, relatively simple short-term loans and investments, and flexible pricing policies that permit adjusting dividends and loan rates to changes in market interest rates, thus maintaining adequate earnings and net worth. In larger credit unions with more complicated balance sheets, particularly those with higher concentrations of long-term assets or more rate-sensitive deposits, the credit union needs a more sophisticated and comprehensive approach to IRR management. It also requires a more extensive review by the examiner.

**IRR
Examination
Procedures**

The depth of analysis and time needed to review a credit union's IRR management process varies from examination to examination. The types of tests and level of examiner scrutiny will depend on the complexity and size of a credit union's balance sheet, from "simple" to "complex."

Credit unions having a conservative, short-term structure of shares, loans, and investments may only need to demonstrate a basic understanding of IRR. Aside from repricing their share and loan products, simple credit unions generally pose lower IRR.

For larger credit unions or those with more complicated balance sheets, the examiner should expect a more comprehensive IRR management process. This should include a more sophisticated analysis prepared and provided to the board on a regular basis with measures of exposure to IRR.

The Interest Rate Risk Questionnaire (IRRQ) in AIREs is a flexible, yet comprehensive tool to help the examiner determine the scope of an IRR review. When examiners find little evidence of IRR, they can narrow and focus the scope on a general review of the risk management process. When a greater likelihood of IRR exists, examiners should expand the scope to review and analyze the risk management program in depth. Regardless of the credit union's approach to risk management, the examiner may use, as necessary, Parts A through D of the IRRQ to document the review of certain basic elements.

**Complex
Investments**

As a first step, the examiner should determine whether the credit union has any loans secured by real estate or any complex investments. According to Part 703 of *NCUA Rules and Regulations*, complex investments have the following characteristics:

- Embedded options (e.g., calls, interest rate caps or floors, prepayments);
- Remaining maturities greater than 3 years; or
- Coupon formulas related to more than one index, or are inversely related to, or multiples of, an index.

In addition to these investments defined as complex by regulation, other investments may exhibit sufficient risk to require treatment as complex. Credit unions may have other investments carrying significant risk that do not fall within the definition of complex; however, these credit unions may require further examiner scrutiny of their IRR management process. For credit unions with complex investments, examiners should review the credit union's procedures for following the regulatory reporting requirements of §703.70 and §703.90.² If examiners determine a credit union has a simple structure, they can limit the scope of the examination.

Policies and Procedures

The IRR examination review is mostly qualitative in nature with the examiner looking at the various areas of a credit union's IRR management process. The examiner should review the credit union's IRR policies and procedures and determine if they adequately correspond to the size and complexity of the balance sheet. The credit union's practices should effectively implement the policies and procedures. Although the regulations do not require an IRR management or ALM policy, safe and sound business practices do.

However, no requirement exists for a separate IRR or ALM policy independent of other policies, even for large, complex credit unions. Credit unions have the option of either creating a separate IRR or ALM policy or incorporating it into Investment, Cash Management, or other policies. The form of the policy is not as important as its scope. Regardless of form, credit unions should clearly document their IRR management program in writing.

The scope of the policy will vary depending on the complexity of the credit union's balance sheet. A credit union that offers personal loans, invests in non-complex or short-term bullet investments (a debt security that returns 100 percent of principal on the maturity date), and offers basic share products may not need to create an elaborate policy. The policy for these credit unions may limit the loan portfolio maturity, require a minimum amount of short-term funds, and restrict the types of permissible investments (e.g., Treasuries, bullet bonds.)

² RegFlex removes the shock test requirement under §703.90 for qualifying credit unions.

More complex balance sheets, especially those containing mortgage loans and complex investments, require a comprehensive IRR management policy. The policy should establish responsibilities and procedures for identifying, measuring, monitoring, controlling, and reporting IRR, and should establish risk limits. Overall, the examiner should determine the adequacy of credit union policies using the following guidelines:

- Written policies addressing IRR, and containing enough detail for the appropriate parties (e.g., board, ALCO, ALM program person, investment officer) to understand the risk limits and their individual responsibilities. Management should avoid vague language and boilerplate policies;
- Reporting requirements providing informative reports to decision makers in a timely manner. The policies quantify risk limits and provide for prompt identification of IRR so management can implement appropriate risk mitigation strategies in a timely manner;
- Risk limits for both short- and long-term cash flow horizons (e.g., both earnings and economic value perspectives, if appropriate); and
- Frequent policy updates addressing the risks inherent in the current balance sheet. When developing or updating policies, management should seek input from across the organization (e.g., board, ALCO, and operational departments such as lending and investments.)

The board should review the policies at least annually, and revise as the credit union makes changes to its business practices (e.g., types of loans, types of shares, and types of investments), introduces new strategies, or when the complexity, asset size, or sophistication of management changes. For example, when a credit union first offers a mortgage loan product, or offers a mortgage loan product with significantly different terms (e.g., new balloon product or home equity line of credit), the board should review the policies to determine if they address any additional potential IRR.

If possible, the policy should require the credit union to spread risk management duties among several divisions (e.g., senior management, lending, cash management, investments, and deposit activities), or assign them to a committee (e.g., ALCO) comprised of both credit union staff and board members. This integrates risk management into credit union operations. Small credit unions with limited staff and resources can vest these responsibilities with the manager and the board.

Effective IRR management programs require strong internal controls. Management must develop internal controls that promote accurate risk measurement and objective reporting. By separating risk-taker responsibilities (e.g., investment officer or CEO) from those responsible for measuring (e.g., ALM program person) and assessing (e.g., ALCO) risk, credit unions decrease the possibility of optimistic and inaccurate risk measurement results and, consequently, inappropriate decisions. If segregation of these duties does not exist, this shortcoming may lead to high IRR exposure. The examiner should determine if the policy addresses the internal controls governing the IRR management process.

Small or non-complex credit unions lacking available resources may have to concentrate risk taking and risk measurement responsibilities in a single individual. The board and supervisory committee should take an active role in monitoring the activities of the individuals. The board should also limit each individual's authority.

The basis of the IRR measurement should correspond with the complexity of the balance sheet: gap and simplistic (short-term) income simulations can suffice for simple balance sheets that primarily consist of short-term bullet type investments (e.g., Treasury bills or notes) and non-mortgage related assets (e.g., no real estate loans or mortgage-backed securities.) Credit unions with more complex balance sheets, including those with complex investments and real estate portfolios, require more sophisticated earnings simulations and economic valuation models (e.g., shocked mortgage and investment [asset] valuation or NEV.) As the complexity of the balance sheet increases, conducting multiple measures can prove advantageous since each methodology may measure IRR differently.

The IRR management or ALM policy should express IRR measures and limits in terms of gap, earnings (i.e., net income [NI], net interest income [NII]), net worth (e.g., mortgage portfolio shock, investment portfolio shock, change in NEV) or a combination of these. For all but the smallest or simplest credit unions, management should establish quantitative IRR measures to alert the credit union of the existence of unacceptable IRR exposure.

While a credit union may use other rate scenarios, and is encouraged to do so, at a minimum it should apply a +/- 300 basis point (bp) instantaneous, permanent, and parallel rate shock. Under this rate shock, the entire current yield curve (both short- and long-term rates) is assumed to shift 300 basis points from its current position immediately and without future movements. NCUA considers this a reasonable stress test.

For additional scenarios, the credit union may apply a yield curve twist by shocking only a portion of the yield curve, such as short-term rates, or apply a ramped rate scenario by adjusting the yield curve gradually over time, generally 12 months. The credit union may also analyze basis risk by measuring the impact of changing relationships between indices (e.g., 90 day Treasury bill versus 3 month LIBOR.) The more scenarios the credit union runs, the better its understanding of potential sources of risk.

For credit unions with complex balance sheets (e.g., mortgages and complex investments), management should provide IRR measurement reports to the board no less frequently than quarterly. In cases where the balance sheet changes frequently and significantly, management should consider providing monthly reports. The board may receive IRR measurement reports less frequently if management provides such reports to an ALCO (preferably, with at least one board member on the ALCO) and the ALCO alerts the board to significant events (e.g., approaching or broaching a policy limit.) Semiannual board reports may suffice for less complex credit unions.

IRR policy limits, commensurate with the earnings and net worth position, mean that highly profitable and well-capitalized credit unions may establish less restrictive limits than those less profitable or with lower capital. Management should consider the degree of

precision and accuracy of the risk assessment model when determining acceptability of a risk limit. A sophisticated model that properly addresses prepayment and other option risks will likely experience less measurement error; therefore, a looser limit may suffice. Conversely, if the risk measurement model and depth of analysis or precision is low, then the credit union should tighten the risk limits to compensate for potential inaccuracies. Refer to the IRR measurement section of this chapter for further discussion.

Sample Credit Union Policy Limits for IRR	
<i>Basis of measurement</i>	<i>IRR Limit</i>
Gap:	beyond +/- 20 percent change in any given period, or cumulatively over 12 months
Earnings Simulation:	
NII	after shock change > 30 percent over any 12 month period
NI	after shock change > 75 percent over any 12 month period
Asset valuation:	after shock change in book value net worth > 50 percent <u>or</u> after shock value of net worth < 4 percent
NEV:	after shock change in market value net worth > 50 percent <u>or</u> after shock value of net worth of < 4 percent
Table 1	

IRR limits exceeding the parameters in Table 1 indicate possible red flags (all limits assume a +/- 300 basis point instantaneous and permanent interest rate shock.)

A red flag exists if the credit union exceeds the limits of the IRR policy. This could signal that (1) the risk assessment methods used did not adequately identify potential risks, (2) the credit union failed to take prompt action to reduce the risk exposure, or (3) management's efforts ineffectively reduced the risks. However, the possibility exists that unforeseen events caused the credit union to exceed the risk limits and the credit union actually took prompt corrective action to mitigate future risk. Examiners should expect management to explain the underlying causes and the resulting credit union action.

**Planning and
IRR
Management**

Examiners should review how the credit union integrates the IRR management process with strategic and financial planning. They should determine if strategic planning occurs at ALCO meetings, or if planning represents a separate function. Strategic planning meetings should include the ALCO, who should have an opportunity to comment on proposed plans. Exclusion of the ALCO from strategic plan development impairs IRR management integration into the planning process. Overall, the examiner should review the following to determine if the credit union adequately integrates IRR management and planning:

- The credit union considers the effect of future events on its IRR exposure;
- The credit union adopts strategic plans after considering the risk/reward relationship. The credit union appropriately analyzes and measures the IRR associated with new products, services, or investments;
- The credit union includes ALCO and other persons with ALM responsibilities in the strategic planning process;
- The credit union updates IRR policies and risk limits as necessary and in a timely manner to reflect the projected risk profile;
- ALCO minutes document that the committee actively assesses risk and makes recommendations to the board to mitigate risk or improve the IRR management program; and
- The credit union conducts periodic assessments to compare actual performance with the plan.

Management may establish new risk limits during the strategic planning process. If so, management should support its rationale for the change. If the strategic plan shows significant growth in services, products, or account balances, the examiner should see an explicit integration with the IRR policy and associated risk limits.

For example, during the strategic (financial) planning process, credit unions should consider the effect on balance sheet IRR resulting from changes to the following:

- Share and borrowing portfolio structure (e.g., non-member shares, high rate money market accounts, long-term advances, or insufficient early withdrawal penalties on CDs);

- Loan portfolio structure (e.g., longer maturities [>5 years], prepayment risk, or non-conforming real estate loans);
- Investment portfolio structure (e.g., lengthening maturities, inverse floaters, dual-index floaters, or callable securities); and
- Future events forecast by management that may have a material effect on balance sheet structure and IRR (e.g., merger, aggressive growth plans, sponsor layoff, or restructure.)

Management should measure the potential effect of projected changes in balance sheet structure. They should model projected balances or product (investment) mix changes under different interest rate scenarios to determine the risk exposure of projected changes.

If credit unions simply adjust product rates in line with market rates, their IRR management programs should not require significant in depth analysis. However, balance sheet exposure changes when the credit union adds products or investments with different:

- Maturities (e.g., 20 years versus 5 years);
- Cash flow behavior (amortizing/callable cash flow versus a bullet);
- Floating rate indices (e.g., Prime versus LIBOR); or
- Repricing intervals (e.g., 1-year versus 5-year ARMS.)

If the credit union has implemented a new loan or share program since the last examination, the examiner should determine whether the credit union performed due diligence by (1) performing an IRR analysis that addressed the characteristics of the product, and (2) documenting its assumptions and analysis. For example, implementing a mortgage program would require comprehensive understanding of prepayment risk and proper analysis of IRR. Similarly, if a credit union currently offers personal loans and chooses to begin offering home-equity lines of credit (HELOCS), it must address the effect on the current portfolio of uncertain cash flows (e.g., draws or prepayments) and other variable rate features. It must also determine whether the existing data processing system can properly handle HELOCS.

Effective management of IRR depends on credit unions evaluating risk/reward relationships and setting appropriate limits on new programs. If the credit union knows about a planned future event (e.g., sponsor layoff, credit union merger, etc.), it should analyze the pro forma effect on its financial standing, especially on IRR exposure. This also applies to credit unions dependent on an industry experiencing turmoil. Further, credit union mergers can radically change the continuing IRR profile, if the merging entities have different asset/liability mixes. Prudent credit unions will conduct pre-merger risk analyses.

Finally, the credit union should conduct periodic assessments to compare the actual performance with those forecasted. Self-assessments of prior projections and plans enable the credit union to (1) identify inaccurate or unreasonable assumptions or other causes for discrepancies, and (2) improve the validity of future projections.

**Oversight,
Monitoring,
and ALCO**

The ALCO typically provides management oversight and guidance for the ALM program as a whole, including IRR management. The major responsibilities of ALCO include identifying and monitoring IRR and developing strategic risk mitigation strategies.

The depth of monitoring necessary for the IRR management program will depend on the credit union's size and relative complexity. Smaller, less complex credit unions with simple balance sheets may not have (or need) an ALCO. They may only need to determine whether the balance sheet has changed significantly, and monitor general ratios (e.g., loan to share ratio, long term assets ratio.) A semiannual evaluation may suffice for these credit unions. More complex credit unions should have procedures in place requiring senior officials to consider the effect of strategic decisions on the IRR exposure, review risk results and ratios, and determine courses of action. These complex credit unions should monitor IRR at least quarterly.

Larger or more complex credit unions should have a well-organized ALCO with clear, relevant, and concise IRR management documentation. The examiner should review the composition of the current ALCO and determine whether members have staff or board

positions. Preferably, at least one board member will sit on ALCO. This improves communication between the ALCO and the board, and increases the board members' knowledge of IRR. The ALCO should consist of representatives across the credit union's divisions of responsibility (e.g., loan department, investment office, marketing department, CFO, and CEO) since IRR management decisions affect the entire credit union operation.

Officials involved with ALCO should have knowledge of the credit union's risk position and actual performance compared to stated objectives. While individual qualifications may vary, the ALCO members should understand IRR. The complexity of the balance sheet will influence the desired level of experience on the ALCO. That is, for simple balance sheets, a basic understanding of interest rate risk should suffice. For complex balance sheets, the committee should understand (1) specific sources of balance sheet risk, (2) risk measurement techniques, (3) risk measurement results, and (4) risk mitigation strategies.

As the degree of balance sheet complexity increases, so should the amount of training provided to ALCO members. Timely training enables members to remain versed on contemporary ideas. Weaknesses in the IRR management process may signal a need for training. Examiners may review the level of training provided to ALCO members since the prior examination.

Overall, the examiner should assess the adequacy of the ALCO's oversight of the ALM program by determining if the ALCO:

- Provides adequate documentation of its discussions and actions, and demonstrates it meets its prescribed responsibilities;
- Understands that IRR risk concepts adequately coincide with the amount of risk permitted;
- Comprehends the risk measurement reports so that it effectively assesses interest rate risk and makes proper recommendations to mitigate risk;
- Attends training regularly on contemporary IRR management issues and risk measurement methodologies; and

- Understands the key assumptions driving the model to ascertain the accuracy of results and precision of risk measurement reports, and offers recommendations for improvement.

The examiner may review ALCO minutes, noting whether the ALCO holds meetings as required by policy. Minutes establish a formal record of ALCO meetings and member attendance. Lack of minutes may indicate the ALCO is inactive, does not follow a consistent agenda in which it evaluates risks, or does not make formal recommendations to the board.

Examiners should note as a finding ALCO's failure to meet as required. By not meeting as required, ALCO not only violates board policies, but it also fails to monitor risk on a regular basis. Examiners may want to consider interviewing ALCO members to determine the extent to which they understand and meet their ALCO responsibilities.

Examiners should review the types of decisions and discussions documented in the minutes. For ALCO meetings, the minutes should evidence that ALCO:

- Reviews IRR exposure and compares the results to ALM policy limits;
- Develops alternative plans when risk in the credit union approaches or exceeds risk thresholds; and
- Discusses and determines whether the current risk measurement system adequately evaluates IRR and liquidity risk exposures. For credit unions with in-house IRR measurement models, this could include the engagement of an outside IRR vendor or consultant to test and validate the IRR modeling process.

As a key user of the model's output, the ALCO must understand the key assumptions driving the results. While the ALCO need not have a thorough knowledge of the underpinnings of the model (e.g., understanding how the model estimates prepayments on amortizing accounts), it should have a broad understanding of model assumptions. For example, it should recognize that mortgage prepayments would vary with changes in market interest rates (e.g., due to the refinancing incentive.) As the key user of the risk

measurement output, ALCO should appropriately determine the shock scenarios (e.g., applying an instantaneous 300 basis point shock) and establish the balance sheet forecasts (if the credit union uses a dynamic balance sheet approach for earnings simulations.)

The minutes should reflect the ALCO's proactive actions to mitigate risks before they approach or exceed established limits. If the ALCO does not take action before risks exceed limits, it is not effectively directing the IRR management program. Furthermore, the credit union may miss the opportunity to implement corrective action in a timely manner (e.g., it takes time to sell loans or arrange for financing), or to contain the costs involved (e.g., if problems arise, creditors may rate the credit union as a higher risk, resulting in higher borrowing rates.) Acting proactively requires the ALCO to develop alternative courses of action, and prioritize them based on cost/benefit relationships, long-term effectiveness, and timely implementation.

The ALCO should understand whether the risk measurement model's sophistication is commensurate with the complexity of the balance sheet. For example, if the balance sheet consists of embedded options and uncertain cash flows, the ALCO should understand whether the model could reasonably measure the effect of these characteristics on the credit union's IRR exposure (e.g., gap and simplistic income simulations would not suffice.)

The ALCO must understand if it receives sufficiently accurate and precise information on which to make informed decisions about the risk profile of the credit union. Therefore, in addition to evaluating current risk measurement outputs, it should question whether other available alternatives could reasonably improve the risk measurement process (e.g., the benefits justify the costs.) The absence of recommendations does not necessarily indicate an adequate system or appropriate output reports. It could signal the ALCO does not have the experience and understanding to make recommendations for improvement.

Examiners should determine whether the ALCO has developed or recommended changes that the board did not adopt (e.g., using a different model, restructuring the IRR management responsibilities,

or adding additional internal controls.) If the board does not respond to recommendations for improvement from the ALCO, it could indicate the board does not understand IRR management or does not embrace it as a management tool.

Examiners can conclude that the credit union does not have an effective ALCO if it has a weak IRR management process and if the ALCO did not know of the problems identified during the examination or supervision contact. Likewise, the ALCO does not meet its responsibilities if it knows of weaknesses but does not resolve them.

IRR Measurement Review

Credit unions should measure IRR no less often than semiannually, assuming the balance sheet does not incur any significant changes (e.g., a rapid growth in fixed rate mortgages, a significantly lengthened investment portfolio maturity, a new CD program attracting a large number of member shares.) For federal credit unions, *NCUA Rules and Regulations* §703.90 requires quarterly measurement if complex securities exceed net worth (unless the credit union receives an exemption under RegFlex provisions.) Less complex credit unions may employ basic gap and other models, while larger or more complex credit unions should employ more sophisticated earnings simulation and/or valuation models, which they run internally or obtain from outside vendors.

IRR Measurement Staff Review

IRR management is a dynamic field that requires frequent updating of risk measurement methodologies to reflect current risk measurement techniques. Outsourcing the risk measurement process does not absolve management from understanding the assumptions driving the results. The complexity of the credit union's balance sheet and risk measurement model will determine the need for an experienced IRR measurement or program person. (Appendix 13A provides a brief description of IRR measurement tools.) The experience of the program person may reflect the credit union's interest in implementing a strong IRR management program.

An effective program person should understand how the model works, and what key assumptions drive the results. For example, the

program person should understand which assumptions require changing in order to tailor the model to the credit union (e.g., mortgage prepayments and non maturity share runoff.) A program person with weak skills will more likely produce inaccurate modeling results, which will demonstrate the need for further training. Conversely, a talented program person should consistently develop reasonable risk reports and make recommendations to improve the risk measurement process.

Training of the program person will help ensure the credit union uses the program proficiently, better understands the model's capabilities and limitations, and accurately measures risk. The initial training should enable the program person to understand the more intricate functions of the model. The degree of training needed will depend on the risk inherent in the balance sheet. A balance sheet consisting of complex securities and mortgage-related assets necessitates more intricate risk measures (e.g., NEV versus gap) than a simpler balance sheet primarily composed of bullet instruments and consumer loans.

The program person should obtain additional training to stay current with the changing climate. For example, if a credit union purchased a model before it implemented a mortgage-lending program, it may not have used the prepayment function of the model originally. However, further training on the prepayment capabilities may prove beneficial because of the mortgage program.

Examiners should review the experience and background of the persons charged with determining the model assumptions and interpreting the output (e.g., program person.) They should determine what training on contemporary IRR measurement concepts the program person has attended.

Examiners may want to discuss the model's strengths and weaknesses with the program person. They should determine the program person's level of understanding of the credit union's risk measurement model. For example, does the program person recognize use of model default values and, if so, can the program person explain the validity of the default values.

Credit unions need backup persons to ensure continuity in the risk measurement process. The backup should also receive full training on the model. The examiner should determine if the credit union has a backup program person, and inquire as to what training the backup has received on the model used.

Overall, the examiner should determine the following to assess the adequacy of the IRR measurement program's ability to generate sound and reasonable IRR measurement results:

- Staff's familiarity with the assumptions driving the model and experience with the model's basis for measurement (e.g., earnings simulation or NEV);
- Default assumption adjustments (e.g., prepayment rates, non-maturity deposit runoff rates) that tailor the model to the credit union. Staff has the institutional knowledge to determine if the model produces accurate results, and regularly makes improvements to the model or its assumptions;
- Assignment and training of a backup person, who can adequately use the model without supervision of the program person;
- Documentation of assumptions to ensure consistent measurement between periods; and
- Validation by a third party for reasonableness of model results for large or complex credit unions.

Review of IRR Measurement System

The credit union's review of the IRR measurement model should ensure that data and assumptions accurately represent its balance sheet and risk profile (e.g., accurate input of balance sheet accounts, rates, and maturities.) By examining the input data directly or testing the output against a benchmark, a credit union could test the model's output. For example, a credit union could benchmark its real estate loan portfolio valuation against the OTS Pricing Tables, or the Mortgage Pricing Tables in AIREs.

Someone other than the person running the model (e.g., supervisory committee, internal/external auditor, supervisor) should conduct the review of the IRR measurement model. The reviewer of the modeling system should understand IRR and the risk measurement system, including the model's methodologies and assumptions. If the supervisory committee or other credit union personnel assumes this task, they should attend periodic training on the model.

Internal controls should require documentation of the key assumptions (e.g., stressed interest rate environment, cash flow assumptions of non maturity shares) for review by the examiner, board, and ALCO. Credit unions should rarely make changes in assumptions, unless they make refinements to improve the underlying quality of the assumptions (as is likely for prepayments because prepayment performance changes over time.)

The model reviewer should look for documentation supporting the underlying assumptions and input, and compare the assumptions to market trends or performance through industry-recognized information providers. For example, the reviewer may benchmark the credit union's prepayment assumptions against (1) generic prepayment data provided by FNMA, or (2) comparable mortgage-backed securities as reported by a financial information supplier (vendor.) Alternatively, the reviewer may benchmark the output against other available data (e.g., the OTS and NCUA real estate loan pricing tables to compare valuation results prepared by the model.) If differences exist, or assumptions appear unreasonable, the reviewer should ask the model program person to reconcile or explain the differences.

If the reviewer does not understand the model, this may hamper the value of the recommendations. Thus, the absence of any recommendations does not necessarily indicate a problem-free modeling process. If the reviewer has made recommendations, examiners should determine whether the credit union acted on them. If not, they should determine the reasons. Lack of a plausible reason could signal that the officials have not embraced the value of accurate risk measurement.

Examiners should determine whether the credit union has established internal controls to ensure the risk measurement input accurately reflects the credit union's financial data. At a minimum, the credit union should reconcile or test the data input against the financial statements to make certain all accounts are in the system. Good internal controls should prevent the program person from also assuming risk-taking authority (e.g., executing investments, or establishing rates on shares and loans.) Certain models provide diagnostic reports to readily identify implausible assumptions or data input. (Examiners can refer to the ALM Public Folder for more information on specific IRR measurement program vendors.)

The examiner should determine who evaluated the reasonableness of the risk measurement system inputs and assumptions and whether it was someone other than the program person. The examiner should ascertain what steps the credit union took to determine the reasonableness of the input and assumptions.

Examiners should determine if the reviewer made any recommendations, and if the credit union implemented these recommendations (especially if the recommendations cover a wide scope of deficiencies.) Examiners should further determine if the board and ALCO knew of errors that could significantly misrepresent the results.

Finally, examiners should determine what steps the credit union has taken to ensure meaningful comparison of results between periods. Consistent measurement between periods enables understanding of the changing risk structure of the balance sheet and identification of the underlying causes. Examiners should take exception if assumptions change from period to period without reasonable cause. The results will likely mislead decision makers (e.g., the ALCO and board) resulting in inappropriate decision-making. The examiner should ascertain whether the credit union documents its assumptions, and makes users of the results aware of changes in key assumptions.

**IRR
Measurement
Techniques and
Level of Risk**

Credit unions can purchase IRR models from vendors, contract with vendors to perform the analysis, or develop their own proprietary systems. The source of the measurement tool is not important as long as the credit union can obtain a reasonably accurate measurement of IRR, and the credit union understands the methodologies and assumptions driving the results.

Reviewing a model's capabilities and the assumptions driving a model requires a comprehensive understanding of the risk measurement system. This can involve understanding a complex process. If the examiners find that the degree of model or user sophistication exceeds their ability to determine whether the model system reasonably measures IRR, they should consult with their supervisor to seek additional assistance (e.g., request assistance by the regional capital market specialist [RCMS] or a capital market subject matter examiner [CM SME].)

Overall, the examiner should determine the adequacy of the degree of measurement precision and accuracy, based on use of the model, not simply its capabilities, as follows:

- The basis for risk measurement is commensurate with the complexity of the balance sheet (e.g., the credit union relies on sophisticated earnings simulation and economic valuation models to measure IRR in a complex balance sheet);
- The measurement horizon captures the short and long-term risk embedded in the balance sheet (e.g., the model analyzes cash flows, earnings, and value over the entire maturity range of accounts);
- The model accounts for mortgage prepayments or interest rate caps when the credit union holds significant portfolios of real estate loans or floating rate assets;
- A reasonable degree of accuracy exists because appropriate and rational assumptions, valid data, and proper cash flow projections (e.g., properly modeling mortgage prepayments) serve as the basis for the results; and

- The credit union analyzes its balance sheet performance and characteristics, and tailors the model’s assumptions to its balance sheet.

Table 2 illustrates how the examiner can use the credit union’s IRR measurement tool to determine if IRR exposure is low, moderate, or high. Examiners should consider the degree of precision and accuracy of the risk assessment model when determining acceptability of a risk limit. A sophisticated model that properly addresses prepayment and option risk will have less measurement error; therefore, a looser limit may suffice. Conversely, if the risk measurement report has a low depth of analysis or precision, tighter risk limits may compensate for potential inaccuracies. All limits assume a 300 basis point instantaneous and permanent interest rate shock.

<i>Basis of measurement</i>	IRR Exposure		
	LOW	MODERATE	HIGH
Gap % change in any given period or cumulatively over 12 months	+/-10%	+/-10-20%	> +/- 20%
Earnings Simulation NII: after shock change over any 12-month period	< 20%	20-30%	> 30%
NI: after shock change over any 12-month period > 75%	< 40%	40-75%	
Asset Valuation: after shock change in book value net worth 50%	< 25%	25-50%	>
<u>or</u> after shock value of net worth	> 6%	4-6%	< 4%
NEV: after shock change in market value net worth 50%	< 25%	25-50%	>
<u>or</u> after shock value of net worth	> 6%	4-6%	< 4%

Table 2

IRR Measures

The examiner should determine what IRR measurement methodologies the credit union uses to identify, measure, monitor, report, and control IRR. For short-term IRR measurement, income simulation provides more reliable results than gap analysis because it not only captures cash flows, but also it projects earnings. Gap analysis may not accurately project earnings because it does not consider interest rate caps or floors, the current rates earned and paid on accounts, and the indices driving floating rate accounts (e.g., Treasury versus Prime.) Credit unions should set earnings limits to measure IRR over two years, but preferably over a longer period (e.g., five years) if the credit union offers mortgage loans and does not perform economic value analysis.

As the complexity of the balance sheet increases (e.g., the credit union more heavily invests in mortgage loans and complex investments), the level of analysis should increase. Gap and simple income simulation models may suffice for simple balance sheets (e.g., assets concentrated in consumer loans and non-complex investments, and funded by member shares.) More sophisticated earnings simulation models and economic value models (e.g., asset valuation and NEV) would better serve complex institutions (e.g., assets include mortgage loans, mortgage-related investments, or complex investments, and liabilities may include borrowings.)

NEV and asset valuation analyses measure the change in net worth in a current and stressed interest rate environment (e.g., under a 300 basis point instantaneous and parallel rate shock.) Both are effective methods (although NEV can provide more precise results because it values shares and liabilities) for evaluating IRR over a long-term horizon (i.e., from the current period to the maturity of the measured assets and liabilities.) Asset valuation and NEV measure the credit union's current economic solvency and projected economic solvency under a stressed interest rate environment. These economic value measures can identify IRR that short-term measures such as gap and income simulation may not reveal.

Based on the complexity of the balance sheet, the examiner should determine whether the credit union's measurement method (IRR measurement model) appropriately measures short- and long-term risks. The examiner should review the rate shock scenario used to

measure interest rate risk and determine whether the credit union sufficiently stratifies assets by type and characteristic. For amortizing accounts (e.g., real estate and commercial loans, and mortgage-related investments [CMOs and mortgage pass-throughs]), the credit union should account for estimated prepayments. Examiners should determine that prepayment estimates (1) meet reasonableness expectations, and (2) have supporting documentation. Examiners should also determine that prepayment assumptions change during different interest rate cycles.

Examiners should review callable investment cash flows to ascertain whether they correlate with call dates under falling rate shock scenarios. By reviewing certificate cash flows, examiners can ascertain if the model accounts for early withdrawals by members under rising rate shock scenarios. Examiners should review the cash flows on borrowings to see if the model accounts for any puts (e.g., puttable FHLB advances) by the lender under rising rate scenarios. Finally, examiners should determine how the credit union treats cash flows on non-maturity share accounts (e.g., how they assign maturity.)

Gap Analysis

Gap analysis generally excludes consideration of prepayments, call options, and interest rate caps and floors. Therefore, gap analysis inappropriately measures IRR if the balance sheet consists of a large portfolio of mortgages and complex investments. Examiners should determine if the gap ratio complies with the credit union's policy limits. They should review the current one-year gap ratio and determine whether the credit union calculates gap on a cumulative or periodic basis.

Income Simulation

Income simulation models focus on short-term measurement of risk (typically less than five years), but can vary in sophistication. More sophisticated models capture the effect of prepayments, different floating rate indices (e.g., Prime, COFI, Treasury) and interest rate caps and floors, and can simulate a multitude of interest rate environments. If the credit union offers long-term (i.e., 15 or 30 year) mortgage loans, and invests in instruments with maturities exceeding three years, income simulation models may not adequately

capture the IRR in the balance sheet, since cash flows may exceed the model's measurement horizon.

Asset Valuation and NEV

Asset valuation and NEV measure IRR through estimating the economic value of financial assets and net worth respectively. These methods can effectively measure IRR over the entire spectrum of cash flows, if they also account for the effects of embedded options within the balance sheet. NEV provides a more complete measure of risk than asset valuation because it measures changes in liability values.

Appendices 13A and 13B provide additional discussion and resources on interest rate risk measurement approaches (i.e., gap, income simulation, asset valuation, and NEV). Appendix 13C contains a glossary of ALM terms.

Red Flags

Examiners should remain aware of the following potential warning signs that may indicate a problem in IRR management. Many credit unions will have some degree of one or two of these elements. These may not result in safety and soundness concerns. However, if several of these signs exist, or if they are material, the examiner should treat IRR management as an area of concern and develop plans to address the problems.

- High level of long-term assets to total assets. The concern is a high concentration of assets with maturities longer than three years will reduce the credit union's ability to react to changing interest rates and expose it to increased interest-rate risk.
- High level of net long-term assets to total assets. This concern is similar to that above; however, even a low net long-term asset ratio does not automatically eliminate the concern about high concentrations of long-term assets. Even variable-rate loans have different terms and conditions for repricing that could potentially present IRR concerns. The examiner should determine that the indexes, margins, repricing intervals, caps, and floors all provide sufficient protection against interest rate exposure.

- Declining net interest margin. This indicates either asset yields falling faster than the cost of funds or the cost of funds rising faster than asset yields. Examiners should address both IRR concerns and should determine whether the credit union has any options to improve the net margin (e.g., raising loan rates or lowering dividends.)
- Low level of net worth. A low level of net worth, or a level of net worth that is not keeping pace with share growth, weakens the credit union 's ability to absorb losses and react to changes.
- Rapid share growth or above market dividends. Share growth that outpaces the ability to generate sufficient net income reduces the overall strength of the credit union's net worth. Above-market rates tend to attract less stable rate-sensitive shares. If the credit union then invests these sensitive deposits in longer-term assets (e.g. real-estate loans), it creates a mismatch of maturities for assets and liabilities that could further increase exposure to IRR.
- Incremental mismatch of asset and liability maturities. Given the difficulty of identifying balance sheet interest rate risk at a specific time, the examiner may benefit from analyzing the changes in balance sheet structure since the last examination contact or over the last full year. For example, if a credit union that did not have a significant long-term asset ratio increased its share base into more rate-sensitive deposits (certificates of deposit, money market funds, shares greater than \$10,000, etc.) during the last year, then loaned out these deposits in longer-term fixed-rate loans, the incremental additions to the balance sheet may have significant IRR exposure.

The Call Report (NCUA 5300) requests type and maturity information for loans, investments, and shares. Examiners can analyze this information to determine if recent product or pricing decisions create a mismatch. If so, the examiners should discuss with the officials the potential for emerging IRR concerns before they become more serious.

- Lack of IRR management or ALM policy. Some credit unions can operate effectively without a formal policy; however, the lack of a written policy often indicates that management remains unaware of the importance of IRR management.

**Interest Rate
Risk and
CAMEL**

Although examiners should perform a quantitative analysis on every examination, the more subjective overall analysis of IRR management in CAMEL depends largely on examiner judgment. The examiner should keep the size, complexity, and other component ratings of the credit union in mind when evaluating IRR management.

Even so, a small "plain vanilla" credit union (shares and loans only) should have:

- Strong net worth and stable earnings;
- Investments with relatively short-term maturities or an acceptable mix based on share structure and size; and
- Adequate cash management procedures.

A large, complex credit union offering many different services and having a diverse share, loan, and investment portfolio requires a more in-depth understanding of IRR, and a formal (preferably automated) process to measure balance sheet position and performance.

If the credit union lacks key elements (e.g., no IRR management policy or inadequate monitoring mechanisms), the examiner should expand the evaluation of the adequacy of IRR.

Examiners should develop a DOR with management requiring establishment (or implementation) of IRR management policies and procedures within a reasonable period of time, if the credit union experiences the following:

- An apparently high amount of IRR;
- No IRR management policies or procedures; or
- Policies and practices having serious inadequacies.

Depending on the degree of apparent risk, the examiner may decide to plan a supervision contact to ensure compliance within established time periods. If the credit union's assumptions or conclusions regarding IRR exposure appear seriously inaccurate, examiners should consider including a RCMS or CM SME to assist with this aspect of the review.

Workpapers and References

- Workpapers
 - Interest Rate Risk Questionnaire (IRRQ) – a supervision tool to assist examiners in evaluating IRR. Part D, Step 5 (IRR Measurement Review) specifically discusses evaluating measurement of IRR.
- References
 - NCUA Letter No. 99-CU-12, dated August 1999, *Real Estate Lending and Balance Sheet Risk*
 - NCUA Letter No. 00-CU-08, dated November 2000, *Camel Rating System*
 - NCUA Letter No. 00-CU-10, dated November 2000, *Asset-Liability Management Examination Procedures*
 - NCUA's Public Folders – Under the ALM Folder (Public Folders are for Internal Use Only)
 - Introduction to Interest Rate Risk Modeling* – summary of key components of modeling IRR
 - Interest Rate Risk Vendor Model Summaries* – summaries of IRR measurement tools (commonly seen in credit unions) offered by vendors and ALM consultants

Chapter 13 – Part 3

ALM – LIQUIDITY RISK

Examination Objectives

- Determine adequacy of credit union's liquidity
- Determine demands on liquidity due to current circumstances
- Determine whether trends are emerging that may cause future liquidity demands
- Determine whether liquidity management processes sufficiently allow management to monitor the credit union's liquidity position on a current and forward basis

Associated Risk

- Liquidity risk may occur whenever management cannot satisfy the cash flow needs and demands for funds;
- Strategic risk may occur when the credit union takes on a significant new strategy that could affect the flow of funds (e.g., instituting an above market CD to attract new shares or implementing a real estate loan program); and
- Reputation risk may occur when the credit union cannot meet member loan and share funding requests, causing concerns about the credit union's solvency.

Overview

Liquidity management is the process of monitoring flows of funds and the liquidity of assets to meet demands for funds in the form of share withdrawals, loan demand, and the operating needs of the credit union. Management must monitor liquidity and anticipate future needs for funds. Understanding liquidity requires an appreciation of it as a matter of cash flow.

Managing Liquidity Risk

Liquidity risk management involves the following:

- Identifying the existence of cash flow demands;
- Measuring the extent of cash flow demands;
- Identifying emerging liquidity demands; and
- Taking corrective measures to minimize the liquidity risk and disruption of member services.

In smaller or less complex credit unions, management's approach to liquidity is sometimes very informal, relying mainly on the manager's knowledge of member deposit, withdrawal, and loan trends. This informal approach can suffice if the membership, management, and services offered will probably not change materially in the short term.

In a larger or more complex operation, the credit union may require a more sophisticated liquidity analysis, including a more detailed projection of cash needs. This projection or cash flow budget can take a variety of forms, but normally, a formal analysis of historical sources and uses of funds serves as the basis for the projection.

A credit union's sources and uses of funds includes the following:

Sources	Uses
- New share deposits	- New loans disbursed
- Loan principal payments	- Share withdrawals
- Interest income	- Operating expenses
- Fee income	- New investments
- Maturing investments	- Liabilities payments
- Borrowing	- Purchase of assets
- Repurchase agreements	
- Sale of assets (i.e., real estate loans in the secondary market)	
- Loan participations	

The safe and sound operation of the credit union requires that management monitor and maintain adequate liquidity. Smaller, less complex credit unions need not meet the same standards as larger credit unions; however, each credit union should follow sound business practices in liquidity risk management.

**Examination
Guidance**

Examiners review liquidity through quantitative and qualitative analyses, including discussions with operational management, to determine if the credit union can meet member share and loan needs in a variety of circumstances. If examiners reviewed the 5300 Risk Parameters in the Scope Workbook (see the Risk-Focused Program

chapter for further discussion), they will have an initial indication of liquidity risk in the credit union. In reviewing liquidity management, the examiner should:

- Review the credit union's process;
- Alert the officials to any noted weaknesses;
- Determine that management sufficiently recognizes the overall significance of liquidity risks; and
- Ensure that the credit union maintains a safe and sound process of monitoring and controlling these risks.

An examiner's overall assessment of liquidity risk should include an overview of a credit union's operations, business plan, management strategies, and resulting cash flows.

The two main purposes for evaluating liquidity management are:

- Risk identification - determine whether any potential causes of liquidity risk exist; and
- Evaluation of management's control - assess whether adequate monitoring tools and methods exist to alert management to emerging liquidity demands in a timely manner.

Liquidity Policies

Credit unions should develop and implement a written liquidity policy (or plan for managing liquidity) tailored to the size and complexity of the balance sheet, and their susceptibility to cash flow volatility. Credit unions may incorporate their liquidity management policies in their ALM or investment policies.

The written policy should clearly establish the purpose, objectives, and goals of liquidity management. It should clearly set forth how the credit union will evaluate its liquidity (e.g., ratios, cash flow projections, minimum cash on hand.) Management should periodically review and revise, if necessary, the policies and plans to reflect the credit union's current tolerance for risk, balance sheet composition, liquidity strategy, and organizational structure.

Policies should clearly convey to management the board's tolerance for liquidity risk. A vague policy that omits risk limits, or provides

limits that would fail to alert management to liquidity demands is ineffective and indicates the board's failure to manage liquidity.

In smaller or less complex credit unions, officials should formalize the policies to ensure adequate management of liquidity risk. The clarity of these objectives will reflect the credit union's recognition and understanding of liquidity risk, and facilitate understanding and acceptance within the credit union. Credit unions with simple balance sheets may only need to:

- Set forth required minimum balances of short-term and overnight funds (e.g., corporate daily share accounts);
- Identify alternative sources of liquidity (e.g., lines of credit); and
- Establish limits in terms of simple ratios (e.g., loan to asset ratio.)

Larger, more complex credit unions should:

- Set limits in terms of ratios and projected net cash flows (cash inflows less cash outflows);
- Prioritize and periodically test alternative sources of funds;
- Assign responsibilities for monitoring liquidity; and
- Establish reporting requirements.

Policies should clearly define responsibilities to ensure accountability. For example, the board should establish prudent policies and limits, and senior management or the ALCO should implement the policies. The assignment of responsibilities should cover the detailed operational implementation of liquidity risk management, including monitoring liquidity, reporting results, and forecasting future needs.

Exceptions to risk limits may constitute a serious violation and should trigger more frequent reporting and measurement requirements. Credit union policy should outline the parameters and time frames for alerting senior management and the board, and implementing contingency plans.

Ratios

For purposes of quantitative analysis, several ratios can assist in assessing the level of liquidity risk at a credit union. The 5300 Risk Parameters (in the Scope Workbook) uses two ratios to indicate the initial level of potential liquidity risk: (1) Loans/Assets, and (2) (Regular Shares and Share Drafts)/(Total Shares and Borrowings.) Credit unions' quarterly call reports provide the data for quarterly updates to the 5300 Risk Parameters. The 5300 Risk Parameters represents one tool that examiners may use in offsite monitoring and for initial risk assessment.

If the initial risk assessment, examination planning, and scope development processes indicate a need for further evaluation, examiners may use the AIREs Liquidity Review Questionnaire (LRQ) while onsite to help assess liquidity risk and arrive at a final risk rating. The LRQ contains more extensive liquidity ratios that will assist examiners in their assessment of liquidity risk. The main ratios found in the LRQ follow:

- **Loans/Assets.** A credit union should strive to maintain a loan to asset ratio sufficient to meet member loan demand and still meet other liquidity needs. A high loan to asset ratio (e.g., in excess of 80 percent) may stress liquidity, especially if (1) the credit union has limited other funding sources, (2) existing funding depends on volatile sources (e.g., non-member shares), or (3) the credit union has minimal short-term investments.
- **(Borrowings and Non-member Deposits)/(Total Shares and Liabilities.)** Borrowings and non-member shares may indicate the credit union cannot meet its cash needs through member shares. Because these funds generally incur a higher cost and more volatility than member shares (i.e., lenders may not renew their funding if yields do not remain competitive or the credit union's financial condition deteriorates), they generally require a higher level of oversight to manage effectively.
- **(Cash and Short-term Investments)/Total Assets.** This ratio provides an indicator of how much available cash the credit union has to meet share withdrawals or additional loan demand. A low or rapidly declining ratio may indicate the credit union will be

unable to meet its current obligations. Credit unions should consider the trend in this ratio and determine whether the current level of cash and short-term investments represent what management has historically maintained, or whether management should increase the levels.

- (Regular Shares and Share Drafts)/(Total Shares and Borrowings.) This ratio reflects the level of stable deposits a credit union has on its balance sheet (as opposed to the level of volatile funding, which the Borrowings and Non-member Deposits ratio indicates.) A credit union can reasonably depend on the availability of these stable funds to meet liquidity demands.

Other ratios that may indicate liquidity concerns include the following (the AIREs LRQ contains definitions for these ratios):

- Loans/Shares;
- Contingent Liabilities/(Cash and Investments);
- Net Liquid Assets/(Liabilities and Shares);
- Volatile Liabilities/(Cash and Short-Term Investments);
- Growth in Volatile Liabilities/Assets;
- Investment Loss Ratio; and
- Estimated Loan Maturity.

Setting Limits

A key step in managing liquidity involves setting acceptable limits. Limits assist the board and management in determining the adequacy of the current level of liquidity and alert them to conditions where liquidity demands may disrupt normal business.

The board should set limits on potentially volatile sources of funds, such as borrowings, non-member deposits, and concentrations from a particular source. Prudent policies may establish concentration limits by asset category or cash flow structure, taking into account maturities and the certainty or uncertainty of cash flows (e.g., due to prepayments, extensions, or calls.)

Policies will usually express limits as a ratio, or required amount of funds on hand (i.e., the credit union will transfer funds greater than

\$X or X percent of assets to the corporate credit union overnight account.) Ratio analysis may suffice for credit unions with abundant short-term assets and stable funding sources. Conversely, credit unions operating under tight liquidity constraints or uncertain cash flows may require a detailed cash flow analysis.

Alternatively, management may use liquidity gap analysis to project inflows and outflows of funds for the coming year. In this case, the policies set liquidity gap targets, which establish ranges or multiple limits to convey an increasing concern over liquidity demands. For example, a credit union may set a loan to asset ratio at 75 percent to trigger formal reporting to the board on a monthly basis, and 80 percent to trigger implementation of an action plan.

Other Measures

In addition to quantitative measures, qualitative elements may signal immediate liquidity concerns. Examples include:

- The loan, investment, or share structures have changed significantly, or significant changes will likely occur in the near future;
- The investment portfolio consists of a significant amount of assets or liabilities with principal cash flows subject to prepayment or extension risk;
- The credit union has attracted shares or non-member deposits by paying above market rates; or
- The credit union has experienced turnover in key management positions that relate to liquidity risk management.

Monitoring and Oversight

Credit unions must monitor liquidity and document their analysis. Small credit unions with basic share and loan products may perform an elementary analysis (e.g., reviewing the loan to share ratio or amount of cash and short-term investments on hand.) Larger, more complex credit unions should analyze projected sources and uses of funds, evaluate liquidity alternatives, and determine expected liquidity under adverse economic conditions.

A credit union should (1) monitor its liquidity over a timeframe commensurate with the composition of its balance sheet, and (2) provide its rationale as to the adequacy of its particular timeframe. A one-year proforma cash flow would not suffice, for example, if significant investment or share certificate maturities exceed one year.

Credit unions should also monitor contingent liabilities, which they may have to fund but have not recognized on their balance sheets. Most commonly, these commitments consist of unused lines of credit and credit card balances. Should members begin accessing these commitments under conditions of limited funding, the credit union could experience liquidity concerns. Failing to meet commitments can result in reputation risk and a loss of members.

The board should assign responsibilities for monitoring liquidity to persons capable of measuring risk, interpreting results, and presenting plausible and timely recommendations for action (e.g., the ALCO, or in the absence of an ALCO, a committee of the board, or senior management.) The background and experience of these persons should coincide with the size and complexity of credit union operations and the amount of liquidity risk present. This background and experience will enable the ALCO to forecast future liquidity demands, and take preventative action in a timely manner.

Larger, more complex credit unions (generally those greater than \$100 million) should separate the risk measurement and risk taking duties. This provides a better independent assessment of liquidity and helps ensure prior decisions do not influence the risk assessment function. Those charged with risk measurement should report to the designated senior management official.

Persons responsible for liquidity decisions should meet regularly. They may have to meet more frequently if crisis conditions emerge or if the credit union takes on a new strategy that could affect the flow of funds (e.g., instituting an above market CD to attract new shares.) Examples of meeting agenda items include but are not limited to (1) reviewing cash flow projections and the current liquidity position, (2) evaluating liquidity alternatives, (3) determining potential future liquidity threats, (4) discussing the

impact of future economic events, and (5) recommending changes to policies and procedures.

Reporting

Ultimate responsibility for liquidity risk management rests with the board. Therefore, management must report existing or anticipated liquidity concerns in an accurate and timely manner. Early notice of emerging pressures enables the board to evaluate the cost/benefit relationship of the various alternatives and initiate action with minimal disruption in the credit union operations.

Credit unions with complex cash flows or a tight liquidity position should have detailed reports, possibly consisting of cash flow projections, ratio results, policy limit comparisons, and expectations of future liquidity. Smaller, simpler credit unions may only report the amount of cash and liquid investments maintained and the credit union's loan to share ratio. The size and complexity of the credit union should determine the frequency of these reports.

If the credit union has delegated liquidity oversight to a committee (e.g., ALCO), board reports may only consist of summary level data, such as compliance with policy limits. If the board has not delegated oversight, then the board should receive more detailed reports from which to make decisions.

Board reports should reflect the credit union's business direction, the composition of the balance sheet, and the volatility of its cash flows. The reports should also provide substantive information on which to make liquidity decisions. For example, reports may indicate liquidity trends, compliance with board-established limits, and changes in the credit union's cash flow structure.

Sources of Liquidity

Liability liquidity refers to the credit union's management of its liability and equity funding sources (e.g., borrowings, shares, and non-member deposits.) When credit unions need to acquire funds they should obtain funds at reasonable costs and structure the maturities or cash flows of liabilities to reasonably match against the uses of funds. The credit union should remain aware of the

composition, concentrations, costs, and characteristics of its funding sources.

Interest rates and creditworthiness influence the credit union's ability to access funding sources (e.g., borrowings.) Therefore, the availability of certain sources of funds, or availability at reasonable costs might not exist under all economic conditions. Thus, a credit union may find borrowings cost prohibitive at a time when its financial position weakens or the economy experiences rapid inflation.

Volatility is derived primarily from interest rate competitiveness and the credit union's creditworthiness. Credit unions should categorize funding sources based on their volatility or stability and should have the ability to defend their decisions. In particular, they should evaluate the volatility of non-maturity shares (e.g., regular shares, share drafts, money market accounts), which typically depend on managerial assumptions rather than empirical data.

Transaction accounts (e.g., share draft accounts) generally do not experience high rate sensitivity, because members retain these balances as a means of paying expenses. Conversely, money market shares and short-term certificates can represent highly volatile shares. Other volatile sources of liquidity include short-term external sources (e.g., borrowings and non-member deposits), which are more sensitive to interest rate risk and the perceived credit risk of the credit union.

Obtaining a significant concentration of funds from a single source, especially highly volatile sources such as short-term or callable borrowings, large dollar deposits, and business deposits, may subject the credit union to an unsafe level of liquidity risk exposure. Even if the credit union carefully maintains a competitive rate and sound credit posture, external factors (e.g., legal restrictions, business decisions) may adversely affect future funding.

Asset liquidity refers to the credit union's management of its asset funding sources. Evaluation of asset liquidity depends on the credit union's ability to convert assets to cash without loss. For example, it can convert the most liquid, overnight shares and deposits, to cash

immediately and without loss of principal. Cash flows also occur as investments mature or are called, and through amortization of loans and mortgage-backed securities. Other means of converting assets to cash include sales, securitized borrowings, and participation agreements.

While loan amortizations will provide a steady stream of funds, the credit union will usually use these funds to support future loans. Should the credit union not fulfill the member loan demand, it may disrupt normal operations, affect profitability, and lead to member concern about the credit union's solvency (i.e., reputation risk.) Therefore, unless principal pay downs result in excess investable funds, amortizations may not provide liquidity.

The credit union should manage its investment portfolio to reasonably match investment maturities or principal pay downs to potential outflows. Concentrations in maturities provide the same risk to liquidity as concentrations of cash flow sources. Thus, a credit union may benefit from staggering its maturities over time.

Investment maturities concentrated in long-term horizons may especially signal liquidity problems. The classification of an investment as held-to-maturity (HTM), available-for-sale (AFS), or trading does not impair its marketability. However, many credit unions are reluctant to sell HTM securities for fear that the sale will necessitate reclassification of the entire investment portfolio as AFS or trading. Thus, if a credit union carries a significant amount of HTM securities that have an unrecognized loss (e.g., market value less than book value), it may not willingly sell any security in the HTM portfolio. This may limit a credit union's liquidity options.

Loans written to secondary market standards have greater marketability than non-conforming loans. These loans can provide a significant backup source of funds to a credit union that has a large real estate portfolio.

Credit unions may also originate loans with the intent to sell them to increase cash flow. Asset securitization permits credit unions to sell their consumer loans (e.g., credit card receivables, auto loans, home equity lines of credit) as a source of liquidity. Besides the underlying

interest rate, the credit quality, as reflected in their delinquency and charge-off history, will determine the marketability of these assets. Higher credit quality will result in better prices. Therefore, credit unions that issue lower quality loans, without compensation in the form of higher interest rates, may experience significant losses when selling them.

Cash flow projections may provide greater benefit to larger credit unions, and those that operate with minimal asset liquidity or rely on volatile funding sources. Proper projection of cash flows requires expertise in understanding liquidity, a comprehensive understanding of the balance sheet structure, and time to construct the analysis. Credit unions can accomplish this by preparing a spreadsheet, or by using a maturity gap report (common in most vendor interest rate risk models.) Examiners should use judgment as to the necessity of recommending these tools.

The credit union should demonstrate that it made sufficient efforts to accurately capture cash flows. However, external causes determine many cash flows, not contracted agreements. For example, prepayments on amortizing instruments, embedded call options, and early withdrawals of certificates can affect liquidity. Further, recent share growth trends may include temporary, cyclical, or other trends unlikely to continue due to other forces (e.g., flight from equity investments in a recession.) The credit union should consider the potential effect of external events.

Though members can withdraw their shares at any time, their actual behavior may differ considerably. On average, most members retain a certain balance in their share accounts. Therefore, the credit union need not maintain cash equal to its regular shares. The effort required to open an account at another institution may result in “maturities” for transaction accounts (e.g., share draft accounts) of several years. Share draft accounts do not generally fluctuate significantly with changes in interest rates.

Conversely, money market shares and short-term certificates will likely experience high volatility, therefore shorter “maturities” are appropriate. Short-term external sources of liquidity (e.g., short-term borrowings and non-member deposits) also fall within the volatile

category, because of their sensitivity to interest rate risk and the perceived credit risk of the credit union. While longer-term shares and external funds can provide stable sources of funds, the credit union must consider early redemption options when making this evaluation.

Credit unions should not assume that business will always continue as it has in the past. Stress conditions could arise from rising unemployment, increases in equity investments, or member dissatisfaction with the credit union's services. These could manifest themselves in credit deterioration, unusually high interest rate volatility, reputation risk, and systemic events (e.g., anti-inflationary monetary policies.) Resulting liquidity demands may extend beyond what the credit union has available to it through "normal" liquidity sources (e.g., lines of credit). Therefore, the credit union may need to explore emergency sources of funds such as loan sales or a liquidation of other assets.

A third source of liquidity is **operating liquidity**. A credit union will experience cash flows from its normal daily operations, as well as from ongoing business activities. Operating income and expenses will affect the credit union's liquidity position. Excessive operating expenses can affect a credit union's liquidity on an ongoing basis. Marginal profitability results in a reduction of a credit union's cash flow from income.

The oversight of liquidity should include consideration of the sources of, and causes of demands on liquidity, from all its points of origin. There is no substitute for thorough analysis of each contributing factor in liquidity because, in most cases, liquidity pressures arise due to multiple causes occurring simultaneously.

Backup Sources of Liquidity

Credit unions should educate themselves regarding alternative backup sources of funding to those that occur within the normal course of operations. All credit unions should establish at least one means for generating cash or funding liquidity needs outside of normal operations. Typically, a credit union will establish a line of credit with its corporate credit union or another lender (e.g., FHLB.) Whatever the source, quick accessibility and reasonable cost are

important. The credit union should have demonstrated its ability to access the source. For example, if a credit union has not sold loans in the past, it should not anticipate using loan sales as a primary source of liquidity.

The credit union should remain aware of recent trends, future events, or management decisions that may have a material effect on the balance sheet's liquidity structure. Examples would include (1) new loan, share, or investment strategies; (2) merger; (3) aggressive growth strategies; or (4) declining trends in asset quality.

Activities Affecting Liquidity

The examiner should understand that the maintenance of adequate liquidity and the management process to monitor liquidity are vital to the safe and sound operation of a credit union. Smaller credit unions need not meet the same standards as larger credit unions; however, each credit union should follow sound business practices in liquidity risk management.

The following activities of a credit union's operation are important in the assessment of liquidity:

- Borrowed funds;
- Repurchase agreements;
- Non-member deposits;
- Real estate and other loan sales; and
- Loan participations.

Borrowed Funds

Credit unions should plan borrowings for a specific purpose that management can reasonably explain. When the credit union borrows funds, they should document a plan for repayment of the funds. Management should understand all terms of the borrowings, including call features, prepayment penalties, and debt covenants.

Generally, examiners should accept preplanned borrowing for a specific purpose or strategy. For example, a credit union may borrow on a long-term basis to fund real estate loans. Properly structured, this reduces the liquidity risk resulting from funding long-term assets with short-term liabilities. However, frequent,

chronic, and unplanned borrowing may evidence liquidity problems. Prepayment penalties, embedded call options, and other indentures may preclude borrowing as an effective liquidity management tool. (Appendix 11A contains definitions of embedded options and indentures.) Borrowing subjects the credit union to potential volatility because interest rates and the creditworthiness of the borrower can influence lenders.

Examiners should consider short-term borrowings highly volatile sources of funds. Concentrations of these funds could subject the credit union to liquidity demands in uncertain economic times, or if the credit union's credit standing deteriorates. Longer-term borrowings generally provide a stable source of funding, although the credit union may incur a premium cost. Embedded call options can reduce the stability. Further, the credit union may be precluded from prepaying borrowings at opportune times (e.g., to refinance at a lower rate, return the funds due to excess asset liquidity.)

Repurchase Agreements

Borrowing repurchase agreements (repos) provide an alternative source of funds that may cost less than lines-of-credit. However, sales or early redemptions of repurchased investments may have significant limitations that prevent collateral sales from serving as a liquidity source. The credit union must execute a master repurchase agreement before it can participate in repurchase activities. Legal counsel should review the agreement before the officials agree to its terms; therefore, the credit union should execute the master agreement before potential liquidity needs arise. If the credit union has not executed the agreement, borrowing repurchase agreements may not provide immediate sources of liquidity.

The credit union must have available high-grade investments (typically, short-term Treasuries and agencies) to engage in repurchase activities. Otherwise, a broker/dealer will not accept the collateral or will charge a higher 'haircut' (excess collateralization—typically the collateral to book value is set at 102 to 103 percent for Treasury and agency securities, and possibly higher for other instruments.)

Non-member Deposits

Non-member shares can provide the credit union with a liquidity source that it can tap quickly. However, these funds may require a higher dividend rate than member shares to entice institutional investors (e.g., other credit unions.) Further, these shares generally have high rate sensitivity and a strong likelihood of their withdrawal exists should alternatives offer better returns. Thus, these shares may not provide a low-cost, long-term funding source. Accordingly, the credit union should develop a plan to address the increased funding costs and high volatility associated with these shares. Failing to do so may result in depressed earnings and future liquidity shortfalls.

Examiners should consider short-term non-member deposits highly volatile sources of funds. Concentrations of these funds could subject the credit union to liquidity demands in uncertain economic times or if the credit union's credit standing deteriorates (especially if the deposit exceeds the insurable amount).

Real Estate and Other Loan Sales

If the credit union has not engaged in a loan sale, it may not recognize the administrative and procedural requirements to complete the sale (i.e., meeting secondary market standards.) Arranging mortgage sales generally involves the buyer, thus precluding sales from being an immediate liquidity source. In addition, prices will vary based on the underwriting quality (e.g., meeting secondary market standards), transfer of servicing rights, current market rates, and selling loans with and without recourse (the ability of the buyer to return the asset to the seller.) Thus, experience in selling loans could increase the credit union's awareness that liquidity may come at a significant cost.

If the credit union has not engaged in prior sales, it may not recognize the potential for losses on loan sales. Accordingly, loan sales may not serve as a realistic source of liquidity, especially if the loan portfolio consists of low coupon mortgages, or the loans were not written to secondary market standards. Credit unions that regularly engage in mortgage lending may have established a mortgage pipeline with the secondary market (e.g., FNMA, FHLMC) to facilitate loan sales. Typically, credit unions that sell loans, sell them on a monthly basis (FNMA and FHLMC set

minimum sales requirements.) If the pipeline is well managed, loan sales can provide a reliable and cost effective source of liquidity.

Recourse refers to the right of the loan purchaser to recover against the credit union, typically from default by the borrower. If the credit union sells a loan with recourse, the purchaser can choose to recover the losses from the credit union rather than from the borrower. Loans sold with recourse can adversely affect a credit union's liquidity because the participating organization may seek a refund of its entire investment. Accordingly, the credit union should closely monitor the performance of loans sold with recourse to project future cash flows.

Loan Participations

Loan participation represents another potential source of liquidity for credit unions. This can and often does include non-real estate loans, such as signature or vehicle loans. Typically, participation involves an agreement between two or more credit unions or other types of financial institutions, and includes a pool of loans. A written agreement should document the transaction and its details, including the identification of the loans involved. Credit unions should have the agreement reviewed by legal counsel, prior to implementation.

In this type of liquidity source, the selling credit union would retain a percentage of the loans, usually 10 percent or more. They would also retain servicing. Thus, the transaction remains transparent to the member. The agreement should include details about (1) whether the sale is with or without recourse, (2) whether buy-back provisions (rider) exist and the timeframes for such provisions, (3) whether the seller can repurchase the balance of the loans at a later date should their level of liquidity increase, and (4) what if any compensation the seller would receive for servicing the loans. As consumer loans have a shorter life and require less servicing, the liquidity afforded through the participation may overshadow the compensation in importance.

Many, but not all, loan participations occur after origination of the loans. Larger credit unions might participate on a large loan to a commercial member to share the risk. A smaller credit union might

use a participation in order to grant real estate loans or loans over their limit to their members.

**Workpapers
and
References**

- Workpapers
 - Liquidity Review Questionnaire (LRQ)
- References
 - NCUA Letters to Credit Unions
 - No. 02-CU-05
 - No. 00-CU-13

INTEREST RATE RISK MEASUREMENT TOOLS – APPENDIX 13A

GAP

A traditional GAP analysis alone does not adequately permit evaluating mortgage-related risks. A repricing GAP represents a measure of the mismatch between the amount of assets and liabilities repricing within a defined time period. It is a simplistic determination of the relative interest rate sensitivity of a balance sheet. GAP analysis can adequately pinpoint large mismatches in assets and liabilities, but lacks as a tool for measuring the complex variables associated with mortgages. GAP does not consider changes in the shape of the yield curve, changes in the spread relationship between different market rates, or option risk (e.g., prepayments). In addition, it does not address the effect of an adverse increase in interest rates on net worth.

Income Simulation

An income simulation model is one means available to simulate the effect on net interest income resulting from (positive and negative) changes in interest rates of 100, 200, and 300 basis points. Typical models use rate shocks to measure the effect on earnings. Income simulation represents an accounting-based earnings approach and can provide useful information for projecting the risk to near-term future earnings and for strategic planning purposes.

Income simulation offers the following improvements over GAP:

- Plots all estimated cash flows;
- Captures actual timing of cash flows; and
- Can accommodate repricing assumptions, amortization assumptions, and yield curve assumptions.

If a credit union limits its ALM analysis to an income simulation model, it should extend the analysis to five years. This provides one way to estimate the effect of embedded options in outlying years. For example, the credit union may own a security that is callable in the second year. If the issuer calls the security, the credit union may have to invest the proceeds at a lower rate; and thus, could cause the

credit union's income to diminish in the second year. The income projection should capture such outlying effects.

However, income simulation makes it difficult to accurately measure the full exposure of prepayment or option risk. In addition, it does not fully address the effect on net worth (value). Income simulation depends highly on assumptions. The longer the time frame, the more these assumptions influence the results. Users must specify what will happen to all the cash flows they receive in future periods. They must incorporate their reinvestment decisions. In short, user bias can increasingly affect the results.

In addition to measuring the short-term effect of interest rate changes on income, it is equally important to measure the long-term effect on capital. Just as changes in interest rates will cause stock and bond prices to fluctuate, changes in interest rates will also affect the fair value of the credit union's balance sheet. As noted earlier, an increase in interest rates will typically cause a credit union's existing loans (and investments) to decline in value. The present value of the balance sheet represents an estimate of the fair value of your credit union's future earnings over the life of the holdings (long-term measure). Credit unions should understand this relationship. NCUA expects credit unions with greater risk to have more sophisticated techniques for quantifying this relationship on their balance sheets. Managing value in relation to risk will increasingly become more important and significant as NCUA implements the system of "prompt corrective action (PCA)," as promulgated by the Credit Union Membership Access Act.

**Asset
Valuation**

For credit unions lacking advanced ALM models, there are additional methods for measuring interest-rate risk in mortgage loans. Using mortgage-backed securities as a proxy, credit unions can obtain estimates of risk exposure on their mortgages. One public source of this information is *The Asset & Liability Price Tables* on the Office of Thrift Supervision Website at <http://www.ots.treas.gov/quarter.html>. These tables provide mortgage pool security prices at 100, 200, 300 basis point shock scenarios. Industry recognized information providers also provide estimated price sensitivity of individual securities.

Net Economic Value

Net Economic Value (NEV)¹ measures the effect of interest rate risk on capital. NEV represents a solvency measure, but it also estimates the balance sheet's future earnings capacity. It measures the balance sheet's value at a fixed point in time. Proper NEV models capture principal and interest cash flows and provide an analysis of option risk. Managing NEV reduces the volatility of earnings and net worth.

In short, NEV equals the fair value of assets minus the fair value of liabilities. NEV calculations must also include the value of embedded options. Models that calculate NEV compute the value of capital under current interest rates (no rate change) and then under a "shocked" interest rate scenario. The variance between these two NEV calculations represents the potential impact on capital if rates were to change. The components of NEV are as follows:

Net Economic Value:	
A	The value today (present value) of future amounts the credit union will receive such as loan principal and interest payments, and investment principal and interest.
- B	Minus: The value today (present value) of future principal and interest amounts the credit union will pay for its funds.
= C	Equals: Net Economic Value.

To compute the present value one must move backward in time from the future cash flow amounts, using a process called discounting. The concept of discounted cash flows represents a basic financial tool that comprehends the relationship between interest rates and fair value. The discounted cash flow computation serves as the basis for many cash flow comparisons and ALM analyses. Please see Appendix 13B for a basic example of discounting future cash flows.

Both credit unions and examiners should understand that variable-rate assets are not free of interest rate risk. Variable-rate loans or securities may contain lifetime and periodic "caps" that limit their ability to increase (reprice) loan rates. In addition, some interest rate coupon formulas on variable rate loans or securities are contractually

¹ For a more extensive discussion of net economic value and the risk of mortgage-related assets, see the *NCUA Corporate Examiner's Guide* under Reference information at NCUA's Website at <http://www.ncua.gov>.

tied to a reference rate that may experience infrequent or unpredictable changes. The modeling of such instruments requires more complex and robust analytical techniques. In all cases, credit unions must employ an ALM methodology commensurate with the risk types and levels assumed.

DISCOUNTING CASH FLOWS – APPENDIX 13B

Discounting Cash Flows Example

The following example demonstrates how a change in interest rates can affect the fair value of a security or loan. **Present value** is the amount of money an individual must invest today to realize a future amount.¹ In other words, it is today's value of the dollar amounts the recipient will receive in the future. Discounting refers to the process of computing a present value. Accordingly, present value represents the discounted value and the interest rate used is often called the discount rate. The price of any financial instrument (e.g., mortgages or investment securities) is the present value of its future cash flows. Understanding the process of discounting cash flows can aid a credit union in valuing its balance sheet and in interpreting the results of its ALM model.

Present value of a future value (cash flow amount) N years from now:

$$\text{Present Value} = \frac{\text{Future Value (Cash Flow Amount)}}{(1+i)^N} \quad X$$

i = annual interest or discount rate N = number of years

(See below for formula to accommodate periodic compounding of interest.)²

This example applies the formula to a fixed-rate security. It first discounts the cash flows at the coupon rate (7.5%) and then again three hundred basis points higher (10.5%).

¹ This discussion follows, for example, a chapter on Present Value in Fixed Income Mathematics; Third Edition by Frank J. Fabozzi; (Irwin Professional Publishing; 1993); pp. 19-33.

² Present value of a future value n periods from now assuming periodic compounding:

$$\text{Present Value} = \text{Future Value} \quad X \quad \frac{1}{(1+i/m)^{mn}}$$

m = Frequency of compounding (e.g., monthly = 12, semiannually = 2);
 i = Periodic interest or discount rate [annual interest rate (in decimal form)];
 n = Number of periods [number of years].

Discounting Cash Flows Example								
Amount: \$1,000,000 Life: 3 Years								
Coupon: 7.5% Payments: Annual								
Period	Cash Flow		P/V Formula @ 7.5%	P/V of Cash Flow Disc. @ 7.5%	P/V Formula @ 10.5%	P/V of Cash Flow @ 10.5%	Change in P/V	% Change in P/V
1	75,000		$1/(1+.075)^1$	69,767	$1/(1+.105)^1$	67,873		
2	75,000		$1/(1+.075)^2$	64,900	$1/(1+.105)^2$	61,424		
3	1,075,000		$1/(1+.075)^3$	865,333	$1/(1+.105)^3$	796,749		
Total	1,225,000					926,046	(73,954)	(7.4%)

Note that the present value of the 7.5% coupon bond equates to its face amount of \$1,000,000 when the cash flows are discounted at the 7.5% coupon rate. This would equate to a no rate change or base case scenario when computing NEV. However, the present value decreases by about \$74,000 when the cash flows are discounted at 10.5%. This would approximate a potential 300 basis point rate shock when computing NEV. The decline in value underscores how an increase in market interest rates can reduce the fair market value of a security or a loan. This diminution also represents potential changes to capital under a NEV rate shock scenario.

While this discounted cash flow example is very basic, it is the fundamental concept behind what an ALM program does to compute NEV. NEV models become more detailed when the user adjusts discount factors for credit, option and liquidity risks.

GLOSSARY OF ALM TERMS - APPENDIX 13C

ALM Definitions

This section defines some terms commonly used in ALM. Standard dictionaries do not contain the definitions of many words and phrases used when discussing ALM; therefore, this glossary may assist the examiner in understanding specialized industry-specific words. (Appendix 12A contains investment terms.)

Basis Risk: the risk to earnings and economic value when a change in one interest rate differs from that of another interest rate for a similar maturity or term. For example, the rate on a money market share account typically changes less than that of an overnight investment account (earning a Federal funds rate.)

Core Share Deposits: in gap analysis, the estimated portion of deposits that are not rate sensitive. Cores share deposits reflect management's judgment of the portion of shares not expected to be withdrawn and reinvested in a higher rate instrument, in response to an increase in market interest rates. Credit unions may consider many regular share accounts with relatively small balances, as well as the portion of share draft accounts reflecting transactional balances, to be core share deposits. Generally, money market share accounts and share certificates are less likely to be considered core share deposits.

Discount Rate: an interest rate used in a model to calculate an estimate of fair value of a financial instrument. A discount rate is used to compute a present value of a cash flow.

Duration of Equity: a simple estimate of the percentage change in fair value net worth for a one percent change in interest rates. See the Investment Chapter for a definition of duration.

Gap Analysis: a simple interest rate risk measurement technique that reports the mismatch between rate sensitive assets (RSAs) and rate sensitive liabilities (RSLs) over a given time period. Common time periods (or gap buckets) are 3 months, 6 months, and 12 months. A gap report typically shows differences between RSAs and RSLs for various gap buckets (i.e., the periodic gaps), and the aggregate difference between RSAs and RSLs up to a specified time period, such as 12 months (i.e., the cumulative gap).

Static gap analysis shows repricing mismatches based on the current balance sheet position. In contrast, *dynamic gap analysis* shows repricing mismatches based on a forecasted balance sheet. Since many credit unions use gap analysis, examiners need to understand its uses and weaknesses. Refer to Appendix 13A for further discussion of gap analysis.

Income Simulation: an interest rate risk measurement technique used to estimate earnings exposure to changes in interest rates. Credit unions use income simulation to forecast Net Interest Income (NII), Net Income (NI), and accounting net worth

under different interest rate scenarios. Refer to Appendix 13A for further discussion of income simulation.

Index: the market interest rate (to which a margin may be added) that is used to reset the interest rate on a variable-rate loan.

Interest Rate Risk (IRR): the risk to a CU's financial condition resulting from adverse changes in interest rates. IRR is a type of market risk. Exposure to IRR can be measured by assessing the effect of changing rates and prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution.

Net Economic Value (NEV): an interest rate risk measurement technique used to measure the economic exposure of net worth to changes in interest rates. NEV equals the present value of assets less the present value of liabilities. Refer to Appendix 13A for further discussion of NEV.

NEV Volatility: measures the change (either in dollar or percentage terms) in NEV from a base case resulting from a change in interest rates. A high level of NEV volatility reflects a high level of interest rate risk.

Prepayment: the early repayment of principal, in advance of scheduled amortization or maturity.

Pricing: a credit union management action to set interest rates and terms on loan and deposit products offered to members.

Rate Ramp: is a gradual increase in interest rates over a specified time period, usually 12 months. Rate ramps are used for management forecasts of future earnings in income simulations.

Rate Sensitivity, Rate Sensitive Assets (RSAs), and Rate Sensitive Liabilities (RSLs): in gap analysis, the degree to which a financial instrument is expected to reprice within a given time frame.

For example, given a 12-month time frame for a gap report, a 5-year-remaining-maturity Treasury note is not "rate sensitive" since it will not mature within 12 months. A credit union can estimate prepayments on consumer loans (e.g., 30-year mortgages) to schedule the rate sensitivity of its cash flows. Rate sensitivity assumptions for administered rate liabilities (e.g., regular shares and money market shares) can be very influential on reported gap results.

Rate Shock: is an immediate change in the level of interest rates. Parallel rate shocks of 1 to 3 percent are often used to assess interest rate risk.

Repricing: the change in interest rate resulting from either an *interest rate reset* on a variable-rate or administered-rate instrument, or a *reinvestment of cash flow* from a maturity, scheduled amortization, prepayment, or early withdrawal of an asset or liability.

A variable rate loan reprices on its interest rate change date and on its maturity date, when the principal can be reinvested at a current market interest rate. Repricing also occurs when a credit union administers a rate change on an account such as a money market share account. A fixed rate loan reprices as scheduled

payments occur, upon prepayment of principal, and on its contractual maturity date when any outstanding principal balance is repaid.

Shocked Value: is a fair value for a financial instrument given a rate shock. The difference between the current value and the shocked value informs management of the price sensitivity of a financial instrument to a change in interest rates.

Volatility: can refer to how much change there is in measures of interest rate risk, such as forecasted net income or NEV, across different interest rate scenarios. Volatility also can refer to how much market participants expect interest rates or prices to change in the future.

Chapter 14

SHARE STRUCTURE

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Chapter 14

SHARE STRUCTURE

Examination Objectives

- Determine whether the credit union has a realistic share product mix and pricing policy
- Determine whether the share program meets the needs of the members
- Analyze the share mix to determine whether it provides for adequate earnings
- Determine whether the share program incorporates adequate internal controls
- Evaluate the reasonableness of fluctuations in the shares and share mix
- Determine whether the share program meets all legal requirements

Associated Risks

- Interest rate risk - improper pricing of products constitutes the leading cause of interest rate risk;
- Liquidity risk - improper pricing and poorly timed duration can cause liquidity risk;
- Reputation risk – improper pricing and product mix, and illiquidity can result in reputation risk;
- Strategic risk - ineffective planning of the share product mix and pricing policies can result in strategic risk;
- Credit risk - allowing members to overdraw accounts can result in credit risk to the organization;
- Transaction risk – improper transaction processing and controls of share account types and processing failures can cause other risks (e.g., interest rate risk, liquidity risk); and
- Compliance risk – inadequate or ineffective compliance policies regarding account disclosures for interest rates, yields, or terms can result in loss exposure.

Overview

Share accounts are the primary source of funds for credit unions. As such, the share program should conform to the credit union's asset liability management policies. In determining the proper share mix, the credit union must consider the cost of funds, the matching of funds

with corresponding assets, and the needs of the members. Management must monitor the share structure and make appropriate changes in a timely manner when needed.

The extent of the examiner's analysis depends on the complexity of the credit union's share structure. The examiner considers such factors as the following:

- Share policies (i.e., terms, dividend rates, fees, etc.); and
- Effect of the share policies on net income, short- and long-term goals, and funds management.

When examiners have concerns with the share program, they should perform sufficient procedures to address and resolve their concerns.

Examination Procedures

Most information systems provide management reports at the end of the members' trial balance. Although the number and types of reports vary with each information system, these reports should enable the examiner to verify the share account balances and confirm the breakdown of share types.

Share Draft Programs

Examiners may review share draft programs to determine the extent of the credit union's control over share draft processing, balancing, and posting. Credit unions must promptly (at least daily) review and process overdrafts and related loan advances, and clear processing exceptions. Examiners should expand their analysis when they encounter or have reason to suspect material risk factors.

Material operational problems (e.g., out-of-balance individual share draft ledgers, failure to promptly post share drafts, out-of-balance bank settlement accounts, and lack of proper control over overdraft activity including exception processing) can prevent a credit union's share draft program from functioning properly. Because share draft programs involve third parties, a credit union's failure to properly maintain internal operations over this program could damage its reputation resulting in increased reputation risk. Delays in processing drafts received for payment can increase credit risk and result in material losses.

Operational Flow With share draft programs, members write drafts and present them to third parties, who present the drafts received to their own banks. The payee's bank forwards the drafts through bank clearing channels for presentation to the credit union's payable-through bank. The payable-through bank receives the drafts and makes provisional payment subject to payment or dishonor by the credit union. Upon receipt of the drafts, the payable-through bank presents the information on the drafts to the credit union. Normally, the payable through bank converts the information on the share drafts to an electronic medium (magnetic tape) transmits it to the credit union for payment or dishonor (the bank may also transmit the information directly to the credit union's information system process supplier.) The credit union then approves payment and posts the share withdrawals to the members' accounts.

Sound Operation It is the board of directors' responsibility to establish sound operational and internal control procedures to safeguard the integrity of a share draft program. A credit union should obtain a written legal opinion that the program not only conforms with federal law and regulations, but also any state law requirements or other requirements, such as clearing house rules. A credit union may use its own routing and transit number (payable-at method) or the routing and transit number of the payable-through bank (payable-through method.) The board of directors should evaluate the cost and conveniences of the two methods before selecting one.

Overdrafts When a credit union receives a share draft that overdraws a share draft account, it has several options available:

- Return the draft as not paid for lack of sufficient funds.
- Accept the draft pending receipt of payment from the member to cover the overdraft. This is rare and usually involves small overdrafts. Credit unions should establish sufficient internal controls to prevent abuse.
- Accept the draft and create an overdraft, and then clear the overdraft by a transfer from another share account or by an advance

from a line of credit, special loan plan or other arrangement established with the member.

Credit unions that offer a line of credit for share draft accounts should ensure the member signs two separate agreements: a line of credit agreement and a share draft agreement. The credit union must comply with any provisions for lines of credit in the NCUA Rules and Regulations. The share draft agreement may authorize the credit union to transfer the amount of loan advance to the share draft account.

Verification

Credit union officials do not normally review the share draft to determine if the member signed the draft presented. Members review the periodic statement for unauthorized drafts. If members find an unauthorized draft, they must notify the credit union.

When a credit union receives notice of an unauthorized draft, the credit union should retrieve the original draft or a copy of the original draft for comparison against the signature card on file at the credit union's office. The board of directors should determine that adequate insurance coverage exists for forged drafts.

Fees

Credit unions offering share drafts to their members may charge periodic fees or service charges to their members using share drafts (e.g., for the distribution of interim statements, processing stop payment orders, overdrafts, obtaining copies of paid drafts for a member, and the actual cost of each member's blank share drafts.) The board of directors establishes the fee structures.

Business Share Accounts

For credit unions offering business share accounts, examiners should assess the materiality of these accounts on overall operations. Examiners may need to expand the scope of the examination in this area based on the following:

- Numbers and amounts of the business share accounts;
- Degree and effectiveness of internal controls surrounding these accounts; and
- Increased risk resulting from offering these shares.

Determining the materiality of business share accounts may require that examiners review more than just a one-day balance of the accounts. If the credit union does not have available average daily balances, the balances for multiple periods, such as monthly or quarterly ending balances, may give a better insight as to the activity and materiality of these accounts in relation to total shares.

Business share accounts can increase the likelihood of Regulation D and Bank Secrecy Act violations. Examiners should ensure credit unions have in place the proper corporate resolutions supporting signature authorizations for business accounts.

Appendix 14A discusses various types of share accounts credit unions can offer.

Fraud and Forgery

Expertise in fraud and forgery detection is beyond the examiner's role. However, if red flags indicate a potential for forgery, examiners should consult with their supervisory examiner to discuss expanding the examination scope. Appendix 14B contains red flag indicators for share accounts.

Forgery of members' shares involves falsely and fraudulently altering a member's share account to one's own use. Establishing proper internal controls over share transactions reduce the opportunity for fraud on members' shares.

Management should develop and implement a fraud policy. The board of directors should adopt the policy and require that staff give written acknowledgment of receiving and reviewing the policy. A fraud policy sends a signal that officials will not tolerate forgery and other improper acts. The board can also request its bond carrier to conduct a risk management analysis audit. The risk management auditor may recommend additional internal control measures to deter fraud and forgery.

Internal Control Structure

The board of directors bears responsibility for establishing internal controls over share transactions. Those internal controls include administrative controls to establish clear lines of authority and

segregation of duties to handle share transactions. Effective internal controls also include accounting controls to ensure accurate and timely share transaction posting.

Credit unions should view the internal control structure as a mechanism to prevent fraud and detect errors, as well as protect the credit union and its employees. Member confidence in the credit union's safety and soundness could diminish if management or staff has manipulated members' shares. The existence of fraud can result in high or increasing risk and a major area of concern. Credit unions rely on good member relations; however, small credit unions, where members personally know management, often depend heavily on member confidence.

The supervisory committee's responsibility includes reviewing the adequacy of the internal controls to safeguard members' share accounts. The supervisory committee should promptly investigate complaints and generate a written report on its findings.

The supervisory committee or internal auditor should document the review of testing the validity of share accounts. The audit steps may include the following:

- Reviewing insiders' statements of accounts for unusual deposits and withdrawals;
- Reviewing the check register for unusual withdrawals (i.e., withdrawals of inactive accounts);
- Reviewing dormant account reports for validity of transactions; and
- Reviewing canceled checks for unusual payees, unusual dollar amounts, or questionable endorsement signatures.

Some credit unions may transfer undeliverable and returned account statements to a dormant share account status. Unless staff reviews dormant account activity regularly, this practice may present a significant risk for fraud.

Advertising and Disclosures

A federal credit union must accurately represent the terms and conditions of its share, share draft and share certificate accounts in all

written and oral advertising, disclosures, or agreements (see NCUA Rules and Regulations §707.8.)

**Workpapers
and
References**

- Workpapers
 - Review Considerations
 - Share Analysis
 - Share Greater Than \$100,000
 - Shares Less Than \$0
 - Shares Detail
 - Share Internal Controls
- References
 - *Federal Credit Union Act*
 - 107(6) Receipt of Funds
 - 117 Dividends
 - 207(k)(2) Insured Account
 - *Federal Credit Union Bylaws*
 - Article III Shares of Members
 - Article XII, Section 1, Loans to Members (Organizations)
 - Article XIV, Dividends
 - Article XVIII, Section 2(b), Organizations of Such Persons
 - *NCUA Rules and Regulations*
 - 701.19 Retirement Benefits for Employees of Federal Credit Unions
 - 701.32 Payment on Shares by Public Units and Nonmembers
 - 701.34 Designation of Low-Income Status; Receipt of Secondary Capital Accounts by Low-Income Designated Credit Unions
 - 701.35 Share, Share Draft and Share Certificate Accounts
 - 701.37(a)(1) Treasury Tax and Loan Accounts
 - 701.37(a)(2) Government Depositories and Agents
 - 707.8 Advertising
 - 724 Trustees and Custodians of Pension Plans
 - 748 Suspicious Activity Report

TYPES OF SHARE ACCOUNTS – APPENDIX 14A

Neither the FCU Act nor the NCUA Rules and Regulations restrict a federal credit union in the types of member share accounts it can offer. Generally, share types fall into the broad categories of regular shares, share drafts, share certificates, money market shares, and retirement plan accounts. Other less commonly used accounts include escrow, nonmember, and public unit accounts.

Regular Shares

Every federal credit union offers a share account that does not require a minimum balance greater than the par value of a share, which provides for continued membership in the credit union. However, federal credit unions can offer variations of the regular share account (e.g., Christmas Club accounts, vacation accounts, no-dividend accounts.)

Share Drafts

By traditional definition, a share draft account is an account from which the authorized holder can withdraw shares by means of a negotiable or transferable instrument or other order. Share draft accounts may differ from regular share accounts. Before establishing a share draft program, the board should determine the economic and operational feasibility of the members' use of share drafts. Written operational and program specifications, available at the credit union's principal office, should support the program.

Settlement Accounts

In order to make settlement for drafts that a payable-through bank provisionally pays, credit unions normally maintain a deposit account in the payable-through bank. Other alternatives for settlement include use of an investment account, such as an account with a common trust, a savings and loan association, or a corporate credit union, through which funds are transferred to the payable-through bank using preauthorized agreements. The payable-through bank writes drafts against these accounts. The bank may also accept drafts in an account receivable clearing status and at the end of each day draw a draft against the credit union's checking account in a bank where the credit union does business.

**Internal
Accounts**

The *FCU Bylaws* require that federal credit unions deposit all funds except petty cash or change funds; therefore, credit unions may not establish their own in-house accounts on which they draw drafts.

However, a federal credit union may draw drafts upon itself. Although a federal credit union may not issue cashier's checks, it may issue "treasurer's drafts" to make credit union payments. These drafts equate to a cashier's check, which is a draft drawn by a bank against its assets. The bank acts as both the drawer and the drawee of the instrument. It becomes the bank's primary obligation, and constitutes its written promise to pay on demand. Therefore, while a federal credit union may draw drafts upon itself, assuming proper accounting procedures and an awareness of any liability it may incur by doing so, it may not have its own internal share draft account.

**Share
Certificates**

A share certificate account earns a dividend at a specified rate (either fixed or variable) if held to maturity. Credit unions may assess a penalty for the early withdrawal of all or any portion of the principal amount before maturity. Share certificates usually require a minimum balance. Credit unions design this account to attract and retain larger share deposits. Generally, accounts having greater restrictions also have higher dividend rates.

**Money Market
Accounts**

A money market account, a short-term insured draft account, pays competitive money market rates. The credit union determines terms and conditions according to competition and its own resources.

General characteristics of a credit union money market account include:

- Competitive yields (money market rates);
- Short-term or no maturities;
- Frequent dividend compounding (e.g., daily);
- Minimum balances and deposit and withdrawal requirements as determined by the credit union;
- Draft access; and
- Penalties, as determined by the credit union, if the account falls below the minimum balance requirements.

Due to the nature of money market accounts (i.e., short-term, rate-sensitive), a credit union offering them should have in place an effective asset-liability management program. To ensure adequate liquidity, credit unions should have in place a program that relates these accounts with assets of similar characteristics. (See the Asset-Liability Management and Liquidity chapters for further information.)

Individual Retirement Accounts

Part 724 of the NCUA Rules and Regulations authorizes a federal credit union to act as trustee or custodian of individual retirement accounts (IRAs) for its members or organizations of its members. IRAs act as trusts or custodial accounts, which requires (1) a written instrument creating the trust, and (2) investment of the funds in share accounts or share certificate accounts of the federal credit union. The credit union chooses the design of IRA share and share certificate accounts, without any maturity or dividend restrictions. The National Credit Union Share Insurance Fund (NCUSIF) insures these accounts separately up to a maximum of \$100,000.

Credit Union Employees' Retirement Plans

A federal credit union can provide retirement benefits for its employees and compensated officers. Except for IRA and Keogh accounts, credit unions have no authority to act as a trustee over any trust accounts. Therefore, for employees and compensated officers, a federal credit union can only offer the following types of pension plans:

- As the sponsor of an employee pension benefit plan with a named trustee other than the credit union; and
- As the trustee or custodian for IRAs for employees and compensated officials of the credit union.

401 K Plan

Part 724 of the NCUA Rules and Regulations provides for development of pension plans that qualify under 401(d) or 408 of Internal Revenue Code. As a result, credit unions have begun to offer services in the deferred compensation field. Most major corporations offer 401K Plans, known as "pay conversion plans," deferred pay plans, or salary reduction plans to their employees. In some credit unions, the growth in this program is offset by a reduction of payroll

deduction deposits in credit unions. Advantages of 401K plans over IRAs include a greater per year maximum and the improved availability of the funds. These accounts reduce current tax obligations by reducing gross wages.

Organizational Accounts

Only organizations composed exclusively of persons who are within the field of membership may open organizational share accounts. The examiner normally determines eligibility on the basis of information obtained from the organization. If questions arise whether the organization meets the Bylaw definition, the credit union could apply for a charter amendment to specifically add the group to its field of membership.

Escrow Accounts

Credit unions normally establish an escrow account as a limited access share account in conjunction with real estate loans. "Escrow account" means either a special limited withdrawal share account or an accounts payable account for the accumulation of funds to pay for taxes, assessments, insurance premiums, construction proceeds, or other charges that could affect the credit union's first lien position.

Nonmember Accounts

Nonmember accounts consist of shareholdings of other federally insured credit unions and, in a credit union designated "low income" (i.e., serving predominantly low-income members), the shareholdings of nonmember individuals or organizations (see §701.32 and §701.34 of the *NCUA Rules and Regulations*.)

Public Unit Accounts

A credit union may receive payments on shares from member or nonmember units of federal, state, and local governments. Because public unit accounts usually consist of large amounts of funds subject to immediate redemption, examiners must carefully analyze them. The term "public unit" means the United States, the District of Columbia, any state of the United States, the Commonwealth of Puerto Rico, any territory or possession of the United States, any county, municipality, or political subdivision thereof. The term "political subdivision" includes any subdivision or principal department of a public unit if state statute:

- Expressly authorized the creation of the political subdivision;
- Delegates to the political subdivision some functions of government; and
- Allocates funds by statute or ordinance for the exclusive use or control of the political subdivision.

Treasury Tax and Loan Accounts

Subject to the U.S. Treasury regulations, a federal credit union may:

- Serve as a Treasury Tax and Loan (TT&L) depository; a depository of federal taxes, a depository of public money, and a financial agent of the U.S. Government;
- Deem funds held in a TT&L Remittance Account, a TT&L Note Account, a Treasury General Account, and a U.S. Treasury Time Deposit-Open Account (§701.37) as deposits of public funds; and
- Exempt funds held in such accounts from the 60-day notice requirement of Article III, Section 5(a) of the *FCU Bylaws*.

A credit union can hold funds in a TT&L Remittance Account established for receipt of payments of federal taxes and certain U.S. obligations. The Federal Reserve Bank (FRB) may withdraw the funds immediately upon receipt of supporting advices. Funds held in a TT&L Remittance Account and a TT&L Note Account are added together and insured to a maximum of \$100,000.

A TT&L depository may credit funds to its note representing payments for U.S. Savings Bonds issued by the credit union in its issuing agent capacity and payments for U.S. Savings Bonds subscribed for through the TT&L accounts, and may enter into such custodial arrangements as necessary to meet Department of Treasury requirements for collateral on a TT&L depository. The examiner should determine that copies exist of the application and board of directors' resolution authorizing the credit union to be a TT&L depository regarding compensation owed and payments due the Treasury. The statement will include:

- The number of federal tax deposit forms, which comprise the basis for the compensation;
- The fee factor;
- The total compensation due; and
- Interest on late fees due the Treasury.

The district FRB or Financial Management Service of the U.S. Treasury can answer specific questions about TT&L accounts.

**Depository
and US Agent
Account**

A federal credit union may act as a depository or financial agent of the U.S. Government under the provisions of Title 31, C.F.R. 202 of the Department of Treasury Regulations, which permits federal credit unions acting under this authority to:

- Maintain accounts as specified by the U.S. Treasury in which balances may exceed the insurance coverage provided for in §207(k)(2) of the *FCU Act*.
- Maintain accounts in the name of the U.S. Treasury. Such accounts may include:
 - A Treasury General Account, which may carry a zero balance and from which the depositor may immediately withdraw the entire balance, under all circumstances except the credit union's closure;
 - A U.S. Treasury Time Deposit-Open Account, which is non-dividend bearing and which generally, may not be withdrawn until the expiration of 14-days after the date of the U.S. Treasury's written notice;
- Accept deposits to these accounts for the credit of the U.S. Treasury;
- Furnish drafts in exchange for collections in these accounts; and
- Pledge specifically identified assets as collateral to secure public funds under provisions specified in 31 C.F.R. 202.6.

Public unit accounts include funds in a Treasury General Account and the U.S. Treasury Time Deposit-Open Account. As such, funds in a Treasury General Account and a U.S. Treasury Time Deposit-Open Account are added together and insured up to a maximum of \$100,000 in the aggregate.

Funds held in a U.S. Treasury Time Deposit-Open Account do not constitute borrowings for purposes of §107(9) of the *FCU Act*, and are not subject to the 60-day notice requirement of Article III, Section 5(a) of the *FCU Bylaws*.

Business Share Accounts

Examiners need to consider the following when reviewing business share accounts:

- Rules and Regulations/Bylaws;
- Advantages/Disadvantages;
- Type of Account
- Internal Controls; and
- Recommended Examination Procedures (if applicable.)

When the membership needs business share accounts and the credit union has the ability to effectively offer them, this service can provide several advantages, including:

- Retaining the business of sponsor organizations, small entrepreneurs, and that segment of the membership requiring business accounts; and
- Providing the credit union with growth potential beyond individual-member accounts. Offering business share accounts could increase credit unions' shares and improve net earnings (depending on cash flows and fee structures).

Disadvantages can also exist, including:

- Large balance accounts in relation to the asset size of the credit union may result in undue influence on the officials and management. Most vulnerable are small credit unions. Examiners may need to focus loan reviews towards large business-account members and related members' accounts for the possibility of preferential treatment;
- Low average daily balances and a large number of transactions can render business accounts unprofitable. If credit unions cannot

restructure these accounts to at least a point of break-even, other services must subsidize this service; and

- Large business accounts can distort the credit union's trend analysis. Examiners should recognize the effect of major balance shifts in assessing the total analysis process.

Other possible disadvantages include:

- Excessive involvement by sponsor organizations in the credit union's operations;
- Need for comprehensive cash flow analysis;
- Cost of special access to services (i.e., coin processing, check cashing, etc.); and
- Inadequate controls regarding compensating balances.

In general, businesses may request business savings and share-draft accounts (e.g., sole proprietorships, small corporations, and small partnerships.) Credit unions offering business share accounts must implement adequate controls to ensure large business accounts, in either volume or dollar amount, do not pose a safety and soundness concern. Credit unions do this by requiring written policies and procedures, and establishing adequate internal controls and oversight.

Policies and procedures must specify the various business-related share accounts and the credit union's objective in offering these accounts. Examiners should encourage management to establish objectives that include quantifiable financial goals consistent with the credit union's capital goals and long-term business plan.

The policy must ensure employees adequately document membership eligibility. Credit unions should identify and monitor business accounts separately from other share accounts. Internal controls should include data processing controls for pledged shares or compensating balances, if applicable.

SHARE ACCOUNT RED FLAGS – APPENDIX 14B

Red Flags

Examiners should remain aware of the following red flags (not an all-inclusive list) when reviewing share accounts.

- Failure to set restrictions on employees processing transactions on their own accounts, the accounts of their family members, and those of their relatives;
- Failure to set computer access controls on authority levels to post transactions;
- Failure to require passwords or a teller ID number for each staff person to identify accountability;
- Employees' failure to produce records or to delay access to records;
- Long-standing problem of records not posted currently or being out-of-balance;
- Employee salaries and fringe benefits substantially below those of other credit unions providing equivalent services. Employees may reason the board is shortchanging them and may attempt forgery to overcome their perception of being under-compensated;
- Employees who live beyond their standard of living on their visible income, often indicated by luxury cars, expensive hobbies, gambling, or heavy drinking;
- Employees who resist taking vacations or resist attempts for someone else to perform their work during vacation;
- Employees who resist giving up control of certain records to another employee when promoted to a new position (e.g., performing the bank reconciliation);
- Failure to review negative Share and Share Draft Reports;
- Failure to review Dormant Share Reports;
- Cost of funds exceeds dividend rates;
- Credit union share growth not commensurate with above market dividend rates paid;
- Print command coded to suppress printing of statement of accounts;
- Numerous statement of accounts delivered to the same P.O. Box;
- Member complaints on accuracy of their statement of accounts;
- Failure to mail statement of accounts;

- Share trial balance report header shows not all share accounts were selected for printing on the share trial balance;
- Missing or incomplete membership cards; or
- Failure to correct internal control weaknesses identified in examinations, supervisory committee audits, internal audits, and risk-management analysis audits.

Examiners should use their professional judgment in questioning high-risk practices involving share accounts.

Chapter 15

PROFITABILITY

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Chapter 15

PROFITABILITY

Examination Objectives

- Review income and expense trends
- Analyze budget projections and practices
- Evaluate due diligence by management of services and products affecting the credit union's profitability (e.g., cost-benefit analysis)
- Determine adequacy of policies and practices addressing income and expenses
- Compare actual performance to the income and expense budget and capitalization goals
- Determine sufficiency of earnings to cover operating expenses, dividends, and necessary reserve transfers
- Determine adequacy of earnings to increase the net worth ratio (if necessary) or to maintain the net worth ratio at or above established benchmarks
- Ensure compliance with applicable laws, regulations, accounting practices, and policy statements when recording income and expense items
- Determine that management has instituted prompt correction of deficiencies or exceptions

Associated Risks

- Credit risk can result from poor underwriting of loans or high-risk investments;
- Interest rate risk can result from insufficient net interest margin to cover operating expenses;
- Liquidity risk can result from inadequate pricing policies, and failure to properly structure share and loan products resulting in weak or negative profitability;
- Strategic risk can result from failure of management to plan for sufficient resources to fulfill business plans or continue offering competitive products and services; and
- Reputation risk can result from loss of member confidence and withdrawal of member shares due to questions regarding the credit union's on-going viability.

**Statement of
Income**

The Statement of Income displays basic information about a credit union's profitability. This workpaper compares profitability from the prior yearend to the current period. The examiner can tailor the workpaper to calculate the individual line items as a percentage of either total assets, average assets, total income, or total expenses. The Financial History and Key Ratios workpapers display profitability trends for prior periods.

If the credit union has a profitability problem, the examiner will evaluate the cause of the deficiency. Examiners may prepare additional schedules or custom worksheets to analyze specific items (e.g., fee income, miscellaneous income, cash over and short, travel and conference expense, operating expenses, professional and outside services, miscellaneous expense, or any non-operating expense).

**Pro-Forma
Estimations**

Examiners may find it necessary to estimate material items such as dividends, reserve transfers, operating income, and operating expenses (if they are not accrued) during an examination or supervision contact performed as of a date other than the end of an accounting period. The estimates can reveal whether the credit union has sufficient earnings to declare its anticipated dividend. It will also show the net effect the dividend will have on net worth. Calculation of estimated dividends may require averaging the prior two periods' dividend-to-shares ratio (taking into account any expected changes in dividend rates) and multiplying the ratio by the average shares outstanding since the prior dividend period.

Example: Assume a September 30 examination in a credit union that offers only regular shares and pays dividends semiannually. As of June 30, the average share balance for the quarter was \$350,000 and dividends totaled \$3,938. The dividend-to-shares ratio is $\$3,938/\$350,000 = .01125$.

On December 31 of the prior year, the average share balance for the 6-month period was \$400,000 and the dividend cost was \$4,700. The dividend-to-shares ratio is $\$4,700/\$400,000 = .01175$. The average of the prior two periods' dividend-to-shares ratio is 1.15 percent $((1.125 \text{ percent} + 1.175 \text{ percent})/2)$.

Assume July 31 shares totaled \$475,000, August 31 shares totaled \$500,000, and September 30 shares totaled \$525,000. Average shares is $(\$475,000 + \$500,000 + \$525,000)/3 = \$500,000$. Multiplying the average shares by the dividend-to-shares ratio yields $\$500,000 \times 1.15 \text{ percent} = \$5,750$, which is the current period's estimated dividend. As of the examination date, the credit union has recorded only one-half or \$2,875 as the estimated dividend. The effective annual cost of shares is the result of multiplying the dividend-to-

shares ratio by the number of dividend periods in a year (2 x 1.15 percent = 2.3 percent cost of shares).

Analysis of Profitability

The Total Analysis Process chapter identifies procedures to properly assess profitability as it relates to the credit union's CAMEL rating and further discusses the ratios described in this chapter. A review of profitability should include a review of the credit union's general financial condition. A credit union with a weak net worth ratio requires strong profitability to improve net worth. In contrast, a credit union with strong net worth may only need profitability adequate to maintain its current position. Other considerations include asset growth, loan loss history, expense trends, growth projections and goals, and economic factors such as sponsor stability.

The Key Ratios workpaper displays the Earnings Ratios further described in the Total Analysis Process chapter. The examiner may supplement the foregoing analysis with data from the Financial Performance Report (FPR).

When reviewing profitability, examiners may evaluate several fundamental ratios. These include (1) the yield on assets, (2) cost of funds to average assets, (3) operating expenses to average assets, (4) net operating expenses to assets, and (4) return on average assets.

In some instances, unusual accounting period entries could distort profitability ratios. For example, recording large "one time" expense items could distort operating expense, while reflection of substantial point fee income from the sale of mortgage loans could distort income. Another distortion can occur when the examiner performs an examination early in the year in a credit union having unusual income or expense items because annualizing the income and expense items magnifies their effect. Annualizing assumes that income and expenses will occur consistently throughout the year, which may not fit the situation at hand.

If profitability concerns the examiner, the examiner may complete the Two Minute Profitability Test. This workpaper displays the profit necessary to maintain the current net worth ratio under varying growth rate assumptions. The examiner can tailor this worksheet to

indicate the additional profit necessary to increase the net worth ratio to a specified level over a selected number of years.

Examiners can also use the Two Minute Profitability Test for reviewing the credit union's budget relative to its net worth goals.

Gross Income to Average Assets

The gross income to average assets ratio reflects the rate at which the assets produce income. Since assets include such non-earning items as prepaid expenses and furniture and equipment, this ratio usually is less than the credit union's interest rate on loans. If the credit union has a low gross income to average assets ratio, or a negative or declining trend, the examiner may extend the analysis to determine the cause of the decreased income. Individually analyzing the yield on loans, yield on investments, and other major assets can assist the examiner in this determination. If these ratios do not point out the cause of the adverse trend, the examiner may look for a major fixed-asset purchase or some other increase in non-earning assets (e.g., the volume of delinquent loans greater than 90 days.)

Yield on Loans

The yield on loans is the rate at which loans produce income. This ratio usually is less than the interest rate charged for loans because it does not consider unaccrued interest on delinquent loans. Examiners should determine the reasonableness of the yield on loans for the types of loans in the credit union's portfolio. The yield on loans should not deviate substantially from the weighted average interest rate charged on loans. If the yield on loans reflects a negative trend, the reasons may include an increase in delinquency, decreased collections, or a reduction in interest rates.

Operating Expenses to Average Assets

Operating expenses to average assets reflects the percentage of assets used for operations. If this ratio is high or if there is an increasing trend, examiners should determine the cause.

Net Operating Expenses to Average Assets

Net operating expenses to average assets considers net operating cost when evaluating operating expenses. Fee income reduces total operating expenses. This ratio tends to put the overall expense picture into focus for those credit unions that offer expensive services but recoup some or all of the costs by assessing fees.

Comparison of this ratio with the operating expenses to average assets ratio provides additional information about the degree to which the credit union depends on fee income.

Cost of Funds to Average Assets

Cost of funds to average assets reflects the percentage of assets used for dividends and interest on borrowed money. Examiners should determine the cause of a high ratio or increasing trend. Calculating the cost of various share types and the cost of borrowed money ratios can assist in this determination. The mix of deposits between lower-costing regular shares and higher-costing share certificates directly affects the cost of shares. By reviewing growth trends by share category, examiners can better isolate changes.

Net Interest Margin to Average Assets

The net interest margin to average assets ratio measures whether income from loans and investments sufficiently covers the cost of funds. In general terms, if the credit union properly matches assets and liabilities, this ratio should remain constant in varying interest rate cycles. A fluctuating ratio could indicate a change in loan rates charged, a change in investment practices, or (in a rapidly changing rate environment) a slow adjustment of dividend rates paid. Examiners may determine the cause of a low or fluctuating ratio.

Return on Average Assets

The return on average assets ratio is the percentage of assets that the credit union realizes as profit before reserve transfers. A negative trend usually indicates a problem that requires addressing with the officials or, if material, in the examination report. A negative ratio may require the examiner to determine the cause and help officials develop corrective actions. The urgency of the situation depends on the degree of negativity in the trend and the amount of available reserves. Available revocable reserves and earnings determine how

long the credit union can support negative earnings without affecting dividends or operations.

Example: If a \$2 million credit union has \$22,000 in Undivided Earnings and a Net Loss From Operations ratio of -0.6 percent, the credit union will lose 0.6 percent times \$2,000,000 per year, or \$12,000 under present conditions.

Therefore, the credit union has 22 months or less to improve operations. However, if the -0.6 percent were the 12-month ratio, and the latest three-month ratio is -0.9 percent, the trend indicates an accelerating loss rate and dramatically reduces the period in which corrections must take place.

To determine the longest time available, examiners should first calculate the annual loss and then convert it into months:

$$\$2,000,000 \times -0.9 \text{ percent} = \$18,000 / 12 \text{ months} = \$1,500 \text{ loss per month.}$$

At that rate, the credit union will deplete its \$22,000 in Undivided Earnings in a maximum 15 months.

The accelerating loss rate may reduce the maximum period. Unless management makes changes, the credit union has less than 15 months in which to operate. A review of the ratio should reveal the validity of this assumption, or determine if less time actually remains to correct the problem.

Once identified, examiners should work with the credit union to correct the problems causing the negative trend. Examiner-designed workpapers may assist in determining and documenting the causes of the negative trends and lead toward corrective action in the Document of Resolution. When necessary, the examiner may choose to use the Supplementary Facts or any examiner-designed workpaper to highlight and explain the key ratios to the officials to increase their understanding.

Workpapers

- Workpapers
 - Financial History
 - Key Ratio
 - Statement of Income
 - Two Minute Profitability Test

Chapter 16

NET WORTH AND OTHER EQUITY ACCOUNTS

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Chapter 16

NET WORTH AND OTHER EQUITY ACCOUNTS

Examination Objectives

- Determine whether the credit union complies with Regulation D, if applicable
- Ascertain compliance with the Credit Union Membership Access Act (CUMAA)
- Determine whether the credit union has sufficient net worth for its degree of risk
- Determine whether the credit union has adequate policies, practices, and procedures regarding net worth and capital accounts
- Determine if officials and employees adhere to established policies, practices, and procedures regarding net worth and capital accounts
- Determine whether reserve accounts are audited periodically
- Determine whether reserve accounts comply with the CUMAA, *FCU Act*, *NCUA Rules and Regulations*, and appropriate accounting guidance
- Determine if the credit union promptly corrects deficiencies or violations noted during examinations or audits

Associated Risks

- Credit risk can result from poor underwriting of loans or high-risk investments;
- Interest rate risk can result from insufficient net interest margin to cover operating expenses;
- Liquidity risk can result from inadequate pricing policies, and failure to properly structure share and loan products resulting in weak or negative profitability;
- Strategic risk can result from failure of management to plan for sufficient resources to fulfill business plans or continue offering competitive products and services;
- Transaction risk can result from failure to establish and implement policies and procedures that ensure the accuracy and integrity of data and information;
- Compliance can result when credit unions fail to comply with applicable laws and regulations; and

- Reputation risk can result from loss of member confidence and withdrawal of member shares due to questions regarding the credit union's on-going viability.

Overview

The adequacy of the credit union's reserves should correlate to the amount of risk it has taken or plans to take.

Two types of reserves apply to credit unions: cash reserves and equity reserves. Cash reserves include transaction account reserves required by Regulation D. Credit unions hold cash reserves in the following forms:

- Vault cash;
- A balance maintained directly with the Federal Reserve Bank (FRB) in the District in which the credit union is located; or
- A pass-through account, which is considered a balance maintained with the FRB.

Cash reserves usually do not apply to smaller credit unions; however, equity reserves apply to all credit unions. Credit unions establish equity reserves (also called capital) by segregating part of their net income into reserve and undivided earnings accounts. Equity reserves may be either appropriated or unappropriated.

A credit union's capital is defined as the total of its regular reserves, allowance for loan and lease losses, special reserves, undivided earnings, accumulated unrealized gains or losses on available-for-sale (AFS) securities, and that portion of year-to-date net income that has not yet been closed to the appropriate capital account. Capital accounts provide (1) a cushion for anticipated and unidentified losses, (2) a base for future growth, and (3) a means by which the credit union can meet competitive pressures as they arise. Capital provides the credit union a cost-free source of funds.

Net worth is defined as the retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles (GAAP). See the *FCU Act* §216(d)(o)(2). Retained earnings consist of undivided earnings, regular reserves, and any other appropriations designated by management or

regulatory authorities. Net worth does not include the Allowance for Loan and Lease Losses account. This means that net worth only includes undivided earnings and appropriations of undivided earnings. (Refer to the Prompt Corrective Action chapter of this Guide for additional information.)

A strong net worth position enables a credit union to take on more risk than can a credit union with a weak net worth position. A stronger overall net worth position better enables a credit union to deal with future uncertainties such as asset losses, sponsor layoffs, and adverse economic cycles.

The credit union board should have a plan for defining and maintaining an adequate net worth level. The examiner should review the net worth position and the officials' philosophy toward building and maintaining net worth. If the net worth position does not meet the credit union's short- or long-term needs, the examiner should determine if the shortfall poses a threat to safety and soundness.

Examiners may find the following ratios useful in reviewing capital and net worth:

- Net Worth to Assets;
- Net Worth Growth vs. Asset Growth (trend);
- Capital to Assets;
- Net Capital to Assets;
- Capital Growth to Asset Growth;
- Net Worth to Loans;
- Classified Assets to Net Worth;
- Total Delinquent Loans to Net Worth; and
- Solvency Evaluation.

When analyzing the adequacy of reserves and net worth, examiners should consider the following factors:

- Size of the credit union;
- Complexity of products and services;
- Degree of sponsor support;
- Level of management's expertise;

- Quality of management's due diligence for existing and new products, services and systems;
- Involvement of the officials;
- Interest rate risk;
- Internal control structure;
- Stability and diversity of the field of membership; and
- Concentrations of credit and savings.

Examiners should also consider the amount of coverage provided by the credit union's surety bond. §713.5(a) of the *NCUA Rules and Regulations* defines the minimum coverage required. Some of the newer bond forms provide significantly less coverage than the standard bond. Examiners should ensure the credit union maintains adequate bond coverage. See the Bond Coverage chapter of this Guide for additional guidance.

**Secondary
Capital for
Community
Development
Credit Unions**

Federally insured credit unions designated as low-income may establish secondary capital accounts, which examiners should review for compliance with §701.34(b) of the *NCUA Rules and Regulations*. Before offering secondary capital accounts, the credit union must adopt, and forward to the appropriate regional director, a written plan for use of the secondary capital account funds and subsequent liquidity needs to meet repayment requirements upon maturity of the accounts.

The following restrictions apply to these secondary capital accounts:

- Establishment as an uninsured secondary capital account or other form of non-share account;
- Minimum five years maturity;
- Not redeemable before maturity;
- Not insured by the National Credit Union Share Insurance Fund (NCUSIF) or any governmental or private entity;

- Holder's claim against the credit union is subordinate to all other claims, including those of shareholders, creditors, and the NCUSIF;
- Required availability of funds deposited, including interest accrued and paid into the secondary capital account, to cover credit union's operating losses that exceed net available reserves and undivided earnings (i.e., exclusive of allowance accounts for loan and lease losses.) Credit unions may not replenish the account for funds so used. Credit unions may pay interest accrued on the secondary capital account directly to the investor or into a separate account available to the investor for withdrawals. Pro-rata distribution of realized losses among all secondary capital accounts held by the credit union is required;
- May not pledge as security on a loan or other obligation with the credit union or any other party;
- Account funds not needed for covering losses at the time of merger (other than merger into another low-income designated credit union) or voluntary dissolution will be closed and paid out to the account holder;
- Contract containing terms and conditions required between representative of the account holder and the credit union; and
- Disclosure and acknowledgment signed by representative of account holder is required and the account holder will receive copies of contract and disclosure at the time of entering into the account agreement (see the Appendix to §701.34 of the *NCUA Rules and Regulations*.) Credit unions must retain original copies of the contract and the disclosure and acknowledgment for the term of the agreement.

The regulation establishes a declining scale for the capital value of accounts with less than five years remaining maturity. Even so, all funds will continue to be at risk to cover losses that exceed reserves and undivided earnings. The declining scale addresses accounts with remaining maturities of at least the following:

- Four years, but less than five years - counted as capital at 80 percent of face value;
- Three years, but less than four years - counted as capital at 60 percent of face value;
- Two years, but less than three years - counted as capital at 40 percent of face value;
- One year, but less than two years - counted as capital at 20 percent of face value; and
- Less than one year remaining maturity - counted as capital at 0 percent of face value.

Examiners should review the disclosure and acknowledgment that the account holder's authorized representative must provide and execute. (See disclosure in the Appendix to §701.34 of the *NCUA Rules and Regulations*.)

**GAAP vs.
RAP**

GAAP classifies secondary capital accounts as subordinated debt. As such, the account holder does not have voting or ownership rights. However, NCUA adopted a regulatory accounting position (RAP) that recognizes secondary capital accounts for low-income designated credit unions as capital accounts. This RAP position applies to all credit unions having a low-income designation, including those with assets equal to or greater than ten million. Examiners should understand that the credit union's outside auditor may recognize these accounts as subordinated debt, and reflect the entire balance in these accounts in the liability section of the balance sheet consistent with GAAP for financial statement presentation.

Examiners should record secondary capital as "Other Revocable Reserves" in the equity section of the balance sheet to ensure their inclusion in capital when AIRES calculates CAMEL component and composite ratings. For secondary capital accounts having a remaining maturity of less than 5 years, AIRES requires examiners to split them into capital (Other Revocable Reserves) and non-capital (Other Liabilities) components based on the sliding scale (see the *NCUA Rules and Regulations* §701.34(c)).

The credit union records secondary capital accounts that have capital value (based on the sliding scale) as "Secondary Capital -

Uninsured”. Credit unions must transfer the portion of secondary capital accounts not considered capital to “Subordinated CDCU Debt” (The *Accounting Manual for Federal Credit Unions* contains more information on this subject.)

When reviewing call reports of low-income designated credit unions that have secondary capital accounts, examiners should ensure proper recording of these accounts. Credit unions should not use the Uninsured Secondary Capital line on the call report for reporting any other type of capital.

**Other
Consider-
ations**

A low-income credit union must include secondary capital accounts in its total borrowing amount. The *FCU Act* §107(9) limits credit union borrowing to 50 percent of paid-in and unimpaired capital and surplus.

Part 705 of the *NCUA Rules and Regulations* addresses the Community Development Revolving Loan Program for Credit Unions (the Program). A participating credit union may receive up to \$300,000 in the form of a loan, which the credit union must match by increasing its shares by a like amount (see the Low-Income Credit Union chapter of this Guide for more information about the Program). The regulation’s matching requirement encourages credit unions to develop a permanent source of member shares as rapidly as possible.

Since secondary capital accounts are not member share accounts, low-income designated credit unions may not use secondary capital accounts as matching funds for purposes of the Program. Additionally, the limitations on public unit and nonmember accounts described in §701.32(b) do not apply to secondary capital accounts.

**Capital and
Solvency
Evaluation**

When reviewing reserve accounts, the examiner should consider capital adequacy, net worth, trends, materiality, unusual activity, and thoroughness of the audit work. In addition, the level of capital in relation to the perceived level of risk will determine the degree of review.

Undivided Earnings

The examiner should determine that the credit union appropriately accounts for its undivided earnings account. It should pay particular attention to the positive and negative growth trends of this account. A decreasing trend may trigger a detailed review to determine the cause.

When analyzing the adequacy of the undivided earnings account, the examiner should consider the following:

- Current and anticipated earnings capacity of the credit union;
- Quality of the loan and investment portfolios (overall assessment); and
- Unanticipated events, such as adverse economic conditions causing plant closings, layoffs, etc.

Credit unions cannot pay dividends, without the prior approval of the regional director if the payment results in a deficit in the undivided earnings account. Credit unions experiencing a deficit, or those in which paying a dividend would result in a deficit, must request and receive approval for 208 Assistance before paying dividends.

If a credit union has a deficit balance in the undivided earnings account at the time of the examination, the examiner should determine if it paid a dividend during the last accounting period. If it did pay a dividend, the dividend was material, and the examiner believes there was obvious intent on the part of the officials to pay an illegal dividend, then the examiner should consider initiating an administrative action against the responsible parties. The examiner should not recommend that the officials recall the dividend because neither the officials nor the NCUA Board has that authority. If the shareholders received the illegal dividend in good faith and without knowledge of the credit union's financial condition, they have no legal obligation to refund the dividend.

However, the examiner should reach an agreement with the officials that a dividend declared at the end of the next accounting period will not exceed available earnings after elimination of the deficit. Examiners should treat an illegal dividend as an area of concern.

Regular Reserve

The regular reserve is a statutory reserve account. When analyzing the adequacy of this account's balance, the examiner should consider the credit union's compliance with statutory reserving requirements, including net worth restoration plans. Refer to §702.201 of the *NCUA Rules and Regulations* for guidance on transfers into this account.

Accumulated Unrealized Gains/Losses on Available for Sale Securities

This account records unrealized gains and losses on available for sale securities. When credit unions write available for sale securities to fair value, they make an entry directly to the investment account with the corresponding debit or credit to the accumulated unrealized gain and losses on the available for sale securities account. The credit union nets this account against undivided earnings when assessing a credit union's ability to pay dividends.

Workpapers and References

- Workpapers
 - Regular Reserves
 - Undivided Earnings
 - Accumulated Unrealized Gain/Loss on Investments
 - Special Reserves
 - Other Reserves
 - Contingency
 - Appropriated Undivided Earnings
 - Critical Solvency
- References
 - *Federal Credit Union Act*
 - 107(9) – Borrowing Limitation
 - 216 – Prompt Corrective Action
 - *NCUA Rules and Regulations*
 - 701.32 – Payment on Shares by Public Units and Nonmembers
 - 701.34 (Appendix) – Disclosures and

Acknowledgment

- 702 – Prompt Corrective Action
- 702.2(f) – Definition of Net Worth
- 702.34(b) – Receipt of Secondary Capital Accounts by Low-Income Designated Credit Unions
- 702.401 - Reserves

705.7 – Loans to Participating Credit Unions

713 – Fidelity Bond and Insurance Coverage for
Federal Credit Unions

- NCUA Letter to Credit Unions #182, dated November 1995
- NCUA Instruction No. 4020
- NCUA Accounting Bulletin 95-1

Chapter 17

PROMPT CORRECTIVE ACTION

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Chapter 17 – Part 1

PROMPT CORRECTIVE ACTION

Examination Objectives

- Assess the calculation for the net worth ratio as mandated by Congress
- Determine whether the credit union meets the definition of complex and must adhere to the applicable risk-based net worth (RBNW) requirement
- Determine whether mandatory supervisory actions (MSAs) apply to the credit union
- Determine whether discretionary supervisory actions (DSAs) apply to the credit union
- Assess whether the Net Worth Restoration Plan (NWRP) or, for new credit unions, the Revised Business Plan, meets the requirements of the statute and provides sufficient measures for the credit union to achieve and maintain a minimum six percent net worth ratio
- Determine the criteria for mandatory and discretionary conservatorships and liquidations

Associated Risks

- Reputation risk may occur when PCA efforts are not successful and the credit union fails.

Overview

(Please note that at the time of this writing, the NCUA Board was considering revisions and adjustments to Part 702, Prompt Corrective Action. This chapter does not reflect any proposed changes. Therefore, users should also consult the latest version of Part 702 when relying on this chapter as a guide to implementation of PCA.)

The *Credit Union Membership Access Act* (CUMAA) amended the *Federal Credit Union Act* to mandate a system of net-worth based capital standards for federally insured credit unions (FICUs.) This amendment to the *FCU Act* required the NCUA Board to (1) adopt, by regulation, a system of PCA to restore the net worth of inadequately capitalized FICUs; and (2) develop an alternative system of PCA for new credit unions that carries out the purpose of PCA while allowing reasonable time to build net worth to an adequate level. PCA does not limit NCUA's authority to take additional supervisory action. The

NCUA Board often delegates specific authority to the regional directors (*FCU Act §216, NCUA Rules and Regulations §702.201, §702.202-§702.204, §702.303-§703.305, and §741.3.*)

Part 702 of the *NCUA Rules and Regulations* establishes the components and requirements of PCA. As a credit union's net worth ratio continues to decline, the actions required of the credit union to restore its net worth ratio to an acceptable level become progressively more stringent. Subpart B addresses requirements for credit unions that do not meet the definition of new; while Subpart C addresses requirements for credit unions defined as new. The three main components of PCA include:

- A framework combining:
 - MSAs prescribed by Congress and indexed to five statutory net worth categories, and
 - DSAs developed by NCUA to enhance PCA when imposed;
- Alternative PCA requirements for credit unions defined by CUMAA as new; and
- RBNW requirement for credit unions that NCUA defines as complex.

Definitions

PCA definitions for some terms may differ from their definitions for other purposes. The following definitions also apply to new credit unions unless otherwise specified:

- **Complex and applicable RBNW requirement.** For purposes of §702.102, a credit union is defined as complex and a RBNW requirement applies only if the credit union meets both of the following criteria as reflected in its most recent call report:
 - Minimum asset size - its quarter-end total assets exceed \$10 million; and
 - Minimum RBNW calculation - its risk-based net worth requirement as calculated under §702.106 exceeds 6 percent.

(Examiners should use the term “applicable RBNW requirement” rather than “complex.”)

- **Contribution.** Per generally accepted accounting principles (GAAP), a contribution consists of cash or other assets the credit union receives unconditionally. Under GAAP, credit unions report donations in the form of cash

or other assets (e.g., fixed assets) as contributions and recognize them as revenues of the period. The credit unions would close them from net income into undivided earnings. Thus, the credit union will include these amounts in net worth. However, any condition placed on the donation prohibits the credit union from accounting for it as a contribution, and conditional donations will not count as part of net worth.

- **Discretionary supervisory actions (DSAs.)** Those actions developed by NCUA to supplement MSAs, and described in more detail in this chapter (§702 Subparts B and C.) DSAs do not include Discretionary Conservatorship or Liquidation under §702.203(c) and §702.304(c.)
- **Mandatory supervisory actions (MSAs) for credit unions that do not meet the definition of new.** The following four Congressionally prescribed MSAs apply to undercapitalized credit unions with less than 6 percent net worth. The earnings transfer to regular reserves also applies to adequately capitalized credit unions with net worth ratios of 6 percent to less than 7 percent. MSAs consist of the following (§702 Subpart B):
 - Earnings transfer to regular reserves;
 - NWRP;
 - Restriction of asset growth; and
 - Restriction of member business loans.
- **Mandatory supervisory actions (MSAs) for credit unions that meet the definition of new.** The following MSAs, developed through NCUA regulation, apply to new credit unions (§702 Subpart C):
 - Earnings transfer to regular reserves;
 - Submission of a revised business plan; and
 - Restriction of member business loans.
- **NCUA examiner.** Any NCUA district examiner, economic development specialist, problem case officer, or AMAC staff member.
- **Net worth.** The retained earnings balance of the credit union at quarter end as determined under generally accepted accounting principles (GAAP) (§702.2(f)). Retained earnings consist of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities. This means that only undivided earnings and appropriations of undivided earnings are included in net worth. For low-income designated credit unions, net worth also includes secondary capital accounts that are uninsured and subordinate to all other claims, including claims of creditors, shareholders and the NCUSIF. Net worth does not include (1) the Allowance for Loan and Lease Losses account; (2) the Unrealized Gain/Loss on Available for Sale Securities; (3) contributions of tangible fixed assets recorded as Donated Equity, per regulatory accounting practice (RAP) that have not been closed into income, or any donations encumbered by conditions; or (4) alternative sources of capital (e.g., secondary capital and paid-in-capital accounts) except as noted above. See also the definition of Retained Earnings.
- **Net worth ratio.** The ratio of the net worth of the credit union (numerator) to the total assets of the credit union (denominator) described in more detail in this chapter (§702.2(g)).

- **Net Worth Restoration Plan (NWRP.)** Management's written plan detailing the steps the credit union will take to become adequately capitalized by the end of the plan's term, and remain so for four consecutive quarters. The credit union will submit the plan within the mandated time frames to the appropriate regional director and, if state-chartered, the appropriate state supervisory authority (SSA) (§702.206.) For PCA purposes, the regulation refers to a new credit union's equivalent of a NWRP as a revised business plan (§702.304(a)(2)).
- **New credit union.** A credit union that has been in operation for less than 10 years and has \$10 million or less in total assets (§702.2(h)). NCUA may classify a credit union that exceeds \$10 million in total assets as new if its total assets subsequently decline to \$10 million or below while it is within its operational limit of less than 10 years (§702.301(b)). NCUA may deem a credit union formed as a result of a spin off of a group from the field-of-membership (FOM) of an existing credit union to be in operation since the effective date of the spin off. A credit union whose total assets decline to \$10 million or below as a result of a spin-off group within its FOM is deemed to be new if it has been in operation less than 10 years (§702.301(c)).
- **Retained earnings.** Retained earnings consist of undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities. An appropriation of undivided earnings consists of a set aside of such an account, e.g., the regular reserve. Items of retained earnings must flow naturally through the income statement.
- **Risk-based net worth requirement.** Additional net worth necessary to compensate for material risks against which the 6 percent net worth ratio does not provide adequate protection. The computation of a credit union's RBNW requirement uses the standard calculation of §702.106. A credit union may substitute one or more alternative components in place of the corresponding standard components (§702.107.)
- **Spin-off credit union.** A newly-chartered credit union formed from a group from the field of membership of an existing credit union (§702.301(c)).
- **Total assets.** For each quarter, a credit union must elect a measure of total assets from the choices below to apply for PCA purposes. The credit union will use this measure of total assets for all of the quarterly PCA calculations, except the risk-based net worth requirements. (§702.103 - §702.106, §702.201(a)).
 - Average quarterly balance - the average of quarter-end balances of the four most recent calendar quarters;
 - Average monthly balance - the average of month-end balances over the three calendar months of the calendar quarter;
 - Average daily balance - the average daily balance over the calendar quarter;
 - Quarter-end balance - the quarter-end balance of the calendar quarter as reported on the credit union's call report.

If the credit union elects one of the alternative methods to compute its NWR, it must also use this total assets election for purposes of computing the reserve transfer amount for the current quarter. For example, if the credit union chooses average daily assets, it must use 0.1 percent of average daily assets for its reserve transfer. Or, if the credit union makes no optional total

assets election, by default its transfer amount will be 0.1 percent of quarter-end total assets.

Net Worth Calculation

The net worth calculation for credit unions is as follows:

$$\text{Net Worth Ratio} = \text{Net Worth} / \text{Total Assets}$$

A credit union with assets over \$10 million must also perform a RBNW calculation to determine if the credit union has an applicable RBNW requirement as described in the Risk-Based Net Worth Requirement section of this chapter.

The following items further describe the net worth calculation and its importance in the examination process:

- Net worth numerator. For purposes of the net worth ratio, the numerator is the credit union's net worth at quarter end. CUMAA defines net worth generally as GAAP retained earnings. The Definitions section of this chapter contains a definition of both net worth and of retained earnings. Net worth includes amounts the credit union had previously closed from net income into undivided earnings. If the credit union does not close its net income into undivided earnings during interim periods, examiners will treat the net income as if it had been closed into undivided earnings.
- Net worth denominator. The definition of "total assets" in the Definitions section of this chapter contains the methods available for determining total assets for the purposes of the net worth ratio. Each quarter, credit unions elect which method of determining total assets they will use to calculate the net worth ratio and, if applicable, the earnings transfer and asset growth restriction. The total asset measurement selected also applies to the determination of whether or not a credit union falls within the definition of "new." A credit union need not maintain consistency from one period to the next in its choice of method for determining total assets; it has the option of choosing the most favorable method each quarter. Absent an election by the credit union, NCUA will use quarter-end total assets as the default.

- Net worth documentation. Responsibility for calculating the net worth ratio at the end of each calendar quarter falls on the individual credit union. The call report contains the PCA Net Worth Calculation worksheet. It automatically computes the credit union's net worth ratio and provides the net worth classification (§702.106.) All credit unions must determine their net worth calculations at the end of each quarter and retain the calculation documentation.

- Effective date. The effective date of the net worth classification is the most recent of the following:
 - The last day of the calendar month following the end of the calendar quarter (quarter-end effective date); or
 - The date the credit union's net worth ratio is recalculated by, or as a result of, its most recent final examination report (corrected net worth category); or
 - The date the credit union received written notice from NCUA or the SSA of reclassification to a lower net worth category, based on safety and soundness grounds (reclassification to lower category) (§702.101(b)).

- Examination verification. Quarter-end net worth ratio calculations provide the basis for PCA requirements because credit unions are only required to compute their net worth ratio at quarter-end.

To verify accuracy, examiners should recalculate the net worth ratio reported on the call report using the credit union's chosen "total assets" as of the most recent quarter end.

If the recalculation process discloses a quarter-end calculation error made by the credit union and correcting that error would place the credit union in a lower net worth category, the effective date of the lower net worth classification will be the date the examiner gives the final examination report to the officials. However, the corrected net worth category effective date cannot precede the quarter-end effective date. For example, if the examiner delivers the examination report with the new corrected year-end net worth ratio on January 15, the effective date of the net worth classification

would be January 31. If the examiner delivers the report on February 15, the effective date will be February 15.

In addition, if the examiner discovers errors, omissions or other findings that would result in a lower net worth ratio, but the source of these events took place after the most recent quarter-end net worth ratio measurement period, the net worth ratio will not reflect these modifications until the credit union's next quarter-end measurement date.

When an examiner computes a net worth ratio as of the effective date of the exam, and that date follows the most recent quarter-end effective date, the net worth ratio only indicates what the credit union's net worth ratio and corresponding net worth classification might be as a result of the credit union's next quarter-end measurement.

- Assigning a capital component rating. For examinations other than quarter end, examiners should also calculate the net worth ratio using the month-end balance of net worth to the month-end balance of total assets as of the examination date. If the examination date falls on a quarter end, then the examiner should use the same total asset calculation as the credit union.

If a material difference exists between the credit union's chosen method at the quarter end and the calculation made by the examiner as of the examination date, the examiner should discuss in the examination report the reasons for the difference and assign an appropriate capital component rating.

- Safety and soundness classification. Examiners may not reclassify a credit union to a lower net worth category for safety and soundness reasons. Only the NCUA Board may reclassify the credit union based on safety and soundness concerns (§702.101(b)(3)).

Statutory Net Worth Categories

Other Than New Credit Unions		New Credit Unions	
Net Worth Category	Net Worth Ratio	Net Worth Category	Net Worth Ratio
Well Capitalized	7% or greater*	Well Capitalized	7% or greater
Adequately Capitalized	6% to 6.99%*	Adequately Capitalized	6% to 6.99%
Undercapitalized	4% to 5.99%	Moderately Capitalized	3.5% to 5.99%
First Tier	5% to 5.99%	Marginally Capitalized	2% to 3.49%
Second Tier (and failed RBNW)	4% to 4.99%	Minimally Capitalized	0% to 1.99%
Significantly Undercapitalized	2% to 3.99%	Uncapitalized	Less than 0%
Critically Undercapitalized	Less than 2%		

*Also must meet applicable risk-based net worth requirements

Illustration 17-A

Illustration 17-A shows the net worth categories for all credit unions. The left side illustrates net worth categories for credit unions other than those defined as new. The right side shows net worth categories for credit unions defined by statute as new (in operation for less than 10 years and assets of \$10 million or less.)

Reasonable Timetable to Build Net Worth

Within # of Years in Operation	Net Worth Ratio
3 Years	0% to 1.99%
5 Years	2% to 3.49%
7 Years	3.5% to 5.99%
10 Years	6% to 6.99%

Illustration 17-B

New credit unions initially have no net worth and, as such, need reasonable time in which to accumulate it. Illustration 17-B is a reasonable timetable for building net worth and serves only as a guide to show the anticipated time for a new credit union to reach the net worth classification of adequately capitalized.

Net Worth Category Change

All credit unions complete a call report each quarter. Therefore, other than filing a call report, a federally insured credit union need not notify the NCUA Board of a change in its net worth ratio that places the credit union in a lower net worth category.

Reclassification The NCUA Board has the discretion to reclassify a credit union to the next lower category if the credit union has an unsafe or unsound condition or engages in material unsafe and unsound practices. The NCUA Board may reclassify a well-capitalized credit union as adequately capitalized, and may require an adequately capitalized or undercapitalized credit union to comply with certain mandatory or discretionary supervisory actions as if it were in the next lower category. The NCUA Board may apply this same discretionary authority to reclassify new credit unions that are well, moderately, or marginally capitalized. The NCUA Board alone has this authority; they may not delegate it. However, credit unions may apply to the NCUA Board for reconsideration of its decision.

PCA requires reclassification to significantly undercapitalized if a credit union in the second-tier undercapitalized category (4.00 percent to 4.99 percent net worth ratio) fails to (1) submit a NWRP within the regulatory timeframes, or (2) implement an approved NWRP.

Mandatory Supervisory Actions

Mandatory Supervisory Actions

MSA	Adequately Capitalized NW Ratio = 6% to 6.99%	Under Capitalized NW Ratio = 4% to 5.99%	Significantly Under Capitalized NW Ratio = 2% to 3.99%	Critically Under Capitalized NW Ratio = Less than 2%
Earnings Transfer	X	X	X	X
Net Worth Restoration Plan		X	X	X
Restrict Asset Growth		X	X	X
Restrict MBLs		X	X	X

Illustration 17-C

Credit unions other than those defined as new. Well-capitalized credit unions are those with net worth ratios equal to, or above, 7 percent and meet applicable RBNW requirements. No MSAs or DSAs apply to these credit unions. However, less than well-capitalized credit unions must comply with the mandatory and discretionary actions prescribed by CUMAA.

Illustration 17-C shows the MSAs and the categories of credit unions to which each applies. The same MSAs apply to undercapitalized, significantly undercapitalized, and critically undercapitalized categories.

- **Earnings transfer.** For credit unions that are less than well capitalized, CUMAA requires annual earnings retention of 0.4 percent or more of their total assets. Credit unions will use the regular reserve account as an appropriation of undivided earnings for the earnings retention. Beginning with the effective date of net worth classification below well capitalized, the credit union will do the following until it reaches the well-capitalized category (§702.201(a)):
 - Increase the dollar amount of net worth quarterly by at least 0.1 percent of total assets; and
 - Transfer that amount to regular reserve.

Reserve transfers in the absence of an increase in the dollar amount of net worth do not satisfy the requirement. (Also, the credit union will not credit undivided earnings to recover the provision for loan and lease losses expense.)

NCUA may permit, on a case-by-case basis, a reduction in earnings transfer to avoid significant redemption of shares and to further the purpose of PCA (§702.201(b)). However, only under exceptional circumstances should NCUA allow a reduction below zero (resulting in net losses) for more than four consecutive calendar quarters. In these cases, documentation should include how NCUA expects the credit union to return to profitability in the near-term following this period.

NCUA cannot accept requests received after the quarter-end for reductions in the minimum earnings transfer requirement.

- **NWRP.** Credit unions must submit a NWRP (described later in this chapter.)
- **Restrict increase in assets.** Beginning with the effective date of the net worth classification, the credit union cannot increase its

assets beyond its total assets for the preceding quarter, except in the following circumstances:

- The credit union's asset growth and net worth are increasing consistent with an approved NWRP, or
- If NCUA has not yet approved the credit union's NWRP (the credit union may be awaiting initial approval) and the credit union's total assets are increasing as a result of increases in the following accounts used in normal operations:
 - i. Total accounts receivable and accrued income on loans and investments;
 - ii. Total cash and cash equivalents; and
 - iii. Total loans outstanding, not to exceed the sum of total assets plus the quarter-end balance of unused commitments to lend and unused lines of credit.

These exceptions to the asset growth restriction are available to the credit union while waiting for approval of its initial NWRP, provided the credit union does not offer rates on shares in excess of prevailing rates on shares and deposits in its relevant market area and does not open any new branches. However, the credit union may not retroactively restrict dividend rates already declared on shares acquired before imposing the restriction.

- **Restrict member business loans.** Beginning with the effective date of net worth classification, the credit union cannot increase the total dollar amount of its member business loans (MBLs), defined as loans outstanding and unused commitments to lend, as of the prior quarter-end, unless the credit union:
 - Was chartered for the purpose of making MBLs;
 - Has a history of primarily making MBLs;
 - Has a low income designation; or
 - Is a community development credit union.

The restriction applies to the total dollar amount of MBLs. Thus, the credit union may make new MBLs provided the total dollar amount of MBLs does not increase (§702.202(a)(3)(ii)(c)).

New credit unions. New credit unions that have less than 6 percent net worth, or were reclassified to moderately capitalized or lower, are subject to MSAs. In addition, MSAs apply to a new credit union that either (1) remains uncapitalized beyond the time period provided in its initial business plan (approved at the time the credit union was chartered); or (2) subsequently declines to uncapitalized from a higher category after expiration of the time period originally approved in its initial business plan for the credit union to operate in the uncapitalized category. The MSAs for new credit unions differ slightly from those prescribed for other credit unions:

- **Earnings transfer.** New credit unions must increase net worth and make quarterly earnings transfers to the regular reserve account in an amount reflected in the credit union's previously approved initial or revised business plan (may be less than the equivalent of 0.4 percent of assets per year.)
- **Submit a revised business plan.** New credit unions will submit a revised business plan if any of the following apply:
 - The credit union's net worth ratio has not increased consistent with its currently approved business plan;
 - The credit union has no currently approved business plan; or
 - The credit union has failed to undertake any mandatory actions (§702.304.)
- **Restrict member business loans.** New credit unions may not increase the total amount of member business loans (defined as loans outstanding and unfunded commitments to lend) unless it meets one of the exceptions of §702.202(a)(4.)

**Discretionary
Supervisory
Actions**

CUMAA required NCUA to develop DSAs to complement the CUMAA-prescribed mandatory actions. To further the purpose of PCA, NCUA developed fourteen DSAs, which are comparable to the discretionary safeguards in the banks' system of PCA. (For a detailed explanation of the internal DSA implementation process, please see Instruction entitled Discretionary Supervisory Actions (DSAs) under Prompt Corrective Action (PCA)).

Discretionary Supervisory Actions

DSA	Under Capitalized ¹ First Tier NW Ratio = 5% to 5.99%	Under Capitalized Second Tier NW Ratio = 4% to 4.99%	Significantly Under Capitalized NW Ratio = 2% to 3.99%	Critically Under Capitalized NW Ratio = Less than 2%
Approval for acquisitions		X	X	X
Restrict transactions with CUSO		X	X	X
Restrict dividend		X	X	X
No or reduce asset growth		X	X	X
Terminate risky activity		X	X	X
No non-member deposits		X	X	X
Dismiss officer or director		X	X	X
Employ qualified officers		X	X	X
Restrict or require other actions		X	X	X
New election of directors			X	X
Restrict compensation			X	X
Require merger			X	X
Restrict payments on secondary capital				X
NCUA approval for operations				X

Illustration 17-D

Illustration 17-D displays the DSAs available in the undercapitalized (the first nine DSAs apply to second tier undercapitalized credit unions), significantly undercapitalized, and critically undercapitalized

¹ No DSAs will apply to first-tier undercapitalized credit unions as long as the credit union is in compliance with all MSAs and is implementing an approved NWRP.

net worth categories for credit unions other than those defined as new. One or more of the fourteen actions may apply to new federally insured credit unions with a net worth of less than 6 percent if they (1) fail to meet their quarterly net worth targets, or (2) fail to undertake any MSAs, regardless of their net worth classification (§702.304(b)).

The undercapitalized category is divided into two tiers. First-tier undercapitalized credit unions have a net worth ratio of 5 percent to 5.99 percent. Nine of the fourteen discretionary actions are available against second-tier undercapitalized credit unions, which have net worth ratios of 4 percent to 4.99 percent. Credit unions classified as first-tier undercapitalized are subject to the second tier DSAs only if they (1) fail to comply with any of the MSAs, (2) fail to implement an approved NWRP in a timely manner, or (3) fail to meet the timetable of net worth targets in the plan for increasing net worth.

All of the DSAs applicable to the second-tier undercapitalized, significantly undercapitalized, and critically undercapitalized credit unions give NCUA authority to require the actions described below. The DSAs are indexed to specific net worth categories described below and shown on Illustration 17-D. (Examiners should review the delegations of authority to determine who can take the action.)

- **Require prior approval for acquisitions, branching, or new lines of business.** NCUA can prohibit a credit union from (directly or indirectly) acquiring an interest in a business entity or financial institution, establishing or acquiring an additional branch office, or engaging in a new line of business. However, these prohibitions will not go into effect if NCUA has approved the credit union's NWRP, the credit union is implementing its plan, and NCUA determines that the proposed action is consistent with and will further the objectives of that plan.
- **Restrict transactions with and ownership of CUSOs.** NCUA can restrict the credit union's transactions with a CUSO or require the credit union to reduce or divest its ownership interest in a CUSO.
- **Restrict dividends or interest the credit union pays to market rates.** NCUA can restrict a credit union's dividend or interest rates

on shares to the prevailing rates for comparable accounts and maturities in the relevant market area, as determined by NCUA. However, dividend rates already declared on shares acquired before imposing the restriction may not be retroactively restricted.

- **Prohibit asset growth or reduce the assets generally or in a particular asset category.** NCUA can prohibit any growth in the credit union's assets or in a category of assets, or require the credit union to reduce its assets or a category of assets.
- **Alter, reduce, or terminate excessively risky activity by the credit union or CUSO.** NCUA can require the credit union or its CUSO to alter, reduce, or terminate any activity that poses excessive risk to the credit union.
- **Prohibit non-member deposits.** NCUA can prohibit the credit union from accepting all or certain nonmember deposits.
- **Dismiss directors or senior executive officers.** NCUA can require the credit union to dismiss from office any director or senior executive officer. However, a dismissal under this clause shall not be construed to be a formal administrative action for removal under 12 U.S.C. §1786(g.)
- **Employ qualified senior executive officers.** NCUA can require the credit union to employ qualified senior executive officers (who, if NCUA so specifies, shall be subject to its approval.)
- **Implement other actions to carry out the purpose of PCA.** NCUA can restrict or require such other action by the credit union if that action will carry out the purpose of PCA better than the actions mentioned in this section.
- **Require a new election of directors.** NCUA can order a new election of the credit union's board of directors.
- **Require prior approval for senior executive officers' compensation and bonus.** Unless the credit union obtains the prior written approval of the NCUA Board, NCUA can impose the following:

- Limit compensation for any senior executive officer to that officer's average rate of compensation (excluding bonuses and profit sharing) during the four quarters preceding the effective date of classification as significantly or critically undercapitalized; and
 - Prohibit payment of a bonus or profit share to such officer.
- **Require a merger if grounds exist for conservatorship or liquidation.** NCUA can require the credit union to merge with another financial institution if one or more grounds exist for placing the credit union into conservatorship pursuant to 12 U.S.C. §1786(h)(1)(F), or into liquidation pursuant to 12 U.S.C. §1787(a)(3)(A)(i.)
 - **Restrict payment of principal or interest on uninsured secondary capital of low-income designated credit unions.** Beginning 60 days after the effective date of classification of a low-income credit union as critically undercapitalized, NCUA can prohibit payments of principal, dividends, or interest on the credit union's uninsured secondary capital accounts established after August 7, 2000. However, unpaid dividends or interest shall continue to accrue under the terms of the account to the extent permitted by law.
 - **Approve certain operational level activities.** NCUA can require a critically undercapitalized credit union to obtain NCUA's prior written approval before doing any of the following:
 - Entering into any material transaction not within the scope of an approved NWRP (or approved revised business plan);
 - Extending credit for transactions deemed highly leveraged by the NCUA Board or, if state-chartered, by the appropriate state official;
 - Amending the credit union's charter or bylaws, except to the extent necessary to comply with any law, regulation, or order;
 - Making any material change in accounting methods; and
 - Paying dividends or interest on new share accounts at a rate exceeding the prevailing rates of interest on insured deposits in its relevant market area.

**Appeals
Process**

NCUA has implemented an independent appeals process by which credit unions and dismissed officials, affected by PCA, can challenge material supervisory decisions by NCUA staff. DSAs qualify as such material supervisory decisions (§747.2002 and §747.2004.)

CUMAA requires that the NCUA Board provide advance notice and an opportunity for a credit union to be heard before imposing a DSA, unless such an action is necessary to further the purpose of PCA. The credit union could challenge the proposed DSA in writing and request that the action be modified or not imposed. The credit union is not entitled to a hearing before the NCUA Board. The NCUA Board, or an independent person designated by the Board, may then decide not to issue the directive or to issue it as proposed or modified (§747.2002.) The credit union may seek the NCUA ombudsman's recommendation regarding a proposed DSA.

When a credit union must dismiss a director or senior executive officer, the NCUA Board must serve the dismissed person with a copy of the directive issued to the credit union accompanied by a notice of the person's right to seek reinstatement by the NCUA Board. Only that person may then challenge the dismissal and request reinstatement. That person also may request an informal hearing and the opportunity to present witness testimony. The dismissal remains in effect while the request for reinstatement is pending (§747.2004.) While the credit union may challenge the proposed DSA, the credit union may not seek reinstatement after the person is dismissed.

**Discretionary
Conservator-
ship or
Liquidation**

The NCUA Board has the discretionary authority to place a significantly undercapitalized federally-insured credit union or a credit union meeting the definition of new that is classified as moderately capitalized or lower into conservatorship or liquidation, provided the credit union has no reasonable prospect of becoming adequately capitalized (§702.203(c) and §702.304 (c)). This includes the NCUA Board's reclassification of a credit union to significantly undercapitalized on safety and soundness grounds (§702.102(b)).

A credit union placed into conservatorship retains the right to challenge the decision in court within 10 days. A credit union placed

into liquidation under PCA can directly appeal to the NCUA Board; however, CUMAA gives the credit union no right to judicial review.

Mandatory Conservatorship, Liquidation, or Other Corrective Action (OCA)

Non-new credit unions. Following are mandatory conservatorship and liquidation requirements for credit unions that do not meet the definition of a new credit union:

- The NCUA Board must place a credit union into conservatorship or liquidation within 90 calendar days after being classified critically undercapitalized, regardless of the credit union's prospect of becoming adequately capitalized; or
- The NCUA Board may take other corrective action (OCA) in lieu of conservatorship or liquidation. §702.204(c.)

Generally, OCA will consist of adherence to quarterly steps and targets in an approved NWRP. The OCA plan should pose the least possible long-term loss to the NCUSIF. OCA may also consist of allowing the credit union time to arrange and complete a merger under NCUA supervision.

OCA Renewal

OCA can range from a period of 1 to 180 days, and will expire unless renewed prior to expiration, regardless of the time limit of any previously approved NWRP. If the credit union remains critically undercapitalized and NCUA does not renew OCA, the NCUA Board generally will immediately place the credit union into conservatorship or liquidation. §702.204(c)(2.)

The statutory 18-month maximum period for OCA to succeed effectively limits renewals of OCA that extend the full 180-day period (§702.204(c)).

Limitation on OCA Renewals

The NCUA Board must conserve or liquidate a surviving critically undercapitalized credit union, regardless of the impact of OCA, if that credit union is critically undercapitalized (less than 2 percent net worth ratio) on average for a full calendar quarter beginning 18 months from the effective date it first was classified critically undercapitalized. This

is true even if the credit union surpasses a 2 percent net worth ratio for any preceding period during the 18-month period. The effective date when a credit union first becomes critically undercapitalized almost always falls one month after the end of a calendar quarter.

Thus, the last possible day for OCA will be no more than 23 months (23 months x 30 days =690 days) from the effective date the credit union first became critically undercapitalized (18 calendar months from the effective date, plus two months to the end of the calendar quarter at the end of the 18-month period, plus the subsequent three months of the next calendar quarter), absent an exception. (See Illustration 17-E for an example of a mandatory conservatorship or liquidation timetable.)

Sample Mandatory Conservatorship or Liquidation

Action	Date	Event
	12/31/X0	Credit union becomes critically undercapitalized (net worth<2%)
	1/31/X1	Effective date of net worth classification
Option of Liquidation or Conservatorship	2/1/X1	18 months begins- First 90 days, Then 180 day periods
	7/31/X2	18 months ends
	10/1/X2	Full calendar quarter after 18 months begins
	12/31/X2	Full calendar quarter ends-credit union still critically undercapitalized
Mandatory Liquidation Only	1/1/X3	23 months after effective date of net worth classification

Illustration 17-E

Because of this statutory deadline, NWRP and Plans for Special Assistance to return the credit union to a 2 percent net worth ratio cannot extend beyond a total of 23 months from the effective date of classification as critically undercapitalized.

As legally authorized, the NCUA Board delegated authority to regional directors to initiate and renew OCA in lieu of conservatorship or liquidation for credit unions with assets less than \$5 million. The NCUA Board cannot delegate OCA authority for credit unions of \$5 million in assets or greater. Therefore, if a credit union has assets of \$5 million or greater, the regional director first must obtain concurrence

for OCA from the Office of Examination and Insurance and then approval from the NCUA Board.

**OCA
Documentation**

Support for the approval of OCA should include the following items:

- Board Action Memorandum (BAM), or memo to the NCUA Board Secretary (if applicable);
- Memo to the Director of the Office of Examination and Insurance recommending OCA approval (if applicable);
- Memo to the regional director recommending OCA approval;
- Regional summary;
- NWRP;
- Regional Director Letter to the credit union informing them of OCA approval; and
- Other supporting financial information at the regional director's discretion such as Financial Performance Reports (FPRs), examination workpapers; financial statements, consolidated balance sheets, time frames, etc.

**Exception to
Mandatory
Liquidation**

NCUA may avoid mandatory liquidation of a credit union only if, after the 23 months, the NCUA Board certifies that the credit union has met the following three criteria for an exception to liquidation:

- The credit union has, since the date of approval, substantially complied with a NWRP requiring improvement in net worth;
- The credit union has positive net income or a sustainable upward trend in earnings; and,
- The credit union is viable and not expected to fail.

NCUA will not routinely grant this exception. In helping credit unions develop NWRPs and in reviewing NWRPs, examiners should not assume the granting of this exception.

Since the NCUA Board must recertify the three exception criteria quarterly, examiners will review the status of critically undercapitalized credit unions at least quarterly. If NCUA cannot recertify the credit union, the NCUA Board must then place the credit union into liquidation (§702.204(c)(3)(iii)).

New credit unions. The NCUA Board must place a new credit union classified as uncapitalized into conservatorship or liquidation based on either of the following criteria:

- The credit union failed to submit a revised business plan within 90 days of the effective date of its classification as uncapitalized; or,
- The credit union remains uncapitalized 90 days after the NCUA Board approved the revised business plan submitted by the credit union as required above, unless, the credit union documents to the NCUA Board why it is viable and has a reasonable prospect of becoming adequately capitalized. Generally, the credit union's success in meeting the plan's financial goals will support this exception.

**Consultation
with SSA**

NCUA will work cooperatively with the appropriate SSA before imposing any DSAs on a federally insured, state chartered credit union (FISCU), and will provide the SSA with prompt notice of its decision.

Before placing a FISCU into conservatorship, NCUA will contact the appropriate SSA and will give that SSA the opportunity to place the credit union into conservatorship or liquidation. If the SSA requests, NCUA will provide, in writing, the reasons for the proposed conservatorship or liquidation along with a reasonable time period for the SSA to respond. If the SSA responds within the time period and disagrees with the proposed conservatorship or liquidation and gives reasons for that disagreement, NCUA will not place the credit union into conservatorship or liquidation unless the NCUA Board determines that the credit union poses a significant risk of loss to the NCUSIF and NCUA expects conservatorship or liquidation to reduce the risk of loss or the expected loss.

**Net Worth
Restoration
Plan**

Credit unions that do not meet the definition of new. The NWRP serves as a blueprint to the credit union's officials and staff for restoring the credit union's net worth ratio to 6 percent or greater. Undercapitalized federally insured credit unions (net worth ratio less than 6 percent or less than the RBNW requirement) must submit their

NWRPs to the appropriate regional director and, if state chartered, concurrently to their SSA (§702.206.)

Responsibility for developing a NWRP rests with the credit union's officials and staff. In developing its NWRP, the credit union must state specific goals and objectives based on reasonable assumptions, financial trends, and projections. The officials must propose the length of time they will need to implement the plan and obtain the intended results. To receive approval, the plan must meet the minimum criteria set forth in §702.206(c) including:

- A quarterly timetable of steps necessary to increase the credit union's net worth ratio to adequately capitalized by the end of the NWRP's term, and to remain adequately capitalized for an additional four consecutive quarters;
- The projected earnings transfer to the regular reserve each quarter during the term of the NWRP. This transfer must equal at least 1/10th of one percent (0.1 percent) of the credit union's total assets, or such lesser amount as the regional director may permit, provided that on an annual basis the transfer must not be less than zero (§702.201(a) and §702.201(b));
- Plans for complying with the MSAs and DSAs imposed on the credit union by the regional director under Subpart B;
- Types and levels of activities in which the credit union will engage;
- Steps necessary to correct the unsafe and unsound practices or conditions if the credit union has been reclassified to a lower category (§702.102(b));
- Pro forma financial statements including any off-balance sheet items covering a minimum of the next two years; and
- Any additional information that the regional director or the SSA may require.

An undercapitalized credit union must file an NWRP within 45 days of becoming undercapitalized (net worth less than 6 percent or less than

the RBNW requirement), unless it was reclassified as undercapitalized solely on safety and soundness grounds. If a credit union has an approved NWRP in place, and the credit union's net worth category changes (e.g., slips to a lower net worth category), it need not submit a new NWRP unless required to do so by the regional director.

The regional director may extend a filing deadline. If a credit union's net worth category changes and the regional director requires that it file a new NWRP, the credit union has 30 calendar days in which to do so, unless the regional director extends that period. The regional director will provide notification to credit unions that fail to file a required NWRP within the required timeframes. The credit union must file its NWRP within 15 calendar days of receiving the notification (§702.206(a)).

The regional director has 45 calendar days to review the NWRP and to provide written notice of approval or disapproval of the plan. If the credit union receives no decision within 45 days, the NWRP is deemed approved. If the regional director disapproves the plan, it will provide the credit union with its reasons. The credit union must then submit a revised NWRP within 30 days of receiving the regional director's notice of disapproval unless the regional director sets a different period. The regional director must respond within 30 days regarding its approval or disapproval of the credit union's revised NWRP (§§702.206(f) and 702.206(g)).

Appendix 17B contains a sample NWRP format.

**Revised
Business Plans**

New credit unions. New credit unions categorized as moderately, marginally, or minimally capitalized must file a revised business plan with the appropriate regional director and SSA, if state chartered, for review and approval. The credit union must file the plan within 30 calendar days of the effective date that (1) it fails to meet a quarterly net worth target of its current approved business plan, (2) it has no current approved business plan, or (3) it has failed to undertake any MSAs.

If a new credit union becomes uncapitalized or remains uncapitalized beyond the period approved in its initial business plan, it must file a

revised business plan within 90 days, or a shorter timeframe prescribed by NCUA. The revised business plan must provide for an alternative means of funding the credit union's earnings deficit. In either case, NCUA can extend the filing deadlines by providing notice to the credit union of a different period (§702.305(a)(2)).

The following requirements apply to the revised business plan:

- It must be based on realistic assumptions;
- It must have the expected result of restoring the credit union's net worth; and
- It must not expose the credit union to an unreasonable increase in risk.

To meet the minimum criteria receive approval set forth in §702.306(b), the plan must:

- Analyze changes since the new credit union's current business plan was approved in any of the business plan elements required for charter approval under Chapter 1, Section IV.D, of NCUA's Chartering and Field of Membership Manual, IRPS 99-1, as amended, or for state chartered credit unions under applicable state law;
- Establish a timetable of quarterly targets for net worth during each year in which the revised business plan is in effect, so that the credit union becomes adequately capitalized and remains so for four consecutive quarters;
- Specify the projected amount of earnings that the credit union will transfer quarterly to its regular reserve (§702.304(a)(1) or §702.305(a)(1));
- Explain how the new credit union will comply with the MSAs and DSAs;
- Specify the types and levels of activities in which the credit union may engage;

- Specify the steps a new credit union, reclassified to a lower category, will take to correct the unsafe or unsound condition or practice (§702.302(d)); and
- Include such other information as the NCUA Board may require.

The regional director must provide notification to a new credit union that fails to file a required revised business plan within the timeframes allowed. The credit union must then file its revised plan within 15 calendar days of receiving the notification.

The regional director must review the revised business plan and provide written notice within 30 calendar days regarding its approval or disapproval. In the event of disapproval, the notice must provide the reasons for disapproval. If the regional director makes no decision within 30 days, the revised business plan is deemed approved. If disapproved, the credit union must submit a revised plan within 30 days from receiving the regional director's notice of disapproval, unless the regional director sets a different period.

The regional director then has 30 days to approve or disapprove the revised plan. In addition, a credit union may amend a previously approved revised business plan. Until the regional director approves the amended plan, the credit union must implement its previously approved revised business plan. The regional director will consult with the SSA regarding the approval or disapproval of new, revised, or amended revised business plans for state chartered credit unions ((§§702.306(e)-(g)).

**NWRP and
Revised
Business Plan
Approval**

The regional director, in consultation with the SSA (for state chartered credit unions), must approve the credit union's NWRP or revised business plan. During the approval process, the regulatory authority will consider the following:

- Compliance with minimum criteria;
- Probability of meeting realistic assumptions; and
- Probability of unreasonably increasing exposure to risk, including credit risk, interest rate risk, or other risks.

Examiners' On-Going Review of NWRP

After the regional director has approved the NWRP and the credit union has implemented it, regional policy will dictate review and monitoring of the plan. The NWRP questionnaire in AIRES provides guidance on areas that require the examiners' review. Examiners should discuss the credit union's progress with management during the examination and, if necessary, during on- and off-site supervision of the credit union. For as long as a credit union has an NWRP in place, examiners should document the credit union's progress in meeting the terms of the NWRP, as well as any changes made to the NWRP, in the examination report (e.g., Supplementary Facts section.)

During the review, examiners should assess the plan's adequacy and implementation and should discuss with the officials any of the goals or objectives that the credit union did not meet. If examiners continue to have concerns about the credit union's ability to meet its NWRP goals, they should document the concerns and recommend corrective action in the examination report.

Plan Changes

A credit union may also amend a previously approved NWRP. The officials must submit the revised plan to the regional director and SSA (if a state-chartered credit union) for re-approval. The credit union need not submit an additional NWRP due solely to a change in net worth category (including reclassification under §702.102(b)), unless the regional director notifies the credit union that it must submit a new NWRP. The regional director will consult with the appropriate SSA regarding the approval or disapproval of new, revised, or amended NWRPs in state chartered credit unions (§702.206(f)(3)). Until NCUA approves the proposed amended NWRP, the credit union must implement the previously approved plan.

When a credit union receives notification from NCUA that it must submit a new or revised NWRP, the credit union must file the new NWRP, in writing, with the appropriate regional director and SSA within 30 calendar days of receiving the notice. However, the regional director can notify the credit union in writing that the credit union may file the NWRP within a different period.

**Assistance In
Preparing Plan**

Responsibility for developing a NWRP rests with the credit union's officials and staff. However, NCUA can assist a credit union in preparing an NWRP or, for new credit unions, a revised business plan. By statute, a credit union having assets less than \$10 million and net worth less than 6 percent will receive NCUA's assistance in preparing its NWRP, if it requests such assistance. This extends to other than new credit unions that were reclassified under §702.102(b) to a lower category if the regional director has required the credit union to develop a NWRP. (Examiners can provide similar assistance during the examination and supervision contacts to credit unions that do not meet these criteria, if so directed by regional policy.) Credit unions needing assistance must submit their requests to the applicable regional director in ample time for the process to meet the regulatory timeframes (§702.206 and §702.306.)

NCUA or SSA examiners may provide guidance to the credit union's officials and staff in preparation of the NWRP. The NCUA Board intends that the NCUA or SSA examiners will be the primary resource for providing this guidance.

When the credit union requests examiner assistance, the request must document the credit union's eligibility for the assistance requested. Also, if the credit union needs additional time to complete and submit its NWRP, it must request an extension of the regulatory timeframe (§702.206 and §702.306.)

New credit unions. NCUA will not provide assistance for preparing the initial business plan required for new credit unions applying for initial charter approval; however, NCUA's economic development specialists often aid credit unions in developing their initial business plans. New credit unions must meet the following criteria to qualify for NCUA assistance in providing guidance in the preparation of their revised business plans:

- They are not meeting the net worth goals set forth in their current business plans; and
- They have a net worth ratio of less than 6 percent.

Examiner Assistance

While the examiner may facilitate discussion about the assistance needed by the credit union, the examiner will not make business decisions for the credit union regarding the NWRP. Examiners will provide assistance by answering the credit unions' questions, providing guidance, and giving support.

Regional policy dictates the procedures credit unions may use to obtain examiner assistance for preparing the NWRP. Clearly, however, the request should come from the credit union. For this reason, the chairman of the credit union's board of directors should sign the request. State chartered credit unions will make their requests to the regional director through their SSAs, again allowing ample time to meet necessary timeframes.

References and Workpapers

References

- *Federal Credit Union Act*
 - Part 216
 - Part 208
 - Part 206
- *NCUA Rules and Regulations*
 - Part 702
 - Section 741.3
 - Section 701.34
 - Section 747.2002
 - Section 747.2004
- NCUA 5300 Call Report
- Guidelines for Submission of an Application for a PCA Risk Mitigation Credit
- Guidelines for Evaluation of an Applications for a PCA Risk Mitigation Credit
- AIRES Net Worth Restoration Plan Checklist
- NCUA Letter to Credit Unions: 01-CU-01 Prompt Corrective Action (PCA) Implementation Information

Chapter 17 – Part 2

PCA - RISK-BASED NET WORTH REQUIREMENT

Examination Objective

- Determine whether the credit union meets the definition of complex and adheres to the applicable risk-based net worth (RBNW) requirement

Associated Risks

- Reputation risk may occur when PCA efforts are not successful and the credit union fails.

Overview

A credit union is defined as complex and a RBNW requirement is applicable only if the credit union meets both of the following criteria as reflected in its most recent call report:

- Minimum asset size. Its quarter-end total assets exceed \$10 million; and
- Minimum RBNW calculation. Its risk-based net worth requirement as calculated under §702.106 exceeds 6 percent.

Examiners should use the term “applicable RBNW requirement” rather than “complex.”

All credit unions whose net worth ratio initially places them in either the adequately- or well-capitalized net worth category (6 percent net worth ratio and above) must satisfy an applicable RBNW requirement, if the credit union’s quarter-end total assets exceed \$10 million.

NCUA will classify a credit union with a 6 percent or higher net worth ratio in the first tier of undercapitalized, if its applicable RBNW requirement exceeds its net worth ratio. If it fails to comply with any MSA or fails to implement a NWRP within the regulatory timeframes, such a credit union is subject to all MSAs and any of the second tier DSAs.

The RBNW requirement also indirectly affects credit unions that have net worth ratios below 6 percent. These credit unions already must operate under an approved NWRP. The NWRP must provide the means and a timetable to reach the adequately-capitalized category.

However, for credit unions in the undercapitalized or lower net worth categories, the minimum net worth ratio to the adequately-capitalized category will be 6 percent or the credit union's RBNW requirement, if higher than 6 percent. If the credit union has an applicable RBNW requirement, the NWRP must prescribe the steps a credit union will take to reach the RBNW requirement (not just 6 percent.)

The 5300 Call Report contains the standard calculation for the RBNW requirement (§702.106.) The burden of calculating the RBNW requirement using alternative components falls on the individual credit union (§702.107.)

AIRES calculates net worth and the RBNW requirement as of the examination date. When the AIRES calculation is not as of a quarter end, the examiner should perform a reasonableness test of the RBNW requirement calculation. Examiners' judgment will be important in determining reasonable accuracy of the RBNW requirement calculation. In most cases, examiners should not cite minor technical omissions.

Standard Calculation

A credit union's risk-based net worth requirement is the aggregate of the standard component amounts shown in Illustration 17-F, each expressed as a percentage of the credit union's quarter-end total assets as reflected in the most recent call report, rounded to two decimal places.

Illustration 17-F contains the following items:

- **Long-term real estate loans.** The sum of:
 - 6 percent of the amount of long-term real estate loans less than or equal to 25 percent of total assets; and
 - 14 percent of the amount in excess of 25 percent of total assets;
- **Member business loans outstanding.** The sum of:
 - 6 percent of the amount of member business loans outstanding less than or equal to 12.25 percent of total assets; and
 - 14 percent of the amount in excess of 12.25 percent of total assets;

**Standard Calculation of RBNW Requirement
With Risk Portfolios Defined**

Risk portfolio	Assets, liabilities, or contingent liabilities	Amount of risk portfolio (as percent of quarter-end total assets) to be multiplied by risk weighting	Risk weighting
Long-term real estate loans	Total real estate loans and real estate lines of credit (excluding MBLs) with a maturity (or next rate adjustment period, if variable rate) greater than 5 years	0 to 25.00% Over 25.00%	.06 .14
MBLs outstanding	Member business loans outstanding	0 to 12.25% Over 12.25%	.06 .14
Investments	As defined by federal regulation or applicable State law	<i>By weighted average life:</i>	
		0 to 1 year	.03
		>1 year to 3 years	.06
		>3 years to 10 years	.12
	>10 years	.20	
Low-risk assets	Cash on hand and NCUSIF deposit	All %	.00
Average-risk assets	100% of total assets minus sum of risk portfolios above	All %	.06
Loans sold with recourse	Outstanding balance of loans sold or swapped with recourse, except for loans sold to the secondary mortgage market with a recourse period of 1 year or less	All %	.06
Unused MBL commitments	Unused commitments for MBLs	All %	.06
Allowance	Allowance for Loan and Lease Losses limited to equivalent of 1.50% of total loans	Limited to equivalent of 1.50% of total loans (expressed as a percent of total assets)	(1.00)
<p>A credit union's RBNW requirement is the sum of eight standard components. A standard component is calculated for each of the eight risk portfolios, equal to the sum of each amount of a risk portfolio times its risk weighting. A credit union is classified "undercapitalized" if its net worth ratio is less than its applicable RBNW requirement.</p>			

Illustration 17-F

Investments (also see Appendix 17A.) The sum of:

- 3 percent of the amount of investments with a weighted-average life (as specified in §702.105) of 1 year or less;
 - 6 percent of the amount of investments with a weighted-average life greater than 1 year, but less than or equal to 3 years;
 - 12 percent of the amount of investments with a weighted-average life greater than 3 years, but less than or equal to 10 years; and
 - 20 percent of the amount of investments with a weighted-average life greater than 10 years;
- **Low-risk assets.** Zero percent (0 percent) of the entire portfolio of low-risk assets;
 - **Average-risk assets.** 6 percent of the entire portfolio of average-risk assets;
 - **Loans sold with recourse.** 6 percent of the entire portfolio of loans sold with recourse;
 - **Unused member business loan commitments.** 6 percent of the entire portfolio of unused member business loan commitments; and
 - **Allowance.** Negative one hundred percent (-100 percent) of the balance of the Allowance for Loan and Lease Losses account, not to exceed the equivalent of 1.5 percent of total loans outstanding.

Alternative Calculation

A credit union may substitute one or more alternative components in Illustration 17-G in place of the corresponding standard components in Illustration 17-F, when any alternative component amount, expressed as a percentage of the credit union's quarter-end total assets as reflected in the most recent call report, rounded to two decimal places, is smaller.

Illustration 17-G contains the following items:

Alternative Components for Standard Calculation

Long-term Real Estate Loans

Amount of long-term real estate loans by remaining maturity	Alternative risk weighting
> 5 years to 12 years	.08
> 12 years to 20 years	.12
> 20 years	.14
The "alternative component" is the sum of each amount of the long-term real estate loans risk portfolio by remaining maturity (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.	

Member Business Loans

Amount of member business loans by remaining maturity	Alternative risk weighting
<i>Fixed-rate MBLs</i>	
0 to 3 years	.06
> 3 years to 5 years	.09
> 5 years to 7 years	.12
> 7 years to 12 years	.14
> 12 years	.16
<i>Variable-rate MBLs</i>	
0 to 3 years	.06
> 3 years to 5 years	.08
> 5 years to 7 years	.10
> 7 years to 12 years	.12
> 12 years	.14
The "alternative component" is the sum of each amount of the member business loans risk portfolio by fixed and variable rate and by remaining maturity (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.	

Investments

Amount of investments by weighted-average life	Alternative risk weighting
0 to 1 year	.03
>1 year to 3 years	.06
>3 years to 5 years	.08
>5 years to 7 years	.12
>7 years to 10 years	.16
> 10 years	.20
The "alternative component" is the sum of each amount of the Investments risk portfolio by weighted-average life (as a percent of quarter-end total assets) times its alternative factor. Substitute for corresponding standard component if smaller.	

Illustration 17-G

Long-term real estate loans. The sum of:

- 8 percent of the amount of such loans with a remaining maturity of greater than 5 years, but less than or equal to 12 years;
- 12 percent of the amount of such loans with a remaining maturity of greater than 12 years, but less than or equal to 20 years; and
- 14 percent of the amount of such loans with a remaining maturity greater than 20 years;

• **Member business loans outstanding.** The sum of:

- *Fixed rate.* Fixed-rate member business loans outstanding as follows:
 - (a) 6 percent of the amount of such loans with a remaining maturity of 3 or fewer years;
 - (b) 9 percent of the amount of such loans with a remaining maturity greater than 3 years, but less than or equal to 5 years;
 - (c) 12 percent of the amount of such loans with a remaining maturity greater than 5 years, but less than or equal to 7 years;
 - (d) 14 percent of the amount of such loans with a remaining maturity greater than 7 years, but less than or equal to 12 years; and
 - (e) 16 percent of the amount of such loans with a remaining maturity greater than 12 years; and
- *Variable-rate.* Variable-rate member business loans outstanding as follows:
 - (a) 6 percent of the amount of such loans with a remaining maturity of 3 or fewer years;
 - (b) 8 percent of the amount of such loans with a remaining maturity greater than 3 years, but less than or equal to 5 years;
 - (c) 10 percent of the amount of such loans with a remaining maturity greater than 5 years, but less than or equal to 7 years;
 - (d) 12 percent of the amount of such loans with a remaining maturity greater than 7 years, but less than or equal to 12 years; and

(e) 14 percent of the amount of such loans with a remaining maturity greater than 12 years.

- **Investments.** The sum of:
 - 3 percent of the amount of investments with a weighted-average life (as specified in §702.105) of 1 year or less;
 - 6 percent of the amount of investments with a weighted-average life greater than 1 year, but less than or equal to 3 years;
 - 8 percent of the amount of investments with a weighted-average life greater than 3 years, but less than or equal to 5 years;
 - 12 percent of the amount of investments with a weighted-average life greater than 5 years, but less than or equal to 7 years;
 - 16 percent of the amount of investments with a weighted-average life greater than 7 years, but less than or equal to 10 years; and
 - 20 percent of the amount of investments with a weighted-average life greater than 10 years.

Risk Mitigation Credit

Under §702.108, the NCUA board may grant a risk mitigation credit, which is a credit to reduce an RBNW requirement for a credit union that fails the standard and alternative calculations for its RBNW, but can demonstrate mitigation of interest rate risk or credit risk through other means.

The credit union starts the process for a risk mitigation credit by applying first to the NCUA regional office and to the SSA (if a state chartered credit union.) The credit union must demonstrate that the level of risk exposure to the NCUSIF is less than that indicated by the RBNW requirement of either the standard or alternative calculations.

The examiner will assess the effectiveness of the reduction of risk using the NCUA staff publication, "*Guidelines for Evaluation of an Application for a PCA Risk Mitigation Credit*" available on NCUA's Internet website.

The review should cover the effect of quantitative factors on interest rate risk and credit risk. Measures that indicate mitigation of risk include, but are not limited to, net economic value (NEV) analysis or levels of collateral for loans.

**References
and
Workpapers**

References

- Federal Credit Union Act
 - Part 216
 - Part 208
 - Part 206
- *NCUA Rules and Regulations*
 - Part 702
 - Section 741.3
 - Section 701.34
 - Section 747.2002
 - Section 747.2004
- NCUA 5300 Call Report
- Guidelines for Submission of an Application for a PCA Risk Mitigation Credit
- Guidelines for Evaluation of an Applications for a PCA Risk Mitigation Credit
- AIRES Net Worth Restoration Plan Checklist
- NCUA Letter to Credit Unions: 01-CU-01 Prompt Corrective Action (PCA) Implementation Information

WEIGHTED AVERAGE LIFE-APPENDIX 17A

The risk based net worth (RBNW) requirement rule specifies NCUA will categorize all investments according to weighted-average life. Weighted-average life may be used to measure all investment types. For example, the weighted-average life of a bullet maturity instrument is the time remaining to maturity. The following table is part of the call report instructions. This table does provide for some exceptions NCUA employs to calculate the RBNW requirement, e.g., corporate credit union membership capital.

Investment	Weighted average life for PCA RBNW Calculation
Fixed-rate, non-callable, non-amortizing debt obligations and deposits (e.g., bullet maturity instruments)	Period remaining to maturity date
Fixed-rate amortizing debt obligations or deposits (investments with periodic principal paydowns, e.g., mortgage backed securities)	Weighted average-life according to industry standard calculations. (For example, industry-recognized information providers make available weighted average-life calculations of mortgage related securities based on current prepayment estimates.)
Cash on deposit and cash equivalents	Less than one (1) year
Mutual funds (registered investment companies) and common trust investments (collective investment funds)	(a) Mutual funds (registered investment companies) and common trust investments (collective investment funds): Use maximum weighted average life as disclosed in prospectus or trust instrument, but if not disclosed, report in the 3-10 year range (as greater than 3 years, but less than or equal to 7 years for the alternative component) (b) Money market funds and Short-term investment funds (STIFs): 1 year or less
Callable fixed-rate debt obligations and deposits	Period remaining to maturity date
Variable-rate debt obligations and deposits (regardless if investment amortizes)	Period remaining to next rate adjustment date
Capital in mixed-ownership Government corporations and corporate credit unions	Greater than 1 year, but less than or equal to 3 years
Investments in CUSOs	Greater than 1 year, but less than or equal to 3 years
Other equity securities	Greater than 10 years

**Sample
Weighted-
Average Life
Calculation**

Weighted-average life is defined as the weighted-average time to the return of a dollar of principal. It is calculated by the following:

- Multiply each portion of principal received by the time at which it is received (Column C = A * B, below).
- Sum the totals of Time * Principal (Column C) and Principal (Column B)
- Divide the totals of Time * Principal (Column C) by total Principal (Column B)

**Weighted Average Life Calculation
Amortizing Debt Obligation or Deposit**

A	B	C
Time (Years)	Principal	Time*Principal C=(A*B)
1	40	40
2	30	60
3	20	60
4	10	40
Total	100	200

$$\text{Weighted-Average Life} = \frac{\text{Sum of (Time*Principal)}}{\text{Total Principal}} = \frac{200}{100} = 2 \text{ Years}$$

**Weighted Average Life Calculation
Non-Amortizing Debt Obligation or Deposit**

A	B	C
Time (Years)	Principal	Time*Principal C=(A*B)
1	0	0
2	0	0
3	0	0
4	100	400
Total	100	400

$$\text{Weighted-Average Life} = \frac{\text{Sum of (Time*Principal)}}{\text{Total Principal}} = \frac{400}{100} = 4 \text{ Years}$$

NET WORTH RESTORATION PLAN (NWRP) SAMPLE FORMAT - APPENDIX 17B

NWRP

Credit Union Name: _____

Charter Number: _____

We, the Board of Directors of [CREDIT UNION NAME] submit for NCUA approval the following Net Worth Restoration Plan (NWRP) and its attachments.

The NWRP is filed because (choose the applicable provision):

- Our net worth ratio declined as of the end of the [1st, 2nd, 3rd, or 4th] calendar quarter of [YEAR];
- Our net worth ratio was recalculated as a result of the examination report received on [DATE RECEIVED] by the officials;
- We received notice we must submit a new NWRP within 30 days of [DATE NOTICE RECEIVED];
- We received written notice of reclassification on safety and soundness grounds on [DATE NOTICE RECEIVED]; or
- We received notice we failed to file a plan on [DATE NOTICE RECEIVED].

Our net worth category is [CLASSIFICATION CATEGORY] as of [EFFECTIVE DATE]. Our net worth totals \$[DOLLARS] and quarter-end assets total \$[DOLLARS]. Using the [CALCULATION METHOD], our total assets are \$[DOLLARS] and our net worth ratio is [PERCENT] percent, calculated to two decimal places.

We understand our net worth ratio must be restored to six percent, or an applicable risk-based net worth (RBNW) requirement, for the credit union to become adequately capitalized. As of the date of our most recent call report, we [DO NOT] have an applicable RBNW requirement [OF _____ PERCENT].

This plan includes the seven components listed below that:

1. Specifies a quarterly timetable of steps to become adequately capitalized (and must likely result in the credit union's remaining adequately capitalized for four consecutive calendar quarters beyond the end of the term);
2. Establishes projected quarterly earnings transfers [*AND REQUESTS A REDUCTION IN THE REQUIREMENT TO TRANSFER TO THE REGULAR RESERVE NOT LESS THAN 1/10 PERCENT OF TOTAL ASSETS*];
3. Sets forth how we will comply with the mandatory supervisory actions we must take [*AND ANY DISCRETIONARY SUPERVISORY ACTIONS IMPOSED UPON US*];
4. Identifies the types and levels of activities in which we will engage;
5. Specifies the steps we will take to correct (or notes the absence of) unsafe or unsound practices or conditions;
6. Incorporates pro forma financial statements; and
7. Includes other information as required by NCUA.

Quarterly timetable of steps to become adequately capitalized
(§702.206(c)(1)(i))

The term of the plan will end at the earlier of either [*END OF PLAN DATE*] or the expiration of four consecutive quarters of "adequate capitalization." We plan to become adequately capitalized by the end of the term of this NWRP. If the plan terminates before achieving "adequate capitalization," a new plan will be required to reach that objective. We understand we may not cancel our plan without NCUA approval. We understand that once we are operating under this approved NWRP, after prior written notice to, and approval by the Regional Director, we may amend our plan to reflect a change in circumstance. We understand that we must carry out the approved plan pending approval of an amended plan.

During the term of our plan, we will take quarterly steps to improve our net worth as follows:

Quarterly Steps to Improve Net Worth

Quarter for Implementation	Plan of Action	Responsible Person Completion Date

Based on these steps, we believe it is likely the credit union will remain adequately capitalized for four consecutive calendar quarters beyond the end of the term for the following reasons:

[OUR PRO FORMA FINANCIAL STATEMENTS (INCLUDED AS AN ATTACHMENT UNDER COMPONENT SIX, BELOW) PROJECT OUR NET WORTH TO BE AT LEAST SIX PERCENT FOR THAT TIME PERIOD]

Projected Quarterly Earnings Transfers (§702.206(c)(1)(ii))

We plan to increase net worth by at least 1/10th percent of total assets in each quarter (except as noted below) and to transfer at least that amount to the regular reserve according to the following schedule:

Schedule for Projected Quarterly Earnings Transfer

Quarter Ending	Projected						
	Total Assets	Gross Income	Operating Expense	Net Income	Reserve Transfer	Net Worth	Net Worth Ratio

[WE PLAN TO TRANSFER LESS THAN 1/10th PERCENT OF TOTAL ASSETS DURING _____ QUARTERS AND REQUEST NCUA APPROVAL. OUR CURRENTLY-OFFERED RATES ON SHARES ARE ATTACHED. WE HAVE SURVEYED THE FOLLOWING DEPOSITORY INSTITUTIONS IN OUR RELEVANT MARKET AREA: [LIST]. THEIR PREVAILING RATES ON SHARES AND DEPOSITS ARE INCLUDED IN THE ATTACHMENT. OUR ANALYSIS OF HOW THE DECREASE IN THE REQUIREMENT WILL PERMIT US TO AVOID CURTAILING OUR DIVIDENDS TO SUCH A DEGREE THAT WE WOULD SUFFER A SIGNIFICANT REDEMPTION OF SHARES IS ALSO ATTACHED. BY AVOIDING A SIGNIFICANT REDEMPTION IN SHARES, WE WILL FURTHER THE PURPOSE OF PROMPT CORRECTIVE ACTION BY RESTORING OUR NET WORTH RATIO BECAUSE WE WILL _____ (AVOID HIGHER COST OF BORROWED FUNDS, AVOID HAVING TO SELL ILLIQUID ASSETS, OR ANY OTHER AVOIDANCE OF LOSS). WE DO NOT PLAN TO OFFER RATES ON SHARES IN EXCESS OF PREVAILING RATES ON SHARES AND DEPOSITS IN OUR RELEVANT MARKET AREA.]

Mandatory and Discretionary Supervisory Actions (§702.206(c)(1)(iii))

Our plan to comply with the mandatory supervisory actions (MSAs) and discretionary supervisory actions (DSAs) imposed on us follows.

The four MSAs are:

- Earnings transfer;
- Submit net worth restoration plan;
- Restrict increase in assets; and
- Restrict member business loans.

Earnings transfer

The first MSA is addressed by the first two components of our plan, our quarterly timetable of steps to become adequately capitalized and our projected quarterly earnings transfers.

Submit net worth restoration plan

The second MSA is addressed by submission of this plan.

Restrict increase in assets

The third MSA is addressed in two time frames: “*plan not approved*” and “*plan approved*.”

“*Plan not approved*.” We expect total assets to increase prior to plan approval. Total assets will increase only by reason of the following three exception categories:

- First, total accounts receivable and accrued income on loans or investments. This exception allows the accrual of income items, increasing our net worth.
- Second, cash and cash equivalents. This exception permits continued receipt of member deposits and collection of cash payments of interest income. We will increase investments only in the form of cash equivalents.
- Third, total loans outstanding, subject to a maximum equivalent to the sum of total assets plus the quarter-end balance of unused commitments to lend and unused lines of credit at the time the credit union is classified undercapitalized or lower. We may continue to make new loans in the normal course of business by reducing liquid investment assets, and to honor unused commitments (such as unused revolving loans or unused commitments for member business loans) existing at the time we were classified undercapitalized or lower. We will monitor total loans outstanding to ensure we do not exceed the maximum.

We will not offer rates on shares in excess of prevailing rates on shares and deposits in our relevant market area and will not open new branches before our plan is approved. Before our plan is approved, we will maintain records of:

- The current offered rates on our shares; and
- The prevailing rates on shares and deposits in our relevant market area.

[WE WILL NOT AVAIL OURSELVES OF THE EXCEPTIONS AND WILL NOT BE SUBJECT TO LIMITATIONS ON RATES AND BRANCHING. WE UNDERSTAND THAT UNTIL OUR PLAN IS APPROVED, WE CANNOT INCREASE TOTAL ASSETS UNDER ANY CIRCUMSTANCES.]

“*Plan approved.*” This MSA is addressed in the first two components of our plan. We understand that our assets may only increase consistent with the approved plan and we must implement our plan’s steps to increase our net worth ratio.

Restrict member business loans (MBL)

We will not increase the total dollar amount of member business loans (defined as loans outstanding and unused commitments to lend) as of the preceding quarter-end, in the amount of \$[DOLLARS].

[WE WERE GRANTED AN EXCEPTION TO THE MBL RESTRICTION AS:

- AN INSURED CREDIT UNION CHARTERED FOR THE PURPOSE OF MAKING, OR THAT HAS HISTORY OF PRIMARILY MAKING, MEMBER BUSINESS LOANS TO ITS MEMBERS, AS DETERMINED BY THE NCUA BOARD; OR
- A LOW-INCOME DESIGNATED CREDIT UNION; OR
- A COMMUNITY DEVELOPMENT FINANCIAL INSTITUTION.]

We plan to extend new member business loans or new commitments for member business loans. We will take the following steps to ensure we will comply with the MBL restriction:

Steps to Comply With MBL Restriction

Quarter for Implementation	Plan to Control Total Dollars of MBL	Responsible Person Completion Date
		Ongoing

Discretionary supervisory actions

The NCUA has not imposed any discretionary supervisory actions on us.

Types and levels of activities (§702.206(c)(1)(iv))

We plan to continue to engage in the types and levels of activities undertaken as of the date of our most recent examination, with the exception that we plan to make the changes in the kinds of services provided to our members noted under the first component of our plan and other material changes as follows:

[DESCRIBE]

We are incorporating a copy of our business plan as an attachment.

[OPTIONAL]

Unsafe or unsound condition or practice (§702.206(c)(1)(v))

[THE NCUA BOARD HAS NOT RECLASSIFIED US TO A LOWER NET WORTH CATEGORY.]

or

[THE NCUA BOARD HAS RECLASSIFIED US TO A LOWER NET WORTH CATEGORY. WE WILL TAKE THE STEPS TO CORRECT THE UNSAFE OR UNSOUND PRACTICES OR CONDITIONS AS FOLLOWS:]

or

[WE HAVE AN UNSAFE OR UNSOUND CONDITION OR PRACTICE IDENTIFIED IN OUR EXAMINATION REPORT RECEIVED ON [DATE RECEIVED] BY THE OFFICIALS. WE VOLUNTEER AS PART OF THIS PLAN TO TAKE THE STEPS TO CORRECT THE PROBLEMS AS FOLLOWS:]

Pro forma financial statements (§702.206(c)(2))

We are incorporating pro forma balance sheets and income statements, including all off-balance sheet items, covering the next two years by quarter *[OPTIONAL: AND THE REMAINDER OF THE TERM OF THE PLAN BY YEAR, AND A SUMMARY OF THE ASSUMPTIONS, AS ATTACHMENTS. WE HAVE EXTENDED THE PRO FORMA ANALYSIS FOR ONE YEAR BEYOND THE TERM OF THE PLAN TO DEMONSTRATE HOW WE PROJECT TO REMAIN ADEQUATELY CAPITALIZED.]* Our pro forma financial statements are consistent with our projected quarterly earnings transfers.

Other information as required by NCUA (§702.206(c)(3))

[OPTIONAL: WE FILE CALL REPORTS QUARTERLY AND THIS DOCUMENT INCLUDES THE INFORMATION FOR THE QUARTER ENDED [MARCH 31 OR SEPTEMBER 30, YEAR] SUPPORTING OUR NET WORTH CLASSIFICATION CATEGORY.]

Submitted for the [CREDIT UNION NAME]:

_____	_____	_____	_____
Chairman	Date	Chief Financial Officer	Date
Board of Directors		Board of Directors	

_____	_____
Secretary	Date
Board of Directors	

Approved by the National Credit Union Administration:

_____	_____
Regional Director	Date

For the [STATE SUPERVISORY AUTHORITY, if applicable]:

_____	_____
[TITLE]	Date

Chapter 18

REGULATORY COMPLIANCE

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Chapter 18

REGULATORY COMPLIANCE

Examination Objectives

- Determine whether the credit union assesses and mitigates risks (e.g., through surety bond rider, internal audits, etc.)
- Initiate corrective action to resolve deficiencies in practices, policies, or procedures as well as violations of statute and regulation

Associated Risks

- Compliance – the risk that failure to comply can result in penalties and lawsuits;
- Strategic risk – the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes; and
- Reputation risk – the risks that the credit union cannot meet member loan and share funding requests, causing concerns about the credit union’s solvency.

Overview

NCUA’s Rules and Regulations along with other regulations that apply to credit unions (e.g., regulations issued by the Federal Reserve Board) form regulatory compliance. The amount of examination time spent on a specific compliance area will depend on the amount of risk identified in that area.

Examination Procedures

Examiners should:

- Obtain and review the credit union’s regulatory compliance program;
- Review the system of internal controls to ensure on-going compliance;
- Ensure the credit union completed independent testing of the program;

- Determine credit union designated an individual responsible for coordinating and monitoring day-to-day compliance; and
- Review the training provided to appropriate personnel.

Examiners should discuss emerging or unresolved deficiencies with management and, if material deficiencies exist, they should include a discussion in the examination report.

Charter and Bylaws

The credit union's charter sets forth the field of membership (i.e., who the credit union may accept as members.) The credit union must seek approval from the regional director for any amendments to the charter (name change, field of membership change, etc.). Examiners may review the current field of membership and the credit union's procedures to ensure that only the individuals within those groups named in the charter are accepted as members.

Each credit union board adopts a set of bylaws, under which the credit union operates. These may consist of a combination of pre-approved bylaws, options, and standard amendments. Additionally, credit unions may obtain approval for nonstandard bylaw amendments if they meet certain criteria. Thus, the credit union has the responsibility to maintain a current and complete set of its own bylaws.

The bylaws function as a contract between the credit union and its members. Although credit unions must permit members to review the credit union's bylaws on request, they need not provide members with a copy of the bylaws.

Security Program

Part 748 of the *NCUA Rules and Regulations* establishes minimum security standards and procedures for credit unions. Examiners should determine that the credit union (1) established an adequate security program in accordance with the regulation, and (2) updates the program to reflect operational changes.

Management must provide adequate safeguards to:

- Protect the credit union from robberies, burglaries, larcenies, and embezzlement;
- Ensure security and confidentiality of member records;

- Assist in identification of persons who commit or attempt such actions and crimes; and
- Prevent destruction of vital records (as defined by Rules and Regulations Part 749.)

The credit union's security program must include administrative, technical, and physical safeguards appropriate to the size and complexity of the institution and the nature and scope of its activities. At a minimum, credit union management should design and implement a comprehensive written security program to:

- Identify key controls, systems, and procedures;
- Assess internal and external threats;
- Assign responsibilities;
- Establish security procedures consistent with operating systems;
- Provide periodic training of all employees;
- Protect against destruction, loss, or damage of information, and develop recovery procedures;
- Ensure periodic testing of the security program;
- Re-assess threats and the adequacy of controls;
- Review monitoring systems and control procedures; and
- Revise strategies.

Examiners may evaluate management's efforts to identify, assess, measure, mitigate, and monitor risks.

**Safeguarding
Member
Information**

Appendix A of Part 748 of the *NCUA Rules and Regulations* provides guidance standards for developing and implementing administrative, technical, and physical safeguards to protect the security, confidentiality, and integrity of member information.

Safeguarding member information requires a written comprehensive program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the credit union and the nature and scope of its activities. The credit union should design the program to:

- Ensure the security and confidentiality of member information;
- Protect against anticipated threats or hazards to the security or integrity of such information; and
- Protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any member.

Examiners may evaluate management's efforts to identify, assess, measure, mitigate, and monitor risks.

Margin Securities

When margin securities secure loans, federal credit unions must follow the provisions of Regulation U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks, and the credit union members are subject to provisions of Regulation X, Rules Governing Borrowers Who Obtain Securities Credit, issued by the Federal Reserve Board. These regulations help curb excessive credit in the securities market. Regulation U generally applies to the lender, whereas Regulation X applies to the borrower.

Records Preservation

Part 749 of *NCUA Rules and Regulations* (Vital Records Preservation) permits credit unions to preserve records in electronic form in compliance with the Electronic Signatures Global and National Commerce Act. The rule also permits a credit union's board to determine which employee will assume responsibility for storing vital records under the records preservation program, and incorporates an appendix with suggested guidelines on retention periods for various records.

Call Reports

All federally insured credit unions must file quarterly call reports. It is essential that each credit union files the call reports on time and assumes responsibility for the material accuracy of the reports.

Examiners should address the credit union's failure to submit an accurate call report on a timely basis with the officials and, depending on the circumstances and materiality, in the examination report. Examiners may address repeat or material exceptions in the Document of Resolution.

Incidental Powers

The Incidental Powers regulation (Part 721, *NCUA Rules and Regulations*) authorizes federal credit unions to engage in activities incidental to their business. The regulation provides examples of permissible activities (such as certification services and finder activities) and information on how to request a legal opinion on the permissibility of activities not listed.

Interest Rate Limitation

§(5)(A)(vi) of the *FCU Act* and §701.21(c)(7) of the *NCUA Rules and Regulations* specify that the rate of interest on a loan may not exceed 15 per centum per annum on the unpaid balance (inclusive of all finance charges) unless the NCUA Board establishes a higher ceiling. The *NCUA Rules and Regulations* reflect the NCUA Board's establishment of a higher rate, currently 18 percent. Charging a rate of interest in excess of the statutory limitation is generally viewed as usurious. Usury questions typically arise primarily in compensating balances and recomputation for rebates.

Appraisals

Part 722 of *NCUA Rules and Regulations* identifies the real estate-related financial transactions at federally insured credit unions requiring the services of a state-certified or state-licensed appraiser (i.e., federally related transactions). Such appraisers must (1) have demonstrated competency, (2) subject their professional conduct to effective supervision, and (3) perform written appraisals in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP). The FFIEC Appraisal Subcommittee monitors states' licensure programs, and maintains a current list of licensed appraisers for each state.

Federal, State and Local Reporting Requirements

Although not formally responsible for enforcing federal, state and local regulations, the examiner should bring any obvious violations to the credit union's attention. The credit union could potentially incur significant penalties and fines, which might harm the credit union's financial condition. Following are regulations commonly present in the operation of a credit union:

- Form 1099 Reporting. The Interest and Dividend Compliance Act requires credit unions to:

- Contact members, in writing, requesting certification of their social security numbers, under penalty of law;
 - Initiate backup withholding on accounts with missing or obviously incorrect social security numbers or if notified by the IRS; and
 - Report member dividends on paper 1099 forms; and report member dividends to the IRS on magnetic media if the credit union has 250 or more information returns, unless the IRS granted the credit union an annual hardship waiver.
- Payroll reporting. If the credit union pays salaries, it must:
 - Comply with the withholding provisions of the laws relating to federal, state, and local income taxes, including obtaining W-4 forms, distributing W-2 forms and filing W-3 forms with the Social Security Administration and state or local tax authorities;
 - Report and pay, as required, federal, state and local withholding, OASDI and Medicare; and
 - Report and pay, as required, federal and state unemployment compensation taxes.
 - Individual Retirement Accounts (IRA) Reporting. If the credit union offers IRAs, it must:
 - Prepare Form 5498 for distribution to the member and the IRS.
 - Mortgage Interest Reporting. If the credit union offers mortgage loans, it must:
 - Report annual interest of \$600 or more paid by borrowers on most real estate-secured loans on Form 1098 for distribution to the IRS and the member.
 - Reporting for Discharges of Indebtedness. For reporting purposes, the IRS considers indebtedness discharged on the occurrence of an identifiable event indicating the debtor will never have to pay the indebtedness. If appropriate, the credit union may report discharges

of indebtedness if the indebtedness meets one of the following tests:

- A debt discharged in bankruptcy, but only if the debt was for business or investment purposes;
- A debt discharged by an agreement between the financial institution and the member to accept an amount less than the full amount of the debt;
- A debt that the credit union decided not to pursue through collection activity and discharges;
- A debt on which a 36-month, non-payment testing period has expired;
- A debt extinguished because the statute of limitations the debtor raised as an affirmative defense has expired;
- A debt canceled or extinguished in receivership or foreclosure in state or federal court;
- A debt canceled or extinguished when the financial institution elects foreclosure remedies; or
- A debt canceled or extinguished, rendering it unenforceable in probate.

(Note: A bookkeeping entry to charge off a loan does not by itself qualify as an identifiable event.) Examiners should consider the trigger points above in conjunction with the charge-off to determine whether a discharge has occurred.

- Additional reporting requirements include:
 - The discharge must be \$600 or more, no aggregation;
 - Credit unions must provide copy of 1099-C to the member by January 31 of the year following discharge; and
 - Credit unions must provide original of 1099-C to the IRS by 2/28 of the year following discharge.

Credit unions must keep records of the return or the ability to reconstruct the required data for four years from the required filing date. For more information, review Section 6050.P of the Internal Revenue Code.

While examiners should bring obvious violations to the attention of credit union management, examiners must take care to avoid dispensing advice or guidance on how to interpret or resolve IRS matters.

Regulation D

Regulation D (Depository Institutions' Reserve Requirements) establishes the required amount a depository institution must reserve based on the level of transaction accounts on deposit. Institutions must maintain a certain level of reserves to assist the Federal Reserve Board (FRB) in handling monetary policy.

Credit unions with net transaction accounts (primarily share drafts) less than \$5.5 million (as of April 2002) are exempt from reserving requirements. The FRB annually updates the required reserve amount.

Credit unions have three options available for the retention of required reserves, including:

- Depositing required funds with FRB;
- Holding required funds in vault cash; or
- Holding required funds in pass through account.

Credit unions report directly to the Federal Reserve Bank in their district. The FRB has the authority to assess penalties against credit unions that do not hold adequate reserves.

Additional Information

This chapter covers most regulatory compliance areas not addressed in the section of the Examiner's Guide to which they apply.

Appendix 18A addresses the Bank Secrecy Act (BSA) and Appendix 18B addresses RegFlex. Attachment 18-1 contains Money Laundering Red Flags.

References

- Regulation D of the Federal Reserve Board
- *FCU Act*
 - §107(5)(A)(vi)

- *NCUA Rules and Regulations*
 - §721
 - §722
 - §748
 - §749
- **IRS Rules**
 - Reporting of Wages
 - Forgiveness of Debt
- **AIRES**
 - Consumer Compliance Questionnaire

BANK SECRECY ACT (BSA) – APPENDIX 18A

Examination Objectives

- Determine the credit union's level of compliance with the Bank Secrecy Act (BSA)
- Ensure the credit union has adequate BSA policies, procedures, and controls for each of the following:
 - Verifying member identity
 - Identifying reportable transactions
 - Filing required reports
 - Maintaining proper documentation
 - Blocking and reporting transactions required by the Office of Foreign Asset Control (OFAC)
 - Complying with the U.S.A. Patriot Act (Patriot Act)

Risk Categories

- Compliance – the current and prospective risk to earnings or capital arising from failure to comply with the BSA and the resulting civil and criminal penalties;
- Strategic – the current and prospective risk to earnings or capital arising from inadequate policies, procedures and controls for BSA; and
- Reputation – the risk that negative publicity will adversely impact earnings and capital.

Overview

Failure to maintain strict compliance with the BSA can subject the credit union to high levels of compliance (regulatory) risk, reputation risk, financial losses, and other risks such as civil and criminal penalties. At its worst, this deficiency can jeopardize national security. Negative publicity may result in operational losses, a decline in net worth, or the inability to attract members and competent staff.

Risk indicators include the following:

- Inadequate due diligence by management when initiating new programs or products;
- Failure to appoint and train a compliance officer;
- Inadequate policies or procedures;

- Inadequate audit;
- Inability of data processing system to generate BSA reports;
- Inadequate review by management of BSA reports from data processing system;
- Lack of adequate management oversight;
- Inadequate training; and
- High staff turnover.

While a credit union may not knowingly risk its reputation for a member engaged in criminal activity, it must take steps to guard against the possibility of permitting or facilitating criminal activity.

Bank Secrecy Act

The BSA includes several related acts such as the Anti-Drug Abuse Act, the Money Laundering and Control Act, the Currency and Foreign Transactions Act and the USA Patriot Act, all of which were enacted by Congress. The BSA requires maintenance of certain types of records and reports useful to criminal, tax, or regulatory investigations. The Department of Treasury issued the implementing regulations in 31 CFR 103. §748.2 of the *NCUA Rules and Regulations* requires that credit unions establish and maintain procedures to assure and monitor compliance with the BSA and the implementing regulations.

Specific provisions of the BSA were designed to:

- Prevent members from using financial service providers as intermediaries to accomplish or hide the transfer or deposit of monies derived from criminal activity;
- Prevent, detect, and prosecute terrorism and international money laundering; and
- Provide a paper trail of activities.

Therefore, credit unions must file certain currency and monetary instrument reports and maintain certain records, including identifying and recording cash purchases of certain monetary instruments. Credit unions must also understand the following constitutes criminal offenses:

- Knowingly helping to launder money from criminal activity;

- Knowingly engaging in (including being “willfully blind”) a transaction of more than \$10,000 that involves property from criminal activity; and
- Structuring transactions to avoid BSA reporting.

The Department of Treasury may assess civil and criminal penalties on any domestic credit union and upon any director, officer, or employee for willful violation of the BSA. Penalties can include both fines and prison terms. Therefore, due diligence regarding BSA requires credit union officials to train their employees, identify members using appropriate documentation, understand members and members’ businesses, and institute systems and procedures to distinguish between routine transactions and those that may indicate suspicious activity. The Treasury may also assess fines for negligence.

Enforcement

NCUA must, by law, determine during each examination whether the credit union:

- Conducts money-laundering schemes;
- Complies with technical reporting and record keeping requirements of the BSA; and
- Adopted policies and implemented procedures to detect, deter, and report unusual or suspicious activities related to money laundering (31 CFR 103.46 (b)(5)).

Therefore, violations of the BSA necessitate immediate corrective action. Failure of a credit union to take immediate and effective corrective action may warrant administrative action. Examiners must document BSA violations and compliance deficiencies on the Consumer Compliance Violations Form.

Member Due Diligence

The objectives of a member due diligence program include:

- Protecting the reputation of the credit union;
- Facilitating the credit union’s compliance with BSA requirements;
- Enforcing OFAC and Patriot Act regulations and enhancing national security; and

- Protecting the credit union from becoming a vehicle for, or victim of, illegal activities by the member.

Credit Union's Responsibility

A credit union's responsibility includes knowing the identity of each member and assuring the member's account is not used for illegal purposes. The credit union should have policies and procedures for verifying the identity of its members and determining consistency of account activity.

The credit union's due diligence policy should reflect the following:

- Size and complexity of the credit union;
- Nature and extent of the services offered;
- Level of risk; and
- Documentation requirements.

The credit union's documentation requirements and due diligence procedures should include, at a minimum:

- Documentation requirements for verifying the identity of the member;
- Documenting the source of the member's funds, if deposits exist that include other than normal routine transactions;
- Determining the member's normal and expected transactions;
- Identifying unusual transactions, or activities disproportionate to the member's known business; and
- Determining criteria for when the credit union should report a transaction as a suspicious activity on a Suspicious Activity Report (SAR.)

Identifying a Member

Member identification procedures should include:

- Obtaining, examining, verifying, and recording primary identification, such as the following:

- Drivers License;
 - Passport;
 - Government ID; or
 - Alien Registration Card.
- Obtaining and recording primary information such as:
 - Full name with street or postal address;
 - Social Security number, taxpayer ID number;
 - Date of birth;
 - Home and work phone numbers; and
 - Bank or other credit union references.
 - Obtaining, examining, verifying, and recording secondary identification, for example:
 - Credit card;
 - Employer card;
 - Union card;
 - Voter registration card; or
 - School ID.
 - Verifying as much of the information as possible, including:
 - Physical observation of the address (drive by to see if the address is legitimate);
 - Call backs (validate the phone number by calling it);
 - Check with a third party (call references given);
 - Use of a verification service;
 - Use of a reverse directory to verify the phone number and address match;
 - Check the telephone book;
 - Contact previous employer; and
 - Obtain a credit report.
 - Determining whether the member is on any list of known or suspected terrorists provided by any federal government agency, including:

- OFAC; and
- the Control List (FBI-maintained).

**Identification
Procedures for a
Business
Account**

When a member opens a business account at a credit union (after staff has determined membership eligibility), the credit union must ascertain the person's authorization to open the account by establishing the true identity of the person and the principals of the business using the following procedures:

- Obtaining, examining, verifying, and recording evidence of the legal status, for example:
 - Incorporation documents;
 - Partnership agreements;
 - Association documents;
 - Business licenses; and
 - Corporate resolutions.
- Obtaining and verifying information about the business, for example:
 - Financial statements of the business;
 - A description of the business; and
 - A description of the trade area.
- Obtaining, verifying and recording identification of principals the same as for natural person members.
- Verifying as much of the information as possible. Some ways include:
 - Physical observation of the address;
 - Callbacks;
 - Check with a third party;
 - Verification service;
 - Reverse directories;
 - Telephone book;
 - Contact previous financial institution;
 - Credit reports;

- Dun and Bradstreet reports; and
- Lexis/Nexis searches.

The credit union should remain alert to inconsistencies between the account activity and the member's business.

Reporting Requirements

Credit unions must file the following as required by provisions of the BSA reporting requirements:

- Currency and Transaction Report (CTR); and
- Suspicious Activity Report (SAR.)

Currency and Transaction Report (CTR)

Credit unions must file a CTR (Form 4789) with the IRS Detroit Computing Center (1) each time a member makes a deposit, withdrawal, exchange, or other transfer of more than \$10,000 in currency, or currency instruments such as bank checks or drafts, money orders, or travelers checks; or (2) when a member exceeds \$10,000 in one cash transaction or \$10,000 in multiple cash transactions in one business day. (Currency is defined as U.S. or foreign coin or currency, but does not include bank checks or other negotiable instruments.) Transactions spread over a number of days may constitute a reportable transaction if the member structured the deposit to evade reporting requirements. (Exemptions exist for transactions between financial institutions and with legitimate retail businesses.)

Structuring

Transaction structuring attempts to circumvent the reporting requirements of BSA. Structuring exists when a person, whether acting alone or with somebody, conducts, or attempts to conduct, a transaction for the purpose of evading the BSA reporting requirements. Notice that the individual does not have to succeed in conducting a transaction for a violation to have occurred, nor do they escape criminal liability by merely assisting someone attempting to structure a transaction.

Due to the possibility of structuring, a credit union must treat multiple currency transactions as a single transaction if it has knowledge that the transactions were made by, or on behalf of, any person and resulted

in either cash in or cash out totaling more than \$10,000 during any one business day. Credit unions should file a CTR with the IRS Data Center in Detroit, Michigan, within 15 days after the transaction and must retain copies of the form for five years.

Credit unions may obtain Form 4789 by calling the IRS Forms Distribution Center at 1-800-829-3676, accessing the IRS web site at http://www.irs.treas.gov/forms_pubs/forms.html, or the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) web site at <http://www.treas.gov/fincen/forms.html>.

**Exemptions
from CTR
Reporting**

Certain account holders receive an exemption from the requirement to file a CTR. The five mandatory exemptions include:

- Banks or other financial institution, to the extent of their domestic operations;
- A government department or agency, including federal, state and local governments;
- Any entity established under federal, state, or local government that exercises governmental authority (i.e., has the power of taxation, eminent domain, or police authority);
- Any entity listed on the New York Stock Exchange, the American Stock Exchange, or whose common stock has been designated as a NASDAQ National Market Security listed on the NASDAQ Stock Market (except those listed under the "NASDAQ Small-Cap issue); and
- Any subsidiary of a listed entity organized under federal or state law where the listed entity owns at least 51 percent of its stock or equity interest.

Following are characteristics of a "non-listed business" that may also receive an exemption:

- Incorporated or organized under the laws of the United States or a state, or is registered and eligible to do business within the United States;
- Maintained a transaction account at the credit union for at least 12 months; and

- Frequently engages in transactions in currency with the credit union in excess of \$10,000, or only withdraws more than \$10,000 in cash to pay its United States employees in currency.

The credit union must designate each exempt person or entity by filing a Designation of Exempt Person Treasury Form (TD F 90-22.53) with the Department of Treasury within 30 days of the date of the first reportable transaction. (The credit union need not file an exemption for transactions with any of the twelve Federal Reserve Banks.)

At least once each year, the credit union must review, verify, and document the information supporting each designation of a “non-listed” or “payroll customer” exempt person or entity and the application of each account of an exempt person or entity. Further, the credit union must renew the exempt status of the “non-listed” or “payroll customer” exempt members by filing a Designation of Exempt Person Treasury Form” (TD F 90-22.53) with FinCEN by March 15 of the second calendar year following the original exemption and biennially thereafter. The renewal must include:

- A statement that the credit union has applied its system of monitoring transactions for suspicious activity to the exempt persons accounts at least annually; and
- Any information about a change in control of the exempt person or entity.

The credit union may not treat any of the following businesses as a non-listed business and may not exempt those with the following characteristics:

- Serve as a financial institution or agent of financial institutions of any type, such as check cashing or currency changers;
- Purchase or sell motor vehicles of any kind, vessels, aircraft, farm equipment, or mobile homes;
- Practice of law, accountancy, or medicine;
- Auction goods;
- Charter or operate ships, buses, or aircraft;
- Gaming of any kind (other than licensed pari-mutuel betting at race tracks);
- Investment advisory or investment banking services;

- Real estate brokerage;
- Pawn brokerage;
- Title insurance and real estate closing;
- Trade union activities; and
- Any other activity that may be specified by FinCEN.

Credit unions may treat a business that engages in multiple business activities as a “non-listed business” as long as it receives no more than 50 percent of its gross income from one or more of the ineligible business activities listed above.

**Exemptible
Accounts**

The credit union may grant exemptions to a member for all share and money market accounts held by the member for the commercial enterprise as long as the enterprise qualifies for the exemption.

If the credit union determines that a member qualifies for a CTR exemption, the exemption includes all large currency transactions as long as they are normal for the type of business conducted by the exempt person or entity. The credit union may not exempt a transaction carried out by an exempt person acting as an agent for another person who owns the funds, but who does not have an exemption.

Liability Limits

Failure to file a CTR with respect to transactions in currency by an exempt person or entity will not subject the credit union to penalty unless the credit union does the following:

- Knowingly files false or incomplete information with respect to the transaction or the member engaging in the transaction; or
- Has reason to believe (1) the member does not meet the criteria for the exemption or (2) the person performing the transaction was not an exempt person.

**Suspicious
Activity
Report (SAR)**

The credit union must use the SAR to report all known or suspected criminal offenses, including transactions involving possible money laundering or violations of the BSA. Generally, a credit union should file a SAR within 30 days from the initial detection of the suspicious

activity. If it cannot identify a suspect, the time period for filing a SAR extends to 60 days. In situations involving violations of law requiring immediate attention, the credit union should immediately notify, by telephone, appropriate law enforcement and supervisory authorities, in addition to filing a SAR.

A credit union must file a SAR with the IRS Detroit Computing Center (Financial Crimes Enforcement Network) following the discovery of known or suspected federal criminal violations, or pattern of criminal violations conducted by, at, or through the credit union with the following characteristics:

- Insider abuse involving any amount. The credit union must have a substantial basis for identifying one of its directors, officers, employees or agents as having committed or aided in the commission of a criminal act regardless of the amount involved;
- Violations aggregating \$5,000 or more where a suspect can be identified. The credit union must have a substantial basis for identifying a possible suspect or group of suspects; and
- Violations aggregating \$25,000 or more regardless of a potential suspect. The credit union has no basis for identifying a possible suspect or group of suspects.

In addition, a credit union must file a SAR for any transaction conducted or attempted by, at, or through the credit union and aggregating \$5,000 or more, if the credit union knows, suspects, or has reason to suspect that the transaction:

- May involve potential money laundering;
- Involves funds derived from illegal activities or is intended or conducted to hide or disguise funds or assets derived from illegal activities;
- Is designed to evade the BSA or its implementing regulations;
- Has no business or apparent lawful purpose, or is not the sort in which the member would normally be expected to engage, and the credit union has no reasonable explanation for the transaction.

The credit union must file a SAR for the above activities at the stated thresholds, but may voluntarily file for transactions below these thresholds. It must not notify any person involved in the transaction that the transaction has been reported and must not make such disclosure even under subpoena.

Credit unions must also file a SAR on suspicious activity even when a portion of the activity occurs outside of the United States or the funds involved in the activity originated from outside the United States. Although federal law does not require foreign-located operations of U.S. credit unions to file a SAR, a foreign branch may wish to file a SAR with regard to suspicious activity that occurs outside the United States if that activity is so egregious that it has the potential to cause harm to the entire organization. (Foreign-located operations of U.S. credit unions that identify suspicious activity should report such activity consistent with local reporting requirements in the foreign jurisdiction where the operation is located.)

**Credit Unions
Completing
SARs**

Credit unions should ensure the accuracy and completeness of any SAR it decides to file. The SAR should describe the following:

- The suspect, including the individual's occupation or nature of the suspect's business and known relationships;
- The instruments or mechanisms used;
- All the accounts involved in the suspicious activity, including account activity in multiple branches;
- The dates the suspicious activity occurred, and was noticed, and the duration of the activity;
- Dollar amount involved; and
- The reasons the credit union suspects the activity. Describe the transaction or activity, why the activity or transaction is unusual for the member, whether a pattern of ongoing activity exists, and the person to contact for more information.

The credit union should provide requested information for each section of the form. It should not use terms such as “same as above” or “not applicable.” If the credit union needs to repeat pertinent information, it should enter the information again. If it does not know certain information, it should leave the section blank.

The credit union should not send supporting documentation with the SAR; however, under the SAR regulations, financial institutions filing a SAR must retain all "supporting documentation" related to the reported activity for five years, and disclose supporting documentation to appropriate law enforcement agencies or FinCEN upon request.

FinCEN’s website has SAR forms, guidance, and software available at <http://www.treas.gov/fincen/forms.html>, or by hyperlink from NCUA's web site www.ncua.gov.

**Money
Laundering**

Objectives of the BSA include detecting and deterring money laundering, providing a paper trail of suspicious transactions, and reducing the profit of the perpetrators. Money laundering constitutes a federal crime designed to conceal the proceeds of another criminal activity, such as drug dealing, arms trafficking, credit card swindles, or terrorist activities.

Money laundering has the following stages:

- Getting illicit funds (cash or cash equivalent) into or out of a U.S. financial institution (placement);
- Commingling the illicit funds with other funds to confuse their origins (layering); and
- Reintroducing the funds into the economy (integration).

**Follow Up on
Suspicious
Activity**

If conduct continues for which a credit union has filed a SAR, the credit union should report continuing suspicious activity with a SAR at least every 90 days even if a law enforcement agency has declined to investigate or the credit union has knowledge that an investigation has begun.

The filing of SARs on continuing suspicious activity provides useful information to law enforcement and supervisory authorities. Moreover, the information contained in a SAR that one law enforcement agency has declined to investigate may interest other law enforcement agencies, as well as supervisory agencies. Should activity of concern continue over a period of time, the credit union should share such information with law enforcement and financial regulators.

By filing a report on continuing suspicious activity at least every 90 days, the credit union will notify law enforcement of the continuing nature of the activity, as well as provide a reminder that it must continue to review the suspicious activity to determine other appropriate actions.

**Dealing With
Persons
Reported on
SAR**

Since a credit union member has a fundamental right to maintain a share account and participate in elections, the credit union cannot deny someone credit union membership because it has identified suspicious activity. However, the credit union may wish to consider limiting access to certain services. To do so, the credit union must have established written policies and have notified its members of the policies in advance. The credit union should not consider the mere filing of a SAR as the basis for limiting services.

Similarly, the credit union may find it necessary to consider reassigning or terminating the services of an employee who is the subject of a SAR. The credit union should seek advice from counsel in these situations.

The credit union may not, by law, notify any person involved in an activity being reported on a SAR that the credit union has reported the activity, or that it has filed a SAR (31 U.S.C. 5318(g)(2)). However, this prohibition does not preclude a disclosure in an appropriate manner of the facts that serve as the basis of the SAR, so long as the disclosure is not made in a way that indicates or implies that the credit union has filed a SAR, or that the SAR includes that information.

Summary of CTR and SAR Reporting

The implementing regulations of the BSA require a credit union to file a CTR whenever a currency transaction exceeds \$10,000. If the currency transaction exceeds \$10,000 and is suspicious, the credit union must file both a CTR and SAR. If a currency transaction equals or is below \$10,000 and is suspicious, the credit union should only file a SAR.

Other Reporting Requirements

Credit unions must also adhere to the following other reporting requirements if applicable:

- Foreign Bank and Financial Accounts Report (FBAR), IRS Form TD F 90-22.1. A credit union must file a FBAR if it has a financial interest in, or signature authority over one or more financial accounts in foreign countries and the aggregate value exceeds \$10,000;
- Reports of certain transactions with designated foreign financial agencies upon specific notice required by the Secretary of Treasury; and
- Special requirements imposed by the Secretary of Treasury for a limited period of time whereby credit unions in a certain geographic area must report currency transactions in amounts below \$10,000.

In addition, an individual must file Form 4790, Report of International Transportation of Currency or Monetary Instrument (CMIR), each time a person sends or receives more than \$10,000 in currency or monetary instruments into or out of the United States. The person (not the credit union) who physically transports, mails, or ships, or causes the shipment, transportation, or mailing of currency and/or monetary instruments into or out of the U.S must file the report within 30 days of the transaction.

BSA Record-keeping Requirements

Credit unions must retain all records required by the BSA for five years, and must provide access to the records upon request within a reasonable period of time. At a minimum, credit unions must retain the records as original, microfilm, or other copy or reproduction, both front and back.

A credit union must verify and record information relating to the identity of the purchaser of monetary instruments, such as bank checks or drafts, money orders, or travelers checks, in exchange for currency in amounts between \$3,000 and \$10,000. (Credit unions must report amounts over \$10,000 on a CTR.) The credit union must maintain the data in monthly chronological logs, which it must retain for five years. The information must include:

- The purchaser's name;
- The purchaser's account number;
- Date of purchase;
- Branch location of purchase;
- Types of instruments purchased;
- Serial number of instrument purchased;
- Dollar amount of each instrument purchased; and
- Verification of purchaser's identity, including the type of verifying information used.

A credit union must also maintain the following:

- A record of each loan that exceeds \$10,000 (except those secured by real estate), which must contain the borrower's name and address, the amount, purpose or nature, and date of the loan;
- A record of each advice, request, or instruction received or given regarding any transaction resulting in or intending to result in the transfer of currency and other monetary instruments, funds, checks, investment securities, or credit, of more than \$10,000 to or from any person, account or place outside the United States;
- A record of any report required by the Department of Treasury's special order concerning the transfer of United States coins or currency in a geographic area;
- Member identification information and payment data related to the sender and the recipient of each incoming or outgoing wire transfer of \$3,000 or more. (31 CFR 103.33 (e));
- Member identification information obtained to comply with the Patriot Act for five (5) years after the account has been closed;
- Social security number or taxpayer identification number (TIN) for each share account and share certificate account;
- Either the original or a copy of each of the following:

- The signature card granting signature authority over each share account, including the information used in verifying the signer's identify, such as a driver's license number;
- Each statement, ledger card or other record for each share account, showing each transaction for that account;
- Each check, clean draft, or money order drawn on the credit union, or issued and payable by the credit union unless the amount is less than \$100, drawn on an account that averages at least 100 checks a month, and written for employee benefits or dividends. (31 CFR 103.34 (b)(3));
- Each item in excess of \$100 comprising a debit to a member's deposit account not otherwise exempted;
- Each item, including checks, drafts, or transfers of credit, of more than \$10,000 remitted or transferred to a person, account, or place outside the United States;
- Each record of remittance or transfer of funds, currency, other monetary instruments, checks, investment securities, or credit, of more than \$10,000 to a person, place, or account outside the United States;
- Each check or draft in an amount in excess of \$10,000 drawn on or issued by a foreign bank which the credit union has paid or presented to a nonbank drawee for payment;
- Each item, including checks, drafts or transfers of credit, of more than \$10,000 received directly and not through a domestic financial institution, by letter, wire, or any other means from a bank, broker, or dealer in foreign exchange outside the United States;
- A record of each receipt of currency, other monetary instruments, investment securities or checks, and of each transfer of funds or credit, of more than \$10,000 received on any one occasion directly from a bank, broker, or dealer in foreign exchange outside the United States;
- Records prepared or received by the credit union in the ordinary course of business and needed to reconstruct a share draft account and to trace a check or share draft in excess of \$100 deposited in such account through its processing system or to supply a description of a deposited check or share draft in excess of \$100 (this applies to demand deposits only);
- A record containing the name, address, and taxpayer identification number, if available, of any person presenting a

certificate of deposit for payment, as well as a description of the instrument, and the date of the transaction; and

- Each deposit slip or credit ticket reflecting a transaction in excess of \$100 or the equivalent record for direct deposit or other wire transfer deposit transactions. The slip or ticket shall record the amount of any currency involved.

Wire Transfers

Credit unions must obtain and retain complete information about the parties to a funds transfer of \$3,000 or more. The text of every payment order must include the following:

- Name and address of the originator;
- Amount of the payment order;
- Execution date of the payment order;
- Payment instructions received from the originator with the payment order;
- Identity of the beneficiary's bank; and
- As many of the following items as the credit union receives with the payment order:
 - Name and address of the beneficiary;
 - Account number of the beneficiary; and
 - Any other specific identifier of the beneficiary.

Office of Foreign Assets Control (OFAC)

The Office of Foreign Asset Control, within the Department of Treasury administers a series of laws that impose economic sanctions against hostile targeted foreign countries and their agents, terrorism sponsoring organizations, international narcotics traffickers and specially designated nationals. The economic sanctions further U.S. foreign policy and national security. The OFAC website, www.treas.gov/ofac, contains specific OFAC laws and provisions. NCUA is responsible for determining that credit unions comply with the OFAC regulations.

Part 748 of NCUA's Rules and Regulations requires a credit union to have a Bank Secrecy Act compliance program and procedures. Although no specific requirement exists for a policy on compliance with OFAC regulations, the credit union must comply with the

regulations. Credit unions may include these requirements within the Bank Secrecy Act compliance policy.

Definitions

Blocking, or freezing: a form of controlling assets under U.S. jurisdiction. While title to blocked property remains with the designated country or national, OFAC may prohibit the exercise of the powers and privileges normally associated with ownership without its authorization. Blocking immediately imposes an across-the-board prohibition against transfers or transactions of any kind without regard to the property.

Property: anything of value. Practically everything that banks do every day involves property within the meaning of the regulation. Examples include: money, checks, drafts, evidences of title, obligations, debts and anything else real, personal, tangible or intangible. Property also covers direct, indirect, present, future and contingent interests.

Credit Union Requirements

Credit unions must block or "freeze" the assets, funds transfers, and all transactions of all designated countries and their agents, specially designated terrorists, foreign terrorist organizations, specially designated narcotics traffickers and blocked persons. In addition, OFAC may require the credit union to reject or return incoming transfers from prohibited sources.

Credit unions can obtain a listing of prohibited sources by checking the OFAC website. The credit union should frequently update the list of prohibited sources by checking the OFAC website and documenting their check. If a credit union does not have website access, the credit union's may call OFAC at 1-800-540-6322.

The credit union should compare new accounts with the prohibited listing. The credit union may open the account, but should immediately block the funds so that account owners can make no withdrawals. In some cases, it is appropriate to reject the funds, i.e., the OFAC website contains the proper course of action for each law.

Credit unions must check the names of all parties to a transaction, including:

- Beneficiaries;
- Collateral Owners;
- Guarantors/Cosigners;

- Receiving Parties; and
- Sending Parties.

The credit union must review every type of transaction for compliance without limitation, including the following:

- Share accounts of all types;
- Loans, credit cards and lines of credit;
- Letters of credit;
- Safety deposit boxes;
- Wire and ACH transfers;
- Currency exchanges;
- Depositing and cashing checks;
- Purchase of money orders or traveler's checks;
- Loan payments;
- Guarantors and collateral owners; and
- Trust accounts.

Large and sophisticated credit unions may have special software which can interdict prohibited transactions. If the credit union identified any accounts, transactions or property, which match the prohibited listing, the credit union must immediately block or reject the assets as required.

OFAC Reporting Requirements

The credit union must report all blockings and or rejections to the Office of Foreign Asset Control within 10 days of the occurrence. For blocked property, the credit union must report the following information:

- Owner or account party;
- The property or amount of funds;
- The property location;
- Any existing or new account number or similar reference necessary to identify the property;
- Actual or estimated value of the property;
- The date it was blocked;
- A photocopy of the payment or transfer instructions;
- The individual or entity subject to blocking;
- The name and address of the holder; and

- The name and phone number of the contact person at the credit union who can provide compliance information.

Reports on rejected items must include:

- The name and address of the transferee credit union;
- The date and amount of the transfer;
- A photocopy of the payment or transfer instructions received;
- The basis for the rejection; and
- The name and telephone number of a contact person at the transferee credit union who can provide compliance information.

There is no designated form for filing reports of blocked or rejected items. Credit unions should fax reports on blockings or rejected items with the above information to the OFAC Compliance Division at (202) 622-2426.

The credit union must also file a comprehensive report on blocked property held as of June 30, by September 30, each year. Credit union must use Form TDF 90-22.50, which is available on the OFAC home page.

Record Retention and Penalties

OFAC requires the credit union retain all reports of blockings or rejected items and the related records for five years.

Penalties vary depending on the specific law, which is violated. However, OFAC has the authority to impose corporate or personal penalties up to \$1 million and 12 years in jail, civil penalties up to \$250,000 per incident, and forfeiture of funds involved in the violation. Criminal penalties may also apply.

U.S.A. Patriot Act

The U.S.A. Patriot Act contains strong measures to prevent, detect, and prosecute terrorism and international money laundering. The U.S. Department of the Treasury issued rules setting forth minimum standards for member identification upon account opening. The rules are part of BSA. Among other items, the rules require credit unions to:

- Verify members' identity;

- Maintain identity documentation records;
- Compare member names with lists of known or suspected terrorists; and
- Provide adequate notice to members.

**Identity
Verification
Procedures**

Credit unions must develop procedures based on the assessment of the risks presented by the various types of accounts (regular shares, share drafts, business, etc) and the methods used to open an account (in person, by mail, etc). The credit union must reasonably believe they know the true identity of the member.

For non-U.S. citizens identity verification becomes more difficult. The credit union may use various methods to verify identity. The credit union may accept any government-issued document evidencing nationality or residence and bearing a photo or similar safeguard. Businesses may provide registered articles of incorporation, government-issued business licenses, partnership agreements, etc. to verify identity. If credit unions use other methods to verify identity, their procedures must require they perform the verification within a reasonable period after the account is opened.

If, according to the credit union's assessment risk is limited, actual documents need not always be obtained when verifying identity. The credit union may choose to monitor the specific account if the member does not provide physical documentation or is in the process of obtaining verification documentation.

**Maintenance of
Verification
Information**

The credit union must maintain all information obtained to document the member's identity for five (5) years after the account has been closed.

**Comparison with
Government
Lists**

The credit union's procedures must specify that it will determine whether the member is on any list of known or suspected terrorists provided by any federal government agency. This would include OFAC and the Control List (maintained by the FBI).

Notification to Members

The credit union must notify members that steps will be taken to verify the identity of all members. This requires the credit union to post a general notice in the lobby, on their website, or by some other general method. It does not require the credit union to send individual paper notices to every member.

Part 748 of the *NCUA Rules and Regulations* covers the Anti-Money Laundering Program provisions of the Patriot Act.

FinCEN issued rules implementing the cooperative efforts to deter money-laundering provisions of the Patriot Act. These rules:

- Encourage information sharing among financial institutions and federal government law enforcement agencies to identify, prevent, and deter the financing of terrorist activity;
- Require credit unions search their records to determine if they have accounts for, or have engaged in transactions with, specific individuals, entities or organizations named by FinCEN in a request;
- Require the designation of a person to receive such requests from FinCEN; and
- Permit information sharing between financial institutions upon prior notification of FinCEN of its intent to share information.

FinCEN

FinCEN collects data on potential violations of federal criminal law as well as suspicious transactions related to money laundering offenses and violations of the BSA. Its primary tool in administering the BSA is a uniform interagency SAR used by all financial institutions.

Referrals to FinCEN

In some instances, examiner should recommend referral of BSA violations for further action. Examiners should forward BSA referrals with appropriate comments through the supervisory examiner to their regional director. In cases involving suspected ongoing criminal activity, the examiner should immediately contact the supervisory examiner, who will give the examiner further instructions after consulting with regional management. The Office of Examination and Insurance consults with the Office of General Counsel before making

final decisions on referrals to FinCEN. Examiners should consider the following in determining whether to recommend referral:

- Suspected instances of money laundering or structuring of transactions to avoid reporting;
- Evidence the credit union or an official committed a flagrant violation, demonstrated bad faith, attempted to conceal the violation, or committed the violation with disregard for the law or the consequences to the institution;
- Failure of the board or an individual to cooperate with NCUA to affect an early resolution and correction of a violation;
- Continuation, frequency, or recurrence of a violation, especially instances where NCUA, Treasury, FinCEN, IRS, Securities and Exchange Commission (SEC), Customs Service, or the credit union's independent reviewer advised the credit union of the violation;
- Evidence that insiders, participants in the currency transaction, or their associates benefited directly or indirectly as a result of a violation;
- Evidence that a violation may have facilitated or concealed illegal activity by the credit union, its employees, its members, or others;
- Absence of a compliance program or severe inadequacies in the compliance program;
- Failure by the credit union or individuals to adhere to the requirements of a compliance program; and
- Indication of false record keeping entries.

The following examples include situations that warrant referral:

- Intentional or unintentional failure to file a CTR or CMIR as a pattern or practice at a certain location or for one or more specific members or accounts. This includes failure to report aggregated transactions when the credit union has a system that identifies multiple related transactions occurring on the same day;
- Failure to maintain a centralized list of members or accounts exempted from the reporting requirements;
- Failure to obtain and maintain the exemption certification statement for exemptions granted after October 27, 1986;

- Inclusion of ineligible members or accounts on the exemption list, especially if the credit union did not file CTRs because of the inclusion; and
- Lack of adequate internal controls, audit coverage, or inaccuracies in the credit union's training materials regarding BSA compliance.

Documenting Violations

FinCEN requires sufficient information to enable it to determine the severity of the problem and to decide whether to pursue a civil or criminal action. NCUA refers significant violations of the BSA to FinCEN for review for possible civil or criminal penalties. FinCEN may assess civil and criminal penalties for willful violations upon any domestic financial institution, and upon any partner, director, officer, or employee. Penalties can include both fines and prison terms. FinCEN forwards potential criminal referrals to the Internal Revenue Service - Criminal Investigation Division (IRS-CID) for investigation.

Examples of documentation necessary to support the referral of violations of BSA include the following:

- A description of the examination procedures used. The description should note the "as of" date of the information reviewed, whether the examiner conducted a review of currency transactions and, if so, the testing dates of the transactions;
- A history of the credit union's compliance with BSA;
- A description of the violations. The description should contain adequate detail to allow FinCEN to determine whether to pursue enforcement action (e.g., name of the member or account, nature of the member's business, the member's tax identification number, and the purpose or type of transaction). The information regarding the violation should identify the area or branch of the credit union in which the violations occurred. If the violation involves ineligible members or accounts on the exemption list, it should indicate whether the credit union has on file exemption certificates for additions to the list after October 27, 1986;
- The credit union's employer identification number (EIN) and the Magnetic Ink Character Recognition (MICR) number;
- Identification of the individuals responsible for the violations or having knowledge of the violation;
- Credit union management's response to the violations; and

- For exemption list problems, the examiner may photocopy and submit the exemption list. Examiners can note the absence of the required exemption certification statement on the photocopy or other problems with the list.

NCUA will submit copies of selected examination workpapers summarizing the violations and other supporting documents with a referral. Examiners may wish to obtain copies of source documents (e.g., teller tapes or microfilm) to substantiate violations, but need not submit all of the source documentation with the referral.

Examiners should maintain the following documentation for referred cases:

- For exemption violations:
 - If the examiner questions the reasonableness of an exemption or the business of an exempt member, the credit union should provide documentation to support its position. Documentation regarding exemptions may also include copies of credit union statements, copies of letters to and from FinCEN or IRS, internal credit union memoranda, and other items evidencing cash flows and descriptions of the business;
 - If an ineligible member has received an exemption, examiners should retain copies of the Designation of Exempt Person Treasury Form and documents stating the reasons why the credit union believed that the member should receive the exemption. In this case, examiners should direct the credit union to contact the IRS Detroit Computing Center, Compliance Review Group, Box 32063, Detroit, MI 48232 to determine if the credit union must backfile CTRs;
- For unreported transactions, examiners should retain in the workpapers a copy of the source document identifying the transaction. The document may be a teller machine tape, microfilm, cash in/out ticket, selected portions of a computer report, a debit/credit ticket, official application/request, wire transfer department documents, memoranda, or any other documents which indicate that a reportable transaction occurred; and

- For incomplete record keeping, documents may include copies of signature cards, record retention schedules, or account documents for which the credit union has failed to obtain a member's taxpayer identification number. If the credit union's BSA Manual or internal memoranda contains incorrect information regarding BSA, examiners should retain copies of such documents noting the credit union personnel responsible for approving, developing, or issuing the document.

IRS Forms

Credit unions may obtain IRS forms by calling the IRS Forms Distribution Center at 1-800-829-3676, or by accessing the IRS web site at www.irs.treas.gov/forms_pubs/forms.html. Some forms are also available from FinCEN's web site at www/treas.gov/fincen/forms.html.

Credit unions should file hardcopy forms with the U.S. Department of the Treasury, P.O. Box 33112, Detroit, Michigan 48232-0112. Magnetic media filers of these forms should mail magnetic media/diskettes to the IRS Detroit Computing Center, FinCEN, 985 Michigan Avenue, Detroit, Michigan 48226.

Credit unions may contact the IRS Detroit Computing Center at 1-800-800-2877 for assistance with questions regarding CTR exemption regulations (31 CFR Section 103.22(d)(2)), completion of the Designation of Exempt Person Treasury Form (TD F 90-22.53), completion of the CTR form (Form 4789), and CTR paper or magnetic filing issues.

For other BSA related questions, credit unions and individuals may call FinCEN's Regulatory Help line at 1-800-949-2732.

REGULATORY FLEXIBILITY PROGRAM (REG FLEX)

APPENDIX 18B

Examination Objective

- Determine whether federal credit unions qualify for exemptions or additional authorities provided by the Regulatory Flexibility Program (RegFlex)

Associated Risks

- Liquidity risk – potential effect on the balance sheet liquidity due to large amount invested in high-risk investments, fixed assets, and nonmember deposits;
- Interest rate risk - potential effect on the balance sheet earnings due to large amount invested in high-risk investments;
- Strategic risk – could materially affect the balance sheet if management overuses RegFlex and develops liquidity and earnings problems; and
- Reputation risk – earnings and net worth problems could cause the membership to doubt the soundness of the credit union.

Overview

A credit union is automatically eligible for the Regulatory Flexibility (RegFlex) Program if it meets the following criteria:

- Has a net worth of 9 percent; and
- Has received a CAMEL rating of 1 or 2 for two consecutive examinations.

Credit unions subject to risk-based net worth requirements under NCUA Rules and Regulation §702.103 must have net worth of 200 basis points over the risk based net worth level, or 9 percent, whichever is higher.

Credit unions assigned a CAMEL 3 (or CAMEL 1 or 2 for less than two consecutive cycles) with a net worth in excess of 9 percent (or credit unions subject to a risk-based net worth requirement with net worth at least 200 basis points over the risk based net worth requirement), may apply to the regional director for a RegFlex designation.

Credit unions can lose their eligibility for RegFlex if they no longer meet the net worth or CAMEL requirements specified in §742.1. Also, the regional director, for substantive and documented safety and soundness reasons, may revoke a credit union's RegFlex authority in whole or part. The regional director must give a credit union written notice stating the reasons for the action. Credit unions may appeal the regional director's decision to the NCUA Supervisory Review Committee.

**Exemptions
under
RegFlex**

Following are the specific exemptions credit unions receive under the RegFlex regulation:

- Charitable donations. The RegFlex designation exempts charitable donation limitations and the need for board approval. (§701.25)
- Payment on shares by public unit and nonmembers. RegFlex designation exempts public unit and nonmember share limitations (20 percent of total shares or \$1.5 million, whichever is greater). Eligible credit unions must still appropriately manage the nonmember shares and any additional risks, including volatility and liquidity concerns. (§701.32(b) and §701.32(c))
- FCU ownership of fixed assets. The RegFlex designation exempts the fixed asset limitation (5 percent of shares and retained earnings), eliminating the need to apply for a fixed asset waiver. The credit union should still establish a fixed asset limitation and incorporate the limit in a written business plan. Reg Flex status does not eliminate the need for sound planning, including developing reasonable and accurate financial projections. (§701.36(a), §701.36 (b), and §701.36 (c)) The RegFlex credit union must continue to comply with §701.36(d) and §701.36(e).
- Investment and deposit activities. RegFlex removes the limitation on discretionary delegation of investments to third parties (100 percent of net capital at time of delegation.) RegFlex credit unions should continue to establish their own limit, documented in a Board-approved policy. (§703.40(c)(6))

- Investment and deposit activities. RegFlex removes the requirement for quarterly stress testing for those credit unions with complex securities exceeding net capital that already measure the impact of interest rate changes on their entire balance sheet as part of their asset liability management programs. These credit unions should continue to measure, at least quarterly, the impact of a sustained, parallel shift in interest rates of plus and minus 300 basis points on their entire balance sheet as part of their asset liability management monitoring. (§703.90(c))
- Investment and deposit activities. RegFlex removes the prohibition of purchasing zero coupon investments with maturity date more than ten years from the settlement date. (§703.110(d))

Additional Authority under RegFlex

RegFlex permits additional authority in the area of purchase, sale, and pledge of eligible obligations (§701.23) The RegFlex designation allows credit unions to purchase and retain any auto loan, credit card loan, member business loan, student loan, or mortgage loans from any other credit union, without being subject to the 5 percent limitation of §701.23 (b)(3), as long as the loans fall within the purchasing credit union's power to grant. The statutory limitations of credit unions purchasing eligible obligations from liquidating credit unions remain (i.e., 5 percent of unimpaired capital surplus of the purchasing credit union.)

Exemptions and Additional Authority for FISCUs

If a state-chartered credit union meets the RegFlex criteria, then the credit union need not comply with §701.32(b) and §701.32(c). A state-chartered credit union that only meets one of the two criteria may also avail itself of the application process. However, RegFlex does not preempt state law. The applicable state law must allow for public unit and nonmember deposits. RegFlex provides the following exemption to FISCUs that meet the RegFlex requirements:

- Payment on Shares by Public Unit and Nonmembers. (§701.32(b) and §701.32(c)) RegFlex designation exempts public unit and nonmember share limitations (20 percent of total shares or \$1.5 million, whichever is greater.) Eligible credit unions must still

appropriately manage the nonmember shares and any additional risks, including volatility and liquidity concerns.

State regulators are responsible for notification to federally insured state chartered credit unions (FISCU) as to RegFlex eligibility. State regulators are also responsible for subsequent monitoring of all FISCU eligible for exemptions under RegFlex.

Illustrations

Illustrations 18B-1 through 18B-4 exhibit examples of letters to federal credit unions regarding their RegFlex status.

**Letter to FCU
Regarding
Denial of
Application**

Date
Ms. Board Chairperson, Chair of the Board XXX Federal Credit Union Address City, State Zip Code
Dear Ms. Chairperson:
We reviewed your application for a RegFlex designation as provided in Part 742 of <i>NCUA Rules and Regulations</i> . [XXX Federal Credit Union] currently does not meet the [CAMEL or net worth] criteria of §742.1. [Insert discussion of justification for denial.]
Please contact your district examiner or the supervision analyst in this office with any questions.
Sincerely,
Jane Doe Regional Director
Illustration 18B-1

**Letter to FCU
Meeting
RegFlex
Criteria**

Date

Board of Directors
XXX Federal Credit Union
Address
City, State Zip Code

Dear Board of Directors:

[XXX Federal Credit Union] is eligible for a RegFlex designation as provided in Part 742 of *NCUA Rules and Regulations* due to advanced levels of net worth and consistently strong supervisory examination ratings. Regulatory relief is awarded with this designation as described in §742.4 and §742.5. Additionally, enclosed is a summary of the regulations you are exempt or given additional authority.

Please contact your district examiner or a supervision analyst in this office with any questions.

Sincerely,

John Doe
Regional Director

Illustration 18B-2

**Letter to FCU
No Longer
Meeting
RegFlex
Criteria**

Date

Board of Directors
XXX Federal Credit Union
Address
City, State Zip Code

Dear Board of Directors:

[XXX Federal Credit Union] is no longer eligible for a RegFlex designation as provided in Part 742 of *NCUA Rules and Regulations* due to a [decline in net worth] [CAMEL rating downgrade]. Because of this, [XXX Federal Credit Union] is not eligible for the regulatory relief provided in Section 742.4 and 742.5. Any action by [XXX Federal Credit Union] while under the RegFlex authority will be grandfathered. Future actions must meet all NCUA's regulatory requirements.

Please contact your district examiner or a supervision analyst in this office with any questions.

Sincerely,

John Doe
Regional Director

Illustration 18B-3

**Revocation
Letter to FCU**

Date

Board of Directors
XXX Federal Credit Union
Address
City, State Zip Code

Dear Board of Directors:

[XXX Federal Credit Union] is no longer eligible for a RegFlex designation as provided in Part 742 of *NCUA Rules and Regulations* due to substantive safety and soundness reasons. [Insert paragraph justifying substantive and documented safety and soundness reasons.]

Any action by [XXX Federal Credit Union] while under the RegFlex authority will be grandfathered. Future actions must meet all NCUA's regulatory requirements. [Insert paragraph, as appropriate, emphasizing Regulations the credit union is no longer exempt where limitations are needed for safety and soundness concerns (i.e., fixed asset limitation).]

You may appeal this decision within 60 days from the date of determination to the NCUA Supervisory Review Committee (Committee). This decision will remain in effect unless the Committee issues a different determination. If you are dissatisfied with the Committee decision, you may appeal to the NCUA Board within 60 days from the issuance of the Committee decision.

Please contact your district examiner or a supervision analyst in this office with any questions.

Sincerely,

John Doe
Regional Director

Illustration 18B-4

MONEY LAUNDERING RED FLAGS

Member Transactions

- Refusal or reluctance to proceed with a transaction, or abruptly withdrawing a transaction. A member may be reluctant or even withdraw a transaction after being informed that a Currency Transaction Report (CTR) will be filed, or that the purchase of a monetary instrument will be recorded. The member may withdraw all or a portion of the transaction to avoid Bank Secrecy reporting requirements.
- Member refusal or reluctance to provide information or identification. A member may be reluctant, or even refuse to provide identifying information when opening an account, cashing a check, recording the purchase of a monetary instrument, or providing information necessary to file a Currency Transaction Report.
- Structured or recurring, non-reportable transactions. An individual or group may attempt to avoid Bank Secrecy Act reporting and record keeping requirements by breaking up, or structuring a currency transaction or purchase of monetary instruments in amounts less than the reporting/record keeping thresholds. Transactions may also be conducted with multiple branches, member service representatives, accounts and/or on different days in attempt to avoid reporting requirements.
- Multiple third parties conducting separate, but related, non-reportable transactions. Two or more individuals may go to different tellers or branches and each conduct transactions just under the reporting/recordkeeping threshold.
- Even dollar amount transactions. Numerous transactions are conducted in even dollar amounts. NOTE: Money laundering and check kiting schemes have similar characteristics.
- Transactions structured to lose the paper trail. The credit union may be asked to process internal debits or credits containing minimal or no description in attempt to “separate” a transaction from its account.

EXAMINER's GUIDE

- Significant increase in the number or amount of transactions. A large increase in the number of or amount of transactions involving currency or non-cash items, the purchase of monetary instruments, wire transfers, etc. may indicate potential money laundering.
- Transactions that are not consistent with the member's business or income level.
- Multiple accounts with numerous deposits under \$10,000.
- Numerous cash deposits under \$10,000 in a short period of time. This includes deposits made at an ATM.
- Accounts with high volume of activity and low balances. Accounts with a high volume of activity, which carry a low balance or is frequently overdrawn, may be indicative of money laundering or check kiting.
- Accounts with large deposits and balances. A member makes large deposits and maintains large balances with little or no apparent justification.
- Deposits and immediate request for wire transfers or cash shipments.
- Numerous deposits of small incoming wires or monetary instruments, followed by a large outgoing wire.
- Accounts used as a temporary repository of funds. The member appears to use the account as a temporary repository for funds that will be transferred out of the credit union. There is little account activity.
- Funds deposited into several accounts, transferred to another account, and then transferred outside the U.S.
- Disbursement of certificates of deposit by multiple checks, each under \$10,000.
- Early redemption of certificates of deposit.

**Cash
Management**

- Inconsistent deposit and withdrawal activity by a member with a retail business account.
- Strapped currency. Frequent deposits of large amounts of currency, wrapped in currency straps that have been stamped by a bank.
- Large amounts of food stamps not consistent with the members legitimate business.
- Transactions by non-account holders. A non-member conducts or attempts to conduct transactions such as currency exchanges, or the purchase or redemption of monetary instruments for no apparent legitimate reason.
- Change in currency shipment patterns. Significant changes in currency shipment patterns between vaults, branches, and/or correspondent banks may indicate a potential money laundering scheme occurring in a particular location.
- Large increase in cash supply or a large increase in the size and frequency of cash deposits with no corresponding increase in non-cash deposits.
- Significant exchanges of small denomination bills for large denomination bills. (See cash shipment records.)
- Significant requirement for large bills. Branches whose large bill requirements are significantly greater than average may be conducting large currency exchanges. Branches that suddenly stop shipping large bills may be using them for currency exchanges.
- International cash shipments funded by multiple monetary instruments. This involves the receipt of funds in the form of multiple official bank checks, traveler's checks, or personal checks that are drawn on or issued by U.S. financial institutions. They may be made payable to the same individual or business, or related individuals or businesses, and may be in U.S. dollar amounts below the Bank Secrecy Act reporting/record keeping threshold.

Funds are then shipped or wired to a financial institution outside the U.S.

- Other unusual domestic or international shipments. For example, the member directs the credit union to ship funds to a foreign country and advises the credit union to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.
- Frequent cash shipments with no apparent business reason.

**Currency
Exchanges
and Other
Currency
Transactions**

- Unusual exchange of denominations. An individual or group seeks the exchange of small denomination bills (five, ten and twenty dollar bills) for larger denomination bills without any apparent legitimate business reason.
- Check cashing companies. Large increases in the number and/or amount of cash transactions from a member who owns a check cashing business.
- Unusual exchange by a member who is in the check cashing business. No exchange or cash-back for checks deposited by an individual who owns a check cashing service can indicate another source of cash.
- Suspicious movement of funds. Suspicious movement of funds out of a bank into the credit union and back in to the bank or vice versa can indicate money laundering.

Lending

- Certificates of deposits used as collateral. An individual buys certificates of deposit and uses them as loan collateral. Illegal funds can be involved in either the CD purchase or the use of the loan proceeds.
- Sudden unexpected payment on loans. A member may suddenly pay down or pay off a large loan, with no evidence of refinancing or other explanation.

- Reluctance on the part of the member to provide the purpose of the loan or the stated purpose is ambiguous. The Bank Secrecy Act requires the credit union to document the purpose of all loans over \$10,000.
- Inconsistent or inappropriate use of loan proceeds. The proceeds are used for other than the stated purpose.
- Overnight loans. A member may use "overnight" loans to create high balances in the account.
- Loan payments received from third parties. Loans repaid by a third party may indicate that the assets securing the loans are really those of a third party, who is attempting to hide the ownership of illegally, gained funds.
- Loan proceeds used to purchase property in the name of a third party, or collateral pledged by a third party.
- Permanent mortgage financing with an unusually short maturity.
- Structured down payments or escrow money transactions to conceal the true source of the funds.
- Attempt by the member or the credit union to sever a paper trail connecting a loan with the security for the loan.
- Wire transfer of loan proceeds for no apparent reason.
- Disbursement of loan proceeds by multiple credit union checks, each under \$10,000.
- Loans to members or businesses outside the U.S. Unusual loans to members in offshore locations, such as "secrecy havens".
- Financial statement of a member's business which differs greatly from those of similar businesses.

Monetary Instruments

- Structured purchases of monetary instruments (travelers checks or money orders) An individual or group purchases monetary instruments with currency in amounts below the \$3,000 reporting threshold.
- Replacement of monetary instruments. An individual uses one or more monetary instruments to purchase another monetary instrument.
- Frequent purchase of monetary instruments without apparent legitimate reason.
- Deposit or use of multiple monetary instruments. The deposit or use of numerous official bank checks or other monetary instruments, all purchased on the same date at different issuers. These instruments may or may not be payable to the same individual or business.
- Incomplete or fictitious information. The member may conduct transactions involving monetary instruments that are incomplete or contain fictitious payees or remitters.
- Large cash amounts. The member may purchase traveler's checks, money orders, or credit union checks with large amounts of cash.

Safe Deposit Boxes

- Frequent visits. The member may visit the box on an unusually frequent basis.
- Out of area members. The safety deposit box may be opened by a member who does not reside or work in the credit union's location.
- Change in safety deposit box traffic. For example, more people may enter or may enter more frequently, or the member may carry bags or other containers that could conceal large amounts of cash.
- Large amounts of cash maintained in a safe deposit box. A member may access the safety deposit box after completing a transaction involving a large withdrawal of cash, or may access the safety

deposit box prior to making cash deposits which are just under \$10,000.

- Multiple safety deposit boxes. A customer may rent multiple safe deposit boxes if storing large amounts of currency.

Wire Transfers

- Wire transfer to bank secrecy haven countries.
- Incoming\Outgoing wire transfers with instructions to pay upon proper identification. The instructions to the receiving financial institution are to "pay upon proper identification." If paid for in cash, the amount may be just under \$10,000 so no Currency Transaction Report is required. The purchase may be made with numerous official checks or other monetary instruments. The amount of the transfer may be large, or the funds may be sent to a foreign country.
- Outgoing wire transfers requested by non-members. If paid in cash, the amount may be just under \$10,000 to avoid a Currency Transaction Report. The funds may also be paid with several official checks or other monetary instruments or the funds may be directed to a foreign country.
- Frequent wire transfers with no apparent business reason.
- High volume of wire transfers with low account balances.
- Incoming and outgoing wires in similar dollar amounts. There is a pattern of wire transfers of similar amounts both in and out of the member's account, or related members, on the same day or the next day. The member may receive many small incoming wires, and then order a large outgoing wire transfer to another city or country.
- Large wires by members operating a cash business. Could involve wire transfers by members operating a mainly cash business.

- Cash or bearer instruments used to fund wire transfers. Use of cash or bearer instruments to fund wire transfers may indicate money laundering.
- Unusual transactions by correspondent financial institutions. Suspicious transactions would include (1) wire transfer volumes that are extremely large in proportion to the asset size of the credit union; or (2) a large volume of wire transfers of similar amount in and out on the same day or the next day.
- International funds transfers which are not consistent with the member's business.
- International transfers funded by multiple monetary instruments. This involves the receipt of funds in the form of multiple official checks, or traveler's checks that are drawn on or issued by U.S. financial institutions and made payable to the same individual or business or related individuals or businesses in U.S. dollar amounts that are below the Bank Secrecy Act reporting threshold. The funds are then wired to a financial institution outside the U.S.
- Other unusual domestic or international funds transfers. The member requests an outgoing wire or is the beneficiary of an incoming wire, and the instructions appear inconsistent with normal wire transfer practices. For example: The member directs the credit union to wire the funds to a foreign country and advises the credit union to expect same day return of funds from sources different than the beneficiary named, thereby changing the source of the funds.
- No change in form of currency. Funds or proceeds of a cash deposit may be wired to another country without changing the form of currency.
- Questions or discussions on how to avoid reporting\record keeping. This involves discussions by members or employees about ways to bypass the filing of a Currency and Transaction Reports or the recording of the purchase of a monetary instrument.

**Other
Activities**

- Member attempts to influence a credit union employee not to file a report. This would involve any attempt by an individual or group to threaten, bribe, or otherwise corruptly influence a bank employee to bypass the filing of a Currency Transaction Report, recording of purchases of monetary instruments or filing a Suspicious Activity Report.
- Lavish lifestyles of customers or credit union employees. Lavish lifestyles of customer or employees, which are not supported by their current salary, may indicate possible involvement in money laundering activities.
- Short-term or no vacations. A credit union employee may no vacation or only take short vacations.
- Circumvention of internal control procedures. Overrides of internal controls, recurring exceptions, and out of balance conditions may indicate money laundering activities. For example, credit union employees may circumvent wire transfer authorizations and approval policies, or could split wire transfers to avoid ceiling limitations.
- Incorrect or incomplete CTRs. Employees may frequently submit incorrect or incomplete Currency Transaction Reports.

Definitions

Monitory Instruments consist of the following:

- United States coins and currency
- Coins and currency of a foreign country (as prescribed by the Secretary of Treasury).
- Traveler's checks, bearer negotiable instruments, bearer investment securities, bearer securities, stock on which title is passed on delivery and similar material.
- Checks, drafts, notes, money orders, and other similar instruments, which are drawn on or by a foreign financial institution.

Chapter 19

CONSUMER COMPLIANCE

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Chapter 19

CONSUMER COMPLIANCE

Examination Objectives

- Determine whether the credit union complies with consumer compliance regulations
- Determine whether the credit union protects its members from violations of their consumer rights
- Determine whether the credit union initiates corrective action if it becomes aware of consumer compliance violations

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with appropriate consumer compliance regulations; and
- Reputation risk can occur when the credit union incurs fines, penalties, and poor publicity as a result of failure to comply with the appropriate consumer compliance regulations; and
- Strategic risk can occur when management fails to perform adequate planning and due diligence in regard to consumer compliance regulations.

Overview

NCUA is the federal agency assigned with the enforcement authority for a broad range of consumer regulations that apply to federally-chartered credit unions and, to a lesser degree, federally insured state-chartered credit unions. This authority confers to examiners' responsibility for providing a satisfactory level of oversight for compliance activities. This oversight is necessary in order to:

- Assure credit union members that their credit union meets the required statutory and regulatory requirements for which NCUA has oversight enforcement responsibility; and
- Provide adequate reporting to Congress.

Compliance risk obviously exists in blatant violations of law. However, it may also arise in situations where ambiguous or untested laws or rules govern certain credit union products or member activities. Compliance risk exposes the credit union to fines, civil

money penalties, payment of damages, and the voiding of contracts. It can result in diminished reputation, limited opportunities, reduced field of membership expansion potential, and lack of contract enforceability.

**Consumer
Compliance
Program**

NCUA's Consumer Compliance Program uses a tiered approach to compliance using field examiners, compliance subject matter examiners (SMEs), regional compliance analysts, and the Office of Examination and Insurance compliance program officers. The program strives to balance (1) examiners' knowledge of consumer compliance laws, (2) the need for an efficient, risk-focused use of resources, and (3) the responsibility for collecting reliable data about the credit union's compliance practices.

**Field
Examiners**

Examiners provide basic compliance oversight in the course of the risk-focused examination program or insurance review. A credit union's compliance risk profile can change rapidly due to innovation of products and services, changes in regulation, competitive pressures, field of membership expansion, and the revolution in information technology.

Examiners identify the level of risk inherent in a credit union's consumer compliance activities based on the complexity of operations, management's level of due diligence regarding compliance issues for existing, new, and proposed products and services, and the extent to which management devotes resources to ensure compliance. For example, in large, complex credit unions with resident compliance personnel, examiners may limit their reviews. They may discuss the credit union's compliance policies and practices with staff responsible for ensuring compliance and monitoring requirements. In contrast, the focus at smaller credit unions or credit unions with limited internal controls may include verifying information through more extensive transaction testing.

**Compliance
Subject Matter
Examiners**

SMEs serve as resource persons for field examiners. They provide advice and support to examiners. SMEs assist the examiners by providing specific guidance in their area of expertise.

During the planning process, examiners may request and arrange through their supervisory examiners for participation of an SME on a particular examination. Requesting a compliance SME may be appropriate when examiners deem a high risk exists in the compliance area, in large complex credit unions with substantial compliance exposure, in credit unions that have not received a compliance review for several examinations, or in other cases where the examiner can support the need for a SME. Examiners must balance their request for resources with existing or potential risk.

SMEs will receive training and resource material to assist them in providing this additional level of support, assistance, and guidance to examiners. Examiners may refer (with supervisory examiner concurrence) unresolved compliance issues or evidence or suspicion of noncompliance to the regional compliance analyst for further action.

**Regional
Compliance
Analysts**

Regional compliance analysts serve as the regional point of contact. They monitor training needs, provide applicable training, and perform in-depth compliance reviews. Information from the following sources may trigger a compliance review:

- The risk-focused examination process;
- The Consumer Regulation Violation Log (CRVL);
- Home Mortgage Disclosure Act (HMDA) data or similar information;
- Member complaints;
- Referral by another government entity; or
- Random sample.

Regional compliance analysts manage, coordinate, and collect compliance data within the region for reporting purposes. These duties include:

- Serving as the regional compliance expert for SMEs and field examiners;
- Analyzing regional compliance information to assist in directing special examination procedures; and,
- Reviewing the accuracy of the region's reported violations.

Regional analysts also serve as contacts for credit union personnel requesting assistance or information on consumer regulations. For example, the regional compliance analysts receive annual HMDA data for the region, which they review to determine compliance and fair lending risks. They will consider credit unions displaying significant compliance risk for a fair lending review. The regions determine which credit unions, if any, should receive fair lending reviews.

**Compliance
Program
Officer (E&I)**

The compliance program officer serves as the agency contact in the area of consumer compliance regulation and enforcement. The compliance program officers are responsible for:

- Coordinating the collection of data for reporting purposes to Congress and others;
- Development of training programs (based on regional input) for field staff, SMEs, and regional compliance analysts, and
- Development of examination and supervision activities for compliance matters.

The compliance program officers serve as resource persons for regional compliance analysts and interfaces with other governmental agencies and offices, e.g. FFIEC.

**Examination
Procedures**

Examiners may use their discretion to determine the level of review of a credit union's consumer compliance program. Factors that may lead an examiner to consider an increased risk exists in the compliance area resulting in the need to expand the examination scope include:

- New products or services offered by the credit union that fall under a consumer compliance regulation;
- New consumer compliance regulation affecting the credit union industry;
- A change in credit union staff responsible for compliance with consumer laws;
- Length of time since an NCUA examiner performed a review of the area;
- Volume and severity of consumer complaints; or

- Current or pending litigation regarding consumer compliance issues.

Examiners may refer concerns or questions raised through the field review to a SME for guidance and assistance. They may refer exceptions or trends that indicate noncompliance beyond the scope of the examiner or SME to the regional compliance analyst for consideration.

AIRES contains a compliance questionnaire for each consumer compliance regulation for which NCUA has enforcement authority. Each questionnaire includes the following key components:

- A summary of the basic purpose of the law/regulation;
- NCUA's enforcement responsibility;
- Penalties resulting from failure to comply; and
- Key questions to consider during a review.

The checklist addresses only those areas that require an onsite review and are within the knowledge and training level of the field examiner.

**State
Chartered
Credit Unions**

NCUA uses the examination work product of state examiners in cases where the state supervisory authority agrees to perform compliance reviews. For those states that have not agreed to perform compliance reviews, NCUA assumes responsibility for only those regulations for which it has enforcement authority.

The regions ensure performance of a compliance review of applicable consumer compliance regulations on each state-chartered credit union as risks warrant.

**Additional
Information**

Illustration 19-A contains a list of laws and enforcement authorities for credit unions. The Appendices to this Chapter contain information about the individual consumer compliance regulations.

Laws and Enforcement Authorities for Credit Unions

Law or Regulation	FCUs	FISCUs	Non-federally insured CUs
B - Equal Credit Opportunity	NCUA	FTC	FTC
BSA – Bank Secrecy Act	NCUA	NCUA	TREAS
C - Home Mortgage Disclosure Act	NCUA	NCUA	NCUA
CC - Expedited Funds Availability Act	NCUA	NCUA	FED
COPPA - Children's Online Privacy Protection Act	NCUA	FTC	FTC
D - Reserves on Transaction Accounts	NCUA	NCUA	FED
E - Electronic Funds Transfer Act	NCUA	FTC	FTC
FCPR - Fair Credit Practice Rule	NCUA	FTC	FTC
FCRA - Fair Credit Reporting Act	NCUA	FTC	FTC
FDCPA - Fair Debt Collection Practices Act	NCUA	FTC	FTC
FDPA – Flood Disaster Protection Act	NCUA	NCUA	¹
FHA - Fair Housing Act	HUD	HUD	HUD
HIDC - Holder in Due Course	FTC	FTC	FTC
HOPA - Homeowners Protection Act	NCUA	NCUA	NCUA
M – Consumer Leasing	NCUA	FTC	FTC
Management Official Interlocks Act	NCUA	NCUA	DOJ
Privacy of Consumer Financial Information	NCUA	NCUA	FTC
RESPA - Real Estate Settlement Procedures Act	HUD	HUD	HUD
RFPA - Right to Financial Privacy Act	PCA	PCA	PCA
SSRA - Soldiers and Sailors Relief Act	PCA	PCA	PCA
TIS - Truth in Savings Act	NCUA	NCUA	NCUA
Z - Truth in Lending	NCUA	FTC	FTC

Legend:

DOJ	Department of Justice
FED	Federal Reserve Board
FHA	Federal Housing Administration
FTC	Federal Trade Commission
HUD	Dept. of Housing and Urban Development
PCA	Private Cause of Action
TREAS	Treasury Department
VA	Veterans Administration

NOTE: Although NCUA is not the primary enforcer under some of these regulations, Title II of the FCU Act authorizes NCUA to take cease and desist actions for violations of any law.

Illustration 19-A

¹ Non-federally insured credit unions are not covered per se. They are only covered if they sell loans on the secondary market to government sponsored enterprises (GSEs), such as Fannie Mae or Freddie Mac, which cannot buy unless the loan conforms with flood guidelines.

CREDIT PRACTICES RULE – APPENDIX 19A

Examination Objectives

- Determine whether the credit union's loan contracts are free from prohibited credit practices
- Determine whether the credit union accurately represents a cosigner's obligation and provides a notice to cosigner
- Determine whether the credit union's method of collecting late charges complies with the regulation
- Determine whether the credit union initiates corrective action if it becomes aware of a violation

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the Credit Practices Rule; and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with the Credit Practices Rule.

Overview

Part 706 of the *NCUA Rules and Regulations* implements the requirements of Subpart B of Regulation AA, also known as the Credit Practices Rule, for federal credit unions. The regulation defines unfair or deceptive acts or practices of credit unions in connection with extensions of credit to consumers. The Federal Trade Commission (FTC) has enforcement authority for the Credit Practices Rule for state-chartered credit unions.

The Credit Practices Rule is broken down into three parts:

- Unfair Credit-Contract Provisions;
- Unfair or Deceptive Practices Involving Cosigners; and
- Unfair Late Charges.

Contract Provisions

It is an unfair act or practice for a credit union, directly or indirectly, to take or receive from a member an obligation in connection with the extension of credit that:

- Constitutes or contains a cognovit or confession of judgment, warrant of attorney, or other waiver of the right to notice and the opportunity to be heard in the event of suit or process thereon;
- Constitutes or contains an executory waiver or a limitation of exemption from attachment, execution, or other process on real or personal property held, owned by, or due to the consumer, unless the waiver applies solely to property subject to a security interest executed in connection with the obligation; or
- Constitutes or contains an assignment of wages or other earnings unless:
 - The assignment by its terms is revocable at the will of the debtor, or
 - The assignment is a payroll deduction plan or preauthorized payment plan, commencing at the time of the transaction, in which the member authorizes a series of wage deductions as a method of making each payment, or
 - The assignment applies only to wages or other earnings already earned at the time of the assignment
- Constitutes or contains a nonpossessory security interest in household goods other than a purchase money security interest.

Cosigners

In connection with the extension of credit to members, it is:

- A deceptive act or practice for a credit union, directly or indirectly, to misrepresent the nature or extent of cosigner liability to any person; or
- An unfair act or practice for a credit union, directly or indirectly, to obligate a cosigner unless the cosigner is informed prior to becoming obligated.

To comply with the cosigner notification requirement, credit unions must provide a clear and conspicuous disclosure statement in writing to the cosigner prior to becoming obligated. The notice may be a separate document or included in the documents evidencing the consumer credit obligation.

Late Charges

In connection with collecting a debt arising out of an extension of credit to a member, it is an unfair act or practice for a credit union, directly or indirectly, to levy or collect any delinquency charge on a payment, if the payment is otherwise a full payment for the applicable period and is paid on its due date or within an applicable grace period, when the only delinquency is attributable to late fees or delinquency charges assessed on earlier installments. To do so would constitute “pyramiding” late fees.

Example: A member’s payments are \$40 a month. The member makes the February payment in full, but makes it late. The credit union assesses a \$5 late charge. The member makes a March payment of \$40 on time, but fails to pay the \$5 late charge. The credit union uses part of the March payment to pay off the outstanding late charge, and then considers the March payment deficient. The credit union may not assess another late charge since the March payment was made in full and on time.

Examination Procedures

An examiner may perform one or more of the following examination procedures, depending on the scope of the review.

- Evaluate loan contracts to determine whether they are free from prohibited credit practices;
- Review the late payment accounting process to verify whether it complies with the prohibition of pyramiding late fees;
- Review cosigned loans and verify that the credit union provided a written notice to cosigner;
- Complete the Credit Practices Rule checklist in AIREs, which provides informative guidance on the requirements of the regulation for each question; and
- Report a violation of the Credit Practices Rule on the Violations form in AIREs.

Additional Information

Additional information is available in Part 706 of *NCUA Rules and Regulations*. In addition, the Staff Commentary on Regulation AA provides question and answer examples. Examiners can access it at www.federalreserve.gov.

EQUAL CREDIT OPPORTUNITY ACT – APPENDIX 19B

Examination Objectives

- Determine whether the credit union discriminates in the granting of credit on any of the bases prohibited by the Equal Credit Opportunity Act (ECOA)
- Determine if the credit union has procedures in place for complying with the requirements of the ECOA

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the ECOA; and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with ECOA.

Overview

The purpose of the Equal Credit Opportunity Act (ECOA) is to promote availability of credit to all creditworthy applicants without regard to race, color, religion, national origin, sex, marital status, age (provided the applicant has the capacity to contract), receipt of public assistance, or good faith exercise of any rights under the Consumer Credit Protection Act.

The basic rule of the ECOA, also known as Regulation B, as found in §202.4, is:

"A creditor shall not discriminate against any applicant on a prohibited basis with respect to any aspect of a credit transaction."

Prohibited basis refers not only to the characteristics of the applicant but also to the characteristics of individuals with whom the applicant is affiliated or with whom the applicant associates. Therefore, a credit union may not discriminate against a member-applicant based on a prohibited basis characteristic of an associated individual. For example, a credit union cannot discriminate against an applicant because of the race of the residents in the neighborhood where the collateral property is located.

Credit transaction means every aspect of an applicant's dealings with a credit union regarding an application for credit or an existing extension of credit including, but not limited to, information requirements, investigation procedures, standards of creditworthiness, terms of credit, furnishing of credit information, revocation, alteration, or termination of credit, and collection procedures.

Regulation B also requires credit unions to do the following:

- Notify applicants of the credit decision within 30 days of receiving a completed application;
- Retain records of credit applications for 25 months after notifying the member of its credit decision;
- Collect information about the applicant's race and other personal characteristics in applications for certain dwelling-related loans; and,
- Provide applicants with copies of appraisal reports used in connection with credit transactions.

Credit Applications

Regulation B prevents credit unions from discouraging prospective applicants from making or pursuing an application.

Credit unions should use industry standard form applications. A credit union choosing to use a non-standard credit application form should obtain a legal opinion stating the forms comply with the applicable legal requirements.

The application may request any information, except for the following:

- Information about the member's spouse, unless the spouse will use or is contractually liable on the account or the applicant relies on the spouse's income;
- Information about the member's marital status when applying for unsecured credit; when applying for secured credit, the application may use only the terms married, unmarried, or separated;
- Information about the member's sex, race, color, religion, and national origin; and,
- Information about childrearing or childbearing such as birth control practices, intentions, or capability to bear children.

A credit union may consider any information obtained in the credit application provided it does not use the information to discriminate against an applicant on a prohibited basis. An exception to this rule relates to the consideration of age in determining an applicant's creditworthiness.

Effects Test

While not specifically mentioned in the ECOA, the legislative history of the ECOA indicates Congress intended an "effects test" concept to apply to a credit union's determination of creditworthiness. The effects test refers to a credit practice that appears facially neutral, but has a disproportionately negative effect on a prohibited basis, even though the credit union has no intent to discriminate. This type of practice is discriminatory, in effect, unless the credit union can demonstrate the practice meets a legitimate business need that cannot be reasonably achieved by means less disparate in impact.

Answering the following questions should assist the examiner in determining if the credit union's credit practices result in a potential violation of the effects test:

1. Does a particular credit practice have a statistically disproportionate impact on a protected group (those covered under the prohibited basis definition)?
2. If so, can the credit union show that the practice serves a genuine business need?
3. If so, is there a less discriminating way to meet that business need?

Appraisals

Credit unions subject to NCUA's regulations are not subject to the appraisal requirements of the ECOA. However, *NCUA Rules and Regulations* §703.1(c)(5) requires a credit union to make available to any requesting member a copy of the appraisal used in conjunction with that member's real estate loan application. The credit union must make that appraisal available for 25 months after the member was notified of the action taken on the credit application.

Enforcement

The National Credit Union Administration Board has responsibility for enforcement among federal credit unions, while the Federal Trade

Commission enforces Regulation B for state-chartered credit unions (12 C.F.R. Part 202 Appendix A). Regulation B contains a civil liability provision. Examiners should determine the adequacy of each credit union's compliance with Regulation B during routine examinations by evaluating patterns and practices. Examiners should note violations, and obtain agreements with management for prompt correction of violations.

Examination Procedures

An examiner may perform one or more of the following examination procedures, depending on the scope of the review:

- Determine whether the credit union has established policies and procedures with regard to Equal Credit Opportunity;
- Determine that all applicable forms (i.e., applications and adverse action notifications) are neutral in terms such as sex; titles are optional; married, unmarried, and separated are the only marital status terms used, etc. When the credit union uses nonstandard forms, the examiner should ask the credit union to provide a legal opinion supporting the use of the forms;
- Determine that the credit union complies with the adverse action notification requirements;
- Determine that the credit union maintains appropriate records as required by the regulation;
- Determine that the credit union requests and documents the monitoring information on real estate related applications;
- Complete the applicable Regulation B checklist in AIRES, which provides informative guidance on the requirements of the regulation for each question; and
- Notify the supervisory examiner if a pattern or practice of ECOA violations becomes evident in the examination process and report the violation on the Violations form in AIRES.

Additional Information

The Federal Reserve Board's website contains additional information at <http://www.federalreserve.gov>. The Publications Services Unit at (202) 452-3245 has copies of the regulation and staff commentaries issued by the Federal Reserve System available.

HOME MORTGAGE DISCLOSURE ACT – APPENDIX 19C

Examination Objectives

- Determine whether the credit union meets the criteria that triggers HMDA reporting
- Determine whether the credit union complies with the reporting requirements of the Act and Regulation
- Determine whether the credit union has implemented adequate policies, practices, and internal controls to ensure compliance with the Act and Regulation

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with HMDA; and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with HMDA.

HMDA - Regulation C

Regulation C implements the requirements of the Home Mortgage Disclosure Act (HMDA). It requires certain credit unions and credit union service organizations to report data about home purchase and home improvement loans they originate, purchase, or for which they receive applications. In general, they must report:

- Data about each application or loan (such as loan type and amount) and the location of the dwelling to which it relates; and
- The race or national origin, sex, and gross annual income of the applicant or borrower.

The purpose of Regulation C is to provide the public with data that can be used to:

- Help determine whether credit unions serve the housing needs of their communities;
- Assist public officials in distributing public-sector investments in order to attract private investment to areas needing it; and,
- Assist in identifying possible discriminatory lending patterns and enforcing compliance with anti-discrimination statutes.

Regulation C is not intended to encourage unsound lending practices or the extension of credit.

Exempt Institutions

A credit union is exempt from the requirements of the regulation for a given calendar year if on the preceding December 31:

- It had neither a home office nor a branch office in a metropolitan statistical area (MSA); or
- Total assets were at or below the threshold established by the Federal Reserve Board (Board). The Board adjusts the threshold based on the year-to-year change in the average of the Consumer Price Index for Urban Wage Earners and Clerical Workers, not seasonally adjusted, for each twelve-month period ending in November, with rounding to the nearest million. NCUA notifies credit unions about the asset threshold change each year in a Regulatory Alert; or
- It made no first-lien home purchase loans (including refinancings of home purchase loans) on one-to-four family dwellings in the preceding calendar year.

Disclosure and Reporting

Non-exempt credit unions must maintain a loan/application register (LAR) on which it will enter data about each application received and each loan originated and purchased. The credit union must send the LAR to its supervisory agency by March 1 following the calendar year to which the loan data relate.

The credit union must make its mortgage loan disclosure statement (provided by the Federal Financial Institutions Examination Council (FFIEC)) available to the public at its home office no later than three business days after receiving it. In addition, if a credit union has branch offices in other MSAs, it must make disclosures available using one of two options:

- It can make the statement available in at least one office in each of those MSAs, within ten business days of receipt from the FFIEC; or
- It can send a copy of the statement if someone makes a written request, within fifteen calendar days of receiving the request. If the

credit union chooses this option, it must post the address for requesting copies in each branch office in an MSA.

Enforcement NCUA enforces compliance with HMDA for all credit unions required to report and may impose administrative sanctions, including the imposition of civil money penalties. NCUA does not consider it an error in compiling or recording required data a violation of the regulation if it was unintentional and occurred despite the credit union's maintenance of procedures reasonably adopted to avoid such errors.

Examination Procedures An examiner may perform one or more of the following examination procedures, depending on the scope of the review.

- Determine whether the credit union has adequate procedures in place for collecting and maintaining accurate data regarding each loan application, loan origination, and purchase of loans;
- Assess whether the individuals responsible for preparing and maintaining the data understand the regulatory requirements and have the resources and tools needed to produce complete and accurate data;
- Determine whether the credit union accurately submitted its HMDA-LAR in an automated, machine-readable form or via Internet email (credit unions that report 25 or fewer entries may report the data in paper form);
- Verify that the credit union properly retains a copy of the register; and
- Determine whether the credit union makes the mortgage loan disclosure statements available in its home office and branch offices located in MSAs by the applicable deadline.

Additional Information Credit unions engaged in mortgage lending should obtain the publication *A Guide to HMDA Reporting: Getting it Right!* Credit unions may obtain a copy from the NCUA publications office or they can download it from the NCUA web site at www.ncua.gov.

EXPEDITED FUNDS AVAILABILITY ACT – APPENDIX 19D

Examination Objective • Determine whether the credit union’s funds availability policy and procedures meet the requirements of the regulation

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the Expedited Funds Availability Act; and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with the Expedited Funds Availability Act.

Overview Regulation CC implements the requirements of the Expedited Funds Availability Act. The purpose of the regulation is to ensure prompt availability of funds and to expedite the return of checks.

The major provisions of Regulation CC include:

- Establishing maximum holds that credit unions can place on deposits; and.
- Requiring credit unions to disclose their funds availability policies to members.

In general, deposited funds fall into one of three categories of availability.

Next-Day Availability Credit unions should make certain types of funds available for withdrawal not later than the business day after the banking day the funds were deposited. The following types of funds generally meet the standards for next-day availability:

- Cash deposits made in person to an employee of the credit union;
- Electronic payments;
- Checks drawn on the Treasury of the United States or a state or local government;

- U.S. Postal Service money order;
- Cashier's, certified, or teller's check.
- Check drawn on a Federal Reserve Bank or Federal Home Loan Bank; and
- Checks deposited in a branch of the credit union and drawn on the same or another branch of the same credit union if both branches are located in the same state or the same check-processing region.

In most cases, the types of funds listed above must be deposited in person to an employee of the credit union and in an account of the payee.

**Second Day
Availability**

A credit union must make funds deposited in an account by check available for withdrawal not later than the second business day following the banking day the funds are deposited, in the case of

- A local check;
- A check drawn on the Treasury of the United States that is not governed by the next-day availability requirements;
- A U.S. Postal Service money order that is not governed by the next-day availability requirements; or
- A check drawn on a Federal Reserve Bank or Federal Home Loan Bank; a check drawn by a state or unit of general local government; or a cashier's, certified, or teller's check; if any check referred to is a local check that is not governed by the next-day availability requirements.

**Fifth Day
Availability**

A credit union must make funds deposited in an account by a check available for withdrawal not later than the fifth business day following the banking day funds are deposited, in the case of

- A nonlocal check; and
- A check drawn on a Federal Reserve Bank or Federal Home Loan Bank; a check drawn by a state or unit of general local government; or a cashier's, certified, or teller's check; or a check deposited in a branch of the depository credit union and drawn on the same or another branch of the same credit union; if any check referred to is

a nonlocal check that is not governed by the next-day availability requirements.

Credit unions must make available for withdrawal by cash or check funds deposited in an account at a nonproprietary ATM not later than the fifth business day following the banking day the funds are deposited.

Exceptions

Exceptions to the availability schedule apply in the case of:

- New accounts;
- Large deposits (\$5,000 or greater);
- Redeposited checks;
- Repeated overdrafts;
- Reasonable cause to doubt collectibility; and,
- Emergency conditions.

Disclosure Requirements

A credit union shall make disclosures clearly and conspicuously in writing. Disclosures, other than those posted at locations where employees accept consumer deposits and ATMs and the notice on preprinted deposit slips, must be a form that the member may keep. The disclosures must be grouped together and must not contain any information not related to the disclosures. If contained in a document that sets forth other account terms, the disclosures must be highlighted within the document.

Examination Procedures

An examiner may perform the following examination procedures, depending on the scope of the review.

- Review the credit union's funds availability policy and procedures;
- Review the credit union's funds availability policy disclosures and exception notices;
- Determine the extent and adequacy of the instruction and training provided to the individuals responsible for the implementation of the credit union's funds availability policy and procedures and whether it adequately enables them to carry out their assigned responsibilities in conformance with Regulation CC; and

- Verify that the credit union provides employees with a written statement regarding the procedures that pertain to that employee's function.

**Additional
Information**

Additional information is available on the Federal Reserve Board's website at www.federalreserve.gov.

CHILDREN'S ONLINE PRIVACY PROTECTION ACT – APPENDIX 19E

Examination Objectives

- Determine whether the credit union's website collects personal information from children under 13
- Determine whether the credit union discloses its privacy notice and obtains verifiable parental consent

Risk Categories

The following risk categories apply to the compliance area:

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with COPPA; and
- Reputation risk can occur when the credit union incurs fines or damaging publicity as a result of failure to comply with COPPA.

Overview

The Children's Online Privacy Protection Act (COPPA) applies to the online collection of personal information from children under age 13. The rule spells out what a website operator must include in a privacy policy, when and how to seek verifiable consent from a parent, and what responsibilities an operator has to protect children's privacy and safety online.

Credit unions who operate a commercial website or an online service directed to children under 13 that collects personal information from children must comply with COPPA. A credit union must also comply if it operates a general audience website and has *actual knowledge* that it is collecting personal information from children.

Personal Information

COPPA applies to individually identifiable information about a child that is collected online, such as full name, home address, email address, telephone number or any other information that would allow someone to identify or contact a child. COPPA also covers other types of information (e.g., hobbies, interests and information collected through cookies or other types of tracking mechanisms) when it is tied to individually identifiable information.

Basic COPPA Provisions

If the credit union is subject to the requirements of COPPA, a link to its privacy notice must appear on the home page of its website or online service and at each area where it collects personal information from children. If the credit union operates a general audience site with a separate children's area, it must post a clear and prominent link to its privacy notice on the home page of the children's area. Credit unions may wish to emphasize the link by using a larger font size or a different color type on a contrasting background.

Privacy Notice

COPPA requires a clearly written and understandable privacy notice that includes the following information:

- Name and contact information of the credit union;
- Types of personal information collected from children and the procedures used for collecting the information;
- How the credit union uses the personal information;
- Whether the credit union discloses the information to third parties;
- Notification that the parent has the option to agree to the collection and use of the child's information without consenting to its disclosure to third parties;
- Notification that the credit union may not require a child to disclose more information than is reasonably necessary to participate in an activity as a condition of participation; and
- Notification that the parent can review the child's personal information, ask to have it deleted, and refuse to allow any further collection or use of the child's information. The notice also must state the procedures for the parent to follow.

Notice to Parents

The notice to parents must contain the same information included on the notice on the website. The credit union must notify a parent that it wishes to collect personal information from the child. The notice must also state that the parent's consent is required for the collection, use, and disclosure of the information and how the parent can provide consent. The credit union must obtain verifiable consent, meaning that the credit union must make reasonable efforts to ensure that the parent receives the notice and consents. The required method of consent depends on the use of the child's information.

**Examination
Procedures**

An examiner may perform the following examination procedures, depending on the scope of the review:

- Review the credit union's privacy notice to determine whether it contains the information required by COPPA;
- Review the notice to parents and determine how the credit union obtains verifiable consent; and
- Review the credit union's procedures and internal controls for maintaining and disclosing personal information collected from children under 13.

**Additional
Information**

Additional information is available on the Federal Trade Commission's (FTC) website at www.ftc.gov/kidzprivacy or through the FTC's Consumer Response Center at 1-877-FTC-HELP.

ELECTRONIC FUNDS TRANSFER ACT – APPENDIX 19F

Examination Objectives

- Determine that the credit union has procedures in place to ensure compliance with the Electronic Funds Transfers Act (EFTA)
- Determine that the credit union complies with the provisions of the EFTA

Risk Category

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the EFTA.

Overview

Regulation E implements the provisions of the EFTA. The regulation establishes the basic rights, liabilities, and responsibilities of consumers who use electronic fund transfer services and of credit unions that offer these services. The primary objective of the regulation is the protection of individual consumers engaging in electronic fund transfers.

The term electronic fund transfer means any transfer of funds initiated through an electronic terminal, telephone, computer, or magnetic tape for the purpose of ordering, instructing, or authorizing a credit union to debit or credit an account. The term includes, but is not limited to:

- Point-of-sale transfers;
- Automated teller machine transfers;
- Direct deposits or withdrawals of funds;
- Transfers initiated by telephone; and
- Transfers resulting from debit card transactions, whether or not they were initiated through an electronic terminal.

The term electronic fund transfer does not include:

- Checks. Any transfer of funds originated by check, draft, or similar paper instrument; or any payment made by check, draft, or similar paper instrument at an electronic terminal;

- Wire or other similar transfers. Any transfer of funds through Fedwire or through a similar wire transfer system used primarily for transfers between financial institutions or between businesses;
- Automatic transfers by account-holding institution. Any transfer of funds under an agreement between a consumer and a financial institution which provides that the institution will initiate individual transfers without a specific request from the consumer; or
- Telephone-initiated transfers. Any transfer of funds initiated by a telephone communication between a consumer and a financial institution making the transfer; and does not take place under a telephone bill-payment or other written plan in which periodic or recurring transfers are contemplated.

**Access
Devices**

An access device is a card, code, or other means of access to a member's account, or any combination thereof, which the member may use to initiate electronic fund transfers.

A credit union may issue a solicited access device:

- In response to an oral or written request for the device; or
- As a renewal of, or in substitution for, an accepted access device whether issued by the institution or a successor.

A credit union may only issue an unsolicited access device if it is:

- Not validated, meaning that the credit union has not yet performed all the procedures that would enable a member to initiate an electronic fund transfer using the access device;
- Accompanied by a clear explanation that the access device is not validated and provides information as to how members may dispose of it if they do not desire to validate the device;
- Accompanied by the disclosures of the member's rights and liabilities that will apply if the access device is validated; and
- Validated only in response to the member's oral or written request for validation, after the institution has verified the member's identity by a reasonable means.

Disclosures

Regulation E requires credit unions to provide members with an initial disclosure at the time the member contracts for an electronic fund transfer service or before making the first electronic fund transfer involving the member's account. The disclosure must contain the following information:

- Liability of the member;
- Telephone number and address of the office to be notified in the case of an unauthorized electronic fund transfer;
- Business days;
- Types of transfers and limitations;
- Fees;
- Summary of the member's right to receipts and periodic statements;
- Stop payment rights;
- Liability of the credit union;
- Circumstances in which the credit union may provide information about the member's account to third parties;
- Error resolution; and
- ATM fees.

If adverse changes in fees, the member's liability, types of transfers available, or limits on transfers occur, the credit union must provide a change-in-terms notice at least 21 days before the changes take effect. The credit union must periodically send a reminder of the error-resolution procedures. It may send a detailed notice annually or provide an abbreviated notice with each account statement.

Members must receive a receipt when they initiate an electronic transfer, and documentation monthly in the form of periodic statements. Both documents must include the type of electronic transfer, the amount and date of the transaction, and the location of the terminal.

Liability for Unauthorized Transfers

A member's liability for unauthorized electronic fund transfers, such as those arising from loss or theft of an access device, is limited to \$50 if notice is given within two business days after learning of the theft or loss. If the member fails to notify the credit union within the

established time frames, the amount of liability shall not exceed the lesser of \$500 or the sum of:

- \$50 or the amount of unauthorized transfers that occur within the two business days, whichever is less; and
- The amount of unauthorized transfers that occur after the close of two business days and before notice to the credit union, provided the credit union establishes that these transfers would not have occurred had the member notified the credit union within that two-day period.

Examination Procedures

An examiner may perform the following examination procedures, depending on the scope of the review.

- Review the credit union's policy and procedures for complying with Regulation E;
- Review the credit union's Electronic Funds Transfer disclosures;
- Review policies regarding liability for unauthorized transfers;
- Review policies regarding issuance of access devices; and
- Perform tests on transactions to determine whether the credit union has implemented the above policy and procedures.

Additional Information

Additional information is available on the Federal Reserve Board's website at www.federalreserve.gov.

E-SIGN ACT – APPENDIX 19G

Examination Objective

- Determine whether the credit union complies with the E-Sign Act when accepting electronic signatures and using electronic disclosures

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the E-Sign Act.

E-Sign Act

The E-Sign Act provides for facilitating the use of electronic records and signatures in commerce. The general rule of the E-Sign Act allows a signature, contract, or other record to be considered valid in an electronic format. To comply with the E-Sign Act, an electronic signature must be executed or adopted by a member with the intent to sign the record. Accordingly, regardless of the technology used to meet this requirement, the process must evidence the member's identity.

The following terms apply to the E-Sign Act:

Electronic: relating to technology having electrical, digital, magnetic, wireless, optical, electromagnetic, or similar capabilities.

Electronic Record: a contract or other record created, generated sent, communicated, received, or stored by electronic means.

Electronic Signature: an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.

Electronic Disclosures

The E-Sign Act permits credit unions to provide disclosures to members in an electronic format. The E-Sign Act does not affect the content or timing of any required disclosure.

Under the E-Sign Act, members must consent electronically or confirm their consent electronically, in order to demonstrate that they can access the information in the electronic format being used. Prior to consenting the credit union must provide the member with a clear and conspicuous statement informing the member of:

- The option to receive the document in paper form;
- The scope of the consent (single transaction or ongoing relationship);
- The right to withdraw consent to electronic disclosures and any consequences (fees or termination of account, for example);
- Hardware and software requirements (if these change and there is a material risk that consumers may not be able to access information, credit unions must provide notice of the changes and a right to withdraw consent); and
- The method to request and obtain a paper copy of an electronic record and any associated fee.

Delivery of Disclosures

A credit union that uses electronic communication to provide disclosures may send the disclosures to the member's designated electronic address (e-mail) or make them available at another location, such as the credit union's website. If the credit union makes the disclosure available at such a location, it effectively delivers the disclosure by sending a notice alerting the member when the member can access the disclosure and making the disclosure available for at least 90 days.

If an electronic disclosure is returned undelivered, the credit union must take reasonable steps to attempt redelivery (either electronically or to a postal address) based on information in the credit union's own files.

A credit union's inability to deliver a disclosure does not affect the timeliness of the disclosure, as long as the disclosure is initially sent in a time appropriate manner.

Record Retention

The E-Sign Act provides for meeting statutory record retention requirements by retaining an electronic record. The electronic record must accurately reflect the information set forth in the record and remain accessible to all persons who are entitled to it in a form that is capable of being accurately reproduced for later reference. An electronic record of the information on the front and back of the check satisfies the requirements for retention of checks.

**Examination
Procedures**

- Determine if the credit union has an informational or transactional web site;
- Determine if the credit union distributes required disclosures in an electronic format;
- Determine whether appropriate disclosures were provided to members for each product or service before completing the transaction; and
- Determine that disclosures are clear and conspicuous, provided in a form the consumer may retain and refer to, and consistent with model disclosure forms.

FAIR CREDIT REPORTING ACT – APPENDIX 19H

Examination Objectives

- Determine whether the credit union meets the requirements of the Fair Credit Reporting Act (FCRA) when it takes adverse action based, in whole or in part, on information obtained from outside sources; and
- Determine whether the credit union acts as a Consumer Reporting Agency (CRA), and if so, whether it complies with the CRA requirements of the FCRA.

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with FCRA; and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with FCRA.

Overview

The FCRA defines the responsibilities and liabilities of those who provide information to and access data from a Consumer Reporting Agency (CRA). The FCRA was designed to promote accuracy, fairness, and privacy of information in the files of every CRA by:

- Regulating the consumer reporting industry;
- Placing disclosure obligations on users of consumer reports;
- Ensuring fair, timely, and accurate reporting of credit information;
- Restricting the use of reports on consumers; and
- In certain situations, requiring the deletion of obsolete information.

Consumer Report

A consumer report means any written, oral or other communication of any information by a CRA bearing on a consumer's credit worthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or in part for the purpose of serving as a factor in establishing the consumer's eligibility for:

- Credit or insurance primarily used for personal, family, or household purposes;

- Employment purposes; or
- Any other purpose specifically stated in §604 of the FCRA.

The term credit report does not mean a report containing information solely about transactions or experiences between the consumer and the credit union.

Consumer Reporting Agency

A CRA is any person which, for monetary fees, dues, or on a cooperative nonprofit basis, regularly engages in whole or in part in the practice of assembling or evaluating consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties, and which uses any means or facility of interstate commerce for the purpose of preparing or furnishing consumer reports.

The FCRA contains additional requirements for organizations which function as a CRA, in addition to the requirements imposed on users and organizations reporting information to a CRA.

Compliance with the FCRA

The FCRA applies to creditors, employers, landlords, and other businesses that exchange consumer information with CRAs, including institutions that offer checking or share draft accounts.

The FCRA also affects lenders extending credit to an individual for business purposes or to a closely held business. When an individual is or will be personally liable for repayment of a loan for business purposes, such as an individual proprietor, co-signer, or guarantor, the loan is a consumer transaction.

Credit Union Consumer Reporting Agency

When one credit union provides another credit union or a CRA information about a member reported to it by another person or organization, the credit union is considered a CRA. It must comply with all the sections of the FCRA relating to CRAs concerning that member.

When a credit union provides information based solely on its own transactions with the member to another credit union or to a CRA, it is

not acting as a CRA. Similarly, if the credit union furnishes information from outside sources to another party involved in the same transaction, the credit union is not a CRA. Such parties could include an insurer or a guarantor (as in the case of FHA, VA, private insurers or insured student loan programs), other financial institutions participating in the transaction, or a collection agency engaged in the collection of the transaction.

Using Consumer Reports

Users of consumer reports must identify themselves to the CRA and certify that they will use the information they request as specified in the FCRA and will not use the information for any other purpose.

If the credit union takes any adverse action with respect to any member that is based in whole or in part on any information contained in a consumer report, the credit union must

- Provide oral, written, or electronic notice of the adverse action to the member;
- Provide to the member orally, in writing, or electronically:
 - The name, address, and telephone number of the consumer reporting agency (including a toll-free telephone number established by the agency if the agency compiles and maintains files on consumers on a nationwide basis) that furnished the report to the person; and
 - A statement that the consumer reporting agency did not make the decision to take the adverse action and cannot provide the member the specific reasons why the adverse action was taken; and
- Provide to the consumer an oral, written, or electronic notice of the consumer's right:
 - To obtain a free copy of a consumer report on the member from the consumer reporting agency;
 - To dispute with the consumer reporting agency the accuracy or completeness of any information in the consumer report furnished by the agency.

To do this, the credit union must supply a standard disclosure form that provides the member with information to gain access to the consumer report and make corrections, if necessary.

Information from Other Sources

If adverse action occurs on the basis of information obtained from a source other than a CRA, the credit union must disclose the applicant's right to file a written request for the nature of the information within 60 days of learning of the adverse action.

If a member requests it, the credit union must then disclose the nature of the information to the consumer, orally or in writing, in sufficient detail to enable the consumer to evaluate its accuracy. The credit union may disclose the source of the information, but is not required to do so.

Information in Credit Union Files

If a credit union takes adverse action because of information it has in its own files (which it has not obtained from outside sources) or on information given to it by the member, the credit union is not required to disclose the nature of the information on which the credit union based the denial of credit. However, most credit unions do give members this information as a matter of courtesy and to counsel them in resolving their financial problems.

(The disclosure forms developed for notifying applicants of adverse actions under Regulation B indicate that the credit union meets FCRA disclosure requirements.)

Documenting Compliance

Credit unions may disclose orally the information required under the FCRA. However, if the action resulting in a denial of credit under the FCRA also meets the definition of adverse action under Regulation B, the credit union must make additional disclosures to the consumer.

Although the credit union may provide the required disclosures for both the FCRA and Regulation B on the same disclosure form, they are independent and one cannot substitute for the other. To meet the requirements of both the FCRA and Regulation B, credit unions may wish to use form letters, copies of which may be kept in files with the

completed application forms. This practice allows internal monitoring of compliance and provides evidence in the event of litigation.

**Providing
Consumer
Information**

Anyone who furnishes information to a CRA:

- May not furnish information that it knows (or consciously avoids knowing) is inaccurate;
- Must notify CRAs when members voluntarily close credit accounts. This is important because some users may interpret a closed account as an indicator of bad credit unless it is clearly disclosed that the consumer, not the creditor, closed the account;
- Must notify the CRA within 90 days after reporting information about a delinquent account placed for collection, charged to profit or loss, or subject to any similar action, of the month and year the delinquency commenced that triggered reporting. It is important to note the correct date the delinquency commenced to compute how long derogatory information can be kept in a member's file; and
- Must correct incomplete or inaccurate information, resubmit it to each CRA, and report only the correct information in the future.

Once a credit union is notified that a member disputes information it provided on the consumer report, the credit union:

- May not give that information to any CRA without also telling the CRA that the information is in dispute;
- Must investigate the dispute and review all relevant information provided by the CRA about the dispute; and
- Must report its findings to the CRA involved and all national CRAs that received the information if the investigation shows the information to be incomplete or inaccurate.

The credit union should resolve the dispute within 30 days after receipt of a dispute notice from the member. If the member provides additional relevant information during the 30-day period, the CRA has an additional 15 days to complete the investigation. The CRA must give the credit union all relevant information that it gets within five business days of receipt and must promptly give additional relevant information provided by the member. If a credit union does not

investigate and respond within the specified time periods, the CRA must delete the disputed information from its files.

Penalties and Liabilities

Credit unions may be liable for willful noncompliance or negligent noncompliance as either users of information or as CRAs. Liability may include actual damages, punitive damages, court costs, and attorney's fees, depending on the type of noncompliance. If a credit union obtains a credit report under false pretenses it may receive a penalty of \$1,000 or actual damages, whichever is greater.

Examination Procedures

An examiner may perform the following examination procedures, depending on the scope of the review.

- Determine whether the credit union uses consumer reports or other outside information in evaluating credit applications.
- Review an adequate sample of rejected loan files to determine if the adverse action notice appropriately discloses the CRA information, if the credit denial was based on information it obtained from the CRA.
- Determine whether the credit union has procedures in place to provide consumers (upon request) the nature of the "other" outside information; and
- If the credit union is a CRA, determine whether it:
 - Provides required disclosures to consumers;
 - Does not report obsolete information;
 - Resolves accuracy disputes with the consumer;
 - Provides reports for only legitimate purposes;
 - Maintains proper records on each recipient of the information about the consumer;
 - Adequately trains personnel in the furnishing of information; and,
 - Maintains procedures to ensure maximum possible accuracy of information received, recorded, and reproduced.

Additional Information

For more information, call the FTC toll-free at 1-877-FTC-HELP (1-877-382-4357), or go to <http://www.FTC.gov>.

FAIR DEBT COLLECTION PRACTICES ACT

APPENDIX 19 I

Examination Objectives

- Determine whether the credit union is subject to the Fair Debt Collection Practices Act (FDCPA) by collecting consumer debts on behalf of another party
- Determine whether the credit union has procedures in place to comply with the FDCPA

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with FDCRA; and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with FDCRA.

Overview

The purpose of the FDCPA is (1) to eliminate abusive debt collection practices by debt collectors, (2) to ensure that those debt collectors who refrain from using abusive practices are not competitively disadvantaged, and (3) to promote consistent state action to protect consumers against debt collection abuses.

A credit union is considered a “debt collector” and is subject to the FDCPA only if it regularly collects consumer debts on behalf of another party, with some exceptions. If the credit union merely collects its own debts, in its own name, compliance with the FDCPA is not required. However, the credit union should avoid those practices prohibited under the FDCPA.

Prohibited Practices

Harassment or Abuse. A debt collector may not engage in any conduct the natural consequence of which is to harass, oppress, or abuse any person in connection with the collection of a debt. The following conduct is a violation of this section:

- Use or threat of use of violence or other criminal means to harm the physical person, reputation, or property of any person;
- Use of obscene or profane language;

- Publication of a list of consumers who allegedly refuse to pay debts;
- Advertisement for sale of any debt to coerce payment of the debt; or,
- Causing a telephone to ring or engaging any person in telephone conversation repeatedly or continuously with the intent to annoy, abuse, or harass any person at the called number.

False or Misleading Representations. A debt collector may not use any false, deceptive, or misleading representation or means in connection with the collection of any debt. Violations of this section include:

- The false representation of the character, amount, or legal status of any debt;
- The false representation or implication that any individual is an attorney or that any communication is from an attorney;
- The threat to take any action that cannot legally be taken or that is not intended to be taken; or,
- Communicating or threatening to communicate to any person credit information that is known to be false, including failure to communicate that a disputed debt is disputed.

Unfair Practices. A debt collector may not use unfair or unconscionable means to collect or attempt to collect any debt such as:

- Collecting interest, fees, charges, or expenses incidental to the principal obligation unless it is expressly authorized by the agreement;
- Depositing or threatening to deposit any postdated check prior to the date on the check; or,
- Causing charges to be made to any person for communications by the concealment of the true purpose of the communication, such as a collect telephone call.

Validation of Debts

A debt collector must send the consumer a written notice within five days after the initial communication unless the following information is contained in the initial communication or the consumer has paid the debt:

- Amount of the debt;
- Name of the creditor to whom the debt is owed;
- A statement that the consumer must dispute the validity of the debt, or any portion thereof, within thirty days of receiving the notice, or the debt will be assumed to be valid by the debt collector;
- A statement that if the consumer disputes the debt in writing, the debt collector will obtain verification of the debt or a copy of a judgment against the consumer and mail it to the consumer; and,
- A statement that, upon the consumer's written request within thirty days, the debt collector will provide the name and address of the original creditor, if different from the current creditor.

Enforcement

The National Credit Union Administration is responsible for enforcement for federal credit unions, while the Federal Trade Commission (FTC) enforces the FDCPA for state-chartered credit unions. Any debt collector who fails to comply with any provision of the FDCPA is liable in an amount equal to the sum of any actual damage sustained by such person. Additional damages may be recovered, not to exceed \$1,000 for an individual plaintiff or named plaintiff in a class action suit, or \$500,000 or 1 percent of net worth for all other class members.

Examination Procedures

An examiner may perform one or more of the following examination procedures, depending on the scope of the review.

- Determine if the credit union meets the definition of a debt collector under the FDCPA;
- Determine if appropriate policies and procedures are in place to comply with the FDCPA; and,
- Review collection practices and procedures to determine if the credit union uses any of the prohibited practices while acting as a debt collector.

Additional Information

Additional information about the FDCPA is available on the FTC's website at www.ftc.gov.

FAIR HOUSING ACT – APPENDIX 19J

Examination Objectives

- Determine that the credit union evaluates each loan applicant's creditworthiness on an individual basis, without presuming the applicant has characteristics of a certain group
- Determine if the credit union's loan policies or procedures limit the inflow of applications from protected classes (pre-screening)
- Determine if the credit union rejects applications from any of the groups with a disproportionate frequency, or if its acceptance levels are disproportionately lower for one or more groups due to such factors as withdrawals or delays
- Determine whether the credit union has adequate economic justification for any policies or practices that have a disproportionately negative effect based on applicants' ages
- Determine if the credit union's lending patterns reflect more stringent loan terms (interest rate, loan maturity, loan-to-value ratio, etc.) for affected groups
- Determine whether the credit union provides reasons for the rejections (or other less than favorable actions) consistent with the credit union's underwriting criteria and whether the credit union uniformly applies them to all applicants and all areas

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the Fair Housing Act (FHA); and
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with the FHA.

Overview

The Fair Housing Act (FHA) provides fair housing throughout the United States by regulating many practices relating to housing. In particular, FHA makes it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap, or familial status.

The FHA works in conjunction with the Equal Credit Opportunity Act (ECOA) to prohibit discrimination on any of the prohibited bases by anyone who is in the business of providing loans for housing. *NCUA*

Rules and Regulations §701.31 summarizes the prohibitions on discrimination in real estate lending activities contained in the FHA and ECOA.

Non-Discrimination in Lending

A credit union may not deny a loan or other financial assistance for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling, nor may it discourage an application for such a loan, on the basis of the race, color, religion, handicap, familial status (having children under the age of 18), national origin, or sex of:

- The loan applicant or joint applicant;
- Any person associated with the loan applicant or joint applicant;
- The present or prospective owners, lessees, tenants, or occupants of other dwellings in the vicinity of the dwelling.

It is unlawful to discriminate because of race, color, religion, handicap, familial status, national origin, or sex in determining the:

- Amount;
- Interest rate;
- Duration; or
- Other credit terms.

The FHA prohibits the lender from considering the following factors because they are not necessary to a federal credit union's business and they generally have a discriminatory effect:

- Age or location of the dwelling;
- Zip code of the applicant's current residence;
- Previous home ownership;
- Age or location of dwellings in the neighborhood of the subject dwelling; or
- Income level of residents in the neighborhood of the dwelling.

A credit union may not rely on an appraisal that it knows or should know is based upon any prohibited bases or factors listed above.

Legal Interpretations

Because the FHA was broadly written by Congress, the courts have ruled a wide variety of lending practices illegal under the Act, including some that the Act itself does not specifically mention but which the courts determined are illegal because they violate implicit requirements and prohibitions. Examples of some prohibited practices include:

- Redlining on a racial basis. "Redlining" is the practice of denying loans for housing in certain neighborhoods even though the individual applicant may otherwise qualify for credit;
- Making excessively low appraisals in relation to purchase prices, based on prohibited considerations (closely akin to redlining);
- Discouraging applications for credit on prohibited bases, as well as outright denials. Taken together, the FHA and ECOA produce a strong statutory prohibition against prescreening or discouraging applicants by housing sellers or lenders, even to the point of ensuring that their advertising policies do not have that effect;
- The use of excessively burdensome qualification standards for the purpose, or with the effect, of denying housing to protected applicants;
- Applying differing standards or procedures in administering foreclosures, late charges, penalties, or reinstatements, or other collection procedures;
- Racial notation or code on appraisal forms or loan forms (other than the information which §202.13 of Regulation B requires the credit union to retain for monitoring purposes);
- Use by initial interview personnel of scripts designed to discourage protected applications; and
- Patterns of significantly greater or exclusive use of insured or guaranteed loan programs by protected groups or in certain areas. This may indicate illegal "steering" to this type of lending by the credit union.

Advertising

Credit unions may not directly or indirectly engage in any form of advertising of real estate related loans that implies or suggests the credit union discriminates.

Any credit union that advertises real estate related loans must prominently indicate in the advertisement, in a manner appropriate to

the advertising medium and format used, that it makes such loans without regard to the prohibited bases. In addition, every credit union engaged in real estate lending must provide a notice of nondiscrimination in its lobby. The notice must be clearly visible to the general public and must contain the logotype and language appearing in the FHA or *NCUA Rules and Regulations* §701.31(d)(3).

Enforcement

Persons who claim they were victims of discrimination may file a complaint with the United States Department of Housing and Urban Development (HUD) for processing under the FHA. HUD will investigate the complaint and may attempt to resolve the grievance through conference, conciliation, and persuasion. It is unlawful to coerce, intimidate, threaten, or interfere with any person in the exercise of, or because they have exercised, rights granted by certain sections of FHA.

Persons who believe they were discriminated against may also file a complaint with NCUA for processing under NCUA Regulations.

Examination Procedures

An examiner may perform one or more of the following examination procedures, depending on the scope of the review.

- Determine that the board has adopted policies, procedures, and general underwriting standards concerning nondiscrimination in lending;
- Determine that the officials review loan underwriting standards and related business practices regularly;
- Determine by reviewing rejected mortgage loan applications if the credit union engages in prohibited practices;
- Determine from the credit union's practices, records, and reports that it refrains from setting more stringent terms (down payments, interest rates, terms, fees, loan amounts, etc.) for housing-related loans in certain geographic areas located reasonably within its operational area. If the credit union imposes more stringent terms, determine from a review of loans in these areas whether the credit union used more stringent standards solely for documented economic reasons;

- Determine that the credit union does not discriminate on the basis of the racial composition or the income level of an area;
- Determine that the credit union does not discriminate on the basis of the language of applicants;
- Determine that the credit union has not set an arbitrary limit on loan size and the income required before granting a loan;
- Determine that the credit union refrains from using appraisals that discriminate;
- Determine that the credit union refrains from discounting appraised values (i.e., lowering the appraised value of property because of location or some negative comment in the appraisal form);
- Determine from reviewing approved and rejected loan applications that the credit union documents uniformly applied economic factors, such as (1) income and debt ratios, (2) credit history, (3) security property, (4) neighborhood amenities, and (5) personal assets;
- Determine from the loan review whether the credit union makes a disproportionate number of loans under one type of financing (FHA, VA, other alternative mortgage instruments);
- Based on a review of appropriate loan records, determine that the credit union administers the following without bias: (1) loan modifications, (2) loan assumptions, (3) additional collateral requirements, (4) late charges, (5) reinstatement fees, and (6) collections;
- Determine that the credit union has policies that prohibit the employees from making statements that would discourage the receipt or consideration of any application for a loan or other credit service;
- Visually determine whether the credit union has an Equal Housing Lender Poster located in a conspicuous place in all of the credit union's offices;
- Visually inspect the size and content of each nondiscrimination notice, such as the Equal Housing Lender Poster, to ensure it is clear and conspicuous and in compliance with the requirements of §701.31(d)(3) of the *NCUA Rules and Regulations*;
- Determine that a sampling of the credit union's advertising complies with the requirements of §701.31(d) of the *NCUA Rules and Regulations*;

- Determine that marketing practices ensure the availability of the credit union's services without discrimination to its field of membership;
- Complete the applicable FHA checklist in AIREs; and
- Document a violation of the FHA on the Violations form in AIREs.

**Additional
Information**

Please refer to §701.31(e) of the *NCUA Rules and Regulations* for additional guidelines concerning nondiscrimination in lending. In addition, information is available on HUD's website at www.hud.gov.

FLOOD DISASTER PROTECTION ACT – APPENDIX 19 K

Examination Objectives

- Determine whether a credit union performs required flood determinations for loans secured by improved real estate or a mobile home affixed to a permanent foundation in accordance with the final rule
- Determine if the credit union requires flood insurance in the correct amount when it makes, increases, extends, or renews a loan secured by improved real estate or a mobile home located, or to be located, in a Special Flood Hazard Area (SFHA) of a community participating in the National Flood Insurance Program (NFIP)
- Determine if the credit union provides the required notices to the borrower, servicer, and to the Director of the Federal Emergency Management Agency (FEMA) whenever it requires flood insurance as a condition of the loan
- Determine if the credit union requires escrow accounts for flood insurance premiums when requiring flood insurance on a residential building and when other items required escrowing
- Determine if the credit union complies with the forced placement provisions if at any time during the term of a loan it determines that flood insurance on the loan does not sufficiently meet the requirements of the regulation

Risk Categories

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with Flood Disaster Protection Act (FDPA); and
- Reputation risk can occur when the credit union incurs fines, penalties, or poor publicity as a result of failure to comply with FDPA.

Overview

The National Flood Insurance Program (NFIP) is a federal program enabling property owners to purchase insurance protection against losses from flooding. It provides an insurance alternative to disaster assistance to meet the escalating costs of repairing damage to buildings and their contents caused by floods. Flooding ranks as the most

common natural disaster, costing more in damages and loss of life than any other disaster.

An agreement between local communities and the federal government governs participation in the NFIP. The agreement states if a community will adopt and enforce a floodplain management ordinance to reduce future flood risks to new construction in SFHAs, the Federal Government will make flood insurance available within the community as a financial protection against flood losses.

If the property securing a member's loan is located in a SFHA, but the SFHA is in a community that does not participate in the NFIP, the member will not have federal flood insurance available.

To obtain information on a community's participation status, telephone FEMA at 1-800-358-9616 or check FEMA's web site at <http://www.fema.gov/fema/csb.htm>.

**Flood
Disaster
Protection
Act**

Part 760 of the *NCUA Rules and Regulations* implements the requirements of the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act (FDPA) of 1973, as amended (42 U.S.C. 4001-4129.) This part applies to loans secured by buildings or mobile homes located or to be located in areas determined by the Director of the FEMA to have special flood hazards.

Part 760 requires the following:

- A credit union cannot make, increase, extend, or renew any loan secured by a building or mobile home located or to be located in a SFHA in which flood insurance is not available unless the collateral securing the loan is covered by flood insurance for the term of the loan;
- The amount of the flood insurance must at least equal the lesser of the outstanding principal balance of the designated loan or the maximum limit of coverage available for the particular type of property under the Act; and

- Flood insurance coverage is limited to the overall value of the property securing the loan minus the value of the land on which the property is located.

Exemptions

The flood insurance requirement does not apply with respect to:

- Loans on state-owned property covered under an adequate policy of self-insurance satisfactory to the Director of FEMA; or
- Loans with an original principal balance of \$5,000 or less and a repayment term of one year or less.

Eligible Structures

The following types of structures are eligible for flood insurance coverage:

- Residential, industrial, commercial, and agricultural buildings that are walled and roofed structures that are principally above ground;
- Buildings under construction where a development loan is made to construct improvements on the land. Insurance can be purchased to keep pace with the new construction;
- Mobile homes that are affixed to a permanent site, including mobile homes that are part of a dealer's inventory and affixed to permanent foundations;
- Condominiums; or
- Co-operative buildings.

Members may also obtain flood insurance coverage for personal property and other insurable contents contained in real property or mobile homes located in SFHAs. The real property must be insured in order for the contents to be eligible.

Second Mortgages and HELOCs

Both second mortgages and home equity loans are transactions that come within the purchase provisions of the FDPA. Since only one flood insurance policy can be issued for a building, a credit union should not request a new flood insurance policy if one already exists. Instead, the credit union should have the borrower contact the insurance agent to:

- Inform the agent of the intention to obtain a loan involving a subordinate lien;
- Obtain verification of the existence of a flood insurance policy; and
- Check that the insurance sufficiently covers all loan amounts.

After obtaining this information, the insurance agent should increase the amount of coverage if necessary and issue an endorsement that will reflect the credit union as a lien holder.

For loans with approved lines of credit that members may access in the future, credit unions may have difficulty calculating the amount of insurance for the loan since the borrower will be drawing down differing amounts on the line at different times. In those instances the borrower must, at a minimum, obtain a policy as a requirement for drawing on the line.

As a matter of administrative convenience to ensure compliance with the requirements, a credit union may take the following alternative approaches:

- Review its records periodically so that as the member draws against the line, the appropriate amount of insurance coverage can be maintained; or
- Require the purchase of flood insurance for the total amount of the loan, or the maximum amount of flood insurance coverage available, whichever is less.

Lending in Non-Participating Communities

Flood insurance coverage is an important component of prudent underwriting for credit unions that extend loans in at-risk areas, to maintain safety and soundness and protect the lender's interest in its collateral. Credit unions with significant lending in nonparticipating communities should take care to ensure that the risks associated with loans secured by properties in flood hazard areas where flood insurance is not available are monitored and controlled.

**Standard
Flood Hazard
Determination Form**

A credit union must use the standard flood hazard determination form developed by FEMA when determining whether the building or mobile home offered as collateral security for a loan is or will be located in a SFHA which has flood insurance. Credit unions may use the standard flood hazard determination form in a printed, computerized or electronic manner. The credit union must retain a copy of the completed form, in either hard copy or electronic format, for the period of time the credit union owns the loan.

**Reliance on
Prior
Determination**

A credit union can rely on a prior SFHA determination if:

- The previous determination is not more than seven years old;
- The basis for it was recorded on the standard flood hazard determination form; or
- The loan is a subsequent transaction by the same institution with respect to the same property, i.e., assumption, refinancing, renewal, or second lien loan. A new determination is not required, assuming the other requirements are met.

A credit union may not rely on a previous determination if:

- FEMA's map revisions or updates show that the security property is now located in an SFHA;
- The lender discovers that map revisions or updates affecting the security property were made after the date of the previous determination; or
- The loan is not a subsequent transaction by the same institution with respect to the same property (e.g., a lender purchases a loan from another lender.)

**Determination
Fees**

Any credit union or a servicer acting on its behalf may charge a reasonable fee for determining whether the building or mobile home securing the loan is located or will be located in a SFHA if the determination:

- Is made in connection with a making, increasing, extending, or renewing of the loan that is initiated by the borrower;

- Reflects a revision or updating of floodplain areas or flood-risk zones by FEMA;
- Is due to FEMA's publication of a notice that affects the area in which the loan is located; or
- Results in the purchase of flood insurance coverage by the credit union or its servicer on behalf of the borrower under the forced placement provision.

A determination fee may also include, but is not limited to, a fee for life-of-loan monitoring.

Required Notices

When a credit union makes, increases, extends, or renews a loan secured by a building or a mobile home located or to be located in a SFHA, the credit union must mail or deliver a written notice to the borrower and to the servicer, regardless of whether or not flood insurance is available for the collateral securing the loan. The written notice must include the following information:

- A warning that the building or mobile home is or will be located in a SFHA;
- A description of the flood purchase requirements set forth in Section 102(b) of the FDPA of 1973, as amended (42 U.S.C. 4012a(b));
- A statement that flood insurance coverage is available under the NFIP, and possibly from private insurers; and
- A statement as to whether Federal disaster relief assistance may be available in the event of damage to the building or mobile home, caused by flooding in a Federally-declared disaster.

Delivery of Notice

Delivery of notice must take place within a "reasonable time" before the completion of the transaction. Ten days is generally regarded as a "reasonable" time interval. A borrower should receive notice timely enough to ensure that:

- The borrower has the opportunity to become aware of the borrower's responsibilities under the NFIP; and
- Where applicable, the borrower can purchase flood insurance before completion of the loan transaction.

Notice to Servicers

The servicer should receive notice as promptly as practicable after the credit union provides notice to the borrower and no later than the time the credit union provides similar notices to the servicer concerning hazard insurance and taxes. Credit unions may provide notice to the servicer electronically or it may take the form of a copy of the notice to the borrower.

Record Retention

The credit union must retain a record of the receipt of the notices by the borrower and the servicer for the period of time the credit union owns the loan.

Forced Placement Provisions

If a credit union, or a servicer acting on its behalf determines at any time during the term of the loan that the building or mobile home, and any personal property securing the loan, is not covered by flood insurance or is covered in an amount less than the amount required, then the credit union or its servicer must provide notice and an opportunity for the borrower to obtain the necessary amount of flood insurance, at the borrower's expense. If the borrower fails to obtain flood insurance within 45 days after notification, then the credit union or its servicer must purchase or "force place" flood insurance in the appropriate amount on the borrower's behalf. The credit union or its servicer may charge the borrower for the cost of the premiums and fees incurred in purchasing the insurance.

Escrow Accounts

If a credit union requires the escrow of taxes, insurance premiums, fees, or any other charges for a loan secured by residential improved real estate or a mobile home that is made, increased, extended or renewed on or after November 1, 1996, it must also require the escrow of all premiums and fees for flood insurance.

Penalties for Non-compliance

Penalties exist for violations of:

- Escrow requirements;
- Notice requirements; and
- Forced placement requirements.

If a credit union is found to have a pattern or practice of committing violations, NCUA shall assess civil penalties in an amount not to exceed \$350 per violation with a total amount against any one credit union not to exceed \$100,000 in any calendar year. Any penalty assessed will be paid into the National Flood Mitigation Fund. Liability for violations cannot be transferred to a subsequent purchaser of a loan. Liability for penalties expires four years from the time of the occurrence of the violation.

Notice to FEMA

When a credit union makes, increases, extends, renews, sells, or transfers a loan secured by a building or mobile home located or to be located in a SFHA, the credit union must notify the Director of FEMA, or the Director's designee (the insurance carrier), in writing of the identity of the servicer of the loan.

The credit union must notify the Director of FEMA, or the Director's designee, of any change in the servicer of the loan within 60 days after the effective date of the change. Credit unions may provide this notice electronically, if electronic submission is satisfactory to the Director of FEMA, or the Directors' designee.

Examination Procedures

An examiner may perform one or more of the following examination procedures, depending on the scope of the review.

- Coverage and Internal Control:
 - Review the methods used by the credit union to ascertain whether improved real estate or mobile homes are or will be located in a SFHA;
 - Verify that the process used accurately identifies SFHAs; and
 - Determine if the communities in which identified SFHAs are located participate in the NFIP.

- Property Determination Requirements:
 - Verify that the credit union accurately prepares flood zone determinations on the standard flood hazard determination form;
 - Verify that the credit union only relies on a previous determination if it is not more than seven years old, is recorded

- on the standard flood hazard determination form, and is not in a community that has been remapped;
- Review the contractual obligations to ascertain that flood insurance requirements are identified and compliance responsibilities are adequately addressed if the credit union uses a third party to prepare flood zone determinations; and
 - Verify that the credit union's escrow procedures comply with Section 760.5 of the *NCUA Rules and Regulations*.
- **Forced Placement Requirements:**
 - Ascertain that the credit union has appropriate policies and procedures in place to exercise its forced placement authority if the credit union determines that flood insurance coverage is less than the amount required by the FDPA;
 - Verify the following if the credit union is required to force place insurance:
 - i. That it provides written notice to the borrower that flood insurance is required; and
 - ii. That if the required insurance is not purchased by the borrower within 45 days from the date of notification, the credit union purchases the required insurance on the borrower's behalf.
 - **Checklists**
 - Complete the FDPA checklist in AIRES, which provides informative guidance on the requirements of the regulation for each question.
 - Report a violation on the Violations form in AIRES.

Additional Information

Additional information is available on the Federal Reserve Board's web site at <http://www.federalreserve.gov>. The Publications Services Unit at (202) 452-3245 furnishes copies of the regulation and staff commentaries issued by the Federal Reserve System.

HOMEOWNERS PROTECTION ACT – APPENDIX 19L

Examination Objective

- Determine whether the credit union has implemented procedures for complying with the requirements of the Homeowners Protection Act (HOPA)

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with HOPA
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with HOPA
- Strategic risk can occur when the board of directors fails to perform necessary due diligence in reviewing existing and prospective products and services for compliance with HOPA

Overview

HOPA applies to residential mortgage transactions consummated on or after July 29, 1999, with the purpose of financing the acquisition, initial construction, or refinancing a single family dwelling that serves as a principal residence.

HOPA addresses the difficulties homeowners have experienced in canceling private mortgage insurance (PMI). The Act establishes provisions for the cancellation and termination of PMI, establishes disclosure and notification requirements, and requires the return of unearned premiums. HOPA protects homeowners by prohibiting life of loan PMI for borrower-paid products, and it establishes uniform procedures for cancellation of PMI policies.

Termination of PMI

HOPA provides three methods to terminate PMI. The credit union should monitor PMI to ensure cancellation occurs in one of the following three ways:

- Borrower cancellation. The borrower must:
 - Submit a written request for cancellation;
 - Maintain a good payment history with respect to the loan;

- Maintain a current balance as required by terms of loan (at time of request); and
 - Satisfy any requirement of the credit union (as of the date of the written request for cancellation) such as evidence (1) of the residence's value, or (2) that the mortgage is unencumbered by other liens.
-
- Automatic termination. The credit union automatically terminates PMI based on the date the principal balance of the mortgage reaches 78 percent of the original value of the property securing the loan according to the initial amortization schedule (or amortization schedule in effect for adjustable rate mortgages);
 - Final termination. If the borrower has not cancelled PMI or the credit union has not automatically terminated PMI, the credit union must cancel or terminate it by the first day of the month immediately following the midpoint of the amortization period of the loan if the member is current on payments. The midpoint of the amortization period is defined as the point in time halfway between the consummation of the loan and the end of the amortization schedule.

If the borrower or credit union alters the terms of the loan before a residential mortgage transaction, the credit union must recalculate the cancellation date, termination date, or final termination to reflect the modified terms and conditions of the loan.

The credit union may not require any further PMI payments from the member after 30 days of termination or cancellation. Generally within 45 days of termination or cancellation of PMI, the servicer must return all unearned premiums to the member.

HOPA provides exceptions for high risk loans. Borrower cancellation and automatic termination do not apply to loans designated as high risk at the time of consummation.

High risk mortgages include:

- Conforming loans defined as high risk by the Federal National Mortgage Association (FNMA) and/or the Federal Home Loan Mortgage Corporation (Freddie Mac); and
- Non-conforming loans defined as high risk by the lender.

The final termination provisions do apply to high risk mortgage loans.

Disclosure Requirements

In the case of mortgages requiring PMI, the credit union must disclose the following in writing:

- Initial amortization schedule (fixed rate only);
- Notice of the ways to cancel or terminate PMI; and
- Notice of the exemptions to the right to cancel and automatic termination.

When the credit union uses a third-party to service its loans, the servicer must provide annual written statements stating:

- The right to cancel or terminate PMI; and
- The address and telephone number the member may use to contact the servicer.

Notification of Cancellation or Termination

Generally within 30 days after the cancellation or termination of the PMI, the servicer shall notify the member in writing of the following:

- PMI has terminated and member no longer has PMI; and
- The member owes no further premiums, payments, or fees in connection with PMI.

Disclosure Requirements for Lender Paid PMI

In the case of lender-paid PMI, the credit union must provide written disclosure to the member not later than the date of the loan commitment that lender-paid PMI:

- Differs from borrower-paid PMI (include differences);
- Results in a higher interest rate (generally); and
- Terminates only upon refinancing of the loan.

Within 30 days after the termination date that would apply in the case of borrower paid PMI, the servicer shall provide a written notice to the member indicating they may wish to review financing options that could eliminate the requirement for PMI.

Fees and Penalties

The credit union may not impose any fee on the member with respect to the provision of any notice or information required by HOPA.

Penalties for violating this Act include liability to the member to whom the violation relates. Liability may include actual damages, statutory damages, costs of actions, and reasonable attorney fees. Statutory damages are limited to \$2,000 in individual cases and the lesser of \$500,000 or 1 percent of net worth in class action cases.

Examination Procedures

In reviewing HOPA, examiners should:

- Review the credit union's HOPA policies and procedures;
- Determine the credit union provides the required written disclosures in residential mortgage transactions;
- Review recent annual disclosure provided to member;
- Review the credit union's process for canceling PMI upon borrower's request;
- Determine the credit union has controls in place to ensure proper processing of the automatic and final termination provisions of HOPA;
- Determine the credit union complies with the notification requirements upon termination or cancellation of PMI;
- Determine the credit union provides appropriate disclosures in the cases of lender paid mortgage insurance.

Examiners should cite material emerging or unresolved deficiencies in the examination report. The examiner should discuss immaterial exceptions with management.

CONSUMER LEASING ACT – APPENDIX 19M

Examination Objectives

- Determine whether the credit union provides meaningful and required disclosures to lessees
- Determine if the credit union limits the amount of balloon payments in lease transactions
- Determine if the credit union accurately discloses lease terms in advertising

Risk Category

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the Consumer Leasing Act.

Overview

The Federal Reserve Board issued Regulation M, the Consumer Leasing Act, to implement the consumer leasing portions of the Truth in Lending Act. The regulation requires meaningful disclosures to lessees for comparing consumer lease terms with other leases and credit transactions. It also limits balloon payments in consumer lease transactions and provides for the accurate disclosures of lease terms in advertisements.

Regulation M applies to **lessors** of personal property under **consumer leases**, as these terms are defined below.

Definitions

For purposes of the Consumer Leasing Act, the following definitions apply:

Consumer lease: a lease that contains the following characteristics:

- Entered into by a natural person;
- For the use of personal property primarily for personal, family, or household purposes;
- For a period of time exceeding four months; and
- For a total contractual obligation not exceeding \$25,000.

The following are not consumer leases:

- A lease that meet the definition of a credit sale in §226.2(a) of Regulation Z;
- A lease for agricultural, business, or commercial purposes;
- A lease made to an organization; and

- A lease transaction that is incidental to the lease of real property where the lessee has no liability for the personal property at the end of the lease term, except for abnormal wear and tear, and the lessee has no option to purchase the leased property.

Lessee: a natural person who enters into or is offered a consumer lease.

Lessor: a person who regularly leases, offers to lease, or arranges for the leasing of personal property under a consumer lease. A person who has leased, offered, or arranged to lease personal property more than five times in the current or preceding calendar year is subject to Regulation M.

Open-end lease: a consumer lease in which the lessee's responsibility at the end of the lease term is based on the difference between the residual value of the leased property and its realized value.

Person: a natural person or organization.

Personal property: any property that is not real property under the law of the state where the property is located at the time it is offered or made available for lease.

Realized Value: 1) the price received by the lessor for the leased property at disposition, 2) the highest offer for disposition of the leased property or 3) the fair market value at the end of the lease term.

Residual Value: the value of the leased property at the end of the lease term, as estimated or assigned at consummation by the lessor, used in calculating the base periodic payment.

Disclosures

Credit unions must make all disclosures required under Regulation M clearly and conspicuously in writing and in a form the consumer can keep. Electronic disclosures are permissible.

Generally, credit unions must make subsequent disclosures for a lease renegotiation (a consumer lease is satisfied and replaced by another lease undertaken by the same consumer) or lease extension (continuation of an existing lease beyond six months from the original lease term.) Subsequent disclosures are not required when another person assumes a consumer lease.

Advertising

An advertisement must include specific terms of the lease. In general, an advertisement for a consumer lease may state that a specific lease of property at specific amounts or terms is available only if the lessor usually and customarily leases or will lease the property at those amounts or terms.

Lessors may not use the terms "annual percentage rate" or "annual lease rate" or any equivalent term in its advertisements. If the lessor provides a percentage rate in advertisements or other documents, a notice stating "this percentage may not measure the overall cost of financing this lease" must be included.

Triggering Terms

An advertisement that includes any of the following Trigger Terms shall contain additional disclosures:

- The amount of any payment;
- Number of required payments; or
- "Down payment" (even if it is zero), capitalized cost reduction, or other payment required at or prior to consummation.

Penalties and Record Retention

Failure to comply with the Consumer Leasing Act may result in criminal and civil penalties. Lessors must retain evidence documenting their compliance with the Consumer Leasing Act for at least two years after the date the disclosures were required.

State Law

Regulation M preempts state law, except where state law provides greater protection and benefit to the consumer.

Examination Procedures

An examiner may perform one or more of the following examination procedures, depending on the scope of the review.

- Determine if the credit union has made or arranged consumer leases since the last examination;
- Review the forms used in granting consumer leases;
- Determine that disclosures were furnished to members before consummation of the lease;
- Determine that lease disclosures are conspicuous, written in a form the consumer may keep, and consistent with the model disclosure forms;
- Determine that the credit union includes the following in its consumer leasing disclosures:

- Description of the leased property;
- Amount due at lease signing;
- Payment schedule and total amount of periodic payments;
- Other charges (i.e., the amount of any liability the lease imposes upon the lessee at the end of the lease term);
- Total of payments;
- Payment calculation:
 - i. Gross capitalized cost;
 - ii. Capitalized cost reduction;
 - iii. Adjusted capitalized cost;
 - iv. Residual value;
 - v. Depreciation and any amortized amounts;
 - vi. Rent charges;
 - vii. Total of base periodic payments;
 - viii. Lease term;
 - ix. Base periodic payment;
 - x. Itemization of other charges; and
 - xi. Total periodic payment;
- Early termination:
 - i. Conditions and disclosure of charges; and
 - ii. Early-termination notice;
- Maintenance responsibilities:
 - i. Statement of responsibilities;
 - ii. Wear and use standard; and
 - iii. Notice of wear and use standard;
- Purchase option:
 - i. End of lease term; and
 - ii. During lease term;
- Statement referencing non-segregated disclosures;
- Liability between residual and realized values;
- Right of appraisal;
- Liability at end of lease term:
 - i. Rent and other charges;
 - ii. Excess liability; and
 - iii. Mutually agreeable final adjustment;
- Fees and taxes;
- Insurance:
 - i. Through the lessor; or
 - ii. Through a third party;
- Warranties or guarantees;

- Penalties and other charges for delinquency;
- Security interest; and
- Limitations on rate information.
- Determine that the credit union discloses the following when advertising a triggering term:
 - That the transaction is a lease;
 - The total amount due at lease signing, or that no payment is required;
 - The number, amounts, due dates or periods of scheduled payments, and the total of such payments under the lease;
 - A statement of whether or not the lessee has the option to purchase the leased property and, if so, when and at what price; and
 - A statement of the lessee's liability, if any, for the difference between the residual value of the leased property and its realized value at the end of the lease term.
- Complete the Regulation M Checklist in AIRES. The checklist provides informative guidance on the requirements of the regulation for each question.
- Report a violation of Regulation M on the Violations form in AIRES.

**Additional
Information**

Additional information is available on the Federal Reserve Board's web site at <http://www.federalreserve.gov>. The Publications Services Unit at (202) 452-3245 can also furnish copies of the regulation and staff commentaries issued by the Federal Reserve System.

PRIVACY OF CONSUMER FINANCIAL INFORMATION – APPENDIX 19N

Examination Objectives

- Assess the quality of a credit union’s compliance management policies and procedures for implementing the Privacy of Consumer Financial Information (Privacy Regulation) to determine whether the information about its policies and practices to members and consumers in the credit union’s notices conforms to the credit union’s actual procedures and practices
- Determine the reliability of the credit union’s internal controls and procedures for monitoring compliance with the Privacy Regulation
- Determine the credit union’s compliance with the Privacy Regulation
- Initiate effective corrective actions for violations of law or deficient policies or internal controls

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with the Privacy Act; and
- Reputation risk can occur when members of the credit union learn of its failure to comply with the Privacy Act.

Overview

Title V, Subtitle A of the Gramm-Leach-Bliley Act (the “Act”) governs the treatment of nonpublic personal information about consumers by financial institutions. Section 502 of Subtitle A, subject to certain exceptions, prohibits a financial institution from disclosing nonpublic personal information about a consumer to nonaffiliated third parties, unless the institution satisfies various notice and opt-out requirements, and provided that the consumer has not elected to opt out of the disclosure. Section 503 requires the institution to provide notice of its privacy policies and practices to its customers. Section 504 authorizes the issuance of regulations to implement these provisions.

Part 716 of the *NCUA Rules and Regulations* implement provisions of the Act governing the privacy of consumer financial information. The

regulation establishes rules governing duties of a credit union to provide particular notices and limitations on its disclosure of nonpublic personal information, as summarized below:

- A credit union must provide a notice of its privacy policies, and allow the consumer to opt out of the disclosure of the consumer's nonpublic personal information, to a nonaffiliated third party if the disclosure is outside of the exceptions in *NCUA Rules and Regulations* §716.13, §716.14 or §716.15;
- Regardless of whether a credit union shares nonpublic personal information, the credit union must provide notices of its privacy policies to its members;
- A credit union generally may not disclose member account numbers to any nonaffiliated third party for marketing purposes; and
- A credit union must follow reuse and redisclosure limitations on any nonpublic personal information it receives from a nonaffiliated financial institution.

Definitions and Key Concepts

Discussion of the duties and limitations imposed by the Privacy Regulation involves using a number of key concepts. These concepts include “financial institution,” “nonpublic personal information,” “nonaffiliated third party,” the “opt out” right and the exceptions to that right, and “consumer” and “member.” Each concept is briefly discussed below. A more complete explanation of each appears in the regulation.

Financial Institution

A financial institution is any institution the business of which engages in activities that are financial in nature or incidental to such financial activities, as determined by section 4(k) of the Bank Holding Company Act of 1956. Financial institutions can include banks, credit unions, securities brokers and dealers, insurance underwriters and agents, finance companies, mortgage bankers, and travel agents.

Nonpublic Personal Information

Nonpublic personal information generally is any information that is not publicly available and that:

- A consumer provides to a credit union to obtain a financial product or service from the credit union;
- Results from a transaction between the consumer and the credit union involving a financial product or service; or
- A credit union otherwise obtains about a consumer in connection with providing a financial product or service.

Information is publicly available if a credit union has a reasonable basis to believe that the information is lawfully made available to the general public from government records, widely distributed media, or legally required disclosures to the general public. Examples include information in a telephone book or a publicly recorded document, such as a mortgage or securities filing.

Nonpublic personal information may include individual items of information as well as lists of information. For example, nonpublic personal information may include names, addresses, phone numbers, social security numbers, income, credit score, and information obtained through Internet collection devices (i.e., cookies.)

Special rules govern lists. Publicly available information would be treated as nonpublic if it were included on a list of consumers derived from nonpublic personal information. For example, a list of the names and addresses of a credit union's members would be nonpublic personal information even though the names and addresses might be published in local telephone directories because the list is derived from the fact that a person is a member of the credit union, which is not publicly available information.

However, if the credit union has a reasonable basis to believe that certain member relationships are a matter of public record, then any list of these relationships would be considered publicly available information. For instance, a list of members with mortgages where the mortgages are recorded in public records would be considered publicly available information. The credit union could provide a list of such members, and include on that list any other publicly available information it has about the members without having to provide notice or opt out.

**Nonaffiliated
Third Party**

A nonaffiliated third party is any person except a credit union's affiliate or a person employed jointly by a credit union and a company that is not the credit union's affiliate. An "affiliate" of a credit union is any company that controls, is controlled by, or is under common control with the credit union. For federal credit unions, a credit union service organization (CUSO) that is controlled by the credit union would constitute the only affiliate. NCUA will presume a credit union has a controlling influence if the CUSO is 67 percent owned by that credit union or by that credit union and other credit unions.

**Opt Out Right
and Exceptions**

Consumers must be given the right to "opt out" of, or prevent, a credit union from disclosing nonpublic personal information about them to a nonaffiliated third party, unless an exception to that right applies. The exceptions are detailed in §716.13, §716.14 or §716.15.

As part of the opt out right, credit unions must give consumers a reasonable opportunity and a reasonable means to opt out. What constitutes a reasonable opportunity to opt out depends on the circumstances surrounding the consumer's transaction, but the credit union must provide the consumer a reasonable amount of time to exercise the opt out right. For example, it would be reasonable if the credit union allows 30 days from the date of mailing a notice or 30 days after member acknowledgement of an electronic notice for the consumer to return an opt out direction. What constitutes a reasonable means to opt out may include check-off boxes, a reply form, or a toll-free telephone number, again depending on the circumstances surrounding the consumer's transaction. It is not reasonable to require a consumer to write his or her own letter as the only means to opt out.

NCUA Rules and Regulations §716.13, §716.14 and §716.15 detail exceptions to the opt out right. Credit unions need not comply with opt-out requirements if they limit disclosure of nonpublic personal information:

- To a nonaffiliated third party to perform services for the credit union or to function on its behalf, including marketing the credit union's own products or services or those offered jointly by the credit union and another financial institution. The exception is permitted only if the credit union provides notice of these

arrangements and by contract prohibits the third party from disclosing or using the information for other than the specified purposes. The contract must provide that the parties to the agreement jointly offer, sponsor, or endorse a financial product or service. However, if the service or function is covered by the exceptions in §716.14 or §716.15 (discussed below), the credit union need not comply with the additional disclosure and confidentiality requirements of §716.13. Disclosure under this exception could include the outsourcing of marketing to an advertising company (§716.14):

- As necessary to effect, administer, or enforce a transaction that a consumer requests or authorizes, or under certain other circumstances that relate to existing relationships with members. Disclosures under this exception could be in connection with the audit of credit information, administration of a rewards program, or to provide an account statement (§716.14); or
- For specified other disclosures that a credit union normally makes, such as to protect against or prevent actual or potential fraud; to the credit union’s attorneys, accountants, and auditors; or to comply with applicable legal requirements, such as the disclosure of information to regulators (§716.15.)

Consumer and Member

The distinction between consumers and members is significant because credit unions have additional disclosure duties with respect to members. All members covered under the regulation are consumers, but not all consumers are members.

A “consumer” is an individual, or that individual’s legal representative, who obtains or has obtained a financial product or service from a credit union used primarily for personal, family, or household purposes.

A “financial service” includes, among other things, a credit union’s evaluation or brokerage of information that the credit union collects in connection with a request or an application from a consumer for a financial product or service. For example, a financial service includes

an evaluation of an application for membership, even if the application is ultimately rejected or withdrawn.

Consumers who are not members are entitled to an initial privacy and opt out notice only if the credit union wants to share their nonpublic personal information with nonaffiliated third parties outside of the exceptions.

A “member” is a consumer who has a “member relationship” with a credit union. A “member relationship” is a continuing relationship between a consumer and a credit union under which the credit union provides one or more financial products or services to the consumer used primarily for personal, family, or household purposes.

For the purposes of the privacy regulation, the term member will include certain nonmembers. For example, the following are considered members:

- An individual who meets the credit union’s bylaws definition of member;
- A nonmember who has a share, share draft, or credit card account held jointly with a member;
- A nonmember who has a loan that the credit union services;
- A nonmember who has an account in a low-income credit union; and
- A nonmember who has an account in a federally insured state-chartered credit union pursuant to state law.

Credit unions must provide members initial and annual privacy notices regardless of the information disclosure practices of their credit union.

A special rule exists for loans. When a member obtains a loan from a credit union, and that is the only basis for the member relationship, if the credit union subsequently transfers the servicing rights to that loan to another financial institution, the member relationship transfers with the servicing rights. However, any information on the borrower retained by the credit union selling the servicing rights must be accorded the protections due any consumer.

Note that isolated transactions alone will not cause a consumer to be treated as a member. For example, if an individual purchases a traveler's check from a credit union where the person has no account, the credit union will treat the individual as a consumer but not a member of that credit union because the individual has not established a member relationship. Likewise, if an individual uses the ATM of a credit union where the individual has no account, even repeatedly, the credit union may regard the individual as a consumer, but not a member of that credit union.

Credit Union Duties

The Privacy Regulation establishes specific duties and limitations for a credit union based on its activities. Credit unions that intend to disclose nonpublic personal information outside the exceptions will have to provide opt out rights to their members and to nonmember consumers. All credit unions have an obligation to provide an initial and annual notice of their privacy policies to their members. All credit unions must abide by the regulatory limits on the disclosure of account numbers to nonaffiliated third parties and on the re-disclosure and reuse of nonpublic personal information received from nonaffiliated financial institutions.

A brief summary of credit union duties and limitations appears below. A more complete explanation of each appears in the regulations.

Notice and Opt Out Duties to Consumers

If a credit union intends to disclose nonpublic personal information about any of its consumers (whether or not they are members) to a nonaffiliated third party, and an exception does not apply, then the credit union must provide to the consumer:

- An initial notice of its privacy policies;
- An opt out notice (including, among other things, a reasonable means to opt out); and
- A reasonable opportunity, before the credit union discloses the information to the nonaffiliated third party, to opt out.

The credit union may not disclose any nonpublic personal information to nonaffiliated third parties except under the enumerated exceptions unless these notices have been provided and the consumer has not

opted out. Additionally, the credit union must provide a revised notice before the credit union begins to share a new category of nonpublic personal information or shares information with a new category of nonaffiliated third party in a manner that was not described in the previous notice.

Note that a credit union need not comply with the initial and opt-out notice requirements for consumers who are not members if the credit union limits disclosure of nonpublic personal information to the exceptions.

Special Rule for Loans. A credit union must provide an initial notice to a co-borrower or guarantor on a loan, who has no other member relationship with the credit union, if it shares the nonpublic personal information with nonaffiliated third parties other than as allowed under the exceptions. Credit unions may provide annual notices to the co-borrowers and guarantors jointly.

Notice Duties to Members

In addition to the duties described above, there are several duties unique to members. In particular, regardless of whether the credit union discloses or intends to disclose nonpublic personal information, a credit union must provide notice to its members of its privacy policies and practices at various times.

- A credit union must provide an initial notice of its privacy policies and practices to each member, not later than the time a member relationship is established. §716.4(e) of the regulation describes the exceptional cases in which delivery of the notice is allowed subsequent to the establishment of the member relationship;
- A credit union must provide an annual notice at least once in any period of 12 consecutive months during the continuation of the member relationship;
- Generally, new privacy notices are not required for each new product or service. However, a credit union must provide a new notice to an existing member when the member obtains a new financial product or service from the credit union, if the initial or annual notice most recently provided to the member was not accurate with respect to the new financial product or service; and

- When a credit union does not disclose nonpublic personal information (other than as permitted under §716.14 or §716.15) and does not reserve the right to do so, the credit union has the option of providing a simplified notice.

Requirements for Notices The following requirements apply to privacy notices:

- **Clear and Conspicuous.** Privacy notices must be clear and conspicuous, meaning they must be reasonably understandable and designed to call attention to the nature and significance of the information contained in the notice. The regulations do not prescribe specific methods for making a notice clear and conspicuous, but do provide examples of ways in which to achieve the standard, such as the use of short explanatory sentences or bullet lists, and the use of plain-language headings and easily readable typeface and type size. Privacy notices also must accurately reflect the credit union's privacy practices.
- **Delivery Rules.** Credit unions must provide privacy notices so that each recipient can reasonably be expected to receive actual notice in writing, or if the consumer agrees, electronically. To meet this standard, a credit union could, for example, (1) hand-deliver a printed copy of the notice to its consumers, (2) mail a printed copy of the notice to a consumer's last known address, or (3) for the consumer who conducts transactions electronically, post the notice on the credit union's web site and require the consumer to acknowledge receipt of the notice as a necessary step to completing the transaction.

For members only, a credit union must provide the initial notice (as well as the annual notice and any revised notice) so that a member can retain or subsequently access the notice. A written notice satisfies this requirement. For members who obtain financial products or services electronically, and agree to receive their notices on the credit union's web site, the credit union may provide the current version of its privacy notice on its web site.

- **Notice Content.** A privacy notice must contain specific disclosures. However, a credit union may provide to consumers who are not

members a “short form” initial notice together with an opt out notice stating that the credit union’s privacy notice is available upon request and explaining a reasonable means for the consumer to obtain it. The following is a list of disclosures regarding nonpublic personal information that credit unions must provide in their privacy notices, as applicable:

- Categories of information collected;
- Categories of information disclosed;
- Categories of affiliates and nonaffiliated third parties to whom the credit union may disclose information;
- Policies with respect to the treatment of former members’ information;
- Information disclosed to service providers and joint marketers (§716.13);
- An explanation of the opt out right and methods for opting out;
- Any opt out notices the credit union must provide under the Fair Credit Reporting Act with respect to affiliate information sharing;
- Policies for protecting the security and confidentiality of information; and
- A statement that the credit union makes disclosures to other nonaffiliated third parties as permitted by law under §716.14 and §716.15.

Limitations on Disclosure of Account Numbers

A credit union must not disclose an account number or similar form of access number or access code for a credit card, share, or transaction account to any nonaffiliated third party (other than a consumer reporting agency) for use in telemarketing, direct mail marketing, or other marketing through electronic mail to the consumer.

The disclosure of encrypted account numbers without an accompanying means of decryption, however, is not subject to this prohibition. The regulation also expressly allows disclosures by a credit union to its agent to market the credit union’s own products or services (although the credit union must not authorize the agent to directly initiate charges to the member’s account.) Also not barred are disclosures to participants in private-label or affinity card programs,

where the participants are identified to the member when the member enters the program.

**Re-disclosure
and Reuse
Limitations on
Nonpublic
Personal
Information
Received**

If a credit union receives nonpublic personal information from a nonaffiliated financial institution, the credit union's disclosure and use of the information is limited.

- For nonpublic personal information received under a §716.14 or §716.15 exception, the credit union is limited to:
 - Disclosing the information to the affiliates of the financial institution from which it received the information;
 - Disclosing the information to its own affiliates, who may, in turn, disclose and use the information only to the extent that the credit union can do so; and
 - Disclosing and using the information pursuant to a §716.14 or §716.15 exception (for example, a credit union receiving information for account processing could disclose the information to its auditors).

- For nonpublic personal information received other than under a §716.14 or §716.15 exception, the credit union's use of the information is unlimited, but its disclosure of the information is limited to:
 - Disclosing the information to the affiliates of the financial institution from which it received the information;
 - Disclosing the information to its own affiliates, who may, in turn disclose the information only to the extent that the credit union can do so; and
 - Disclosing the information to any other person, if the disclosure would be lawful if made directly to that person by the financial institution from which it received the information. For example, a credit union that received a member list from another credit union could disclose the list (1) in accordance with the privacy policy of the credit union that provided the list, (2) subject to any opt out election or revocation by the members on the list, and (3) in accordance with appropriate exceptions under §716.14 and §716.15.

Other Considerations

Examiners should keep in mind the following when reviewing a credit union's privacy policies and procedures:

Fair Credit Reporting Act. The regulations do not modify, limit, or supersede the operation of the Fair Credit Reporting Act.

State Law. The regulations do not supersede, alter, or affect any state statute, regulation, order, or interpretation, except to the extent that it is inconsistent with the regulations. A state statute, regulation, order, etc. is consistent with the regulations if the protection it affords any consumer is greater than the protection provided under the regulations, as determined by the FTC.

Grandfathered Service Contracts. Contracts that a credit union has entered into, on or before July 1, 2000, with a nonaffiliated third party to perform services for the credit union or functions on its behalf, as described in §716.13, will satisfy the confidentiality requirements of §716.13(a)(1)(ii) until July 1, 2002, even if the contract does not include a requirement that the third party maintain the confidentiality of nonpublic personal information.

Guidelines for Protecting Member Information. The regulations require a credit union to disclose its policies and practices for protecting the confidentiality, security, and integrity of nonpublic personal information about consumers (whether or not they are members). The disclosure need not describe these policies and practices in detail, but instead may describe in general terms who is authorized to have access to the information and whether the credit union has security practices and procedures in place to ensure the confidentiality of the information in accordance with the credit union's policies.

NCUA has published guidelines (Appendix A to 12 C.F.R. Part 748 of the Rules and Regulations), pursuant to section 501(b) of the Gramm Leach Bliley Act, that address steps a credit union may take in order to protect member information. The guidelines relate only to information about members, rather than all consumers.

Examination Procedures

In reviewing a credit union’s compliance with the Privacy Act, examiners should:

- Identify the credit union’s information sharing practices (and changes to those practices) with affiliates and nonaffiliated third parties; how it treats nonpublic personal information; and how it administers opt-outs;
- Determine the adequacy of the credit union’s internal controls and procedures to ensure compliance with the privacy regulation as applicable;
- Ascertain areas of risk associated with the credit union’s sharing practices (especially those within §716.13 and those that fall outside of the exceptions) and any weaknesses found within the compliance management program; and
- Determine which procedures if any the examiners should complete in the applicable module, focusing on areas of particular risk. The selection of procedures depends upon the adequacy of the credit union’s compliance management system and level of risk identified. Each module contains a series of general instruction to verify compliance, cross-referenced to cites within the regulation. Additionally, there are cross-references to a more comprehensive checklist, which the examiner may use if needed to evaluate compliance in more detail. (Refer to E&I’s intranet site at <http://eandi/Supervision/ConsCompl/ConsCompl/Privacy/default¹.htm> for the modules and checklist.)

Examiners should discuss emerging or unresolved deficiencies with management and, if material, in the examination report.

Additional Information

Refer to *NCUA Rules and Regulations* Part 716 and NCUA Letter to Credit Unions number 01-CU-02 for additional guidance.

Also, for more detailed examination procedures and checklist refer to the following intranet site:

[http://eandi/Supervision/ConsCompl/ConsCompl/Privacy/default.htm¹](http://eandi/Supervision/ConsCompl/ConsCompl/Privacy/default.htm<sup>1</sup)

¹ These E&I Intranet cites are available to only to NCUA employees.

REAL ESTATE SETTLEMENT PROCEDURES ACT – APPENDIX 19 O

Examination Objective

- Determine whether the credit union has implemented policies and procedures complying with the requirements of the *Real Estate Settlement Procedures Act (RESPA)*

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with RESPA;
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with RESPA; and
- Strategic risk can occur when the board of directors fails to perform necessary due diligence in reviewing existing and prospective products and services for compliance with RESPA.

Overview

RESPA provides borrowers with pertinent and timely disclosures associated with the nature and costs of the real estate settlement process. It addresses disclosure requirements for the transfer, sale, or assignment of servicing a loan. Also, RESPA protects borrowers against certain abusive practices, such as kickbacks, and places limitations upon the use of escrow accounts. The Department of Housing and Urban Development's (HUD) Regulation X implements RESPA.

Coverage

RESPA applies to "federally related mortgage loans." It defines these loans as any loan secured by a first lien on residential real property designed principally for the occupancy of one to four families and made by a lender regulated by any federal government agency, or whose deposits any federal government agency insures.

Exempt transactions include (24 C.F.R. §3500.5(b)):

- Loans on property of 25 acres or more;
- Loans on vacant or unimproved property;

- Business purpose loans (except if an individual places a lien on a 1-4 family dwelling);
- Temporary financing (i.e., construction or bridge loans);
- Loan conversions not requiring a new note;
- Assumptions that do not require lender approval; and
- Secondary market transactions.

**Special
Booklet
Information**

Credit unions will supply the special information booklet to each purchase transaction applicant for a federally related mortgage loan by delivering it or by placing it in the mail to the applicant no later than 3 business days after the credit union receives the application. When there is more than one applicant for the loan, the credit union need only provide a copy of the booklet to one of the applicants.

Part one of the booklet describes the settlement process, the nature of charges, and suggests questions that the member may ask of lenders, attorneys, and others to clarify what services these professionals will provide for the charges quoted. It also contains information on the rights and remedies available under RESPA and alerts the borrower to unfair or illegal practices.

Part two of the booklet contains an itemized explanation of settlement services and costs and sample forms and worksheets for cost comparisons.

**Good Faith
Estimate
(GFE)**

The credit union must provide, no later than 3 business days after receiving the written application, a clear and concise GFE of the amount or range for each settlement charge the borrower will likely incur. The estimate of the amount or range for each charge must meet the following requirements:

- Present a reasonable relationship to the borrower's ultimate cost for each settlement charge; and
- Evidence experience in the locality or area of the property involved.

GFEs need not exactly match the actual charges, but they should approximate them. Credit unions may make the disclosures using

commercial forms, or may develop a separate one. Credit unions must use clear and concise forms that include the lender's name. The forms must also contain in boldface type the following or a substantially similar statement (the statement need not refer to real estate taxes if a the credit union provides a GFE for them):

This form does not cover all items you will be required to pay in cash at settlement, for example, deposit in escrow for real estate taxes and insurance. You may wish to inquire as to the amounts of such other items. You may be required to pay other additional amounts at settlement.

HELOCs do not require GFEs, because Regulation Z requires fee disclosures.

**Uniform
Settlement
Statement
(HUD-1 or
HUD-1A)**

The person conducting the settlement must complete the appropriate form and must conspicuously and clearly itemize all charges imposed on the borrower and the seller in connection with the settlement. It must indicate whether any title insurance premium included in such charges covers or insures the lender's interest in the property, the borrower's interest, or both. (HELOCs do not require the statement. Regulation Z requires the disclosures for HELOCs.)

The credit union must retain the Uniform Settlement Statements for five years or until it disposes of its interest in the property.

Prohibitions

RESPA provides fines up to \$10,000 and imprisonment up to one year for anyone who violates the section concerning kickbacks and unearned fees.

**Title
Companies**

RESPA states a seller cannot require property purchased with a federally related mortgage loan to buy title insurance from any particular title company. Any seller who violates this is liable to the buyer for three times all charges made for the title insurance.

**Escrow
Accounts**

RESPA limits the amount that the credit union can require a borrower to place in an escrow account. RESPA limits escrow funds at settlement to the amount that would bring the accrual of taxes, insurance premiums, and other charges current to the date of the first full payment, plus one-sixth of the amount of such charges the member will pay during the following 12 months. The Act further limits any monthly escrow payment to no more than one-twelfth of the anticipated amount due for such charges during the following 12 months plus the amount necessary to maintain a balance not to exceed one-sixth of the amount of charges due during that period. RESPA provides guidance on how to handle escrow shortages and surpluses.

Within 45 days after establishing an escrow account in connection with a federally related mortgage loan, the servicer must send an itemized list to the borrower of expected payments from the account and the expected dates of the payments. The credit union may give the list to the borrower at closing. HUD regulations incorporate the escrow requirements into the uniform settlement statement. The servicer must also give annual notice to the borrower of any shortage in an escrow account.

The servicer must send an annual statement by January 30 of the next year to the borrower itemizing payments made into and from the account. The servicer may not charge a fee for the annual statement. RESPA provides penalties for violating this requirement.

**Servicing of
Mortgage
Loans**

The credit union shall disclose to each applicant at the time of application or within 3 days of the application a Servicing Disclosure Statement. The statement shall include:

- Whether the credit union may transfer to another person the servicing of the loan;
- The percentage of loans, within the nearest 25%, made by the credit union during the past 3 calendar years for which the credit union transferred servicing (credit unions need not disclose information before 1989);
- The best estimate of the percentage of all loans made during a 12 month period beginning on the date of origination for which the credit union may assign, sell, or transfer servicing; and

- A written and signed acknowledgement that the applicant and any co-applicant has/have read and understood the disclosure.

When a servicer transfers a loan, both the transferor and the transferee servicers must make the following disclosures to the borrower:

- The effective date of the first payment to the transferee;
- The name, address, and toll-free or collect call telephone number of the transferee;
- The transferor's and transferee's toll-free or collect call telephone numbers, which the borrower may use to make inquiries relating to the transfer;
- The date on which the transferor will cease to accept payments, and the date when the transferee will begin to accept payments;
- Any information concerning the effect of the transfer on the availability or terms of any optional insurance, and any action that the borrower must take to maintain coverage;
- A statement that the transfer does not affect any term of the mortgage, other than the terms directly related to servicing the mortgage; and
- A statement of the borrower's rights in connection with complaint resolution.

The transferor must make the disclosures at least 15 days before the transfer; the transferee must make the disclosures within 15 days after the transfer. Both the transferor and transferee may make the disclosures within 30 days after the transfer, if one of the following specifies the reason for the transfer:

- Termination of the servicing contract for cause;
- The servicer enters bankruptcy proceedings; or
- Proceedings for conservatorship or receivership of the servicer, or an entity that owns or controls the servicer.

These time limits do not apply if the credit union provided written notice to the borrower at settlement.

During the 60-day period after the borrower's first payment due date, the transferee may not consider a payment late if the transferor receives the payment in a timely manner.

RESPA provides specific guidelines on how a servicer must respond to borrower inquiries. Whoever fails to comply with any provision concerning the servicing is liable to the borrower for damages and costs.

**Examination
Procedures**

Examiners should:

- Review the credit union's RESPA policies and procedures;
- Determine the credit union provides the required written disclosures (Special Information Booklet, GFE, HUD 1 or HUD 1-A, transfer of servicing, and escrow disclosures) in residential mortgage transactions; and
- Determine the credit union only receives reasonable and appropriate fees for services provided (no kickbacks or unearned fees.)

Examiners should discuss emerging or unresolved deficiencies with management and, if material, cite them in the examination report.

RIGHT TO FINANCIAL PRIVACY – APPENDIX 19P

Examination Objective

- Determine whether the credit union has implemented policies and procedures for complying with the requirements of the Right to Financial Privacy Act (RFPA)

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with RFPA; and
- Reputation risk can occur when members of the credit union learn of its failure to comply with RFPA.

Overview

RFPA protects the personal financial privacy of federal credit union members by restricting access to the member's financial records.

RFPA sets forth the conditions required before a credit union may grant access to or provide copies of financial records of a member to a government authority. In most cases, the credit union must obtain authorization from the member or secure from the government authority a subpoena or summons, a search warrant, a judicial subpoena, or a formal written request. Some exceptions to this rule include, but are not limited to:

- Credit union employee has information on a possible violation of a statute or regulation. RFPA provides that the credit union or any official, employee, or agent is not liable to the member for making such disclosure;
- Records needed to perfect a security interest, prove a claim in bankruptcy, collect a debt, or process an application with regard to a government loan; and
- Records needed by supervisory agency (NCUA) to perform examination.

Examination Procedures

Examiners should determine the credit union understands RFPA and has procedures in place to comply with RFPA.

SOLDIERS' AND SAILORS' CIVIL RELIEF ACT – APPENDIX 19Q

Examination Objective

- Determine whether the credit union has implemented policies and procedures for complying with the requirements of the Soldiers' and Sailors' Civil Relief Act (SSCRA)

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with SSCRA; and
- Reputation risk can occur when members of the credit union learn of its failure to comply with SSCRA.

Overview

SSCRA provides financial relief and legal protections for persons on active duty. Some of the key provisions include:

- Credit unions may generally not charge over a 6 percent interest rate on debt obligations if the borrower incurred the obligation before entering active duty;
- Credit unions generally may not foreclose on property securing a mortgage during the period of active duty or for 3 months thereafter, if the mortgage predated the borrower's active duty; and
- Credit unions must abide by special procedures in obtaining default judgments or proceeding with other court actions.

Examination Procedures

Examiners should:

- Review the credit union's SSCRA policies and procedures; and
- Determine the credit union has implemented policies and procedures to comply with SSCRA requirements.

Additional Information

Examiners may obtain additional information at the following website:
<http://www.jagcnet.army.mil/legal>.

HOME OWNERSHIP AND EQUITY PROTECTION ACT – APPENDIX 19R

Examination Objectives

- Determine whether the credit union has procedures in place to recognize mortgages meeting the requirements of the Home Ownership and Equity Protection Act (HOEPA)
- Determine whether the credit union has policies and procedures in place for complying with the requirements of HOEPA

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with HOEPA
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with HOEPA
- Strategic risk occurs when the board of directors fails to perform necessary due diligence in reviewing existing and prospective products and services for compliance with HOEPA

Overview

HOEPA regulates high cost loans and applies to home equity loans, second mortgages, or refinances secured by primary residences with high costs. HOEPA defines high costs as those that contain the following:

- APR exceeds by more than 10% the rate on a Treasury note of comparable maturity, or
- Fees and points at or before closing exceed the larger of \$480 (as of 2001, adjusted annually) or 8% of the total loan amount.

HOEPA does not limit the interest rate or the finance charge a credit union can charge a member (although §107(5)(vi) of the *Federal Credit Union Act* provides such a limitation.)

Requirements for Certain Mortgages

HOEPA requires specific disclosures for mortgages that fall within the regulation. The regulation provides necessary language to include in the disclosures. In general, the credit union must give the member the

required disclosures not less than 3 business days before consummation of the transaction.

A mortgage falling under the requirements of HOEPA may not provide for an interest rate applicable after default that is higher than the interest rate that applies before default. HOEPA also has the following provisions:

- No balloon payments (if term is less than 5 years);
- No negative amortization;
- No prepaid payments;
- Prohibition on extending credit without regard to payment ability of member; and
- Requirements for payments under home improvement contracts (directly to contractor).

**Reverse
Mortgage
Disclosure**

HOEPA includes additional disclosures for reverse mortgages that fall within its requirements.

Penalties

The credit union is open to civil liability for failing to comply with any portion of HOEPA.

**Examination
Procedures**

If examiners review for HOEPA, their review should include the following:

- Reviewing the credit union's HOEPA policies and procedures;
- Determining whether the credit union has any loans meeting the criteria of HOEPA; and
- Reviewing a sample of loans meeting the HOEPA criteria for compliance and required disclosures.

**Additional
Information**

The Federal Reserve Board added HOEPA as a subsection of the Truth in Lending Act (Reg Z). HOEPA is located in §226.32 of the Truth in Lending Act.

TRUTH IN LENDING ACT – APPENDIX 19S

Examination Objective

- Determine whether the credit union has implemented policies and procedures for complying with the requirements of the Truth in Lending Act (TILA)

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with TILA;
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with TILA; and
- Strategic risk occurs when the board of directors fails to perform necessary due diligence in reviewing existing and prospective products and services for compliance with TILA.

Overview

TILA (Regulation Z) is a disclosure regulation developed to promote the informed use of consumer credit by consumers. The required disclosures assist consumers in shopping for credit based on terms and cost. The regulation also gives consumers the right to cancel certain transactions involving a lien on their primary residence, and it regulates credit card practices and billing disputes. TILA imposes some limitations on home equity and mortgage loans, and requires that lenders state maximum interest rates on variable-rate mortgage plans.

TILA primarily applies to loans for personal, family, or household purposes. Exempt transactions include credit in excess of \$25,000 unless secured by real property or a dwelling, or student loans insured or guaranteed by the U.S. government.

General Disclosures

A creditor that offers or extends consumer credit to any consumer must furnish disclosures. Every person (whether a creditor or not), who advertises consumer credit, must comply with the advertising provisions of the regulation.

The creditor is a person who regularly extends consumer credit, and to whom the borrower makes the initial payment of consumer credit. The creditor must furnish the disclosures to the consumer.

In addition to disclosure requirements, Regulation Z imposes certain restrictions on credit unions by regulating the:

- Form and content of advertisements for consumer credit;
- Issuance of credit cards; and
- Consumer's liability for the unauthorized use of credit cards.

The regulation also provides certain rights to consumers by permitting the consumer to:

- Revoke a credit transaction, with some exceptions, if the credit involves a security interest in the consumer's principal dwelling; and
- Assert against a credit card issuer claims and defenses arising out of a credit card purchase if the consumer fails to resolve a dispute satisfactorily with the person who honored the credit card.

**Summary of
Transactions
Covered**

Lenders must consider several factors when deciding whether a loan requires Truth in Lending disclosures or must meet other Regulation Z requirements.

Generally, Regulation Z does not apply to a credit transaction unless:

- The transaction applies to consumer credit (i.e., for personal, family, or household use);
- The creditor extends credit to a consumer (i.e., a cardholder, a natural person, or, in a rescindable transaction, any non borrower whose primary residence secures the loan);
- The creditor regularly extends consumer credit (i.e., the person to whom the borrower initially pays the debt); and
- A written agreement makes the obligation payable in more than four installments or subject to a finance charge.

Even if those conditions exist, the regulation still exempts the transaction if real property or the consumer's principal dwelling does

not secure the obligation and the amount financed exceeds \$25,000. §226.3 contains other exempt credit transactions.

Summary of Exempt Transactions

§226.3 normally exempts from all requirements of the regulation transactions that do not have a consumer purpose. For example, a loan made for working capital secured by the company president's personal residence need not comply with the regulation because it has a business purpose and therefore is not a rescindable transaction.

Credit Categories

Regulation Z divides covered consumer credit transactions into two categories, "open-end" (which includes 'home equity lines of credit') and "closed-end" credit. The regulation provides requirements for each separately.

Open-End Credit

§226.2(a)(20) defines open-end credit as consumer credit extended under a plan in which the credit union:

- Reasonably contemplates repeated transactions;
- May impose a finance charge from time to time on the outstanding unpaid balance; and
- Generally makes credit extensions available to the consumer during the term of the plan (up to any limit set by the credit union) to the extent that the consumer repays any outstanding balance.

Under open-end credit plans, the creditor furnishes the consumer with appropriate disclosures before the consumer actually uses the account. Later, when the consumer uses the account, the creditor provides certain disclosures on each billing statement sent to the consumer. Within the open-end credit category, special rules apply to home equity loans and credit card transactions only, such as certain prohibitions on the issuance of credit cards and restrictions on the right to offset a cardholder's indebtedness.

§226.13, Billing-Error Resolution, mandates specific time frames and resolution requirements upon the credit union's receipt of a billing error notice. It states the requirements for correcting and crediting disputed amounts to a member's account. It also covers the credit

union's rights after the resolution of a billing error on a credit card or open-end credit plan.

**Closed-End
Credit**

Closed-end credit encompasses all consumer credit not extended under an open-end plan including residential mortgage transactions and installment credit contracts (e.g., direct loans by credit unions and purchased dealer paper.) Under the closed-end credit concept, the consumer receives a complete disclosure of the costs associated with the credit transaction at any time before actual consummation of the transaction.

Regulation Z provides separate rules applicable to closed-end credit for residential mortgage transactions and loans secured by real property. Those rules relate mostly to when creditors must make disclosures, consumer rescission rights, and what constitutes finance charges.

**General
Disclosure
Provisions**

A credit union must make required disclosures (1) clearly and conspicuously, (2) in writing, (3) in a form that the consumer may keep, (4) not buried in fine print, (5) visible without undue searching, (6) phrased to communicate information effectively, (7) grouped together and segregated from all other written material, and (8) not containing any information unrelated to the required disclosures.

When creditors must disclose the terms “finance charge” and “annual percentage rate,” with a corresponding amount or percentage rate, the creditors must make these terms more conspicuous than any other required disclosure. Although a few exceptions to this rule exist (e.g., a credit union need not make these terms more conspicuous in advertisements), the purpose of giving those terms prominence is to highlight their importance above all other disclosures. Credit unions may accomplish this by using larger or bolder type, underlining, marking with an asterisk, or printing in colored ink. The disclosures should attract the consumer's attention more readily than other required terminology.

**Multiple
Consumers**

If a transaction includes more than one consumer, the credit union may make the disclosures to any consumer that assumes primary

liability on the obligation. §226.5(d) and §226.17(d) address such instances. A credit union must make the disclosure to an endorser, guarantor, or similar party who assumes primary liability. If the borrower may rescind the transaction, the credit union must give one copy of material disclosures and two copies of the rescission notice to each person who has the right to rescind the transaction, whether or not such person has primary liability or has signed the evidence of debt.

Record Retention

Credit unions must maintain evidence of compliance with all requirements of Regulation Z for at least 2 years after the date mandated for action or disclosures by §226.25. The 2-year requirement applies even though an obligation may have a maturity of less than 2 years, or, be prepaid, refinanced, or sold within the first 2 years.

Credit unions may retain evidence of compliance on microfilm, microfiche, or by any other method that reproduces records accurately (including computer programs.) The credit union need retain only enough information to reconstruct the required disclosures or other records.

Consequences of Noncompliance

The TILA authorizes NCUA as the federal regulatory agency to require credit unions to make monetary and other adjustments to the accounts of consumers when the true finance charge or APR exceeded the disclosed finance charge or APR by more than a specified accuracy tolerance as addressed by §108(e) of the TILA. That authorization extends to unintentional errors, including isolated violations (for example, errors which occurred, often without a common cause, only once or infrequently on a random basis).

Under certain circumstances, the TILA requires NCUA to order credit unions to reimburse consumers when understatement of the APR or finance charge involves:

- Patterns or practices of violations (e.g., errors which occurred, often with a common cause, consistently or frequently, reflecting a pattern with a specific type or types of consumer credit);
- Gross negligence; and

- Willful noncompliance intended to mislead the person to whom the credit union extended credit.

Any proceeding that a regulatory agency can bring against a creditor, it can also bring against any assignee of the creditor if the violation appears on the face of the disclosure statement, except where the assignment was involuntary, as described by §131(a) of the TILA.

Examination Procedures

As it applies to these procedures, the term "consumer credit" means credit subject to the provisions of Regulation Z. Examination procedures fall within the categories of General and Adjustable Rate Mortgages.

General

In reviewing the credit union's compliance with TILA, examiners should:

- Determine the types of consumer credit (open-end and closed-end, direct and indirect) offered by the credit union and the terms applicable to each;
- Obtain and review blank copies of forms used by the credit union in extending all types of consumer credit. Determine that the credit union has on file a legal opinion for any nonstandard forms they may use including:
 - Note and credit contract forms (including those furnished to dealers);
 - Disclosure statement forms;
 - Rescission notices;
 - Initial disclosure statement forms for open-end credit plans;
 - Periodic billing statement forms;
 - Notices regarding billing error resolution procedures; and
 - Merchant agreements;
- Determine which individuals actually perform the various activities necessary to comply with the different provisions of Regulation Z. Then, review the adequacy of the training received by those individuals to enable them to carry out their assigned

responsibilities in conformity with TILA. For example, this would include personnel engaged in:

- Completing disclosure statements;
 - Completing and furnishing rescission notices;
 - Preparing advertising copy for consumer credit; and
 - Responding to public inquiries (by telephone or otherwise) about the cost and terms of consumer credit;
- Obtain and review any written directives and training materials pertaining to employee responsibilities for ensuring institutional compliance with Regulation Z; and
 - Determine the extent to which (if any) the internal or external auditors or other credit union staff monitors or periodically reviews the credit union's policies, procedures, practices, and staff to assess results and ensure continued compliance with Regulation Z.

**Adjustable Rate
Mortgages**

Review the credit union's policies, procedures and practices when completing the following steps:

- Determine if the credit union offers open-end or closed-end variable rate credit;
- Review the ability of the computer system or servicer to handle the credit union's variable rate products. Determine if the credit union has adequate operating procedures and internal controls;
- Verify whether internal or external auditors or other staff periodically test the accuracy of the credit union's variable interest rate adjustment system;
- Determine the extent and adequacy of the instruction and training received by those individuals who implement rate changes;
- Determine whether the credit union has retained records of index values (e.g., copies of the Federal Reserve Statistical Release). (226.25(a));

- Verify that the credit union correctly recorded account and loan data into the credit union's calculation systems (e.g., its computer). Determine the input accuracy of the following:
 - Index value (226.6(a)(2)) and (226.19(b)(2)(ii));
 - Method for calculating rate changes (226.6(a)(2)) and (226.19(b)(2)(iii));
 - Rounding method (226.6(a)(2)) and (226.19(b)(2)(iii));
 - Adjustment caps (periodic and lifetime) (226.6(a)(2)) and (226.19(b)(2)(vii)); and

- Sample periodic disclosures for open-end variable rate accounts (e.g., home equity loans) and closed-end rate change notices for adjustable rate mortgage loans (ARMS):
 - Compare the rate change date on the credit obligation to the actual rate change date and to any rate change notice (226.7(g)) and (226.20(c)(2));
 - Determine that the credit union bases the index on the terms of the contract (e.g., the weekly average of 1-year Treasury constant maturities, taken 45 days prior to the change date.) (226.7(g)) and (226.20(c)(2));
 - Determine that the credit union correctly computes the new interest rate by adding the correct index value with the margin stated in the note, plus or minus any contractual fractional adjustment (226.7(g)) and (226.20(c)(1)); and
 - Determine that the credit union bases the new payment on an interest rate and loan balance in effect at least 25 days before the payment change date (consistent with the contract) (226.20(c)(4)).

Examiners should discuss emerging or unresolved deficiencies with management and, if material in the examination report.

Additional Information

Refer to the appendix on the Home Ownership and Equity Protection Act (HOEPA) for additional requirements on certain real estate transactions.

TRUTH IN SAVINGS ACT – APPENDIX 19T

Examination Objectives

- Determine whether the credit union complies with all required provisions of the Truth in Savings (TIS) regulation
- Determine whether the credit union provides all required account disclosures to members and potential members within the required time frames and ensures that account disclosures reflect the terms of the legal obligation between the parties
- Determine whether the credit union accurately discloses all required information on periodic statements for covered accounts
- Determine whether the credit union uses a permissible method for paying dividends, and accurately applies other calculations (e.g., daily balance, average daily balance, minimum balance, etc.)
- Determine whether advertisements include all required information and are not misleading or inaccurate (credit unions should maintain an advertising file containing copies of the credit union's advertisements)
- Determine whether the credit union maintains evidence of compliance (for a period of two years) with all provisions of TIS

Associated Risks

- Compliance risk can occur when the credit union fails to implement the necessary controls to comply with TIS;
- Reputation risk can occur when the credit union incurs fines and penalties as a result of failure to comply with TIS; and
- Strategic risk can occur when the board of directors fails to perform necessary due diligence in reviewing existing and prospective products and services for compliance with TIS.

Overview

Part 707 of the *NCUA Rules and Regulations*, Truth-in-Savings (TIS), implements the Truth in Savings Act (TISA) of the Federal Deposit Insurance Corporation Improvement Act of 1991. TISA exempts credit unions with assets of \$2 million or less, after subtracting any nonmember deposits, that are not sufficiently automated.

TIS covers member accounts at all credit unions insured by (or eligible to be insured by) the National Credit Union Share Insurance Fund (NCUSIF) including federal credit unions (FCUs), federally insured state-chartered credit

unions (FISCUs), and non-federally insured credit unions (NFICUs.) Accounts include share and deposit accounts such as shares, share drafts, and term share (certificate) accounts held by, or offered to, a natural person member or potential member primarily for a personal, family or household purpose.

Disclosures

TIS enables members to compare accounts using uniform disclosures about terms, fees, and rates. Credit unions must provide members or potential members with account disclosure information:

- Before an account is opened or a service is provided, whichever is earlier;
- Upon request;
- When the terms change (with a few exceptions), if the change adversely affects the member;
- On most term share accounts that renew or mature (depending on maturity date);
- On periodic statements; and
- On advertisements.

Payment of Dividends

TIS applies equally to interest-bearing deposit accounts at state-chartered credit unions and to dividend-bearing share accounts at federal and state-chartered credit unions. Confusion between the terms “share” and “deposit” accounts and between “dividends” and “interest” could result in a violation of Part 707.

On dividend and interest-bearing accounts, TIS requires credit unions to pay dividends or interest based on the full amount of principal in an account once the member meets the minimum balance to earn dividends. Unless specified otherwise, the word "interest" and "dividend" or "dividends" are interchangeable.

The dividend rate is the annual rate the credit union pays on an account (not reflecting compounding.) When a credit union pays dividends, it applies a periodic dividend rate to an account balance. Dividends do not include the absorption of expenses, forbearance in charging fees, non-dividend membership benefits, extraordinary dividends, or the payment of bonuses. If a credit union chooses to pay dividends for the use of funds, TIS mandates:

- Each day the credit union must pay dividends equal to at least 1/365 (or 1/366 in a leap year) of the dividend rate on the full amount of principal in the account. A credit union may apply a daily periodic rate greater than 1/365 of the dividend rate (e.g., a daily periodic rate of 1/360) as long as the credit union applies that rate 365 days a year;
- The credit union must calculate the account balance on which it pays dividends using either:
 - The daily balance method, which applies a daily periodic rate to the full amount of principal in the account every day; or
 - The average daily balance method, which applies a periodic rate to the average daily balance (the sum of the full amount of principal in the account for each day of the period, divided by the number of days in the period);
- Credit unions with a minimum balance requirement to earn dividends may choose not to pay a dividend for those days when balances fall below the required minimum. Credit unions using the average daily balance method may choose not to pay a dividend if the average balance for the period falls below the minimum. If a credit union imposes a minimum balance to earn a dividend, it must use the same calculation method to determine whether the member meets the minimum balance as it uses to calculate dividends. If members would benefit, the credit union can use an additional method to determine if the members meet the minimum balance requirement;
- Credit unions must choose how often they will compound and credit dividends. If previously disclosed in writing, credit unions may require members that close accounts between crediting dates to forfeit accrued but uncredited dividends; and
- Dividends begin to accrue not later than the business day the funds are deposited in an account, unless the credit union provides notice of a later time in its policy disclosures under §606 of the Expedited Funds Availability Act and Regulation CC. Once started, dividends must continue to accrue until the member withdraws the funds. However, a credit union need not pay dividends (1) during a grace period for automatically renewable term share accounts if the member decides during the grace period not to renew the account, or (2) after a nonautomatically renewable term share account matures.

A term share account is a share certificate, interest-bearing certificate of deposit account, or other account (e.g., club account) with a maturity of at least seven days, and members may not make withdrawals for six days after opening the account unless an early withdrawal penalty of at least seven days' dividends on the amounts withdrawn exists.

**Annual
Percentage
Yields**

The following two terms describes the yield earned by members:

- **Annual percentage yield (APY)**, used for account disclosures and advertising, measures the total amount of dividends paid on an account based on the dividend rate and the frequency of compounding for a 365-day period.
- **Annual percentage yield earned (APYE)** reflects the relationship between the amount of dividend actually earned and the average daily balance in the account for the statement period or, in some cases, for a period other than the statement period such as the dividend period.

**General
Disclosure
Requirements**

The written account disclosures must (1) reflect the legal obligation between the parties, (2) contain clear and conspicuous information so that members may readily understand the terms of their accounts, and (3) present the information in a form that the member or potential member can permanently retain. Credit unions may deliver periodic statement disclosures in electronic form if the member agrees to this form of delivery. A credit union may have a separate disclosure for each account or it may combine TIS disclosures for several accounts in a single document, such as a brochure for all savings accounts.

Credit unions must use the following specific terminology for TIS:

- “Annual percentage yield” in account disclosures and advertisements;
- “Dividend rate” in account disclosures and advertisements (credit unions may also use “annual percentage rate” in account disclosures in addition to the term “dividend rate”); and
- “Annual percentage yield earned” on periodic statements.

The credit union must show APY and APYE to two decimal places and rounded to the nearest one-hundredth of one percent (.01%). The same rule

applies to dividend rates, except that account disclosures may show the dividend rate at more than two decimals.

TISA considers the APY or APYE accurate if it is within 1/20 of one percentage point (.05%) above or below the actual percentage yield as determined in Appendix A of Part 707. Credit unions may not intentionally incorporate the tolerance as part of their calculations. There is no corresponding tolerance for the accuracy of the dividend rate; it must be precise.

**Providing
Account
Disclosures**

Credit unions must provide accurate account disclosures, before they open an account or provide a service (when assessing a fee), whichever is earlier. If members do not open accounts in person, the credit union must mail or deliver the account disclosures within 10 business days after opening the accounts. Credit unions must also provide disclosures within a reasonable period of the request (10 business days) for each account for which the member requests information.

For member-requested dividend-bearing term share account (share certificate) and interest-bearing account disclosures, the credit union must specify the APY and interest rate offered within the most recent seven calendar days, that the rate and yield are accurate as of the identified date, and must provide a telephone number to obtain current rate information. For term share accounts, the credit union may state maturity as either a term or a date.

For share (dividend-bearing) accounts other than term share accounts, the credit union must disclose the dividend rate and APY that applied as of the last dividend declaration date. If these rates can change, the credit union may disclose the prospective dividend rate and APY in lieu of, or in addition to, the rate and APY as of the last dividend declaration date.

**Oral
Responses to
Inquiries**

When credit unions respond orally to inquiries about rates, they must state the APY as discussed above in the Providing Account Disclosures section and may state the dividend rate. If they state the dividend rate, they must do so as discussed in the above section.

**Content of
Account
Disclosures**

Credit unions must disclose the following information in account disclosures (as applicable):

- Rate information:
 - APYs and dividend rates using the terms "annual percentage yield" and "dividend rate" (credit unions may disclose a periodic rate corresponding to the dividend rate);
 - Time period the dividend rate will remain in effect after a member opens a fixed-rate account;
 - Each dividend rate, along with corresponding APYs for each specified balance level for tiered-rate accounts;
 - A single composite APY, all dividend rates, and period of time the rate will be in effect for each step for stepped-rate accounts (has two or more dividend rates that take effect in succeeding periods and are known at account opening); and
 - Information on variable-rate accounts (those where the dividend rate may change after the member opens the account, unless the credit union contracts to give at least 30 calendar days advance written notice of rate decreases.) The credit union must disclose the following information:
 - i. A statement that the dividend rate and APY may change;
 - ii. The method by which the credit union determines the dividend rate. If the credit union reserves the right to change rates and does not tie changes to an index, it must disclose that rate changes are within the credit union's discretion;
 - iii. Limitations on the amount the dividend rate may change; and
 - iv. The frequency with which the dividend rate may change. Credit unions that reserve the right to change rates at any time must state that fact.
- Compounding and crediting information:
 - The frequency with which the credit union compounds and credits dividends (e.g., daily, monthly, quarterly, etc.);
 - The dividend period (for dividend-bearing accounts); and
 - The effect of closing an account when the account contract provides that the credit union will not pay accrued but uncredited dividends if

the member closes the account before the credit union credits the dividends.

- Balance information:
 - Any minimum balance requirements to:
 - i. Open an account;
 - ii. Avoid the imposition of fees; or
 - iii. Obtain the APY.
(A credit union must also describe how it determines the balances (ii) and (iii)).
 - The balance computation method (i.e., the daily or average daily balance method) used to calculate dividends on the account;
 - The par value of a share necessary to become a member and maintain accounts at the credit union; and
 - When dividends begin to accrue.
- Fee information (amounts and types of all fees that may be assessed), including:
 - Maintenance fees;
 - Fees related to deposits or withdrawals, whether by check or electronic transfer;
 - Fees for special account services (credit unions need not disclose fees for services unrelated to accounts, e.g., money order fees, traveler check fees, etc.); and
 - Fees to open or close accounts.
- Transaction information including:
 - Limitations on the number or dollar amount of deposits to, withdrawals from, or checks written on an account for any time period; and
 - When the member may not make withdrawals from or deposits to term share accounts.
- Term share information:

- Time requirements including the term (for generic disclosure requests), otherwise, the credit union must state the maturity date;
- Early withdrawal penalties including how the credit union calculates them and the conditions under which it assesses them;
- Withdrawal of dividends prior to maturity requirements (i.e., on a term share account that compounds dividends, if a member may withdraw accrued dividends prior to maturity, the credit union must disclose the resulting reduction in account earnings.) The APY assumes that dividends remain in the account until maturity. Credit unions that do not compound dividends on an annual or more frequent basis, and that require the dividend payouts at least annually, and that disclose the APY in accordance with Section E of Appendix A, must state that dividends cannot remain on account and that payout of dividends is mandatory; and
- Renewal policies including:
 - i. Whether a term share account automatically renews at maturity; and
 - ii. Whether the credit union provides a grace period and, if so, its length. For nonautomatically renewable term share accounts, a credit union must disclose whether it will pay dividends after maturity if the member does not renew the account.
- Bonus information:
 - The amount and type of bonuses the credit union offers;
 - The timeframe in which the credit union will pay the bonus; and
 - The minimum balance or time requirements necessary to obtain the bonus.
- Nature of Dividends (i.e., credit union pays dividends at the end of a dividend period from current income and available earnings after required reserve transfers.) Credit unions need not make this dividend statement for dividend-bearing term share accounts or interest-bearing accounts. However, if the credit union requires a member to open a share account in order to open a dividend-bearing term share or interest-bearing account, the credit union must disclose the "nature of dividends" for the share account. The credit union need not make the disclosure in advertising and oral responses to rate inquiries.

**Change In
Term Notices**

Credit unions must send a written notice 30 calendar days before the effective date of a change of the term for an account that requires disclosure, if that change may reduce the APY or adversely affect members. No requirement for notices exists under the following circumstances: (1) if the rate changes on a variable-rate account, (2) if the terms change for term share accounts with a maturity of 31 days or less, or (3) if the fees (or the credit union's mark-up) for share draft printing increase.

**Notices for
Maturing Term
Share
Accounts**

TIS requires the following disclosures for term share accounts that automatically renew and those that do not renew automatically:

- Automatically renewable:
 - Credit unions with automatically renewable term share accounts having maturities of more than one year must provide the same account disclosures that they would provide to a member opening a new account, along with the date the existing account matures. If credit unions do not know the APY and dividend rate when they send the account disclosures, they may explain that they do not have this information available along with the date when they will have the yield and rate available and a telephone number where members can obtain the new yield and rate. Credit unions must send disclosures either 30 calendar days before the scheduled maturity date, or 20 calendar days before the end of a grace period if the grace period is at least five calendar days. Therefore, if the credit union has at least a 5-day grace period, it may send the disclosures 15 calendar days before the maturity date;
 - Credit unions with automatically renewable term share accounts having maturities of more than one month but less than or equal to one year must either (1) provide account disclosures identical to the automatically renewable term share accounts with maturities of more than one year; or (2) provide abbreviated disclosures that include the date the existing account matures, the new maturity date (if the account is renewed), the dividend rate and the APY for the new account (if known), along with any differences in the terms of the new account as compared to the terms of the existing account. Credit unions must provide these disclosures (or the disclosure required if the dividend rate and the APY are unknown) within the same timeframes as those

for automatically renewable term share accounts with a maturity of longer than one year; and

- Nonautomatically renewable:
 - Credit unions with nonautomatically renewable term share accounts having terms longer than one year must send a notice 10 calendar days before maturity stating the maturity date of the existing account and whether the credit union will pay dividends after maturity. If renewed, credit unions must provide new account disclosures; and
 - Credit unions with nonautomatically renewable term share accounts of one year or less need not provide notice prior or subsequent to maturity. Credit unions must provide new account disclosures on renewed accounts.

Notices for Maturing Term Share Accounts

	Automatically Renewable (Rollover) Term Share Accounts	Nonautomatically Renewable (Nonrollover) Term Share Accounts
1 month or less (31 days)	No <u>advance</u> notice required.	No notice required. New disclosures if renewed.
Greater than 1 month but 1 year or less	<p><u>Timing:</u> (A) 30 (calendar) days before maturity; or (b) 20 (calendar) days before end of grace period, if a grace period of at least 5 (calendar) days is provided.</p> <p><u>Content:</u> Dividend rate and APY for new account (or fact that rates have not been determined, when they will be, and telephone number to call for rates), and <u>either:</u> (A) maturity date of existing and new accounts, and any change in terms; or (B) full disclosures for account (§707.4(b)) and maturity date for existing account.</p>	<p>No notice required.</p> <p>New account disclosure if renewed.</p>
Greater than 1 year	<p><u>Timing:</u> Same as for accounts greater than 1 month but 1 year or less.</p> <p><u>Content:</u> Full disclosures for account (§707.4(b)) and maturity date for existing account.</p>	<p><u>Timing:</u> 10 (calendar) days before maturity.</p> <p><u>Content:</u> Maturity date, and whether or not dividends will be paid after maturity. New disclosures if renewed.</p>

Illustration 19T-1

**Periodic
Statement
Disclosures**

TIS does not require credit unions to send periodic statements (those with account information provided on a regular basis four or more times a year), but if the credit union does provide a statement, it must include certain information.

Credit unions may deliver periodic statement disclosures in electronic form if the member agrees to that form of delivery. State law determines whether the parties have an agreement. The credit unions must provide the periodic statements in a clear and conspicuous form that the member can display as visual text and can retain. Credit unions that provide periodic statements must disclose the following information for the statement period, as applicable:

- APYE:
 - Credit unions must disclose the "annual percentage yield earned" (computed according to Part 707, Appendix A, Part II), using that term. The APYE is an annualized rate that shows the actual dollar amount of dividends earned (either accrued or paid and credited) on an account as a percentage of the average daily balance in the account for the actual number of days in the period. Credit unions should clarify their definition of "earned". Credit unions that calculate and credit dividends for a period other than the statement period (e.g., the dividend period) may calculate and disclose the APYE and amount of dividends earned based on that period rather than the statement period.
 - If credit unions provide periodic statements more frequently than the dividend period, only the statements covering the period in which dividends (not interest) are credited must include the amount of dividends earned and the APYE. For interest-bearing accounts, credit unions must base accrued but uncredited interest on the statement period, unless they calculate interest using the average daily balance method and the average daily balance period is less frequent than the statement period. (For purposes of determining the APYE, credit unions compute the average daily balance since usually they already determined the dividends earned and the number of days in the period.) Conversely, if the dividend period is more frequent than the statement period, the credit union may either disclose a single dividend rate and APYE or disclose three dividends earned and three APYEs, one for each dividend period, as long as the credit union states the number of days (or beginning and ending dates) in each dividend period that varies from the statement period.

- Amount of dividends:
 - Credit unions must disclose the dollar amount of dividends credited and interest earned (accrued or paid and credited.) They may base dividend disclosure on the statement period or another period (e.g., dividend period); however, they must base interest on the statement period unless they use the average daily balance method to calculate interest and the average daily balance period is not as frequent as the statement period. The dollar amount of the dividend disclosed and the APYE must reflect the same period. Credit unions must disclose dollar amounts of extraordinary or bonus dividends earned during the period separately.

- Fees:
 - Credit unions must disclose fees (see *NCUA Rules and Regulations* §707.4(b)(4)) that they have actually debited from the account during the period. They must itemize the fees by dollar amount and type and may either group the fees by type or individually itemize the fees.

- Length of period:
 - Credit unions must disclose the total number of days in the statement period. Alternatively, they may state beginning and ending dates of the statement period as long as they make clear whether they included both of these days in the period. If credit unions disclose the dollar amount of dividends earned based on a period other than the statement period, they must disclose the length of that period as well.

- Special Formula:
 - Credit unions that provide statements more frequently than the period for which they compound dividends must use the special APYE formula in Part 707, Appendix A, Part II B.

Advertising

Credit unions must exercise care in advertisements for share and deposit accounts. An advertisement is any commercial message appearing in any medium (e.g., newspaper, television, lobby boards, and telephone response machines) if it directly or indirectly promotes the availability of, or deposit in, an account.

TIS prohibits misleading or inaccurate statements in advertisements (e.g., TIS does not allow the term "profit" in ads for interest-bearing accounts, but does

allow it in ads for dividend-bearing accounts, since dividends are a return on a member's share investment.) TIS does not allow the term "free" or "no-cost" if the credit union imposes any maintenance or activity fee on the account. However, since credit unions usually consider automated teller machines (ATMs) a service that does not require a user to open or maintain an account, ATM fees associated with such accounts would not restrict a credit union from advertising the accounts as "free". Credit unions may advertise free transactions at ATMs as "free"; however, the credit unions must disclose time limits placed on a free service.

If credit unions advertise a rate, they must express it using the term "annual percentage yield" (abbreviated as "APY") if the term is spelled in full at least once in the advertisement. Credit unions may state no other rate, except the "dividend rate" that corresponds to the advertised APY.

Credit unions trigger the following additional disclosure requirements, as applicable, if advertisements (not exempt under §707.8(e)) display an APY:

- Variable rates;
- Time period - how long the credit union will offer advertised APYs (e.g., "from March 7 through March 13" or "annual percentage yield effective as of March 7");
- Accuracy of APY – for dividend-bearing accounts other than term share accounts, a statement that APY is accurate as of the last declaration date or, if inaccurate, the prospective APY;
- Minimum balances required to obtain the advertised APY;
- Minimum opening deposit;
- Fees that could reduce earnings on the account;
- Term share accounts - specifying the term (e.g., three months) and early withdrawal penalties;
- Advertisement – if advertisement states that APY equals dividend rate for noncompounding multi-year account, it must state that dividend payouts are mandatory;
- Tiered-rate accounts - including all APYs (including APY ranges), all dividend rates, and any minimum balance required to obtain the APYs for each tier; and
- Stepped-rate accounts – these accounts stating a dividend rate must state all dividend rates and the time period for each;
- Bonus – if a bonus is displayed in an advertisement, it must disclose (1) the APY, (2) time restrictions to obtain the bonus, (3) when the credit

union will provide the bonus, and (4) required minimum balances necessary to obtain the bonus.

**Exemptions
from Some
Advertising
Requirements**

§707.8(e) of NCUA's Rules and Regulations permits abbreviated disclosure requirements for advertisements made through:

- Broadcast or electronic media (radio and television);
- Outdoor media (billboards);
- Telephone response machines;
- Indoor signs (any sign that can reasonably be viewed only by a member from outside the premises, such as lobby boards, is not subject to the portions of §707.8 regarding permissible rates, minimum balance, bonuses, and certain media); and
- Newsletters distributed only to existing members.

If the credit union discloses a rate of return or bonus on one of the first three media listed above, the advertising requirements specify that, if applicable, the credit union must:

- State the rate of return as an "annual percentage yield", using that term at least once;
- State no rate other than the APY, except that the dividend rate may also be stated;
- State the minimum balance to earn the APY and the bonus;
- State the time requirement to obtain the bonus;
- State the term of the account (if a term share account);
- State dividend payouts required, if applicable;
- State all APYs and balance requirements for each tier for solicitations of tier-rate accounts through telephone response machines; and
- State the same disclosures required of a nonexempt media (if a tiered-rate account.)

Credit union newsletters are exempt from many of the advertising requirements if the credit union distributes the newsletter to existing members only and does not intend it as a promotional piece for potential members. Exercising care to reach only existing members demonstrates compliance with the requirement for the exemption (e.g., credit unions should not leave newsletters in the lunch room of the sponsor.)

If the credit union discloses a rate of return on an indoor sign or sends a newsletter to existing members only, the advertising requirements specify that the credit union state:

- The rate as an "annual percentage yield", using that term at least once;
- No other rate than the APY, except that the dividend rate may also be stated; and
- A statement that members should contact an employee for further information about applicable fees and terms.

Effect on State Laws

TIS may preempt state law requirements that are inconsistent with the requirements of the TISA or NCUA's TIS regulation, but only to the extent of the inconsistency. A state law is inconsistent if it requires a credit union to make a disclosure or take action that federal law prohibits. Credit unions desiring a preemption determination should request one from NCUA.

Record Retention

Credit unions must retain records of compliance with TIS for a minimum of two years after the date disclosures are required to be made or action is required to be taken. Although they need not retain a copy of each disclosure, credit unions desiring to establish compliance should (1) document established procedures for providing the various disclosures, (2) follow the procedures, and (3) retain sample disclosures for the types of accounts offered. Credit unions must keep sufficient rate and balance information to enable examiners to verify dividends paid on the account.

Acceptable records storage methods include microfiche, microfilm, magnetic tape, or other methods capable of accurately retaining and reproducing information (e.g., a computer file.) Credit unions need not retain disclosures or advertisements in hard copy, as long as they can reconstruct required disclosures or other records.

Failure to Comply

NCUA may enforce compliance of the Truth in Savings Act and Part 707 under both the Truth in Savings Act and the *Federal Credit Union Act*.

Defenses

If the evidence demonstrates that a violation was unintentional and resulted from a bona fide error, a credit union may not be subject to civil liability for

violations. To avoid liability, a credit union must document that it had instituted reasonable procedures to avoid inadvertent errors including clerical, computer programming, and printing errors. An additional defense may include the credit union's reliance on the Official Staff Commentary or interpretations. Credit unions cannot use errors of legal judgment as defenses; however, they may avoid liability by notifying the account holders and making adjustments within 60 days after discovering the violation.

**Examination
Procedures**

If necessary, examiners should:

- Review the credit union's TISA policies and procedures;
- Determine the credit union has a detailed disclosure as required;
- Determine the credit union accurately calculates the APY, dividends, and APYE;
- Determine whether the credit union provides initial disclosures as required;
- Determine whether the credit union appropriately discloses the annual percentage yield and the dividend rate;
- Determine procedures are in place for staff to accurately respond to oral account inquiries;
- Determine whether the credit union notifies members of any adverse changes at least 30 days before the change;
- Determine whether periodic statements include clear and conspicuous disclosure of:
 - APYE;
 - Amount of dividends earned;
 - Amount and type of fees imposed;
 - Time frame of the reporting period; and
- Determine whether the share account advertisements, announcements, internet web pages, or other solicitations avoid misleading or inaccurate representations of share account terms;

Examiners should discuss emerging or unresolved deficiencies with management and, if material, in the examination report.

Chapter 20

REPORT WRITING

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Chapter 20

REPORT WRITING

Report Writing Objectives

- Communicate to the credit union officials the results of the examination, including an appropriate discussion of risk areas and the required disclosure of CAMEL components and composite ratings
- Present for discussion and adoption (or revision) necessary plans for correcting problems and reducing unacceptable risks
- Prepare documented administrative record for NCUA

Overview

The examination report is NCUA's official report to the credit union. It serves as an important communication tool between the examiner, the credit union, and NCUA. The examiner-in-charge obtains information from the team members on areas they reviewed, prepares the report, and delivers it to the board of directors at the conclusion of the examination. The examiner should individualize the report for the officials, who comprise the report's primary users and primary audience.

Examiners should prioritize communicating with credit union officials and management throughout the examination process. Nothing presented at the joint conference, exit interview, or in the examination report should surprise the officials. Examiners should set aside time throughout the examination for discussion with management and officials regarding developments and findings in the examination. They may also provide the officials a draft copy of the report and give the officials and management sufficient time to review it before the joint conference or exit interview.

The examination report represents a written explanation of the risk profile, significant financial conditions, trends, problems, agreements, and guidance to officials. As such, it documents all significant items identified during the examination and risk assessment. Examiners must retain a copy of the official report, including all workpapers, schedules, checklists, forms, and examiner-prepared notes used to support their conclusions. Appendix 20A lists (1) a complete set of all AIRES workpapers; (2) the minimum required workpapers the examiner must

provide for regional management and quality control reviewers; and (3) the minimum required output reports that the examiner must provide in the examination report to the credit union.

Components

Examiners must complete the following required workpapers:

- Scope Workbook,
- Examination Contact Information,
- Overview,
- Document of Resolution (if applicable),
- Confidential Section, and
- Table of Contents.

The following required questionnaires represent performance of the three minimum exam procedures:

- 5300 Review Questionnaire,
- Supervisory Committee Audit and Verification Review Questionnaire, and
- Bank Secrecy Act Questionnaire.

Examiners will use the AIREs Table of Contents to organize the report given to the officials and to document which workpapers they included in the report.

Although these comprise the required workpapers, examiners must document the areas they reviewed and the steps they performed during the examination. This documentation will support the examiner's findings and conclusions, and will serve as an administrative record. Examiners will use their judgment to determine which workpapers appropriately document the work they perform and which they will include in the copy of the report to the credit union.

Examiners will provide the credit union copies of the Overview and the Document of Resolution (if applicable). The credit union will not receive a copy of the Scope Workbook, Examination Contact Information, or the Confidential Section. Examiners may provide the credit union any schedules, findings, optional workpapers, questionnaires, and examiner-designed workpapers to support their

conclusions and assist in gaining resolution to problems uncovered during the examination or supervision process.

Additionally, some regional directors have separate agreements with various state supervisory authorities (SSAs) on the completion of the Compliance Violation Input Form and the Consumer Compliance Checklists in state credit unions. Therefore, examiners should follow regional instructions on such agreements.

Scope Workbook The Scope Development and Planning chapter of this Guide provides guidance in completing the Scope Workbook.

Examiner Contact Information Examiners use the Examiner Contact Information workpaper to update NCUA's database with certain information compiled during examinations and supervision contacts. The data for this report flows from the Contact and Problem Areas screens and the CAMEL evaluation and Key Ratios worksheets.

Examination Overview During each examination in federal credit unions, examiners will complete an Overview that, at a minimum, discloses the CAMEL ratings, both component and composite. If no material risks exist, the Overview normally will be brief.

Even though the CAMEL ratings constitute the only requirements of the Overview, examiners will often use it to discuss and support their review, analysis, and conclusions, and to put examination findings into proper perspective. Examiners may also make appropriate comments about risk assessment aspects of the examination scope. The depth and complexity of the Overview will vary depending on the degree of problems noted. To make the Overview as effective as possible in relating the material results of the examination, examiners should structure it to discuss the most critical risks first.

Examiners usually complete the Overview near the end of the examination, according to regional timeframes. If examiners learn of additional information at or after the joint conference that affects the report's content, they may amend the Overview or comment on the

matter in the Confidential Section. In state-chartered credit unions, examiners should follow the disclosure policies of the respective state supervisor. Generally, the agreement between the regional director and state supervisor contains these disclosure policies.

Document of Resolution

Examiners use the Document of Resolution to outline plans and agreements reached with officials to reduce areas of unacceptable risk. An area of unacceptable risk is one for which management does not have the proper structure for identifying, measuring, monitoring, controlling, and reporting risk. The Document of Resolution should parallel the Overview (most critical to least critical risks); however, the Document of Resolution will include persons responsible and timeframes for correction.

Examiners should not address minor issues in the Document of Resolution, but should discuss minor issues with management. Examiners can document these minor issues using an optional AIREs or examiner-prepared workpaper. They can provide these workpapers informally to management for correction, but should not clutter the formal report to the credit union with minor or immaterial issues. The region's copy of the report should include workpapers provided to management. These will be part of the administrative record.

Before the joint conference, examiners should strive to reach agreements on corrective action the credit union needs to take. At times, officials will not agree to a Document of Resolution. If this occurs, the examiner should work with officials to develop alternative solutions or give them additional time to develop acceptable plans of their own. If they fail to do so within the agreed-upon timeframe, the examiner should consider drafting a Regional Director Letter urging officials to formulate an acceptable plan that recognizes and resolves the problems.

In instances where the officials did not adopt the Document of Resolution, the Confidential Section should explain why. The following example documents an appropriate footnote to a Document of Resolution not adopted:

These plans for action, although not approved by the credit union officials, are recommended to correct the area of concern. The officials have agreed to review the plans and to notify the Regional Director, National Credit Union Administration, (enter appropriate address), by (enter date), of the actions to be taken.

Examiners may, at their option, add the following wording to the footnote:

If appropriate, the officials will submit alternate plans of action for review.

In rare instances, the directors do not agree to the Document of Resolution and do not offer alternate plans, or fail to do so within the agreed upon timeframe. In these cases, the examiner should consider the nature of the Document of Resolution and discuss the course of action with the supervisory examiner following regional policy. When the overall risk to the credit union so warrants, the examiner and supervisory examiner may find it necessary to recommend administrative action, again following regional policy.

When the examiner must repeat a Document of Resolution from a previous examination because the officials failed to sufficiently correct the area of concern, the examiner should emphasize the repeated agreement. The examiner should place an asterisk beside the item and footnote the lack of corrective action to draw management's attention to the ongoing problem.

**Confidential
Section**

The Confidential Section is for NCUA's internal use only. Examiners should comment briefly but completely enough to clearly reflect actions taken during the examination. The Confidential Section should reduce repetition by not repeating items covered in the Scope Workbook, Overview, or other sections of the report, unless additional information is needed. If not discussed elsewhere in the report, the Confidential Section should state what formal actions the board took and how the officials will handle major problems.

Examiners should also discuss agreements reached with officials apart from the Document of Resolution. Of particular importance is an explanation of what the examiner accomplished during discussions with officials.

The Confidential Section should document (1) whether the examiner held a joint conference, (2) whether the officials requested the joint conference (if Code 1 or 2), and (3) the attendees at the joint conference or exit meeting. It may also document discussions with management about correction of minor issues and should document discussions regarding expansion into underserved areas. (See the Joint Conference/Exit Meeting chapter for additional guidance.)

Examiners should cover pertinent matters of a private or restricted nature, including personal opinions based on the examiner's observations. However, the examiner should not make statements based on gossip or hearsay. Situations exist when a court directs the release of all or part of a particular Confidential Section. Further, NCUA may release some parts of a Confidential Section in compliance with a Freedom of Information Act request. The possibility of release should not dissuade examiners from presenting necessary information; however, examiners should maintain their professionalism and objectivity when writing the Confidential Section.

Examples of material that examiners may cover in the Confidential Section include the following:

- Perspective on a new credit union's progress,
- Comments on the attitudes and abilities of the officials,
- Potential difficulties facing the credit union,
- Plans for monitoring the credit union (i.e., on-going risk-focused supervision,) and
- Other appropriate topics.

Examiners should use the Confidential Section as extensively as necessary but they should not clutter the section with inconsequential or irrelevant facts and opinions.

**Supplementary
Facts**

Examiners may use the Supplementary Facts to discuss material facts or situations not contained in other narrative sections of the examination report (e.g., bond claims, discussion of fraud, progress on Letters of Understanding and Agreement, progress on Net Worth Restoration Plans, etc.). If there exists no need to prepare the

Supplementary Facts, examiners will not include the form with the workpapers.

**LUAs, NWRPs,
and Revised
Business Plans**

The examiner may use either the Supplementary Facts or the Overview to document management's progress in complying with outstanding Letters of Understanding and Agreement (LUAs), Net Worth Restoration Plans (NWRPs), and Revised Business Plans.

Examiners may record the date the officials signed one of the above agreements, and any subsequent revisions to the agreements. Examiners should list each item of the agreement and document the degree of compliance. In the rare event that NCUA publishes an LUA, the examiner should contact the supervisory examiner before discussing compliance with the terms of the LUA in the report.

**Examiner's
Findings**

Examiners may use the optional Examiner's Findings workpaper to list material operating exceptions, violations of law or regulation, and unsafe and unsound policies, practices, and procedures. Examiners should not discuss minor, infrequent infractions in the Examiner's Findings since they detract from the more important matters. As previously discussed, other vehicles exist for documenting discussions of minor concerns with management.

Examiners, at their discretion, may include the Examiner's Findings in the Examination Report to the board of directors or they may provide the workpaper to credit union management and not include it in the report.

When identifying a finding, the examiner should cite the specific section of the *FCU Act*, *FCU Bylaws*, *NCUA Rules and Regulations*, or other authority. In the event that the credit union violates more than one of the above, the examiner should cite the highest authority.

Examiners should list exceptions noted during previous examinations but not yet corrected under a heading similar to: "Findings Noted at Previous Examination That Are Not Yet Corrected" or by placing an asterisk next to the exception and footnoting it with similar wording.

**Possible
Additional
Actions**

- Submittal of Periodic Reports. Under the risk-focused approach, examiners will supervise the credit union throughout the year. As part of that supervision, examiners may request that the credit union mail them copies of the monthly financial reports, delinquency reports, board minutes, etc. to monitor existing and potential risks.

- Regional Director Letters. In problem credit unions, regions attempt to correct noted problems by sending Regional Director Letters to the credit union in question. In severe cases, the letters indicate that unless the credit union takes corrective action or makes reasonable progress, NCUA may pursue administrative action. The letter should cite the serious or persistent problems and the unsafe or unsound practices that exist. The examiner should follow regional policy for wording and processing of the letter. The examiner should tailor the letter's contents to suit the needs of the individual credit union.

- Administrative Action. The Administrative Action chapter outlines procedures for when the examiner believes that an administrative action is necessary to correct financial or operational deficiencies.

Workpapers

- Workpapers
 - Scope Workbook
 - Examiner Contact Information
 - Examination Overview
 - Document of Resolution
 - Supplementary Facts
 - Examiner's Findings
 - Confidential Section
 - Table of Contents

AIRES REPORTS - APPENDIX 20A

Legend:

- ✓ Minimum requirement for report to NCUA
- ✓✓ Minimum requirement for report to credit union
- 1 If violation noted is repetitive or substantial
- 2 Required, if applicable
- 3 Completed as set forth in agreements between individual SSA and regional director

Report Name	FCU	FISCU	CU
General			
Examiner Contact Information	✓	✓	
Compliance Violation Input Form	✓1	✓1	
Scope Workbook	✓	✓	
Credit Union Location Information			
Review Considerations			
Credit Union Update			
Analyst Report Review			
Final			
Table of Contents	✓	✓	✓✓
Executive Summary			
Examination Overview	✓	✓	✓✓
CAMEL Rating Explanation			
Supplementary Facts			
Document of Resolution	✓2	✓2	✓✓2
Examiner Findings			
Examiner Findings Abbreviations			
Confidential Section	✓	✓	
Informal Discussion Items			
Board Minutes			
Items Needed for Examination			
Financial			
CAMEL Evaluation			
Key Ratios			
Key Ratio Definitions			
Financial History			
Solvency Evaluation			
Statement of Financial Condition			
Statement of Income			
Reasonableness Ratios			
Budget Analysis			
Comparative Analysis			
Exam Trends			
Projections			
Two Minute Profitability Test			
General Ledger			
General Ledger Journal Adjustments			
Operating Fee/Share Insurance			
Risk-Based Net Worth			

Report Name	FCU	FISCU	CU
<i>General Ledger (Continued)</i>			
Alternative Components for Risk-Based Net Worth			
Allowance for Loan Losses			
GL – Cash on Hand			
GL - Cash on Deposit			
GL – Cash Equivalents			
GL - Prepaid and Deferred Expenses			
GL – Land			
GL – Buildings			
GL – Furniture and Equipment			
GL – Leasehold Improvements			
GL – Leased Assets Under Capital Lease			
GL - Other Real Estate Owned			
GL – Accounts Payable			
GL - Notes Payable			
GL - Regular Reserves			
GL – Appropriation for Non Conforming Investments			
GL - Other Reserves			
GL – Retained Earnings Reconciliation			
GL – Undivided Earnings			
GL – Unrealized Gains/Losses on AFS			
GL – Miscellaneous Equity			
<i>Loans</i>			
Loan Trends			
Loan Analysis			
Allowance Evaluation			
Watch List Loans			
Loan Exceptions			
Loan Profile			
Insider Loans			
Delinquency Calculator			
<i>Investments</i>			
Investment Trends			
Investment Maturity			
Investment Classification			
Amortizing Investments Review			
Certificate Review			
<i>Shares</i>			
Share Trends			
Shares Greater Than \$100,000			
Shares Less Than \$0			
<i>Asset Liability Management</i>			
IRR – Part A			
IRR – Part B			
IRR – Part C			
IRR – Part D			

Report Name	FCU	FISCU	CU
<i>Asset Liability Management (Continued)</i>			
17-4 Test (ALM Analysis)			
Pricing Table Input (ALM Analysis)			
Shock Summary (ALM Analysis)			
Liquidity – Part A			
Liquidity – Part B			
Liquidity – Part C			
<i>Questionnaires</i>			
Checklist			
5300 Review	✓	✓	
ACH – Optional			
IRR – Part A			
IRR – Part B			
IRR – Part C			
IRR – Part D			
Liquidity – Part A			
Liquidity – Part B			
Liquidity – Part C			
BSA – Bank Secrecy Act	✓	✓	
OFAC		3	
Compliance Program			
Security Program			
E – Commerce I			
E – Commerce II			
EDP Review			
Enforcement Authority			
IC – ATM			
IC – Cash			
IC – CUSO			
IC – Financial Triggers			
IC – LOC			
IC – Management			
IC – Money Orders & Travelers Checks			
IC – Security			
IC – Wire Transfers			
Inv – Account Controls			
Inv – Cash Forward			
Inv – CDs			
Inv – Controls			
Inv – Fed Funds			
Inv – IC – Optional			
Inv – IRPS 98-2 Optional			
Inv – Mutual Funds			
Inv – Optional – IC			
Inv – Repurchase Transaction			
Inv – Reverse Repurchase			
Inv – SBA			
Inv – Securities Lending			

EXAMINER'S GUIDE

Report Name	FCU	FISCU	CU
Questionnaires (Continued)			
Ln – Agricultural			
Ln – ARM			
Ln – Business Loans			
Ln – Collection Program			
Ln – Construction			
Ln – Controls		3	
Ln – Credit Cards IC		3	
Ln – Credit Practices Rule		3	
Ln – FHA-Real Estate		3	
Ln – FDPA–Flood Disaster Protection Act		3	
Ln – Home Equity			
Ln – HOPA–Homeowners Protection Act		3	
Ln – Indirect Lending		3	
Ln – Leasing–IC		3	
Ln – Leasing-IC		3	
Ln – Lines of Credit-IC		3	
Ln – Optional IC		3	
Ln – Real Estate-IC		3	
Ln – Reg B-Equal Credit Opportunity		3	
Ln – Reg B-Real Estate		3	
Ln – Reg C-HMDA		3	
Ln – Reg M – Leasing		3	
Ln - Reg Z-Closed End Credit		3	
Ln - Reg Z-HELOCs		3	
Ln - Reg Z-Open End and Credit Cards		3	
Ln - Reg Z-Variable RE Loans		3	
Ln - Reg Z-General		3	
Ln – Reg Z-Closed End Credit		3	
Ln – RESPA		3	
Ln - Reg Z-Right of Recision		3	
NWRP - Net Worth Restoration Plan			
Privacy of Consumer Information		3	
COPPA			
Red Flag Procedures			
Red Flag			
Supervisory Committee Audit and Verification Review	✓	✓	
SC – CPA Non-Opinion			
SC – CPA Opinion			
SC – General Review			
SC – Internal Audit			
SC – SC Audit			
Sh – Controls			
Sh – Optional-IC			
Sh – Reg CC-Expedited Funds Avail.		3	
Sh – Reg D – Reserve Requirements		3	
Sh – Reg E – Electronic Funds Transfer		3	

Report Name	FCU	FSCU	CU
Questionnaires (Continued)			
Sh – Share Drafts-IC			
Sh – TISA-Truth in Savings Act		3	

NOTE: In order to complete the required reports, **examiners must complete the required inputs, all color-coded yellow.**

At the examiners' option, they may also provide to the credit union any reconciliation workpapers, questionnaires, and examiner-designed workpapers as needed to assist in gaining resolution to problems.

Agreements between the SSA and the regional director may permit variations of these reports. SSAs may prescribe additional examination elements which are peculiar to their states.

Chapter 21

JOINT CONFERENCE AND EXIT MEETING

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Chapter 21

JOINT CONFERENCE AND EXIT MEETING

Examination Objectives

- Establish an open forum for discussion of items of interest or concern
- Convey the results of the examination to the officials and senior management
- Reach agreements on plans of action and timeframes to reduce levels of unacceptable risk

Joint Conference

A joint conference is a meeting of the examiners and a sufficient number (quorum) of the board of directors to conduct official credit union business. A joint conference provides the examiner the opportunity to reach agreements with the board that they will take appropriate action for reducing levels of unwarranted risk in the credit union. Examiners rely on the joint conference and the examination report to convey concerns about the credit union's operation and persuade management to take appropriate steps to implement necessary corrective action. The examination report provides the officials with documentation of conclusions reached at the joint conference and other problems noted during the examination.

Examiners should prioritize communicating with credit union officials and management throughout the examination process. Nothing presented at the joint conference, exit interview, or in the examination report should catch the officials by surprise. Examiners should set aside time periodically to discuss with management and officials developments in the examination. They may also provide a draft copy of the report and give the officials and management sufficient time to review it before the joint conference or exit interview.

Examiners must hold a joint conference at the end of every examination for a credit union coded CAMEL 3, 4, or 5. Additionally, examiners will hold a joint conference in a Code 1 or 2 credit union if the credit union board so requests. Otherwise, the examiner will hold an exit meeting, rather than a joint conference meeting, unless substantive concerns exist or if the examiner determines the need for a communication forum. In state-chartered credit unions, the agreement

between the region and the state usually governs the procedures for a joint conference (refer to the FISCU chapter for more specific information.)

Examiners should inform key officials in credit unions with probable codes of CAMEL 1 or 2 early in the examination process that they may request a joint conference. The examiner may invite the credit committee, supervisory committee, and key staff to attend the joint conference; however, as a courtesy, the examiner may want to discuss whom to invite with the board chairperson before extending invitations.

When the likelihood of holding a joint conference is high, the examiner-in-charge should meet with the president or chairman as early as possible during the examination to make necessary arrangements. The examiner should emphasize the importance of having a quorum of the board of directors in attendance. If the examiner learns that a quorum cannot or will not attend, or encounters problems that may extend the examination time, the examiner should reschedule the joint conference.

Examiners should endeavor to make the joint conference constructive, and conduct it in a business-like manner that promotes clear, understandable communication with the officials. Requesting the officials prepare minutes of the joint conference will avoid misunderstandings. Credit unions often use tape recorders to record their meetings. The officials usually ask for the examiner's concurrence before taping the joint conference, a request to which the examiner normally agrees. However, the examiner may request a copy of the tape or a transcript.

When examiners do not expect to hold a joint conference, they should make certain the officials understand they may request a joint conference at the conclusion of the examination. In the event no joint conference will occur, examiners should make every effort to have at least one volunteer official present at the exit meeting.

Exit Meeting

An exit meeting differs from a joint conference in that an exit meeting does not require a quorum of the board attend. Generally, attendance at

an exit meeting consists of top management, key staff and possibly one or more officials. Without a quorum of the board in attendance, binding action cannot take place at an exit meeting. Examiners must hold an exit meeting and/or a joint conference at the end of every examination; however, Code 1 or 2 credit unions require only an exit meeting, not a joint conference.

The examiner can determine the format and structure of the exit meeting, which need not require the same degree of formality as a joint conference. For example, before a joint conference, the EIC will provide a preliminary review of the examination results to key staff and possibly some officials. This gives management the opportunity to discuss their concerns and any aspect of the examination (e.g., risk profile, recommendations, findings, loan exceptions.) The examiner can use information gathered from this meeting to prepare for the joint conference and finalize the exam report.

At an exit meeting, the examiner normally discusses the following:

- Current and potential risk profile of the credit union;
- Examination findings (normally, fairly minor in nature);
- Needed corrections; and
- Any necessary action that management must take to the next board meeting, with the agreement that management will notify the examiner of the actions taken.

Joint Conference/ Exit Meeting Agenda

Examiners should conduct both joint conferences and exit meetings in a clear, concise, and orderly manner. An agenda helps examiners keep their meetings focused and organize their presentations to ensure coverage of pertinent data in a logical order. It assists the examiners in differentiating material items from nonessential ones, and allows them to concentrate on topics of most importance. An agenda also provides documentation of topics discussed. Although an agenda is recommended for every meeting, some examiners may forgo preparing an agenda for an exit meeting in a credit union with no, or very minor, concerns.

In cases of a team examination, the EIC may ask the team member most familiar with a specific problem area to attend the meeting. This

team member can discuss or answer questions that may arise concerning that portion of the examination.

**Joint
Conference/
Exit Meeting
Preparation**

During the course of each examination, examiners will discuss the credit union's risk profile, problems, and recommended solutions with management or key officials. This discussion serves to elicit their cooperation and agreement as well as eliminate or reduce potential conflicts that may occur at the joint conference. To maximize the meeting's effectiveness, the EIC should resolve minor problems with management before the exit meeting.

Before a joint conference, examiners should also develop with management and key officials initial plans for corrective action that the credit union will take to correct material problems noted in the examination. The officials then need time to read, discuss, and understand what the Document of Resolution means and the effect it will have on the credit union. Examiners may minimize conflicts if management and officials agree to plans of action before the joint conference.

**Conducting
the Joint
Conference**

The effectiveness of the joint conference directly relates to successful communication and examiner credibility. Examiners enhance their credibility when their conduct remains dignified, professional, and objective. They should keep in mind the volunteer status of most officials, who often have differing backgrounds and skills. Examiners should provide the officials encouragement as well as constructive criticism. The examiner should discuss major points and present the information needed to enact corrective action.

Examiners may incorporate the following guidelines to help effectively plan and conduct a joint conference:

- Establish rapport with officials early in the joint conference. Let attendees know that everyone present has the common goal of serving the best interests of credit union members;
- Compliment the officials for specific achievements and for their volunteer time, if appropriate;

- Encourage two-way communications. Invite the officials to participate freely in the discussions. Ask questions frequently to ascertain the officials' understanding of the information presented; and
- Present material in a clear, concise, positive and logical manner.

Examiners should not dictate credit union policy, but rather should lead and persuade officials to proper action. Examiners may find that using a "working copy" of the Document of Resolution, which was previously discussed with management, promotes better understanding and discussion at the joint conference. Key officials and staff will more likely "buy into" and implement plans that they have a part in developing. The willingness of the examiner to adjust or revise recommendations during the joint conference can directly affect the plan's effectiveness.

If the board adopts the proposed Document of Resolution, the examiner may present the formal copy of the examination report to the chairman of the board at the joint conference. If the proposed Document of Resolution changes, the examiner should arrange to either deliver the formal report to the chairman or mail it upon completion.

If the examiner and credit union do not reach agreement for needed corrective action during the joint conference, the examiner should give the officials a reasonable amount of additional time after the joint conference to discuss the Document of Resolution and develop an alternate plan of action. In this situation, the examiner should footnote the Document of Resolution to require that officials present the examiner with the board-developed plans of action, usually within 30 days after the joint conference.

If the officials recommend a reasonable alternative method of resolving a problem, examiners should give strong consideration to accepting the recommendation. After reviewing the board's plan, the examiner should notify the board as to its acceptability. An unacceptable alternative plan of action may require the examiner to schedule another meeting with the board.

The examiner should obtain firm commitments from the officials for carrying out the plans of action. The board minutes should record agreements, disagreements, and promises. The examiner should review all the agreements reached with officials at the conclusion of the conference.

The Confidential Section of the examination report provides examiners a place to record the details of the meeting, including whether expansion into underserved areas was discussed. The examiner should discuss the opportunity to expand credit union service to underserved communities in certain credit unions identified for such possible expansion by the region, the supervisory examiner, or the examiner. When meeting with officials of the credit union, either at the joint conference or exit interview, the examiner must state clearly that the discussion regarding increasing credit union service to underserved communities is not part of the examination.

**Other
Persons
Present**

Since examiners must maintain confidentiality regarding the matters discussed at the joint conference, they may prefer not having persons other than credit union officials and employees present. However, officials may wish to invite other persons. When this occurs, the examiner should advise all officials that they must take full responsibility for disclosure of any confidential information that may result from the presence of outsiders. If any official objects to an outsider and the participants cannot resolve the issue, the examiner should postpone the meeting until a later date.

In those rare instances when examiners object to the attendance of any outside individual, they should consult their supervisory examiners for guidance. If the supervisory examiner concurs with the examiner, the examiner should review the situation with the board chairman. If the chairman cannot or will not resolve the problem, the examiner should reschedule the meeting and prepare a memorandum outlining the problems. Determining in advance who will attend the joint conference will usually avoid such conflict.

Chapter 22

EXAMINATION EVALUATION AND REVIEW POLICY

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Chapter 22

EXAMINATION EVALUATION AND REVIEW POLICY

Examination Evaluation and Review Objectives

- Communicate consistent feedback regarding the overall quality of examiner work in a timely manner
- Measure the quality and effectiveness of NCUA's examination and supervision program by assessing the quality of examiner problem identification, recommendations for resolution and risk mitigation, and effectiveness of communication with officials
- Provide feedback for improving the examination and supervision program to management and the examiner

Associated Risks

Although the associated risks in this chapter do not apply to the examination evaluations and reviews, the quality of the examination report can cause risk to the National Credit Union Share Insurance Fund (NCUSIF.)

Overview

For purposes of staff development and quality control, NCUA evaluates and reviews examination reports. The process occurs at two levels:

- Supervisory examiners in the field evaluate all of the examiners' work as part of the examiner's development and overall appraisal; and
- Division of supervision (DOS) analysts perform a quality control function, and as such, limit their review to the written reports.

Supervisory examiners have responsibility for developing staff and ensuring the effectiveness of the examination and supervision program. To meet these responsibilities, they encourage the district examiners to perform high quality examinations and supervision. The Supervisory Examiner (SE) Evaluation commends the examiners for high quality work, provides guidance to examiners, and informs examiners of needed improvements in their work.

DOS analysts review reports to identify existing or emerging trends, common or frequently occurring findings, and systemic risk factors. DOS can further observe trends within the credit unions (e.g., increases in member business loans, decreases in net worth) and trends in the examination process (e.g., decrease in consumer compliance reviews, misinterpretation of ALLL criteria.)

After DOS identifies and analyzes region- or area-wide findings, trends, and risks, they communicate resulting information as appropriate. Sharing of this information in a timely manner will enable NCUA to determine the extent of the situation under review, monitor it for further developments, and take action when necessary.

The “Selecting Reports for Evaluation and Review” section of this chapter sets forth the national standard minimum criteria for reports requiring an SE Evaluation or a DOS Review. The regional office may adopt additional criteria thereby increasing reports they review to further assure quality control or to meet other regional objectives.

Minimum Standards

All regions adhere to the following minimum standards for evaluations and reviews, presented in priority order. Regions may add standards according to their needs.

Supervisory Examiner Evaluations

SE Evaluations serve as the basis for annual performance appraisals and staff development. These evaluations should determine the following:

- Examiners receive consistent, prompt feedback regarding the quality of their work, including the strengths, weaknesses, and suggestions for improving performance;
- Examiners prepare an appropriate and effective scope and report that adequately addresses risk, identifies problems, and makes sound recommendations to resolve major problems within acceptable time frames;
- Examiners have written a report that stands alone and documents a complete administrative record of the examination contact; and

- Examiners minimize NCUSIF losses through adequate identification and resolution of problems.

**DOS
Reviews**

DOS Reviews focus on quality control and should address whether the report:

- Addresses risk through an appropriate and effective scope;
- Focuses on results and includes plans for correcting problems promptly;
- Addresses negative trends and includes sound recommendations to resolve major problems within acceptable time frames;
- Complies with uniform examination, insurance review, and supervision standards;
- Presents a stand-alone document of the examination contact; and
- Provides a complete administrative record of the examination contact.

**Selecting
Reports for
Evaluation and
Review**

Supervisory examiners select at least five reports each year from each examiner for formal evaluation. They should make every effort to select the reports evenly throughout the year. When reviewing a report that addresses a specific risk area well, the supervisory examiner may determine that other examiners could benefit from the information presented and methods outlined in the report. They may choose to share this information for continuing staff development.

DOS, at a minimum, reviews reports meeting the following criteria:

- All credit unions coded CAMEL 4 or 5 with assets greater than \$100,000;
- All credit unions coded CAMEL 3 with assets greater than \$50 million;

- All credit unions coded CAMEL 3 for longer than 36 months and with assets greater than \$5 million;
- All credit unions with assets greater than \$250 million; and
- A selected sample of examinations and supervision contacts determined by the regional director.

NCUA's reviews of federally insured state-chartered credit unions (FISCUs) include at a minimum:

- Insurance reviews performed independently by NCUA, including supervision contacts designated by the regional director, using the above criteria; and
- Joint NCUA insurance review and state supervisory authority (SSA) examination reports, including supervision contact reviews designated by the regional director, using the above criteria.

Independent Review and Feedback

The supervisory examiner and DOS will conduct the evaluation and review processes independently. Both supervisory examiners and DOS will complete and disseminate their evaluations and reviews within 30 days of the report upload. Regional policy determines whether the region will release DOS Reviews to examiners.

Each region will develop its own policy to identify and resolve material differences between DOS Reviews and SE Evaluations.

DOS Review

The DOS Review will address the following:

1. Risk Identification;
2. Scope Development;
3. Proper Solutions;
4. Continuing Supervision/Examination Plans; and
5. Comments.

Appendix 22A contains a sample form for a DOS Review. This form contains the minimum elements regional office staff must include in

their reviews. In addition to these required elements, each regional director has the discretion to add other elements to these standard criteria and use whatever format best fulfills regional needs.

**Risk
Identification**

Risk identification is the recognition of significant problems through the collection, analysis, and verification of data. The Scope Workbook and report will address and document material risks. The DOS review will determine whether the report:

- Properly assessed and appropriately rated risks (low, moderate, or high) from the seven major risk areas (strategic, interest rate, credit, liquidity, transaction, compliance, and reputation) and reasonably determined the direction of the risks (increasing, decreasing, or unchanged);
- Identified and discussed areas with high or increasing risk (moderate or high risk rating) including (1) the underlying cause; (2) the problem's severity, duration, and effect on the credit union's financial condition; and (3) deficiencies in policies, processes, personnel, and control systems (refer to the Risk-Focused Program chapter);
- Identified and discussed material negative financial trends (e.g., key ratios, loan analysis, liquidity and funds management, shares and deposits, capital evaluation, etc.);
- Supported conclusions using the Total Analysis Process (TAP) considering both quantitative and qualitative data;
- Stated clearly that credit union officials acknowledged or refused to acknowledge the existence of risks, problems, and weaknesses; and
- Supported CAMEL ratings consistent with risk ratings and in accordance with current NCUA guidance.

**Scope
Development**

Scope development involves the process of evaluating the potential for loss, and building examination procedures to review risk areas.

Examiners require proficiency in developing the scope when performing a risk-focused examination. Regional office staff assesses whether the Scope Workbook:

- Contained a preliminary risk assessment using historical examination information, current financial data, 5300 data (risk management reports and Financial Performance Reports [FPRs]), and local economic factors;
- Included modifications to the preliminary scope based on examination analysis, unforeseen issues, and emerging problems; and
- Documented sufficient examination procedures used to evaluate the risk areas using *process* (e.g., review of policies and procedures) and *transactional* procedures to ensure high-risk areas received in-depth review and low-risk areas only a limited review.

**Proper
Solutions**

The report's effectiveness depends on the development and communication of proper resolutions for the risks and problems identified both during the scope development and the examination. The analyst will evaluate the recommendations for problem resolution, timeliness, and effectiveness. The DOS Review will include an analysis of whether:

- The Overview:
 - Summarizes the risk profile, conditions, problems, and probable effect of problems on operations and financial condition; and
 - Documents the plan for handling severe or persistent problems clearly and provides information to officials concerning consequences of inadequate action if management does not correct noted problems by the next contact;
- The Document of Resolution:
 - Contains reasonable, effective, and timely corrective action plans.

Continuing Supervision/ Examination Plans Regional analysts will determine whether the Scope Workbook focuses on continuing supervision and/or monitoring the financial condition of the credit union and existing and potential material risks.

Comments Regional office staff will use the Comments section of the DOS Review for items that do not fall under the other criteria as explained above.

SE Evaluation The SE Evaluation will address the following:

1. Risk Identification;
2. Scope Development/Resource Allocation;
3. Proper Solutions;
4. Form;
5. Continuing Supervision/Examination Plans; and
6. Comments.

Appendix 22A contains a sample form for an SE Evaluation. This form contains the minimum elements supervisory examiners must include in their evaluations. Each regional director has the discretion to add to these standard criteria and use whatever format best fulfills regional needs.

Risk Identification Risk identification involves comparing the scope to the examiner's analysis in the narrative sections of the report. The supervisory examiner determines whether the examiner:

- Properly identified, assessed, and rated risks (low, moderate, or high) from the seven major risk areas (strategic, interest rate, credit, liquidity, transaction, compliance, and reputation) and reasonably determined the direction of the risks (increasing, decreasing, or unchanged) using appropriate workpapers;
- Used the Total Analysis Process (TAP) to consider both quantitative and qualitative data, weigh relative importance of data, check accuracy, and reach and support valid conclusions;

- Adequately discussed major areas of risk (moderate or high risk rating) including (1) the underlying cause; (2) the problem's severity, duration, and effect on the credit union's financial condition; and (3) material deficiencies in policies, processes, personnel, and control systems (refer to the Risk-Focused Program and Report Writing chapters);
- Stated that credit union officials acknowledge or refuse to acknowledge the existence of risks, problems, and weaknesses;
- Assigned CAMEL ratings consistent with risk ratings and in accordance with current NCUA guidance.

**Scope
Development and
Resource
Allocation**

The SE Evaluation will address the appropriateness of the scope and assess the examination process for the efficient use of resources. When evaluating scope development, the supervisory examiner considers whether the examiner:

- Performed and documented a preliminary risk assessment using historical examination information, current financial data, 5300 data (risk management reports and Financial Performance Reports [FPRs]), and local economic factors;
- Documented modifications to the preliminary scope based on examination analysis, unforeseen issues, and emerging problems; and
- Documented sufficient examination procedures used to evaluate the risk areas using *process* (e.g., review of policies and procedures) and *transactional* procedures to ensure high-risk areas received in-depth review and low-risk areas only a limited review.

When evaluating resource allocation, the supervisory examiner considers whether the examiner:

- Allocated resources appropriate to the risk posed by the credit union and consistent with the report's findings and recommendations;

- Used subject matter examiners (SMEs) to review complex areas with a significant degree of risk; and
- Documented material changes to the anticipated examination and supervision hours.

Proper Solutions

The examination's effectiveness depends on the development and communication of proper solutions for the risks and problems identified during the examination. The supervisory examiner will evaluate the timeliness and effectiveness of the solutions. The supervisory examiner will determine whether the report:

- Is clearly written for the credit union officials;
- Contains reasonable, effective corrective action plans;
- Assigns responsibility and deadlines for action and defines benchmarks, as necessary, to attain agreed-upon goals;
- Provides a realistic plan that will assist officials in resolving the problems, if followed; and
- Includes other information such as agreements reached during discussions with officials and other items as required by regional management.

The supervisory examiner will evaluate the examiner's interaction with management and officials at the joint conference or other exit meeting, if attended by the supervisory examiner.

Report Form

Form includes the clear and professional presentation of facts and solutions to credit union officials. The supervisory examiner determines whether the report exhibits the following:

- Complete, concise, and well-organized discussion and conclusions;
- Correct grammar, spelling, and punctuation; and
- Appropriate enhancements such as bolding, underlining, white space, graphics, and lists for presenting information.

Continuing Supervision/ Examination Plans

The supervisory examiner's evaluation will assess the examiner's recommendations for ongoing supervision and future examination plans. Plans should provide for timely and appropriate supervision to ensure prompt resolution of problems and implementation of adequate measures to control risk. The supervisory examiner will evaluate continuing supervision and examination plans to ensure they:

- Focus on material risk-related areas;
- Monitor the condition of the credit union efficiently and effectively (may include informal discussions with management and onsite contacts targeting specific areas of risk);
- Address future plans regarding any outstanding administrative action (Discretionary Supervisory Actions, Letters of Understanding and Agreement, Preliminary Warning Letters, Cease and Desist Orders, Net Worth Restoration Plans, etc.);
- Project resources needs for future contacts (hours and examiners needed, including a specialist or subject matter examiner (SME)) consistent with the report's findings and recommendations.

Comments

The supervisory examiner will use the Comments section of the SE Evaluation form for items that do not fall under the other criteria, as explained above.

SE Evaluation Summary

Narrative comments clearly document the supervisory examiner's evaluation of an examination report. Supervisory examiners will not rate a report using the terminology "exceeds standards," "meets standards," "minimally meets standards," or "does not meet standards." These terms have specific meanings for the year-end appraisal process; supervisory examiners should limit the use of these terms to that purpose only.

If a supervisory examiner notes material deficiencies with an examination report, the supervisory examiner discusses these with the examiner, who then signs the evaluation form and returns it to the supervisory examiner.

EXAMINATION EVALUATION AND REVIEW POLICY

If the supervisory examiner notes no material deficiencies, discussion of the report occurs at the option of the supervisory examiner or examiner. The examiner's signature on the evaluation form is optional at the supervisory examiner's discretion.

The supervisory examiner will submit evaluations to the regional office in accordance with regional policy.

DOS REVIEW AND SE EVALUATION FORMS - APPENDIX 22A

DOS Review

Sample DOS Review Form

Examiner:		SE:	
CU #:		CU Name:	
CAMEL:		Assets:	
Effective Date:		Reviewer:	
Date Completed:		Hours to Complete Exam:	
Date Received:			
Date Reviewed:		Contact Type:	

CATEGORIES OF RISK:

Risk Category	Examiner Assessment	Risk Category	Examiner Assessment
Credit		Interest Rate	
Liquidity		Transaction	
Compliance		Strategic	
Reputation			

RISK IDENTIFICATION

SCOPE DEVELOPMENT

PROPER SOLUTIONS

CONTINUING SUPERVISION/EXAMINATION PLANS

COMMENTS

SE Evaluation

Sample SE Evaluation Form

CU Name:		Examiner:	
CU#:		SE:	
Assets:		Date Exam Completed:	
CAMEL Comp:		Date Report Received:	
Days Exam Open:		Date Report Appraised:	
Effective Date:		Budget Hrs:	
Hours Charged:		Contact Type:	

CATEGORIES OF RISK:

Risk Category	Examiner Assessment	Risk Category	Examiner Assessment
Credit		Interest Rate	
Liquidity		Transaction	
Compliance		Strategic	
Reputation			

RISK IDENTIFICATION:

SCOPE DEVELOPMENT/RESOURCE ALLOCATION:

PROPER SOLUTIONS:

FORM:

CONTINUING SUPERVISION/EXAMINATION PLANS:

COMMENTS:

Supervisory Examiner: _____ Date: _____

I have reviewed this evaluation and discussed its contents with my Supervisor.

Examiner's Signature: _____ Date: _____

(Optional at the SE's discretion unless the evaluation noted material deficiencies.)

Examiner's Comments: (Affix additional pages if necessary)

STATE CREDIT UNION REPORT REVIEWS - APPENDIX 22B

State Credit Union Report Reviews

NCUA examiners review state examination reports to determine the risk state-chartered credit unions pose to the National Credit Union Share Insurance Fund (NCUSIF.) Because economic conditions or circumstances may vary from one region to another, the regional directors (at their discretion) may require that examiners expand the procedures outlined in this appendix and provide additional documentation.

At a minimum, the NCUA examiner-reviewer (reviewers), after analyzing the state supervisory authority's (SSA's) examination report and any other pertinent information, assesses the operational and financial condition of the credit union. In addition, the reviewer determines if the SSA followed up on problems from the prior examination, accurately identified problems existing at the current examination, and reached agreement with the officials to resolve these problems.

Examiners and regional staff must treat information obtained from the state examination report reviews as confidential. The region may distribute the information to the SSA according to the agreements between the regional director and each SSA.

Assigning FISCUs to Examiner Districts

Supervisory examiners normally assign district responsibility, including state examination report reviews for federally insured state-chartered credit unions (FISCUs), to examiners based on factors such as their experience level, technical ability, and areas of expertise. The supervisory examiner also considers the credit union's asset size, complexity, quality of operations, and geographical location.

Supervisory examiners monitor the state examination report reviews to ensure that reviewers promptly complete high-quality state examination report reviews that are both accurate in content and appropriate in their recommendations.

In order for reviewers to keep abreast of the credit union's economic and political environments and the overall quality of the SSA's supervision and examination programs, supervisory examiners should communicate significant changes affecting the state's examination program to their district examiners.

While it is the mission of NCUA, as the insurer, to ascertain the safe and sound operation of FISCUs, examiners must remember that primary responsibility for the supervision of state-chartered credit unions rests with the SSA. As in all situations, NCUA examiners should demonstrate a courteous, professional, business-like, and cooperative attitude in all communications and contacts with the SSAs and their staff members.

**Processing and
Reviewing State
Examination
Reports**

The Division of Supervision (DOS) processes state examination reports, distributes them to field examiners, and monitors the process for compliance. To ensure compliance with regional and national policy, DOS maintains and provides to management staff, at least monthly, statistics regarding the receipt of state examination reports and the completion of the report reviews. As a minimum, DOS will maintain the following statistics:

- Supervisory examiner, district, insurance certificate number, NCUA reviewer's (examiner's) name;
- Date examination report was received from the state;
- Date examination report was mailed to the field;
- Date examination report was received in the regional office; and
- Number of days required for completing the review.

District examiners review state examination reports on a flow basis. To ensure information contained in the report does not become dated and that any risk exposure to the NCUSIF is promptly disclosed, examiners will complete the review within 30 days from the date the regional office receives the state's report. If examiners cannot review the report within the 30-day time period, they should request an extended

turnaround time from the supervisory examiner and note the reasons for the extension in the Examiner Comments section of the Examiner Contact Information. Outstanding state examination report reviews, however, should not exceed 60 days. Supervisory examiners should reassign report reviews if they expect extended delays.

Upon receipt of the report, reviewers will:

- Review the state examination report, financial performance, and any other information pertinent to the credit union;
- Complete the Examiner Contact Information and upload it to the host system within three days of completing the review;
- Complete a State Examination Report Review Summary and any other work papers required by the regional director; and
- Forward the State Examination Report Review package to the regional office and supervisory examiner within three days from the last date the examiner charged time.

Generally, NCUA examiners will not perform a formal review for joint examination reports (NCUA participates on the contact), or insurance reviews with an effective date within 30 days before or after the state's examination, if the reviewer was also the examiner-in-charge of the examination. Since the NCUA examiner was recently onsite and familiar with the credit union, completing a formal review would duplicate work. However, the examiner will:

- Scrutinize the state examination report to ensure it contains and conveys to the credit union the joint findings and recommendations agreed upon by the NCUA and SSA staff;
- Complete and upload the Examiner Contact Information;
- Note in the Examiner Comments section of the Examiner Contact Information that this was a joint examination or insurance review completed 30 days before or after the state examination, and specify whether or not the joint report conveyed the joint findings and recommendations; and

- Forward copies of the Examiner Contact Information to the regional office and supervisory examiner.

**State
Examination
Review Summary**

Examiners will use the review summary (see Attachment 22.1, State Examination Report Review Summary) to document their analysis of state examination reports during the review process.

The summary contains the narrative detail of (1) the reviewer's analysis of the credit union's financial condition (key trends and ratios), (2) quality of management, (3) recommendations for future supervision, and (4) any other related and pertinent information. This section also contains the reviewer's conclusions substantiating the assignment of the CAMEL components and composite ratings.

When reviewing state examination reports, the reviewer should ensure that the report:

- Included all required work papers or equivalent documents;
- Adequately addressed major areas of concern noted at the prior examination and noted implementation of appropriate SSA action;
- Provided sufficient information to assess the credit union's financial condition;
- Adequately disclosed and discussed negative key trends and ratios;
- Proposed appropriate solutions to correct the noted major areas of concern;
- Developed supervision plans in line with the conditions found;
- Addressed the quality of lending policies and procedures, loan documentation, and underwriting practices;
- Documented that the credit union properly funded the Allowance for Loan and Lease Losses account (see the Allowance for Loan and Lease Losses Account chapter of this Guide for additional information);

- Discussed conformance to Part 723 of *NCUA Rules and Regulations* (when business loans exist);
- Discussed the adequacy of investment policies, practices, and controls including compliance with SFAS 115;
- Documented establishment of an investment valuation reserve for non-conforming investments in accordance with the share insurance agreement;
- Indicated adequacy of asset-liability management policies, procedures, and practices based on a review of the financial reports and information noted in the examination report;
- Discussed completion of an acceptable supervisory committee audit and verification of member accounts that meet the requirements of Part 715 of the *NCUA Rules and Regulations*;
- Discussed the existence of accurate, reliable, and current accounting records and operational data;
- Completed appropriate questionnaires and addressed deficiencies noted;
- Indicated substantial compliance with the applicable sections of the *NCUA Rules and Regulations*; and
- Documented the accuracy of the 5300 call report data.

The State Examination Report Summary should discuss material exceptions, including failure to adequately address material exceptions to one or more of these guidelines.

If the NCUA and state CAMEL composite ratings differ, the reviewer must present the specific facts, ratios, and justifications to support the basis for the NCUA examiner's position. The reviewer, while supporting the NCUA CAMEL rating, should avoid subjective comments critical of, or antagonistic to, the state examination program, the state regulator, or the state examiner. Examiners will consult their supervisory examiners before assigning a composite

CAMEL rating different from the state's rating when the variance in the composite ratings will necessitate an onsite contact. NCUA may use the support presented by the reviewer to enhance NCUA's position to the SSA in those instances where the supervisory examiner finds it necessary to schedule a joint contact.

Regional Office Review

DOS performs an informal cursory review of all state examination report reviews when the composite ratings of the state and NCUA differ. DOS also selects a sample of state examination reports to formally review in accordance with the regional office's quality control process.

The regional office review simultaneously assesses the quality of the SSA's report and the NCUA examiner's review of that report. The DOS reviewer should critique:

- The analysis of the condition of the credit union;
- The presentation of pertinent facts, circumstances, problem identification, and proposed resolution as disclosed in the SSA's report; and
- The NCUA examiner's review of the report.

The DOS review ensures consistent identification of risk factors that FISCUs pose to the NCUSIF.

Regional office staff use the comments section at the bottom of the review summary (see Attachment 22.1, State Examination Report Review Summary) to document findings, including any deficiencies noted, of quality assurance reviews performed on the selected sample of state examination reports. DOS maintains a log of reports that regional staff reviews and retains for future audits and quality control reviews.

In addition to the areas that the NCUA examiner reviews, DOS will, at a minimum, assess the following during its quality control review:

- Timely receipt of SSA's report - comparison of the effective date, completion date, and the date the regional office received the SSA's report;
- SSA and NCUA supervision plans - appropriateness and adequacy of the follow-up plans in the SSA's report and NCUA examiner's review. DOS will note if the credit union's condition requires, but the report does not provide supervision plans;
- Quality of the NCUA examiner's review - adequacy of the narrative, with supporting ratios, to substantiate the ratings assigned for Capital Adequacy, Asset Quality, Earnings, and Asset/Liability Management, and an overview of Management; and
- Other comments and observations concerning the SSA's report, credit union, or examination process, including (1) identification of all major areas of concern in the SSA's report and NCUA examiner's review, (2) assessment of the SSA's solutions to correct the problems, (3) assessment of the credit union's compliance with Section 741 of *NCUA Rules and Regulations*, and (4) completion of the required or agreed-upon SSA consumer compliance questionnaires.

State Examination Report Review Summary

Ins. #:	CU Name:
State:	Exam Effective Date:
State Examiner (EIC):	Exam Assets:
Date SSA Report Received from RO:	NCUA Ex.-Reviewer:
Date NCUA Review Mailed to RO:	Exam Contact Type:

Through the review of the state examination report, the examiner should determine the credit union's financial and operational condition and provide sufficient quantitative and qualitative data to substantiate the analysis and assignment of the CAMEL component and composite ratings. Current and past trends, effectiveness of problem resolution from prior examinations, agreements with officials to correct problems, and results of previous supervision contacts should be addressed in this review. Examiners should base the extent of the narrative on the risk, size and complexity of the credit union and severity of the problems noted.

COMPOSITE CODE: **NCUA CODE** _____ **STATE CODE** _____

CAPITAL ADEQUACY: **NCUA CODE** _____ **STATE CODE** _____
 (Discussion should include past, future, and current aspects of capital.)

ASSET QUALITY: **NCUA CODE** _____ **STATE CODE** _____
 (Discussion should include loan programs, quality of lending, appropriateness of investments, fixed assets, etc.)

MANAGEMENT: **NCUA CODE** _____ **STATE CODE** _____
 (Discussion should include supervisory committee audit and verification, policies and procedures, record keeping, problem resolution, etc.)

EARNINGS: **NCUA CODE** _____ **STATE CODE** _____
 (Discussion should include the various components of the income statement (e.g., gross income, operating expenses, and the cost of funds.)

LIQUIDITY MANAGEMENT: **NCUA CODE** _____ **STATE CODE** _____
 (Discussion should address the adequacy of liquidity and appropriateness of the ALM policy.)

Attachment 22.1

EXAMINER'S GUIDE

INSURABILITY REQUIREMENTS: (Does the report provide adequate information to assess compliance with part 741 of the NCUA Rules and Regulations, including the Requirement for Insurance, and with applicable federal consumer regulations?)

APPROPRIATENESS OF SSA PROBLEM RESOLUTIONS AND FOLLOW-UP PLANS: (Does the report provide documents of resolution and examiner's findings and are they appropriate and adequate? List any supervision plans the SSA has provided in the report. (Please indicate if none are provided.))

NCUA EXAMINER RECOMMENDATIONS: (Are offsite supervision and monitoring plans or formal onsite supervision plans appropriate given the condition of the FISCU?)

OTHER ITEMS:

REGIONAL OFFICE COMMENTS:

The information contained on this form is based on our review of the state examination report.

Attachment 22.1

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Chapter 23

LOW-INCOME CREDIT UNIONS

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Chapter 23

LOW-INCOME CREDIT UNIONS

Examination Objectives

- Determine that any nonmember deposits comply with limitation, use, and recording requirements
- Determine that any waivers received proper approval
- Determine that Community Development Revolving Loan Fund for Credit Unions' funds meet the requirements of that program
- Evaluate management's ability to identify, measure, monitor, and control (i.e., manage) risk
- Determine the credit union's current and potential risk
- Evaluate the adequacy and accuracy of management's risk reporting mechanisms
- Assess the credit union's ability to withstand any negative effects of risks taken in relation to its financial condition and net worth position
- Work with management to reach agreeable solutions to reduce levels of unwarranted risk

Risk Categories

Low-income credit unions, like all credit unions, are subject to the seven categories of risk, discussed in the Risk-Focused Program chapter. These risks include Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation. As with other credit unions, low-income credit unions must mitigate their risks by implementing measures such as management's due diligence, sound internal controls, the audit process, and well-trained management and staff. These should coincide with the size and complexity of the credit union.

Overview

Low-income credit unions have the same mission as other credit unions, with an additional requirement: a majority of their members must meet or fall below the income standard set by the *NCUA Rules and Regulations*. For many low-income members, their credit union serves as the only access to financial services.

The task of operating a low-income credit union challenges its officials and management for a number of reasons, including:

- The membership tends to include more renters, who may move more often than homeowners;
- Members often need high cost, labor-intensive services such as money orders, financial counseling, and check cashing;
- Members tend to have limited financial reserves and have fewer resources to overcome the effect of setbacks such as illness, an expensive car repair, or a job cutback; and
- Member share account balances tend to be low for these credit unions. To provide needed services, low-income credit unions may have to augment savings with nonmember deposits. Low-income credit unions often have cooperative relationships with a variety of social services and other organizations.

The *FCU Act* uses the term "low-income" credit union to refer to credit unions having "predominantly" low-income members. §701.34(a)(2) of the *NCUA Rules and Regulations* defines low-income members to mean those members (1) who make less than 80 percent of the average for all wage earners as established by the Bureau of Labor Statistics; (2) whose annual household income falls at or below 80 percent of the national median household income as established by the Census Bureau; or (3) who otherwise qualify as low-income by order of the NCUA Board. The NCUA Office of Credit Union Development (OCUD) annually publishes the qualifying thresholds for the national average wage and median household income. In applying standards, the NCUA regional director shall make allowances for geographical areas with higher costs of living.

The term "low-income" also includes student credit unions. Student credit unions may accept nonmember deposits, but cannot participate in the Community Development Revolving Loan Program discussed later in the chapter.

Credit unions that NCUA designates as "low-income" can (1) receive nonmember deposits from any source in addition to deposits from

public units and other credit unions, (2) offer secondary capital accounts and include this account in the credit union's net worth, (3) qualify for an exception from the aggregate member business loan limit, and (4) participate in the Community Development Revolving Loan Fund for Credit Unions.

Qualifying for the Low-Income Designation

Examiners should understand that a credit union may meet the income standard that makes it eligible for the low-income designation, but has not yet applied for or received the designation. Lower-than-average account balances, loan balances, and member incomes (as documented in the loan files) may indicate an institution qualifies as a low-income credit union. §701.34 of the *NCUA Rules and Regulations* outlines the low-income designation requirements. Examiners should encourage any credit union that may qualify to request the low-income designation.

Examiners should also discuss the opportunity to expand credit union services to underserved communities in certain credit unions identified for such possible expansion by the region, the supervisory examiner, or the examiners themselves. When meeting with credit union officials, either at the joint conference or exit interview, examiners must clearly state that the discussion regarding increasing credit union service to underserved communities is not part of the examination. Examiners should briefly document whether they held such a discussion and the credit union's response in the Confidential Section of the examination report.

Credit unions requesting the low-income designation should support their requests with sufficient documentation to demonstrate that they serve predominately low-income members by providing the following:

- Individual documentation of the members' individual incomes;
- Individual documentation of the members' household incomes;
- Membership surveys; and/or
- Income levels of members identified by zip codes or census block data, or demographic information customarily used and accepted to document low-income eligibility for federal and state programs.

Any credit union, not just one with a community charter, can use these methods for qualifying. For example, a church-based associational credit union could meet the standard if most of its members live in a cluster of zip codes or census blocks, which if averaged together, meet the income standard.

Credit unions can obtain this income information from U.S. Census publications in public libraries and on the Internet at the Census Bureau's website (<http://www.census.gov/>). Examiners can obtain demographic information on behalf of the credit union from their NCUA regional offices. If the demographics fail to show that the credit union's operational area has a median household income within regulatory limits, the credit union can document the wages of its members.

State-chartered credit unions should first approach their state supervisory authority (SSA) to obtain the designation, which is subject to NCUA regional concurrence. If the state has no such designation, then the credit union should apply to NCUA. NCUA's procedures for state-chartered credit unions will mirror those for federal credit unions. In the event that state law does not provide for a low-income designation, the regional director would approve the designation after obtaining concurrence of the SSA. The possibility exists that state laws would prohibit certain activities, such as acceptance of nonmember accounts.

The examiner should notify the supervisory examiner of any low-income designation problems before discussing them with the officials. If examiners review problems associated with the low-income designation, they should disclose the results of that review in accordance with regional policy.

**Field of
Membership and
Chartering**

A prospective credit union may submit a separate low-income designation request with its charter application. The potential field of membership forms the base for a charter applicant's low-income designation. If the prospective credit union provides the appropriate documentation, NCUA may grant the low-income designation and charter simultaneously.

**Nonmember
Deposits**

Low-income designated credit unions can accept nonmember accounts. They can use these nonmember accounts to (1) fund loans, (2) arbitrage and build reserves, or (3) cover expansion or services costs. Generally, these deposits have interest rates at or below market rates.

Nonmember accounts in a low-income designated credit union mean shares, share certificates, share drafts, or other types of nonmember deposit accounts approved by the NCUA Board. Unless the regional director has approved a greater amount, the maximum amount of all public unit and nonmember shares cannot, at any given time, exceed the greater of 20 percent of the credit union's total shares or \$1.5 million. During each examination, the examiner should review compliance with the nonmember deposit limit. (Credit unions eligible for Part 742, the Regulatory Flexibility Program, may be exempt from some of the nonmember share limitations.)

The examiner may assist the credit union in understanding the need and proper use for nonmember deposits. The credit union should negotiate a mutually acceptable time span for the deposit, with adequate notice before withdrawal. It must guard against interest rate risk resulting from an interest rate agreement that could force it into a negative spread position if market rates change. Deposits that create a negative spread, whether brokered or otherwise, are unsuitable for any credit union, including low-income credit unions.

**Booking
Nonmember
Deposits**

Where permitted, low-income credit unions record accounts of nonmembers as "nonmember deposits," not as notes payable, and report them in the equity section of the balance sheet. Some states do not permit nonmember accounts. In these states, the credit union records the funds as notes payable. NCUSIF insurance does not cover notes payable.

**Use of
Nonmember
Deposits**

Credit unions may invest nonmember deposits using the safety, liquidity, and yield (SLY) principle, or they may loan out nonmember deposits. To mitigate interest rate and liquidity risks, management should have a plan that coordinates the maturity of the loan or investment with the maturity of the deposit.

Waiver of the 20 Percent or \$1,500,000 Rule

A low-income credit union must apply to the regional director for a waiver of the 20 percent of total shares or \$1.5 million threshold. Federally insured state-chartered credit unions must also obtain the concurrence of the appropriate state regulator. (Credit unions eligible for Part 742, the Regulatory Flexibility Program, may be exempt from some of the nonmember share limitations.)

The application for a waiver serves as a check to determine that the nonmember funds do not pose an undue risk to the NCUSIF. All requests for a waiver must include a plan outlining the need and proposed use of the deposits. §701.32 of the *NCUA Rules and Regulations* contains specific requirements governing the waiver process.

When determining the nonmember deposit ratio, §701.32 permits exclusion of (1) matching funds required under the Community Development Revolving Loan Program for Credit Unions, (2) Treasury Tax and Loan Depositories accounts, and (3) Depositories and Financial Agents of the Government. This chapter discusses funds specified in (1) above in more detail.

There is a presumption in favor of granting the credit union's request when the credit union has mitigated its risk through sound financial condition, good management, and a reasonable plan for the funds. The regional office will provide a written determination within 30 calendar days of receipt of the request. The credit union has the right of appeal in the case of denial.

Community Development Revolving Loan Fund

NCUA administers the Community Development Revolving Loan Fund (Fund) for Credit Unions. The Fund consists of two programs: (1) a loan/deposit program, and (2) a technical assistance program. Part 705 of the *NCUA Rules and Regulations* contains detailed information about the governance and operation of the Fund.

The purpose of the Fund supports the efforts of participating credit unions through loans to them for (1) providing basic financial and related services to residents in their communities, and (2) stimulating economic activities in the communities they service, which will result in increased income, ownership, and employment opportunities for

low-income residents, and other community growth efforts. (As noted earlier, student low-income credit unions may not participate in the Fund.)

Credit unions can apply for Fund loans any time during the year. Loans repay in five years; however, NCUA will consider shorter repayment periods. Generally, credit unions repay the loans in semiannual installments, with no principal balance repayment due until the second semiannual installment. The last installment will require a double principal payment.

The aggregate loan limit to one credit union is \$300,000. No credit union may have more than two separate loans at any one time. There is no minimum loan amount. While the OCUD can tailor the terms and conditions of the loans to an individual credit union's circumstances, all loans carry a fixed interest rate, which the NCUA Board sets annually. Credit unions may record a Fund loan or deposit as either a note payable or as a nonmember deposit, at NCUA's discretion.

The Fund's loan agreement requires the credit union to develop other sources of matching funds as described in §705.7(b). Credit unions can match loan funds "dollar-for-dollar" with nonmember deposits. However, they can match loan funds with member deposits as a "two-for-one" match. Within one year of receiving the Fund loan, the credit union must match the loans with member shares or nonmember deposits. Nonmember deposits accepted to meet the matching requirement are not subject to the 20 percent limitation on nonmember deposits under §701.32.

The examiner should understand that credit unions need not reduce the matching deposits as they pay down the loan. As a result, the matching funds may exceed the loan balance once principal repayments begin. A credit union may continue to exclude the full amount of matching funds consisting of nonmember deposits from the nonmember deposit rule calculation as long as the credit union has any loan balance on its books.

In addition, the examiner should understand that the presence of the Fund's loan plus matching deposits could significantly affect financial

ratios of small asset size credit unions, lowering every ratio having assets, average assets, or shares as the denominator.

The income earned by the Fund's loan program supports the Fund's technical assistance program. Examiners should know about the Fund and encourage its use, when appropriate.

Credit unions can request Fund loan applications from either OCUD or the applicable regional office. The Director of the OCUD serves as the Community Development Revolving Loan Fund Chairman, and assumes administrative responsibilities. The Fund's chairman may restrict the use of funds, approve less than the full amount requested, or deny the loan. The chairman may require a credit union to invest the funds in a specified way and take the positive spread as income. No special restrictions apply to the use of matching funds except the usual safety and soundness considerations, unless specifically noted in the loan agreement.

Technical Assistance Program

The income earned on the Fund's assets and possibly congressional appropriations provide monies for technical assistance grants to credit unions. NCUA makes these grants to aid participating credit unions in providing services to their members and in the efficient operation of the credit unions. Only a credit union with a NCUA low-income designation may participate in the Technical Assistance Program (i.e., low-income student credit unions can not participate in this program.)

Credit unions submit technical assistance applications to OCUD. The agency has a goal of using technical assistance grants for credit unions where this funding could make the greatest impact on improving their operations. Since NCUA has limited technical assistance funds available, smaller grants enable a larger number of credit unions to participate. No specific limitation on the amount of the grant request exists; however, the average technical assistance grant approved is under \$5,000.

Credit unions may apply for technical assistance grants anytime during the year. They must obtain approval of the technical assistance grant before committing to, or contracting for, the service or purchase. Once OCUD approves the request for technical assistance, the credit union

must submit an original invoice showing proof of service or purchase for payment.

NCUA Rules and Regulations §705.10 describes the technical assistance program and provides guidance for completing the technical assistance application.

Mentoring

When appropriate, examiners should encourage credit union management to network and seek assistance from trade groups, associations, credit unions, and banks. Mentoring can help small credit unions mitigate several risk factors and provide them the assistance they need with little or no direct dollar expense.

Mentoring can take many forms including:

- **Nonmember accounts.** Credit unions can use nonmember accounts to fund lending, build shares, arbitrage and build reserves, or cover costs of expanding services.
- **Training.** Inexperience in credit union operations is the leading reason many small credit unions fail. Due to limited financial resources, volunteers in small credit unions often do not have an opportunity for training.
- **Marketing advice.** Small credit unions that have limited access to network with other credit unions may have difficulty developing plans for increasing membership. A mentor's marketing tips could help extend the credit union's outreach programs.
- **Supervisory committee training.** The annual audit is a major expense for small credit unions. Small credit unions usually have basic share and loan operations. A mentor could actually perform the supervisory committee audit or assist the supervisory committee in performing the audit.
- **Credit committee training.** Low-income credit unions often serve members for whom proper credit evaluation is essential. Understanding the need for proper documentation on collateral or the ability to identify appropriate collateral could enable the credit

union to reduce delinquency and write-offs. A minimal commitment by a larger credit union to allow their loan specialist to train employees of the low-income credit union could help mitigate credit risk and improve operations.

- Fee-based back-office services. Many small credit unions do not have the personnel available or the expertise to fill all operational functions. A mentor could provide these services on a fee-based or no-cost arrangement.
- Loan participation. Properly managed, loan participation could benefit both participants. Larger credit unions can help low-income credit unions provide liquidity for loans needed by the low-income credit union's membership. Low-income credit unions can benefit from the lending expertise and policies of the larger credit union. Examiners should review the loan participation agreement.

Secondary Capital

A federal credit union with a low-income designation may offer secondary capital accounts to non-natural person members and non-natural person nonmembers. Uninsured secondary capital accounts are part of the low-income designated credit union's net worth. Examiners should refer to §701.34(b) for information regarding secondary capital accounts conditions and requirements.

The NCUA Board established key safety and soundness element, to ensure (1) the availability of secondary capital accounts to absorb losses, and (2) the investor understands the risks involved. In §701.34, the NCUA Board permits credit unions to offer secondary capital accounts providing the credit union does the following:

- Offers the accounts to organizational investors only, not to natural persons;
- Subordinates the accounts to all other claims on the assets of the credit union, including claims of creditors, shareholders, and the NCUSIF;
- Does not offer the accounts as share accounts and discloses they are not insured by the NCUSIF, or any other government entity;

- Makes the funds available to cover losses after depletion of reserves and undivided earnings, but before liquidation;
- Establishes the accounts with a minimum maturity of five years, which may not be redeemable before maturity;
- Requires that the investors sign standard account agreements and disclosures (per the Appendix to §701.34) and retain them for at least the life of the loan;
- Recognizes the capital value of an account having a remaining maturity of less than five years on a declining scale for each subsequent year (i.e., accounts with maturities between four and five years will have capital value of 80 percent of the balance, those with three to four years remaining – 60 percent, two to three years remaining – 40 percent, one to two years remaining – 20 percent, and accounts with maturities of less than one year - zero capital value). All of the funds, however, will remain at risk; and
- Adopts and submits to the regional director a written plan that addresses the use of the funds and provision for liquidity upon maturity. The credit union need not wait for approval.

Finally, under prompt corrective action (PCA), NCUA can restrict payment of principal or interest on uninsured secondary capital of a low-income designated credit union classified as critically undercapitalized.

**Examiner's
Respon-
sibility**

To determine the existence of compliance risk, examiners should review outstanding Fund loan agreements for compliance during each examination. If the credit union has a compliance problem, the examiner should seek direction from the supervisory examiner about the approach to use in discussing it with the officials. As a minimum, the examiner should disclose the results of the Fund's loan review in the Confidential Section of the examination report.

**Record
Keeping**

The examiner should ensure that the credit union understands transaction risk and the importance of keeping accurate and complete

records. If necessary, the examiner should help the credit union obtain the assistance and training it needs to gain competence in record keeping.

Delinquency and Charge-Offs

The credit union needs a functioning, written, effective loan collection program. Improving the loan collection program would benefit many low-income credit unions. Examiners should encourage low-income credit unions to react quickly (within a few days after a missed first payment) to each delinquency. Many low-income credit union members have a difficult time recovering if they get behind in their payments. The loan collection program may benefit from expanding the role of credit counselor to include community resources referral.

When classifying loans, managers often have personal knowledge of individual members who, despite high debt ratios or slow repayment records, are of good character and likely to repay. Examiners should consider management's judgment when discussing which loans the credit union should charge off.

Expense Ratios

As a result of some characteristics of low-income credit unions (discussed in the Overview section of this chapter), these credit unions sometimes have higher expense ratios than other credit unions. In addition, delinquency (e.g., collection costs, loss of income, provision for loan loss expense) and net charge-offs may have more periodic volatility.

Compared to other credit unions, low-income credit unions generally have slightly higher employee compensation and benefits expense ratios. Low-income credit unions tend to have a slightly larger full-time staff than do occupational groups that receive payroll deductions, and tend to pay slightly more per employee. Office operations and occupancy expense ratios are also higher on average.

Examiners should counsel management and the board on expense control. Although NCUA recognizes that low-income credit unions operate with higher expenses, this counseling can help management with the budget process, cost-benefit analysis, and maximize earnings potential.

Business Lending

Low-income credit unions historically have regarded lending to small businesses as a major part of their mission. The examiner should obtain a historical perspective on the credit union's previous success with this kind of lending before commenting to the credit union about its program.

For low-income credit unions that have not previously engaged in business lending, examiners should help ensure the credit union obtains needed expertise to succeed in this program, either through training or hiring. The examiner should remind the credit union that it must meet the requirements of the business lending regulations in §723 of the *NCUA Rules and Regulations*. In addition, the examiner may:

- Encourage the low-income credit union to obtain training through technical assistance;
- Suggest help from other credit unions; or
- Assist the manager in identifying the qualities and expertise needed in prospective employees.

Low-income designated credit unions may also participate in various mortgage and business loan funding sources sponsored by government or private programs. The examiner should review outstanding contracts governing the use of the funds and reporting requirements to determine if the credit union's activities with regard to such programs present significant risk. Examiners must ask sufficient questions to (1) understand the funding arrangement (some are complicated), (2) determine the legality of the arrangement, and (3) determine that the arrangement serves the credit union's best interest from a safety and soundness standpoint. If examiners have concerns about a funding arrangement, they should discuss those concerns with their supervisory examiners before discussing them with the officials.

Contributions Received

Sponsors or other parties occasionally provide the credit union a gift or donation such as cash or a fixed asset. Low-income credit unions are more likely than other credit unions to receive such assistance. Credit unions under \$10 million may accept fixed asset gifts and record them as donated equity. Credit unions with assets of \$10 million or more must follow GAAP and record unconditional gifts as income when received. All credit unions must record gifts of cash as income. The

examiner must ensure that the credit union properly records such gifts on its books. Credit unions should use the gifts for the purpose for which they were donated.

**Asset-
Liability
Management**

While sufficient liquidity is the objective of asset-liability management (ALM), proper matching of sources and uses of funds has particular importance in low-income credit unions with their nonmember deposits, the Fund's loan, and matching deposits. To maintain an adequate match, credit unions should invest nonmember deposits and loan funds in instruments that have maturities compatible with the term of the loan or deposit.

**Board and
Management**

Well-trained officials and paid staff remain as crucial to low-income credit unions as to any other credit union. A well-diversified board, which includes community leaders, brings a variety of talents to work for the credit union and encourages the sharing of collective knowledge among all officials. Every credit union management team should develop a plan addressing four basic elements of operation:

- Get Money In,
- Get Money Out,
- Get Money Back with Interest, and
- Make a Profit.

Often, in smaller credit unions, the lack of sufficient internal controls, including inadequate segregation of duties and insufficient backup support for the manager and key staff, can present a serious concern when knowledge about the credit union's operation is concentrated in one or a few staff members. Frequently, the officials and volunteers assume verification and backup responsibilities by taking on some of the more labor-intensive services (e.g., collection efforts and bank reconcilements.) The officials must address the need for management continuity and succession planning.

The officials can often increase the credit union's viability by seeking out ways to increase their participation in the credit union. This may include encouraging board members to participate in loans and

savings, or it may mean increasing membership by penetrating potential fields of membership.

§715.4 and §715.8 of the *NCUA Rules and Regulations* and §115 of the *FCU Act* require the officials to obtain an annual audit and verification of the members' accounts at least once every two years. §715.5 requires an outside, independent CPA audit under certain conditions. If the credit union receives \$300,000 or more in government funds (including the Fund's loan, other public monies or federal government appropriation funds), it must obtain an independent audit as required by the Single Audit Act Amendment of 1996, §7501(a)(14) and §7501(b)(3) of Title 31. The examiner must monitor the credit union's use of federal awards and assess the quality of their audits.

The examiner should recognize the importance of meeting directly with the officials. As in any credit union, the examiner should:

- Recognize the credit union's progress;
- Discuss with the officials areas in need of strengthening and ensure that the officials and necessary staff understand the concerns;
- Develop and prioritize action plans with the credit union's help; and
- Ensure that the credit union has resources to implement action plans. Technical assistance may aid the credit union in these efforts.

References

- *Federal Credit Union Act*
 - Part 115
- *NCUA Rules and Regulations*
 - §701.32
 - §701.34
 - §715.4
 - §715.5
 - §715.8
 - Part 705
 - Part 723
- *NCUA Chartering and Field of Membership Manual*
- *Accounting Manual for Federal Credit Unions*

Chapter 24

SHARED BRANCH

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Chapter 24

SHARED BRANCH

Examination Objectives

- Determine whether the shared branch functions as a separate entity
- Assess whether the design of the shared branch agreement provides stability and limits the risk to the participating credit unions
- Determine whether the services offered by the shared branch operation comply with *NCUA Rules and Regulations*
- Determine whether the shared branch operation poses significant risk to the participating credit union's financial condition

Associated Risks

- Strategic risk – Includes the risk that a poorly managed CUSO will adversely affect the credit union's strategic goals and plans.
- Transaction risk – Includes the risk that member transactions will not be posted properly or promptly.
- Compliance risk – Includes the risk that CUSO personnel will not comply with applicable laws and regulations.
- Reputation risk – Includes the risk that the quality of service received at the CUSO will affect the credit union's reputation.

Overview

A shared branch operation, also known as a shared service center, can be structured as a corporation, limited liability company, or limited partnership, or it can result from an agreement with a third-party vendor that provides branch office services to more than one credit union. Many shared branch operations exist as Credit Union Service Organizations (CUSOs). Others may function as correspondent credit union activities or service contract activities.

Shared branch arrangements can provide added benefits to credit union members. For example, additional branch locations and services, and expanded office hours increase convenience to the membership. Additional services may include traveler's checks and money orders, utility bill payments, notary services, etc. The credit union may potentially reduce transaction costs because of economies of scale.

Thus, participating credit unions can offer these benefits without acquiring additional fixed assets or adding staff.

A shared branch operation is chartered under state law, and is not directly regulated by NCUA. However, since shared branch networks primarily perform member transactions, and the majority of the network's assets consist of credit union funds, NCUA has the responsibility to limit the exposure to the National Credit Union Share Insurance Fund (NCUSIF).

Officials of Participating Credit Unions

The board of directors of participating credit unions must perform due diligence regarding the shared branch operation. This includes reviewing the shared branch management and financial reports (such as board minutes, financial statements, budgets, audit reports, etc.) and periodically performing a cost/benefit analysis of the shared branch operation.

The participating credit unions must closely monitor the activities of the shared branch operation to mitigate the risks, both to the shared branch operation and to the participating credit unions as a result of the shared branch operation.

Examination Procedures

The examiner should determine if the credit union participates in a shared branch arrangement. If the shared branch is a CUSO, the examiner should determine whether the operation complies with Part 712 of the *NCUA Rules and Regulations*. (See Appendix 24A for further discussion of CUSO shared branches, Appendix 24B for shared branch CUSO review procedures, and the Credit Union Service Organizations (CUSO) chapter of the Guide for information on CUSO reviews.)

The examiner should ensure the credit union has a signed agreement with the shared branch provider. Examiners should document the review of the shared branch in the Scope Workbook. The examiner may include in the examination report, or possibly in the Supplementary Facts section, a discussion of the shared branch network.

Examiners should inform their supervisory examiners when they learn about newly formed or previously undetected shared branch networks.

References

- References
 - *NCUA Rules and Regulations*
Part 712, Credit
Union Service Organizations (CUSOs)

SHARED BRANCH CUSO - APPENDIX 24A

Review Objectives

- Determine whether the degree of risk the CUSO poses to affiliated credit unions and the NCUSIF is acceptable
- Review the financial stability and soundness of operations
- Determine the experience level, capabilities, and effectiveness of management directing the shared branch CUSO
- Determine the adequacy of policies, procedures, and controls safeguarding the assets of the participating credit unions and the individual credit union's membership
- Determine whether the CUSO maintains accurate and current records
- Determine the adequacy of surety bond coverage
- Ascertain whether contracts are legal and binding and do not require conditions or costs which adversely affect the financial condition or operations of the participating credit union
- Determine whether the shared branch CUSO operates in compliance with applicable laws and Part 712 of *NCUA Rules and Regulations*
- Determine the stability of the shared branch CUSO's participants

Associated Risks

- Strategic risk – Includes the risk that a poorly managed shared branch CUSO will adversely affect the credit union's strategic goals and plans.
- Transaction risk – Includes the risk that member transactions will not be posted accurately or promptly.
- Compliance risk – Includes the risk that shared branch CUSO personnel and management will not comply with applicable laws and regulations.
- Reputation risk – Includes the risk that the quality of service received at the shared branch CUSO will harm the credit union's reputation.

The participating credit unions must ensure they closely monitor the activities of the shared branch CUSO operation to mitigate these risks.

Overview

NCUA and the respective states periodically review shared branch CUSO operations. When only federally chartered credit unions participate in the CUSO, NCUA will perform the review. If federally insured state-chartered credit unions constitute the participating credit unions, the state assumes primary responsibility for the review, but NCUA may participate as the insurer. If all of the credit unions are privately insured, NCUA does not participate in the review. However, if a combination of federally insured and privately insured credit unions exists, NCUA requires access to the shared branch facility and all necessary records. §712.3(d)(3) of *NCUA Rules and Regulations* stipulates the CUSO will provide NCUA complete access to any books and records of the CUSO and the ability to review CUSO internal controls. Examiners should keep in mind NCUA does not regulate CUSOs, only the credit union's investment in or loan to the CUSO.

(Examiners should review both the Credit Union Service Organizations (CUSO) and the Shared Branch chapter for additional information.)

Review of a Shared Branch CUSO

Since shared branch CUSOs potentially involve a large number of credit unions, the regional director and the state supervisory authority should coordinate and give approval before the examiner schedules the review. Examiners should review regional guidance to determine the correct procedures for requesting a CUSO review.

Shared-Branch Review Procedures

Review procedures may vary depending on the size and structure of the shared branch arrangement. Examiners should consider reviewing the following areas:

- Structure of organization. To understand and evaluate the shared branch operation, the examiner should:
 - Identify the size, structure, and services during initial meetings with the CUSO's management;
 - Obtain and review a list of all participating credit unions, and the corresponding contracts and arrangements;
 - Obtain an organizational chart of the CUSO; and

- Determine the legal aspects of the CUSO by reviewing the Articles of Incorporation, Bylaws, contracts, and any legal opinions.
- Capital structure and financial condition. Several methods exist for funding a shared branch CUSO by the participating credit unions. The examiner should determine the following during the review of the shared branch operation's capital structure and financial condition:
 - The sufficiency of the CUSO's funding. Weak or inadequate funding arrangements may require additional, unanticipated costs to the participating credit unions;
 - The reasonableness of projected operating and capital costs under a variety of future operating and economic environments;
 - The future plans of management for the shared-branch CUSO. By reviewing management's budgetary process, business plan, and projected cash flows, examiners can estimate the effect such plans will have on the cost to participating credit unions;
 - The stability of the CUSO's financial condition. By analyzing ratios and financial trends in comparison to current industry standards, the examiner can evaluate the organization's financial performance. Examiners may need to review several years of ratios and financial trends, if available. Ideally, participating credit unions should track their own per-transaction costs and compare those costs to the monthly fees of the shared-branch CUSO arrangement; and
 - The changes in costs incurred by and transaction fees charged to the member credit unions over time. These include reviewing and analyzing income and expense, transaction costs, and monthly fees charged to the participating credit unions for appropriateness and proper controls. In most cases, economies of scale should reduce transaction costs in a growing shared branch CUSO.

- **Management.** The examiner may determine the quality and capabilities of management. The review of shared branch CUSO management is similar to the review of management performed during a regular credit union examination. The examiner should review:
 - Minutes of board and appropriate committee meetings;
 - The CUSO's mission statement and business plan;
 - Policies and procedures;
 - Personnel hiring practices including qualifications, training programs, and evaluation procedures;
 - Management contracts;
 - The planning and budgetary process; and
 - Methods by which participating credit unions have input in the operation (i.e., users' meetings.)

- **Recordkeeping.** The examiner should determine the records accurately reflect the financial condition of the shared branch CUSO, management accurately evaluates the costs of each separate shared branch, and the shared branch operation has reasonable and accurate records for allocating the costs and fees to the participating credit unions. The examiner should consider reviewing and testing the following items to determine the accuracy of the records:
 - Material general ledger and sub ledger accounts;
 - A sample of bank statements and reconcilements;
 - Major income and expense accounts;
 - Internal audit practices, procedures, and workpapers; and
 - Branch accounting procedures for allocating operating costs and assessing monthly fees and charges to the participating credit unions.

- **Annual audit.** The examiner should determine that the shared branch CUSO obtains annual audits. Examiners may review the most recent audit report and workpapers, including the confirmations of the member credit unions' investments, deposits, and additional paid-in-capital.

- Lending practices. The examiner should determine the type and extent of lending practices at the shared branch CUSO. Lending practices vary from one branch to another. Some shared branches only receive and forward applications to the participating credit unions for approval. Others receive loan applications, forward them to the participating credit union, and disburse the loan funds. In federal credit unions, an automated loan system, programmed to implement loan policies can approve loan applications. The automated loan system cannot deny applications; they can only refer the applications to a loan officer for lending decisions that the system's preset lending criteria would deny.

The depth of review depends on the extent of the lending practices. When the shared branch receives applications and disburses loan proceeds, but the participating credit union approves the loan, the examiner can limit the review to the controls for membership determination, document verifications, and disbursement procedures. In a shared branch CUSO for federal credit unions, shared branch staff cannot approve applications unless a loan officer is onsite. The examiner should determine that the practices and procedures used by the shared branch comply with the member credit union's individual loan policies.

- Internal controls. The examiner should review and evaluate all operating policies and procedures and determine that the shared branch has implemented complete and adequate internal controls throughout the shared branch CUSO operation. Examiners should make sufficient onsite contacts to shared branch offices to verify the standardization and consistency of the practices. When performing onsite contacts at the branches, examiners should consider reviewing the following:
 - Control of cash, money orders, traveler's checks;
 - ATM and night depository procedures and controls;
 - Access and control of passwords, keys, etc.;
 - Controls for preventing staff from performing fraudulent transactions on their own or family members' accounts at the participating credit unions;
 - Procedures for verifying membership and for becoming a member at the shared branch office;

- Procedures for safeguarding information about the member, and;
 - Contingency plans including backup systems, procedures, and authorization for member transactions when the computer is off line.
-
- Insurance and surety bond coverage. The examiner should determine that the shared branch CUSO has sufficient insurance and surety bond coverage to protect the assets of the operation and limit potential loss to the participating credit unions. Examiners should review the adequacy of the bond coverage, whether on a standard bond form as seen at many credit unions or on other forms. (No regulatory requirement for minimum bond coverage currently exists for a shared branch CUSO.)

 - Information processing. Complex information processing procedures may exist at a shared branch CUSO. Processing transactions at various credit unions from one teller station requires that the shared branch employ a system commonly known as a “switch” which selects and accesses the appropriate credit union. To safeguard members' assets, the policies, procedures, and internal controls must control and limit access to authorized transactions.

If possible, the shared branch review team should include knowledgeable and qualified individuals to review the IS (i.e., an IS&T SME or IS auditor). A specialized IS review, which includes review of the system's controls and procedures, requires the examiner-in-charge to plan for and coordinate qualified team members well in advance of the review date.

Shared branch CUSO management should obtain independent, periodic, IS processing audits. The examiner should obtain a copy of the audit report and determine if management is correcting exceptions, deficiencies, and weaknesses noted in the auditor's reports, management letters or other correspondence.

- Regulatory compliance. The examiner should determine that the shared branch CUSO complies with all necessary federal and state laws and regulations.

- Review report. At the conclusion of the shared branch CUSO review, the examiner should prepare a review report. The report may take the form of a letter to the shared branch CUSO management, signed by the regional director and state supervisory authority (if applicable). The examiner maintains a field file containing the letter to the officials, all pertinent workpapers, and the confidential section. AIRES workpapers designed for credit union examinations will often not adapt to shared-branch CUSO reviews. Examiners may choose to design their own workpapers for these types of reviews.

As with any credit union examination, examiners should discuss findings with management as they discover questions or problems. Examiners should further discuss any resulting recommendations with management before issuing the final report to the officials. In the case of CUSOs involving FISCUs, examiners should follow regional policy for communicating issues to CUSO management.

References

- *NCUA Rules and Regulations*
Part 712, Credit Union Service Organizations (CUSOs)

SHARED BRANCH CUSO REVIEW PROCEDURES - APPENDIX 24B

Strategic Risk

- Review cost trends (e.g., per transaction)
- Review operational costs per transaction (e.g., increasing or decreasing)
- If costs are increasing, inquire as to whether management has alternative programs planned (e.g., emphasis on ATMs to limit labor costs)
- Review the extent of the CUSO's lending services
- Review a sample of contracts with various credit unions involved in the lending program

Transaction Risk

- Perform general ledger review
- Review accuracy of material adjusting journal entries
- Review appropriateness of the branch accounting procedures
- Inquire about contingency plans including backup systems, procedures, and authorization for member transactions when the Information System is off line
- Review Information System contracts, controls, and adequacy of output information
- Review internal controls for completeness, adequacy, and consistency throughout the shared branch network
- In the absence of an internal control function, review compensating controls (particularly in the cash area)
- If on-site contacts are performed at CUSO branches:
 - Review control of cash, money orders, travelers checks, and other negotiable instruments
 - Review ATM and night depository procedures and controls
 - Spot check teller cash reconcilements
 - Inquire about tellers' use of bait money, responsibility for this area, and frequency of bait money review
 - Review access and controls of passwords, keys, etc.
 - Inquire about controls to prevent staff from performing transactions on their own accounts and accounts of family members

- Review CUSO's loan application approval process for compliance with individual credit union's lending policies
- Review membership controls, verifications, and disbursement procedures
- Review consumer regulation compliance procedures
- Review compliance with terms and conditions of the contract

**Compliance
Risk**

- Review procedures to verify credit union membership
- Review procedures to safeguard release of information about credit union members
- Review compliance with:
 - Currency and foreign transactions
 - Posting of NCUA and/or other applicable insurance
 - Member confidentiality
 - The participating credit unions must ensure they closely monitor the activities of the shared branch CUSO operation to mitigate these risks

Chapter 25

CREDIT UNION SERVICE ORGANIZATIONS

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Chapter 25

CREDIT UNION SERVICE ORGANIZATIONS

CUSO Review Objectives

- Determine that the credit union's investment in and loans to a CUSO comply with Part 712 of *NCUA Rules and Regulations*
- Determine that the CUSO engages in permissible activities or services
- Determine the degree of risk the CUSO poses to the affiliated credit union
- Determine the ongoing feasibility of the CUSO
- Determine the CUSO is in compliance with the Privacy Act

Associated Risks

- Interest rate risk - improper pricing of products and services constitutes the leading cause of interest rate risk;
- Liquidity risk - improper pricing and poorly timed duration can cause liquidity risk;
- Reputation risk – poor decisions by the CUSO can reflect poorly on the member and third-party perception of the credit union;
- Strategic risk - ineffective planning of the products, services, and pricing policies can result in strategic risk;
- Credit risk - credit risk can occur when the CUSO fails to meet its obligations;
- Transaction risk – improper transaction processing and controls of share account types and processing failures can cause other risks (e.g., interest rate risk, liquidity risk); and
- Compliance risk – inadequate or ineffective compliance policies regarding account disclosures for applicable consumer compliance regulations can result in loss exposure.

Specific activities undertaken by the CUSO and the amount of funds invested in or loaned to the credit union may magnify these risks. Strategic risk applies in all CUSOs, because if the board has not properly planned, and the CUSO has taken on excessive risk, losses can damage the credit union's profitability, net worth, and reputation. Transaction, credit, and liquidity risks can affect the credit union's ability to continue to offer the services (provided by the CUSO) to its

members. These can also negatively impact the financial condition and reputation of the credit union.

Overview

A credit union service organization (CUSO) is a corporation, limited liability corporation, or limited partnership that provides services primarily to credit unions or members of affiliated credit unions. Part 712 of NCUA's Rules and Regulations authorizes federal credit unions to invest up to one percent of unimpaired capital and surplus in CUSOs and/or to loan up to an aggregate of one percent of unimpaired capital and surplus to CUSOs.

A CUSO's organizational requirements, i.e., corporation (established and maintained under federal or state law), limited liability corporation, or limited partnership (an FCU may only participate in a limited partnership as a limited partner), limit the risk of loss to the affiliated credit unions to each credit union's loan and/or investment in the CUSO. However, the loss of a CUSO service could affect the operations and financial condition of affiliated credit unions beyond their one percent investment in and/or one percent loan to the CUSO.

CUSOs exist as separate legal entities chartered under state law (except that a corporation may also be established under relevant federal law). NCUA neither charters nor insures CUSOs; therefore, they are not subject to NCUA regulations and credit union-type examinations. CUSOs must comply with applicable state laws, including state licensing and regulated activities' laws.

NCUA does have contractual rights of "complete access to any books and records of the CUSO and the ability to review CUSO internal controls . . ." For this reason, the term "CUSO review" appears throughout this chapter. NCUA performs CUSO reviews when safety and soundness concerns to affiliated credit unions may exist. Examiners perform CUSO reviews in a consensual manner in cooperation with CUSO management when NCUA deems the CUSO may pose an undue risk to the National Credit Union Share Insurance Fund (NCUSIF).

In instances when disputes arise between the examiner and a CUSO over access to books and records or problem resolution, the examiner

should look to the supervisory examiner and regional policy for guidance on resolution. Examiners should take a professional, reasonable approach with CUSO management and consult their supervisors if they encounter circumstances that they cannot cooperatively resolve with CUSO management. Examiners should tailor review procedures according to the size, complexity, and business of the CUSO.

Services

Unless safety and soundness concerns exist, an FCU may invest in, loan to, or contract with CUSOs sufficiently bonded or insured for their specific operations. The CUSO must engage in the preapproved activities and services related to the routine daily operations of credit unions.

The *NCUA Rules and Regulations* specifies and categorizes all services that CUSOs may perform. Categories of permissible services include: checking and currency services; clerical, professional, and management services; consumer mortgage loan origination; electronic transaction services; financial counseling services; fixed asset services; insurance brokerage or agency; leasing; loan support services; record retention, security, and disaster recovery services; securities brokerage services; shared credit union branch (service center) operations; student loan origination; travel agency services; trust and trust-related services; real estate brokerage services; and CUSO investments in non-CUSO providers. (The listings under the broad categories shown in §712.5 serve illustrative purposes and are not an exclusive or exhaustive list of permissible activities.)

The credit union must ensure that the services provided by the CUSO meet the requirements of the Privacy Act. The contractual agreement between the CUSO and the credit union should specifically limit access and distribution of members' records to accomplish compliance under the Privacy Act. The credit union must pay particular attention to the CUSO's privacy policies and procedures to determine compliance with all applicable laws and regulations on disclosure of members' information. Information that the credit union shares with the CUSO should also comply with privacy regulations.

The cyber financial services that CUSOs may provide (under the electronic transaction services) to credit unions and their members include electronic delivery of any permissible CUSO service and electronic delivery of any permissible credit union service.

An FCU that wants to invest in or loan to a CUSO that offers an unapproved activity or service must seek an advisory opinion from NCUA's Office of General Counsel regarding whether the proposed activity falls within one of the authorized categories without filing a petition to amend the regulation. If General Counsel determines that an authorized category does not cover the activity in question, the credit union must petition the NCUA Board to amend the regulation. The request for petition must comply with the following:

- Request NCUA Board approval and include an explanation and documentation of the activity or service and how that activity or service is associated with routine credit union operations;
- Submit request jointly to regional office and to the Secretary of the NCUA Board.

CUSO Reviews

Examiners may consider recommending a CUSO review if, during an examination of an affiliated credit union, the following questions arose:

- Is the CUSO operation adversely affecting the financial condition and operation of the credit union?
- Does the financial condition of the CUSO significantly affect the operations of a credit union or group of credit unions that depend on the CUSO's services?
- Is the credit union taking appropriate steps to ensure that the CUSO operates as a separate entity thus limiting the credit union's risk exposure?
- Is the credit union board of directors ensuring the CUSO's separate entity status?

- Is credit union or CUSO management involved in any conflicts of interest as described in §712.8 of the regulation?
- Are the services offered permissible (see §712.5)?
- Did the affiliated credit union obtain a written agreement from the CUSO, before investing in or lending to the CUSO, that provides for compliance with §712.3(d)?
- Does the CUSO obtain an annual certified public accountant (CPA) audit?
- Did the CPA note substantive operational or financial problems?

Purpose

Examiners perform a CUSO review to determine the degree of risk the CUSO poses to affiliated credit unions. Following are several steps that may assist the examiner in determining such risk:

- Assessing the financial condition of the CUSO;
- Verifying the accuracy of the financial statements;
- Assessing the adequacy of controls;
- Determining the viability of operations and service to the member credit unions; and
- Confirming compliance with applicable laws and regulations.

Preparation

Before conducting a CUSO review, the examiner must understand the services offered, market trends and conditions, and service viability. The Reference section of this chapter contains reference sources that may familiarize the examiners with acceptable practices for a specific service offered. As examiners become familiar with a CUSO's internal operations, the examiner may need to update or modify the review procedures to achieve a more effective review. Examiners may consider the following when preparing for a CUSO review:

- **Initial Contact.** Once the region determines that the potential risk posed by the CUSO warrants a review and obtains the necessary regional approval, an NCUA regional representative should contact the president or chairman of the CUSO to discuss the purpose of

the upcoming review, schedule a mutually agreeable date, and request basic financial and audit information needed for the review.

After agreeing upon the date, the examiner may draft a letter to the CUSO confirming the date of the review and providing a list of items needed for the review.

- **State Supervisory Authority (SSA).** When NCUA decides to proceed with a review of a CUSO that also serves state-chartered credit unions, an NCUA regional representative contacts the SSA to (1) convey its concerns, (2) request information that the state may have regarding the operations of the CUSO, and (3) invite the SSA's participation on the CUSO review. SSAs often have special CUSO review reports, which the examiner may benefit from reading before proceeding with a CUSO review. To avoid duplication of effort and unnecessary regulatory burden, NCUA should use information provided by the SSAs' CUSO review reports whenever possible.
- **Team.** Choosing qualified team members is important. For example, examiners that have accounting, finance, outside audit experience or expertise in the areas of the CUSO's operation will benefit the CUSO team.
- **Review.** The examiner-in-charge develops a review program emphasizing areas of immediate concern as well as covering general operations, financial condition, management, and corporate separateness (see Appendix 25A for a sample CUSO review.)

The extent of the tests performed vary relative to the nature of the services offered and risks involved. However, the following steps may assist the examiner in becoming familiar with the CUSO's operation and developing an initial review:

- Obtain knowledge of the industry in which the CUSO operates;
- Obtain general information about the CUSO's business (e.g., requesting an organization chart, business plan);
- Review the field file of an affiliated credit union for any prior information regarding CUSO policies;
- Review prior CUSO examination and audit results;

- Determine the existence of related party transactions;
- Determine the need for outside specialists (e.g., information systems specialist);
- Develop a review strategy;
- Write a review program that places primary emphasis upon weaknesses noted in reviewing the CUSO's operations, facilities, and financial condition; and
- Request a tour of the CUSO facilities.

The extent of operational tests performed for the CUSO review vary relative to the services offered by the CUSO (e.g., data processing, share draft clearings, leasing, etc.). Therefore, the examiner should exercise flexibility and innovation in preparing and modifying the review to the services and operations of the CUSO.

Review of Operations and Management

When performing an onsite review of the CUSO's operations, the examiner may inquire about the CUSO's managerial controls and about the CUSO's working arrangements with leagues or trade associations. The following guidelines may assist the examiner's review of operations and management:

- **Management.** The examiner may arrange to review the CUSO's policies, procedures, budgets, business plan, goals and objectives, reporting processes, articles of incorporation, and bylaws. The examiner may discuss with management the nature and extent of managerial planning, the overall reasonableness of the business plan, and budgetary projections.
- **Business Plan.** Good business planning involves management's development of a written business plan before the organization begins doing business. A CUSO's business plan should, at a minimum, include (1) a statement of goals (including profitability goals) and objectives; (2) policies, procedures, and timeframes for achieving the goals and objectives; (3) budget projections demonstrating management's efforts to meet profitability and capitalization goals, and achieve (and maintain) self-sufficiency; and (4) monitoring techniques to inform management of the operation's status. Management should revise and update the

business plan as necessary to keep it current. (A CUSO's well-developed and maintained business plan provides affiliated credit unions a valuable resource for making decisions about permissible investment and lending decisions.)

- **Managerial Personnel.** An onsite CUSO review provides the examiner an opportunity to observe and ascertain management's ability to effectively direct and control the CUSO's operations. As part of the review of key personnel, the examiner may find it helpful to request resumes and employee evaluations and to detail, in the working papers, background information of key management officials. (State laws may affect disclosure of staff evaluations.) The necessary experience and education for key personnel depends on the types and levels of service the CUSO offers. NCUA's CUSO review report should note observed managerial weaknesses.
- **Minutes.** The examiner reviews board minutes for content, decisions, and required frequency of meetings according to the CUSO's bylaws. If available, the examiner may also request other minutes, including those of user/client meetings, special meetings, and executive committee meetings.
- **Investment and Loan Documents.** The examiner reviews investment and loan documents and CUSO agreements with affiliated credit unions.

Review of Services

The examiner should determine that the CUSO follows the regulation in performing permissible services and serving primarily credit unions or their members.

The CUSO's quality of services provides information about the ongoing feasibility of the CUSO. If available, membership surveys, complaint departments, and third-party studies can assist the examiner in assessing the quality of services.

Financial Condition

Examiners evaluate the CUSO's financial condition to (1) determine its ability to meet its goals, objectives, and financial projections; (2) analyze its prospects for future success; and (3) assess the risk to

affiliated credit unions. Financial trends for a start-up operation are often misleading; therefore, when calculating trends, the examiner must differentiate between start-up CUSOs and those with several years' experience (e.g., cash flow projections, since CUSOs expense start-up costs as they incur the costs.) The following areas may assist examiners in the review of financial condition:

- **Trend Analysis.** The financial analysis of a CUSO resembles that performed during credit union examinations using the Financial History and Key Ratios workpapers; however, some ratios used to evaluate CUSOs differ from those used for credit unions (see Appendix 25B for suggested key CUSO financial ratios.) To better understand the CUSO's trends and ratios, examiners may request at least three years' financial data. Comparative ratios (both over the prior three years and to industry averages) assist the examiner in determining the reasonableness of the CUSO's current financial condition. Both Dun & Bradstreet (www.dnb.com) and Robert Morris Associates (www.rma.org) publish industry averages.
- **Profitability.** Because of tax consequences, CUSO profitability objectives may differ from those of credit unions; however, CUSOs still require sufficient cash flow to meet their objectives. Examiners analyze earnings to ensure their sufficiency to pay for services offered, while achieving profitability and capital goals.

Examiners should know that in non asset-based CUSOs many expenses incurred are a function of sales and, therefore, directly relate to sales. To ensure meaningful ratios and trends in these credit unions, examiners should compare expenses to sales.

- **Cash Flow.** Profitable corporations, including CUSOs, do not always have positive cash flow. This is more often true in the initial or start-up stages, but can also result from mismanagement. Conversely, since CUSOs hope to reduce taxes by minimizing net income without affecting cash flow, CUSOs may not show a profit, but have positive cash flow.

To analyze cash flow, examiners may request cash flow statements. If the CUSO does not prepare cash flow statements and cash flow appears to be a problem, examiners should analyze the cash flow

position to ensure the CUSO has sufficient cash flow to maintain normal operations. Depending on its severity, negative cash flow may require the examiner to expand review, discuss the situation with CUSO management, and develop (with CUSO management) a plan to reverse the trend.

- Taxes. As taxable entities, CUSOs should adjust their projections for their tax liabilities. During the review, the examiner may request a copy of the CUSO's IRS filings (and documentation of other local, state, or municipal tax liabilities) for review of proper payment and inclusion in the supporting work papers.

Accounting Audit

Determining the extent of the review of the CUSO's accounting and audit requires that examiners use judgment in the following areas:

- General Ledger. The examiner requests for review the audit report, notes to the audit report, engagement letter, report of reportable conditions (if available), and other correspondence before determining the extent of the general ledger review. If the examiners do not question the CPA's competence and independence, they may place greater reliance on the CPA's work.

The examiner may decide to rely on the CPA's work and not perform a comprehensive general ledger review. In these instances, examiners may limit their general ledger reviews to the areas of concern. For example, the examiner may choose to review only the CUSO's tax filings and aging of receivables and payables, or only the appropriateness of classification of accounting information (e.g., expenses improperly capitalized or income improperly recognized.) Examiners may want to pay particular attention to the collectibility of accounts receivable. (If material uncollectible receivables exist, NCUA may require affiliated credit unions to reserve for their investments in and loans to CUSOs.)

- Audit. The examiner reviews the most recent CPA opinion audit report, notes to the audit report, engagement letter, report of reportable conditions (if available) and other correspondence with the CPA. When examiners determine that the CPA is competent

and independent, they may find a review of the workpapers unnecessary.

When examiners believe reviewing the correlating audit workpapers is necessary, they may request permission from the CUSO to review the workpapers and ask the CUSO to make necessary arrangements with the CPA firm. Review of audit workpapers often provides meaningful information they cannot obtain by simply reviewing the audit report (e.g., the CPA's assessment of the CUSO's internal controls and a statement regarding ongoing concern.)

Examiners should also confirm that the CUSO follows GAAP, as required by §712.3(c) and §712.3(d)(1) of the regulation.

Controls

The examiner's onsite CUSO review may include assessing the adequacy of internal controls necessary for the CUSO's business. Likewise, if the CUSO has an internal audit function, the examiner may arrange to review the audit scope and procedures.

Data Processing

During an onsite review, the examiner may arrange to review the CUSO's information processing system including related controls and the disaster recovery plan.

Privacy of Consumer Financial Information

Part 716 requires that credit unions provide notice to their members and consumers regarding the credit union's privacy policies and practices for information provided to affiliated and nonaffiliated third parties. The rule describes the conditions under which a credit union may disclose nonpublic information about consumers to nonaffiliated third parties. Finally, Part 716 provides for opting out, whereby consumers may prevent a credit union from disclosing nonpublic information to most nonaffiliated third parties.

An affiliate is a company that a credit union or a group of credit unions controls. Examples include the following:

- For federally chartered credit unions, a credit union service organization (CUSO) controlled by the credit union would constitute the only affiliate. NCUA will presume a credit union has a controlling influence over the management or policies of a CUSO, if the CUSO is 67 percent owned by that credit union or by that credit union and other credit unions; and
- For federally insured state credit unions, an affiliate would include a CUSO or another company controlled by the credit union.

A nonaffiliated third party is any person except:

- The credit union's affiliate; or
- A person employed jointly by the credit union and any company that is not the credit union's affiliate.

**Maintaining
Legal
Separation**

§712.4 of the Rules and Regulations requires that a credit union investing in or loaning to a CUSO take reasonable steps to ensure that a court would not "pierce the corporate veil" and hold it liable for the obligations of the CUSO. This can happen when (1) the corporation (the CUSO) has insufficient assets to satisfy its debts, and (2) a parent entity (the credit union) so closely identifies with the corporation that justice requires holding the parent liable for those debts. The factors courts look to in deciding whether to impose liability on the credit union include inadequate capitalization of the CUSO, lack of separate CUSO identity, common boards of directors and employees, control of the credit union over the CUSO, and lack of separate books and records. The following help determine these factors:

- Whether CUSOs follow the corporate forms (holding meetings, taking minutes, etc.);
- Whether the CUSO's management is distinct from the credit union's;
- Whether the CUSO's operations are distinct from the credit union's; and

- Whether the CUSO has adequate capitalization for its type of business.

There is usually no single controlling component that the courts use in determining whether to pierce the corporate veil

§712.4(b) requires a written attorney's opinion stating that the CUSO's structure as a separate legal entity limits the credit union's potential exposure to no more than the loss of funds invested in and/or loaned to the CUSO. The legal opinion should address the factors specified above. Affiliated credit unions should obtain a new legal opinion if the CUSO restructures its organization or if the operations of the CUSO raise potential credit union liability issues.

The examiner should review the following items, which evidence that the CUSO and the credit union function as separate entities. However, the examiner may decide to forgo this review if through the scoping process, the examiner has determined that the prior examiner reviewed them, and no changes have subsequently occurred, or the annual CPA audit of the CUSO indicates no material problems exist.

- Articles of incorporation or partnership agreement filed with the state;
- Written bylaws;
- Minutes of the first meeting of shareholders or partners or a unanimous consent of the shareholders or partners electing the board of directors;
- Minutes of the first meeting of directors or a unanimous consent of the directors electing officers and authorizing the issuance of the shares and adoption of the bylaws;
- Review of stock certificates;
- Proof of capitalization and minimally adequate capital to support the business plan; and

- A letter from an attorney licensed to practice in the state where the CUSO principally operates opining that the CUSO's structure limits the liability of the credit union to the investment in and/or loan to the CUSO.

The following can aid the examiner in determining whether the CUSO operates as a separate entity with sufficient financial resources of its own and necessary distinction in management and operations:

- Each ensures against intermingling of its respective business transactions, accounts, and records (e.g., appropriate management agreements, equipment leases, or real estate leases support payments made by the CUSO to the credit union for rent, shared employee costs, etc.);
- Each observes the formalities of its separate corporate procedures (e.g., each holds regular separate board meetings, each has separate management);
- Each is adequately financed as a separate unit in the light of normal obligations reasonably foreseeable in a business of its size and character (e.g., each has adequate capitalization in relation to its business plan);
- The public sees each as a separate enterprise (e.g., space that a CUSO rents in the credit union should be separated from the credit union operations with a separate mailing address and telephone number, if possible);
- The credit union does not dominate the CUSO to the extent that it or the members treat the CUSO as a department of the credit union; and
- Except if the CUSO has a loan guaranteed by the credit union, all borrowing by the CUSO indicates that the credit union is not liable (i.e., the credit union does not provide guarantees to the CUSO which could cause the credit union to incur liability in excess of the permitted investment limitation in the regulation).

Additionally, during onsite reviews, the examiner may arrange to review the CUSO's compliance with all other applicable regulations, such as consumer regulations and state laws.

Finally, NCUA encourages CUSOs to maintain appropriate levels of liability insurance and bonding. Management should periodically review coverage to ensure adequate protection. In reviewing the adequacy of bond coverage, examiners use their professional judgment considering the CUSO's type (e.g., shared branching CUSOs would require similar coverage as credit unions), state law requirements, industry standards, and insurance company recommendations.

Impairment Assessment

Under GAAP, an "other -than-temporary" impairment in the credit union's CUSO investment (assuming a cost method CUSO investment), requires a write down of the asset through the income statement to a new cost basis. This new cost basis cannot be subsequently written up for a recovery of value. The credit union should consult its independent accountant if it suspects an "other-than-temporary" impairment and provide the examiner with the independent accountant's assessment as it relates to GAAP. Examiners should watch for the following "red flags," which may indicate possible "other-than-temporary" impairment:

- Material negative cash flow resulting in an inability to meet obligations;
- Continual operating losses resulting in, or leading to, a deficit in retained earnings; or
- Piercing of the corporate veil.

Report Format

The final report drafted by the examiner may include the following work papers:

- Open section:
 - Narrative giving overall results of the CUSO review;
 - Findings;

- Conclusions and Recommendations; and
- Financial data and trends.
- Closed section:
 - Confidential section;
 - Extent of CUSO risk-focused review (at examiner's discretion, they could include this in the open section); and
 - Any other work papers needed to support the examiner's conclusions.

Supervision

When examiners discover material problems that may adversely affect affiliated credit unions, the regional director may arrange with the CUSO for supervision and follow-up measures commensurate with the problems cited at the last contact. Supervision normally consists of reviewing problem areas and weaknesses noted during the most recent review. This should not imply that NCUA has the same supervision authority over CUSOs as it has over credit unions. As with CUSO reviews, supervision contacts are performed on a consensual basis through the affiliated credit unions.

Supervision responsibilities vary depending on the equity and debt structure of the CUSO. If the CUSO is a direct subsidiary of a credit union or if all affiliated credit unions are in the same supervisory examiner's group, the supervision responsibilities logically would remain with the supervisory examiner responsible for the credit union. In other cases, however, the regional director or associate regional director for programs assigns supervision responsibilities.

Suggested Procedures

In addition to those already discussed, the following are suggested procedures for performing a CUSO review once regional management has approved the review:

- At the close of the review, the examiners meet with the officials and key management (exit conference) providing them with a draft copy of the open section of the report (clearly labeled DRAFT). The examiner invites the SSA to attend exit conferences of CUSOs that also serve state-chartered credit unions;
- The examiner submits to the region's Division of Supervision:

- The CUSO review report;
 - All supporting work papers (including financial statements, documentation specifying extent of the review, financial data and trends, and a listing of all affiliated credit unions); and
 - A final letter to the CUSO briefly describing the review procedures, conveying the results and findings of the review, and requesting a written response to the recommendations and findings;
- The regional office reviews the CUSO review report and letter for quality control and submits the letter to the regional director for approval;
 - When the CUSO has state-chartered credit union investors or affiliated credit unions, the regional director furnishes a copy of the CUSO review report to the SSA for comment before mailing the open section to the CUSO. (Examiners should encourage CUSOs to hold the report in confidence knowing, however, that CUSOs have no obligation to confidentiality);
 - Once approved and signed by the regional director, the regional office provides a copy of the CUSO review report to applicable supervisory examiners, noting that the content is confidential. (In the rare instance that a CUSO's risk to its owner credit unions requires a write-down of the asset, the regional director notifies the owner credit unions in writing); and
 - When filing CUSO review reports, regional offices should cross reference these CUSO review reports to the examinations of the affiliated credit unions to give further credence to the fact that NCUA performs CUSO reviews to assess risk to insured credit unions.

References

- *NCUA Rules and Regulations Part 712*
- *NCUA Rules and Regulations Part 716*
- Federal Financial Institutions Examination Council (FFIEC) manuals (www.ffiec.gov);

- Handbook of Accounting and Auditing (Warren, Gorham & Lamont) - available at local libraries and business schools (and possibly in the regional office);
- Generally Accepted Auditing Standards (GAAS);
- (Current Year) Miller GAAS Guide (for various checklists that can be modified for examinations) - available at local and business libraries (and possibly in the regional office);
- Finance textbooks which define and describe financial ratios - available at local and business libraries; and
- Robert Morris (www.rma.org) or Dun & Bradstreet (www.dnb.com) - available at local and business libraries.

SAMPLE CUSO REVIEW - APPENDIX 25A

CUSO Reviews are performed in a consensual manner in cooperation with the CUSO's management. This review is not a required form; rather, it is intended to be a guideline for examiners to complete as necessary.

The General CUSO Review applies to most CUSO operations. Specialized CUSO Reviews contain additional procedures that examiners may use to review CUSOs formed for a specific purpose.

CUSO General Review

Organization/Management

Review the articles of incorporation, bylaws, and mission statement _____

Review attorney's opinion stating that the CUSO has been structured as a separate legal entity (including any recommendations for strengthening the corporate veil) to limit the liability of affiliated credit unions' investment in and/or loans to CUSOs _____

Review the limited partnership agreement and inquire as to whether the CUSO is a limited partner _____

Inquire about the General Partner and the General Partner's relationship to affiliated credit unions if the CUSO is organized as a limited partnership _____

Review the documentation of the limited liability corporation and inquire as to whether this organizational structure is permitted by federal or state law _____

Inquire as to whether the limited liability corporation provides sufficient limits to the liability of affiliated credit unions' investment in and/or loans to CUSOs _____

Review whether the CUSO has funding guaranteed by affiliated credit unions _____

Inquire as to whether there are contingent liabilities of the CUSO that could directly affect affiliated credit unions _____

Review what steps have been taken to evidence to members, customers and third parties that the CUSO and affiliated credit unions have separate identities both in operation and management _____

Inquire whether CUSOs that offer non-deposit products (e.g., mutual funds, annuities, insurance products, etc.) have adopted policies and procedures to comply with NCUA Letter No. 150 _____

Inquire about management interlocks _____

- Inquire about primary users of CUSO services (i.e., that CUSO primarily serves credit unions and/or membership of affiliated credit unions) _____
- Review permissibility of activities and services _____
- Review business plan (including feasibility of goals and objectives) _____
- Request organizational chart and job descriptions for management and staff _____
- Review qualifications and performance of management and officials _____
- Review the CUSO's policies and procedures manual _____
- Review the board and committee minutes _____
- Review supporting documents for credit unions with loans to and/or investments in the CUSO _____
- Request list of participating credit unions and other third parties (including leagues and trade associations) _____
- Review CUSO's working arrangements with the league and trades _____
- Review promotional materials and sample service agreements _____
- Request information regarding member satisfaction with services offered:
 - Review complaint department _____
 - Review any member surveys performed _____
 - Review any third party reviews _____
- Request minutes of users' meetings (if any) _____
- Review management's budgetary process _____
- Review material contracts (e.g., management, data processing, vendors, leases) _____
- Financial Condition**
 - Review feasibility of budget in conjunction with business plan goals (including capitalization projections) _____
 - Review the statement of financial condition, statement of income, and statement of changes in financial position _____
 - Review operating fee agreements with participating credit unions for stable, reasonable, projected costs under various future operating environments _____

Review projections for operating and capital costs, review management's capital requirements goals for compliance with SEC capital requirements (where necessary) _____

Review the CUSO's cash flow analysis _____

Request information about CUSO's backup funding arrangements _____

Review CUSO's exposure resulting from its reliance on one or more credit unions _____

Compute key financial ratios (usually for past three years), analyze financial trends and ratios, and compare trends and ratios with industry averages _____

Accounting/Auditing

Perform general ledger review (as necessary):

Reconcile financial statements to general ledger _____

Reconcile major accounts to the subsidiary ledgers _____

Review recent bank reconciliations _____

Review major income and expense accounts _____

Review the accounts receivable and accounts payable aging schedules _____

Review the adjusting entries to payable and receivable accounts to and from member credit unions _____

Review valuation of assets and accuracy of financial statements _____

Review adequacy of allowance for doubtful accounts _____

Review notes to financial statements (e.g., for contingent liabilities and outstanding commitments) _____

Review CUSO structure for "second tier" CUSO and review functions _____

Review recent IRS tax filings and state and local tax filings _____

Review CPA audit report, the engagement letter, letter of reportable conditions, contingency letter (make inquiries through present date) and check for statement regarding ongoing concern _____

Review procedures for allocating operating costs and assessing monthly fees and charges to member credit unions _____

Review sample of billing statements to credit unions _____

Review auditor's verification of member credit unions' investment and loan balances _____

Internal Controls

- Request internal auditor or audit committee procedures, work papers, and other supporting documentation (if applicable) _____
- Review for proper segregation of duties, vacation policy, supervisor review process _____
- Review access and password control procedures _____
- Review CUSO's procedures for verifying credit union membership _____
- Review CPA's assessment of CUSO's internal controls (if problems are noted) _____

Information Systems (IS) Processing

- Review third party vendor IS audit (if available) _____
- Review IS data security policies, procedures, and controls (e.g., limited access to the system) _____
- Develop or review flow chart of IS system _____
- Review reports generated and inquire about supervisory management levels responsible for reviewing the reports _____
- Review disaster recovery program (if available) _____

Regulations/Legal

- Inquire about outstanding or pending litigation and probability of loss _____
- Review bond coverage and other insurance coverage for reasonableness and compliance with applicable state and federal requirements _____
- Review CUSO's practices as to compliance of the services performed with applicable privacy laws and regulations _____
- Review compliance with applicable consumer regulations _____
- Review compliance with applicable state and federal regulations _____

**Mortgage
Services
CUSO**

Additional Mortgage Services CUSO Review

Organization and Management

- Review the rate lock reports to ascertain if the CUSO is meeting commitments _____
- Review HMDA reports (if applicable) _____
- Request a list of appraisers used by CUSO _____

Financial Condition

Review current status (and future assumptions) of the mortgage pipeline and the promptness of processing loans _____

Inquire about the monthly minimum number of mortgage contracts for the CUSO to be profitable _____

Review how changes in mortgage interest rates impact the mortgage pipeline _____

Internal Controls

Review disbursement procedures _____

Regulations/Legal

Review compliance with consumer compliance regulations (Reg B, Z, C, Reg X, HMDA, RESPA, Fair lending) _____

**Shared
Branch CUSO**

Additional Shared Branch CUSO Review

Financial Condition

Review cost trends (e.g., per transaction) _____

Review operational costs per transaction (e.g., increasing or decreasing) _____

If costs are increasing, inquire as to whether management has alternative programs planned (e.g., emphasis on ATMs to limit labor costs) _____

Accounting/Auditing

Perform general ledger review:

Review accuracy of material adjusting journal entries _____

Review appropriateness of the branch accounting procedures _____

Internal Controls

Review internal controls for completeness, adequacy, and consistency throughout the shared branch network _____

In the absence of an internal control function, review compensating controls (particularly in the cash area) _____

If on-site contacts are performed at CUSO branches:

Review control of cash, money orders, travelers checks, and other negotiable instruments _____

Review ATM and night depository procedures and controls _____

Spot check teller cash reconcilements _____

Inquire about tellers' use of bait money, responsibility for this

- area, and frequency of bait money review _____
- Review access and controls of passwords, keys, etc. _____
- Inquire about controls to prevent staff from performing transactions on their own accounts and accounts of family members _____
- Review procedures to verify credit union membership _____
- Review procedures to safeguard release of information about credit union members _____
- Inquire about backup systems, procedures, and authorization for member transactions when the IS is off line _____

Lending (for service centers that perform lending services)

- Review the extent of the CUSO's lending services _____

- Review CUSO's loan application approval process for compliance with individual credit union's lending policies _____

- Review membership controls, verifications, disbursement procedures _____

- Review a sample of contracts with various credit unions involved in the lending program _____

- Review consumer regulation compliance procedures _____

- Review compliance with terms and conditions of the contract _____

Information Systems (IS) Processing

- Review IS contracts, controls, and adequacy of output information _____

Regulations/Legal

- Review compliance with:
 - Currency and foreign transactions _____
 - Posting of NCUA and/or other applicable insurance _____
 - Member confidentiality _____

Information Systems Processing CUSO

Additional Information Systems (IS) Processing Review

(Refer also to Information Systems and Technology chapter for guidance regarding information systems' processing)

Financial Condition

- Review CUSO's analysis of each cost center or branch (if applicable) including the profitability of each segment _____

- Review at least one actual service contract for each type of service arrangement (e.g., on-line, in-house, disaster recovery) _____

- Review contract expiration dates of institutions using the IS processing system _____

Review the contracts' expiration date schedules for impact of potential nonrenewal of contracts _____

Internal Controls

Review internal controls in the computer operations area _____

Review operational procedures for adherence to the CUSO's formal policies _____

Review disaster recovery procedures including testing schedule to ensure that backup procedures remain adequate and computer service to credit unions will not be interrupted in case of disaster _____

Review access to CUSO computer operations (e.g., limited to authorized personnel) _____

Review methods used to confirm transactions _____

Information Systems (IS) Processing

Request copy of the most recent third party review opinion and review management's response to weaknesses noted in the report _____

Review controls pertaining to access, passwords, keys, etc. _____

Review controls to prevent staff from performing transactions on their own accounts or family members' accounts _____

Review security logs for possible security breach attempts _____

Review procedures safeguarding release of information _____

Review intrusion detection procedures _____

Review backup systems and procedures _____

Inquire whether backup site is on a different grid from main office _____

Inquire about anticipated downtime (time needed to transfer major records to backup system) _____

Review results of the most recent test of the backup system _____

Regulations/Legal

Review compliance with confidentiality of credit union members' data _____

**Auto Leasing
CUSO**

Additional Auto Leasing CUSO Review

Internal Controls

Review operational policies and procedures including purchase of cars, establishment of capital cost amounts and residual values _____

Regulations/Legal

Review that CUSO's contingent liability insurance policy contains a specific endorsement for leasing _____

Review insurance contracts that pertain to the leased vehicle and the strength of the insurance providers (e.g., ratings) _____

Review insurance policies including:

Residual value insurance - credit union should receive the principal balance of the loan upon fruition of the lease term (NOTE: residual value insurance is necessary if the residual value used in the lease agreement is over 25 percent of the initial value of the vehicle) _____

Gap insurance - protects the credit union from loss due to the gap between the insurance company's book value of the vehicle and the credit union's principal balance of the vehicle in the event the car is stolen or wrecked beyond repair _____

Review insurance documents to ensure that all financed leased vehicles are covered by the policies (NOTE: if documentation does not specify the attachment of coverage to each individual vehicle, an attorney's opinion should be on file stating that blanket policy covers all financed leased vehicles) _____

Review whether the CUSO's insurance coverage is in compliance with applicable state and federal requirements _____

Review compliance with Regulation M _____

**Financial
Services
CUSO**

Additional Financial Services CUSO Review

(Includes Electronic Transaction Services, Financial Counseling Services, Real Estate Brokerage Services, and Insurance Brokerage or Agency)

Organization/Management

Review employees' compliance with licensing requirements _____

Inquire about training programs for the sale of nondeposit products (i.e., that training is provided to all employees that have direct contact with the members and imparts a thorough knowledge of the products involved, applicable legal restrictions, and customer protection requirements) _____

Inquire about the disciplinary actions in background of employees hired for the sale of nondeposit products _____

Review the need for SEC filings _____

Review compliance with Employment Retirement Income Security Act of 1974 if broker handles any retirement programs (e.g., credit union staff's pension) _____

Regulations/Legal

Review compliance with applicable sections of NCUA Letter No. 150 _____

Review compliance with the following:

Currency and foreign transactions _____

Posting of NCUA or other applicable insurance _____

Leasing Services

Review Leasing policies and procedures

Review contractual relationship between credit union and CUSO regarding delivery of CUSO leasing services _____

Refer to Leasing –Internal Controls questionnaire for guidance in reviewing leasing services _____

Trust and Trust Related Services

Review Trust Service policies and procedures _____

Review Trust Agreements with clients/customers _____

Review what steps are taken to ensure that the agreements are being followed. _____

Review minutes of any Trust related committee meetings _____

Review Auditors' verification of Trust account assets _____

Review vendor contracts _____

Review compliance with member confidentiality _____

Review Insurance/Bond coverage _____

FINANCIAL LIQUIDITY RATIOS - APPENDIX 25B

Liquidity is a measure of the quality and adequacy of current assets to meet current obligations as they come due.

- Current Ratio:
$$\frac{\text{Total Current Assets}}{\text{Total Current Liabilities}}$$

This ratio is a rough indication of a firm's ability to service its current obligations. Generally, the higher the current ratio, the greater the cushion between current obligations and a firm's ability to pay them. The stronger ratio reflects a numerical superiority of current assets over current liabilities. However, the composition and quality of current assets is a critical factor in the analysis of an individual firm's liquidity.

- Quick Ratio (or Acid Test Ratio):
$$\frac{\text{Cash \& Equivalents} + \text{Net Trade Receivables}}{\text{Total Current Liabilities}}$$

This ratio is a refinement of the current ratio and is a more conservative measure of liquidity. It expresses the degree to which a company's current liabilities are covered by the most liquid current assets. Generally, any value of less than 1 to 1 implies a reciprocal dependency on inventory or other current assets to liquidate short-term debt.

- Sales/Receivables:
$$\frac{\text{Net Sales}}{\text{Net Trade Receivables}}$$

This ratio measures the number of times trade receivables turn over during the year. The higher the turnover of receivables, the shorter the time between sale and cash collection. For example, a company with sales of \$720,000 and receivables of \$120,000 would have a sales/receivables ratio of 6.0, which means receivables turn over six times a year. If a company's receivables appear to be turning slower than the rest of the industry, further research is needed, and the quality of the receivables should be examined closely.

One problem with this ratio is that it compares one day's receivables, shown at statement dates to total annual sales and does not take into consideration seasonal fluctuations. Another problem in interpretation may arise when there is a large proportion of cash sales to total sales.

- Day's Receivables:
$$\frac{365}{\text{Sales/Receivable ratio}}$$

This figure expresses the average time in days that receivables are outstanding. Generally, the greater number of days outstanding, the greater the probability of delinquencies in accounts receivable. A comparison of a company's daily receivables may indicate the extent of a company's control over credit and collections. The terms offered by a company to its customers, however, may differ from terms within the industry and should be taken in to consideration.

In the example above, 365 divided by 6 = 61 - i.e., the average receivable is collected in 61 days.

- Cost of Sales/Inventory:

$$\frac{\text{Cost of Sales}}{\text{Inventory}}$$

This ratio measures the number of times inventory is turned over during the year. High inventory turnover can indicate better liquidity or superior merchandising. Conversely, it can indicate a shortage of needed inventory for sales. Low inventory turnover can indicate poor liquidity, possible overstocking, obsolescence, or, in contrast to these negative interpretations, a planned inventory buildup in the case of material shortages. One problem with this ratio is that it compares one day's inventory to cost of goods sold and does not take seasonal fluctuations into account.

- Day's Inventory:

$$\frac{365}{\text{Cost of Sales/Inventory Ratio}}$$

Division of the inventory turnover ratio into 365 days yields the average length of time units are in inventory.

- Cost of Sales/Payables:

$$\frac{\text{Cost of Sales}}{\text{Trade Payables}}$$

This ratio measures the number of times trade payables turn over during the year. The higher the turnover of payables, the shorter the time between purchase and payment. If a company's payables appear to be turning more slowly than the industry, then the company may be experiencing cash shortages, disputing invoices with suppliers, enjoying extended terms, or deliberately expanding its trade credit. The ratio comparison of company to industry suggests the existence of these possible causes or others. If a firm buys on 30-day terms, it is reasonable to expect this ratio to turn over in appropriately 30 days.

One problem with the ratio is that it compares one day's payables to cost of goods sold and does not take seasonal fluctuations into account.

- Day's Payables:

$$\frac{365}{\text{Cost of Sales/Payables Ratio}}$$

Division of the payables turnover ratio into 365 days yields the average length of time trade debt is outstanding.

- Sales/Working Capital:

$$\frac{\text{Net Sales}}{\text{Net Working Capital}}$$

Working capital is a measure of the margin of protection for current creditors. It reflects the ability to finance current operations. Relating the level of sales arising from operations to the underlying working capital measures how efficiently working capital is employed. A low ratio may indicate an inefficient use of working capital while a very high ratio often signifies overtrading -- vulnerable position for creditors.

Coverage Ratios

Coverage ratios measures a firm's ability to service debt.

- Earnings Before Interest and Taxes (EBIT) Interest:
$$\frac{\text{Earnings Before Interest \& Taxes}}{\text{Annual Interest Expense}}$$

This ratio is a measure of a firm's ability to meet interest payments. A high ratio may indicate that a borrower would have little difficulty in meeting the interest obligations of a loan. This ratio also serves as an indicator of a firm's capacity to take on additional debt.

- Net Profit, Depreciation, Depletion, Amortization/Current Maturities Long-Term Debt:
$$\frac{\text{Net Profit} + \text{Depreciation} + \text{Depletion} + \text{Amortization Expenses}}{\text{Current Portion of Long-Term Debt}}$$

This ratio expresses the coverage of current maturities by cash flow from operations. Since cash flow is the primary source of debt retirement, this ratio measures the ability of a firm to service principal repayment and is an indicator of additional debt capacity. Although it is misleading to think that all cash flow is available for debt service, the ratio is a valid measure of the ability to service long-term debt.

Leverage Ratios

Highly leveraged firms (those with heavy debt in relation to net worth) are more vulnerable to business downturns than those with lower debt to worth positions. While leverage ratios help to measure this vulnerability, remember they vary greatly depending on the requirements of particular industry groups.

- Fixed/Worth:
$$\frac{\text{Net Fixed Assets}}{\text{Tangible Net Worth}}$$

This ratio measures the extent to which owner's equity (capital) has been invested in plant and equipment (fixed assets). A lower ratio indicates a proportionately smaller investment in fixed assets in relation to net worth, and a better cushion for creditors in case of liquidation. Similarly, a higher ratio would indicate the opposite situation. The presence of substantial leased fixed assets (not shown on the balance sheet) may deceptively lower this ratio.

- Debt/Worth:
$$\frac{\text{Total Liabilities}}{\text{Tangible Net Worth}}$$

This ratio expresses the relationship between capital contributed by creditors and that contributed by owners. It expresses the degree of protection provided by the owners for the creditors. The higher the ratio, the greater the risk assumed by creditors. A lower ratio generally indicates greater long-term financial safety. A firm with a low debt/worth ratio usually has greater flexibility to borrow. In the future a more highly leverage company has a more limited debt capacity.

Operating Ratios

Operating ratios are designed to assist in the evaluation of management performance.

- % Profits Before Taxes/Tangible Net Worth
$$\frac{\text{Profit Before Taxes}}{\text{Tangible Net Worth}}$$

This ratio expresses the rate of return on tangible capital employed. While it can serve as an indicator of management performance, it should be used in conjunction with other ratios. A high return, is normally associated with effective management and could indicate an undercapitalized firm whereas a low return is usually an indicator of inefficient management performance and could reflect a highly capitalized, conservatively operated business. This ratio is multiplied by 100 since it is shown as a percentage.

(NOTE: Profit before taxes may be zero, in which case the ratio is zero. Profits before taxes may be negative resulting in negative quotients.)

- % Profit Before Taxes/Total Assets
$$\frac{\text{Profit Before Taxes}}{\text{Total Assets}}$$

This ratio expresses the pre-tax return on total assets and measures the effectiveness of management in employing the resources available to it. If a specific ratio varies considerably from industry standards, the analyst will need to examine the makeup of the assets and take a closer look at the earnings figure. A heavily depreciated plant and a large amount of intangible assets or unusual income or expense items will cause distortions of this ratio. This ratio is multiplied by 100 since it is shown as a percentage.

- Sales/Net Fixed Assets
$$\frac{\text{Net Sales}}{\text{Net Fixed Assets (Net of Accumulated Depreciation)}}$$

This ratio is a measure of the productive use of a firm's fixed assets. Largely depreciated fixed assets or a labor intensive operation may cause a distortion of this ratio.

- Sales/Total Assets
$$\frac{\text{Net Sales}}{\text{Total Assets}}$$

This ratio is a general measure of a firm's ability to generate sales in relation to total assets. It should be used only to compare firms within specific industry groups and in conjunction with other operating ratios to determine the effective employment of assets.

Expense to Sales Ratios

The following two ratios relate specific expense items to net sales and express this relationship as a percentage. Comparisons are convenient because the item, net sales, is used as a constant. Variations in these ratios are most pronounced between capital and labor intensive industries.

- % Depreciation, Depletion, Amortization/Sales
$$\frac{\text{Depreciation, Amortization, Depletion Expenses}}{\text{Net Sales}}$$

This ratio is the annual depreciation, amortization, and depletion expenses divided by net sales and multiplied by 100.

- % Officers', Directors', Owners' Compensation/Sales
$$\frac{\text{Officers', Directors', Owners' Compensation}}{\text{Net Sales}}$$

Annual officers', directors', owners' compensation divided by net sales and multiplied by 100. Included here are drawings of partners and proprietors, total salaries, bonuses, commissions, and other monetary remuneration to all officers; directors; and owners of the firm during the year covered by the statement.

Chapter 26

FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS (FISCUS)

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Chapter 26

FEDERALLY INSURED STATE-CHARTERED CREDIT UNIONS (FISCUS)

Insurance Review Objectives

- To work cooperatively with state supervisory agencies to assess the financial and operational condition of federally insured state-chartered credit unions (FISCUs)
- To address material risk in FISCUs that may negatively affect the NCUSIF

Risk Categories

FISCUs, like all credit unions, are subject to the seven categories of risk, discussed in the Risk-Focused Program chapter. These risks include Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation. As with other credit unions, FISCUs have the obligation to mitigate their risk to the NCUSIF by implementing measures such as management's due diligence, sound internal controls, the audit process, and well-trained management and staff. The size and complexity of the credit union should determine the extent of these risk mitigation measures.

Overview

The National Credit Union Share Insurance Fund (NCUSIF) provides the same account insurance coverage to FISCUs as to federal credit unions. However, the means of monitoring insurance risk differs. NCUA recognizes state supervisory agencies as the government agencies primarily responsible for the supervision of insured state credit unions. State regulators normally share parts or all of the state examination reports or audits with the appropriate NCUA regional office.

When applying for federal share insurance, state credit unions sign an Agreement for Insurance of Accounts and agree to follow Part 741 of NCUA's Rules and Regulations. Appendix 26A contains a copy of the Agreement.

Each regional office and the respective state supervisory authority (SSA) create their own working relationships and agreements to accommodate the unique circumstances of each state. The agreements must contain provisions for periodic meetings, and the sharing of credit union information and insurance concerns.

These agreements with each SSA will determine how NCUA will communicate an insurance concern to the SSA, and may cause a variation to the procedures in this chapter. Communication between the region and each SSA may be as informal as periodic telephone calls or as structured as monthly written status reports or quarterly meetings.

The periodic meetings between regional management and each SSA will include (1) discussion of current issues, (2) review of existing or potential problem FISCUs, and (3) scheduling or coordination of scheduling onsite insurance examinations, reviews, and supervision contacts. After each meeting with the SSA, the region should evaluate, update, and reduce to writing the individual programs to reflect current agreements with each state.

NCUA limits its concerns to insurance risk, which includes safety and soundness issues that could have a material effect on the FISCU's operation. Specific safety and soundness areas to address, in addition to those discussed in Part 741 of the NCUA Rules and Regulations, include each of the seven risk areas identified in the Risk-Focused Program chapter.

NCUA's concerns include the following:

- The examiners adequately addressed material risks with the FISCUs;
- The credit union understands the seriousness of the risks; and
- An agreement or plan exists for resolving unacceptable risks in a timely manner.

**Monitoring
Insured
Credit Unions**

The primary ways by which NCUA monitors the financial condition and the progress of FISCUs are through the district examiner's review

of examination reports completed by the SSA, 5300 Call Reports, the scope workbook, and the Financial Performance Reports (FPRs.)

State regulators provide copies of their examination reports to the respective NCUA regional office and upload completed scope workbooks to the NCUA server. The NCUA examiner independently reviews the report and scope workbook offsite to ensure they document the following:

- Identification of all material risks that may negatively affect the NCUSIF or the safety and soundness of the FISCUS;
- Recommendation for corrective action that adequately addresses the potential insurance risk for such material risks;
- Establishment of reasonable timeframes for implementation; and
- Determination that the credit union is sufficiently progressing toward correcting previously noted problems (where applicable.)

Additional tools for monitoring FISCUSs may include periodic receipt and review of the credit union's financial statements, attention to the news media, risk management reports using call report data, and discussions with the credit union officials, trade organizations, and the SSA. These sources may alert the SSAs, regional office, and examiner staff to adverse conditions affecting an individual credit union or a group of credit unions that serve a specific geographic area or a particular type field of membership.

These monitoring tools may trigger regional communication with the SSA for more information, revision of the scope workbook, and possible inclusion of the credit union in future onsite contacts. If these monitoring measures indicate no severe risks, NCUA usually does not require or take further action.

**Criteria for
Onsite
Reviews**

The SSA and NCUA share responsibility for developing mutually satisfactory criteria and procedures for scheduling and completing onsite insurance reviews. Reasonableness should govern NCUA's requests to conduct insurance reviews.

The fundamental purpose for onsite insurance reviews is to assess risk to the NCUSIF. To that end, NCUA will schedule FISCUSs for onsite

reviews based on risk factors of individual credit unions. For example, large credit unions, due to the concentration of assets, represent a substantial risk to the NCUSIF that necessitates greater oversight, including more frequent insurance reviews and supervision. Secondly, NCUA performs its due diligence by selecting FISCUs as needed to assure a certain percentage of credit unions of varying size, complexity, and risk profile receive onsite reviews.

NCUA, as the administrator of the NCUSIF, has the legal and fiduciary responsibility to ensure the safety of the NCUSIF. Therefore, NCUA reserves the right to conduct an insurance review of any federally insured credit union if necessary to determine its condition for insurance purposes.

Planning an Onsite Contact

When planning an onsite contact in a FISCU, NCUA staff will consult with the SSA before contacting state credit union officials. Working agreements between the regional offices and individual SSAs have established defined procedures for various types of contacts and means of communicating information concerning risk areas that may affect the FISCUs in their jurisdictions. However, when examiners perform an onsite contact in a FISCU, they will explain to management and the officials the purpose for the contact and the reason for NCUA's involvement.

Types of Onsite Reviews

The two most common types of onsite FISCU reviews are an independent insurance review and a joint examination/insurance review. An independent insurance review differs from a joint examination/insurance review. In both, NCUA limits the scope of an insurance review to risk issues negatively affecting the NCUSIF, and does not address regulatory issues except as they relate to safety and soundness concerns.

During an insurance review in a FISCU, the NCUA examiners limit their role to the review and analysis of existing or potential risks to the NCUSIF only, rather than to complete an examination of the FISCU. Should the examiners uncover other safety and soundness problems during an insurance review, they should also address these problems. Therefore, NCUA will discuss with the SSA safety and soundness

issues that require addressing and resolving, and will ensure that either the state or NCUA examiner discusses these issues with the credit union.

In joint examinations/insurance reviews, both NCUA and the SSA focus on risk issues (including safety and soundness issues, commensurate with the size, complexity, and risk profile of the credit union), while the state examiner focuses additionally on regulatory concerns.

**Onsite
Procedures**

NCUA conducts an onsite insurance review in one of the following formats:

- Joint examination/insurance review - performed concurrently or jointly with the SSA. In most cases, the working agreement developed by the regional office and each respective state contains agreed-to procedures for joint examinations.

In all joint examinations/insurance reviews, unless otherwise agreed to by the SSA, the SSA examiner will act as the examiner in charge. This means that the SSA examiner assumes responsibility for the scope workbook and leads all of the discussion with the credit union officials. Within the parameters of the working agreements, the SSA examiner in charge defines the scope of an individual FISCU examination, considering all relevant factors, including NCUA's concerns.

NCUA, as administrator of the NCUSIF, will ensure satisfactory addressing of the risk factors that affect or potentially affect the NCUSIF. Otherwise, NCUA may need to express its concerns to the SSA in a joint meeting. NCUA examiners should contact their supervisory examiners and follow regional guidance if disagreements arise. If NCUA cannot agree to the scope of a joint examination/insurance review based on risk factors in the FISCU, it will conduct an independent insurance review.

The goal of the joint examination/insurance review is to (1) assess the risk in the credit union, (2) address the credit union's risks to the satisfaction of both the SSA and NCUA, and (3) ensure the

credit union adequately mitigates the risk. Responsibility for the scope workbook rests with the SSA examiner in charge.

- Insurance review - independently performed by NCUA staff. NCUA determines the scope of the insurance review, which it normally limits to insurance risk, including safety and soundness issues. NCUA generally does not address regulatory issues unless they present a risk that may affect the NCUSIF. For example, even though NCUA does not have responsibility for enforcing Regulation Z, Truth in Lending, with respect to state-chartered credit unions, a credit union could incur money penalties resulting from violations of Regulation Z that may result in losses for the credit union.

Rather than performing just an insurance review, NCUA will perform a complete examination if the SSA so requests and NCUA agrees to the SSA's request. In these cases, NCUA assumes responsibility for the scope workbook.

Whenever possible, NCUA schedules onsite insurance reviews in conjunction with state examinations. NCUA will remain as flexible as possible in working with the SSA, but not to the extent that risk to the NCUSIF increases. NCUA limits its examination steps to a review of a FISCO's insurance risk.

NCUA examiners should avoid duplication of the SSA's effort during a joint examination/insurance review. The SSA examiner in charge develops an examination plan outlining the division of work to address insurance issues, safety and soundness concerns, and regulatory requirements. The plan sets forth tentative timeframes for finishing various examination steps. While an efficient examination necessitates such a plan, both the plan and time should allow enough flexibility to accommodate expanding (or reducing) the examination scope if conditions in the credit union or preliminary findings so warrant.

The SSA and NCUA jointly assume responsibility for adequately addressing safety and soundness issues and for coordinating with the SSA examiner in charge any necessary corrective action. In a situation where the state law or regulation does not prohibit, or is silent regarding a policy or procedure that NCUA considers a violation of

safe and sound practices, NCUA will take exception and, after notification and review with the SSA, reach agreement for appropriate corrective action. The treatment of the issue in the report depends on its severity and materiality.

During a joint examination/insurance review or an independent insurance review, and before meeting with credit union officials, state and federal examiners jointly discuss their findings and recommendations. Whether or not they reach agreement, state and federal examiners share responsibility for striving to reach compatible conclusions. Disagreements between NCUA and the SSA should not occur at briefings with the officials, and examiners should take care not to introduce topics during these meetings that they had not previously discussed.

If examiners cannot reach mutual agreement, their supervisors will attempt to resolve the disagreements before meeting with the credit union officials. Both parties understand that NCUA has the appropriate right to ensure that the SSA examiner in charge or a designee addresses all significant findings, concerns and recommendations with the credit union's officials and management, and communicates expected corrective actions to officials and management during the joint examination/insurance review or independent insurance review. This may result in NCUA voicing its own concerns in joint meetings; however, NCUA should not voice its concerns without prior discussions between the examiners' supervisors.

**Assignment
of CAMEL**

During an insurance review, the NCUA examiner will not discuss CAMEL component or composite ratings with officials of the FISCUS. In states where the SSA assigns a CAMEL code, the code assigned by NCUA may differ from that of the SSA. Since NCUA does not release its code to FISCUS, the state's CAMEL code will be the only one the credit union receives. NCUA will explain any differences from an insurance perspective in the confidential section in accordance with regional policy.

The SSA examiner generally assigns CAMEL codes in FISCUS toward the end of an insurance review in a manner similar to the assignment of CAMEL codes in federal credit unions. All FISCUS rated a code 4

or 5 by NCUA must have proper regional management approval in accordance with the region's policies.

**Joint
Examination
and
Insurance
Review
Reports**

Reporting differs in a joint examination/insurance review from a concurrent examination/insurance review. During a joint examination/insurance review, the SSA examiner and NCUA examiner issue a single combined report to the FISCO. In a concurrent examination/insurance review, the SSA examiner and the NCUA examiner issue separate reports to the credit union officials.

A goal exists of a single report encompassing both state and NCUA work. NCUA encourages examiners to jointly write the report and avoid duplication of effort during the examination. However, whether examiners issue a single report or two separate reports, the report or reports must address the concerns of both parties and document plans of action, developed with the credit union's officials and management, to correct noted deficiencies.

NCUA examiners should not take issue with SSA reporting practices merely because they differ from the standard NCUA examination report format. The overriding concern remains that the credit union officials receive sufficient direction to correct weaknesses and problems. The procedure to accomplish this is secondary to the effective communication of existing risks and necessary corrective action. NCUA and SSAs (with few exceptions) have adopted the AIREX examination program. Examiners may provide the credit union with additional workpapers needed to supplement specific areas of the examination.

Generally, the agreement enacted between each SSA and the respective regional office governs if, how, and when NCUA releases the examination report in that particular state. The region institutes procedures for performing regional office reviews and supervisory examiner appraisals of a joint examination/insurance review report.

The time required for reviewing and appraising the reports of joint examinations/insurance reviews varies from region to region. The regional offices have the option of performing insurance review due

diligence reviews on a sample of the reports, rather than reviewing every report.

After completion of the examination/insurance review, the regional office sends the examination report to the appropriate SSA using either electronic or regular mail. NCUA's goal for reviewing the reports of joint examinations and insurance reviews is an average 30-day turnaround. Generally, the SSA's procedures dictate methods for transmitting the report.

Joint Conferences

SSAs' practices vary regarding the holding of joint conferences and exit interviews. Some SSAs hold joint conferences on select cases, and others after their office has reviewed the report. NCUA may meet with the officials at the conclusion of each joint examination/insurance review to discuss problems and seek agreements to resolve the problems. This occurs only after notification and review with the SSA, who must always have the opportunity to participate and to lead the meeting.

When the state holds a joint conference, the SSA examiner usually leads the meeting. NCUA attends and, jointly with the SSA, discusses all safety and soundness areas, and ensures adoption of appropriate plans of action. If the officials will not adopt the proposed plan, the SSA and NCUA obtain agreement that the credit union will develop alternative plans acceptable to both parties. Generally, the examiners should avoid duplicating issues unless previously agreed upon as a method of underscoring the importance of a particular concern to both the state and NCUA; however, fully airing the concerns of both parties must remain the overriding consideration.

The SSA examiner in charge should provide credit union management reasonable opportunity to respond to existing and potential problems following the joint conference. The SSA examiner in charge instructs the credit union to respond to all areas of concern raised by both the SSA and NCUA. Both the SSA and NCUA receive copies of any written response.

In rare instances, credit union officials do not concur with the examiner's recommendations for corrective action, even though a

defined or potential loss exists that requires closer monitoring. The SSA and NCUA jointly outline a plan for corrective action, which contains procedures and timeframes for completion. The SSA should then ask the credit union to respond with their plans for carrying out the corrective actions, or to develop an alternative plan that will accomplish the same goals. In any case, the credit union remains responsible for correcting its safety and soundness weaknesses.

**Supervision
of FISCUs**

Supervision is the ongoing monitoring of a credit union's financial and operational condition. As such, supervision involves not only review of areas of concern and the progress the credit union is making in correcting those problems, but supervision also looks forward at risk indicators, which may alert the examiner to emerging areas of risk. Responsibility for routine monitoring and supervision of FISCUs primarily rests with the SSA. When an NCUA examiner believes the credit union needs further supervision or monitoring, the examiner will discuss it with the SSA to determine what supervision or monitoring, if any, the credit union needs, and who will perform any supervision contacts, and when.

NCUA may, after consulting with the SSA, schedule independent onsite supervision to review the credit union's progress in accomplishing the corrective actions. NCUA will discuss with the SSA, in advance, any meetings scheduled with officials as a result of this review. The SSA or a representative may attend the meeting, if they so request.

**Prompt
Corrective
Action**

The Credit Union Membership Access Act (CUMAA) amendment to the FCU Act mandates a system of prompt corrective action (PCA) to restore the net worth of inadequately capitalized federally insured credit unions, and an alternative system of PCA for new credit unions that allows a reasonable time to build adequate levels of net worth. As a credit union's net worth continues to decline, the actions required of the credit union to restore its net worth ratio to an acceptable level become progressively more stringent.

The three main components of PCA include:

- A framework combining:
 - Mandatory supervisory actions (MSAs) prescribed by Congress and indexed to five statutory net worth categories, and
 - Discretionary supervisory actions (DSAs) developed by NCUA to enhance PCA when imposed;
- Alternative PCA requirements for credit unions defined by CUMAA as new; and
- Risk-based net worth (RBNW) requirement for applicable credit unions.

When a FISCO requires prompt corrective action, NCUA will notify and work cooperatively with the SSA for certain actions including the following:

- Lowering a net worth category resulting from a decline in the net worth ratio;
- Imposing any DSAs;
- Approving or disapproving of new, revised, or amended net worth restoration plans or revised business plans;
- Placing a FISCO into conservatorship or liquidation; and
- Approving a reduction in the earnings retention requirement.

The Prompt Corrective Action chapter contains more detailed information on this subject. Additionally, the written agreements between the SSA and region may address PCA and FISCUS.

**Problem
Credit Unions**

NCUA's district examiners monitor most problem credit unions and, along with the SSA examiners, work with the credit unions to resolve problems. However, NCUA assigns to the regions' Divisions of Special Actions some problem credit unions, because of their size, complexity of problems, or degree of potential risk or loss to the NCUSIF. NCUA notifies the SSA when it assigns a FISCO to special actions. The NCUA Special Actions Problem Case Officers (PCOs) and the SSA attempt to arrange a mutually convenient date to commence joint onsite work. If the SSA PCO or examiner is unavailable, the NCUA PCO should arrange to meet with the SSA following the contact to review results and recommendations before meeting with the FISCO officials. The examiners should make efforts to eliminate multiple contacts and return trips.

NCUA and SSA examiners should work collectively to prepare a joint supervisory agreement, a Letter of Understanding and Agreement (LUA). NCUA and SSA examiners should work jointly with FISCUs to assist them in the development of Net Worth Restoration Plans (if required by PCA) to address the risks. These agreements should address insurance risk that threatens the credit union's viability and presents a significant risk to the NCUSIF. SSA and NCUA staff should maintain a professional demeanor with each other and the FISCUs at all times to avoid unnecessary distraction from insurance risks, safety and soundness issues, or other regulatory problems.

In FISCUs having serious operational or management problems that normal supervisory efforts have not, or cannot resolve, administrative actions represent the strongest supervisory tools available to NCUA and the SSA. The purpose of administrative actions is to prevent, alter, or eliminate serious operational problems in a credit union. They further protect the credit union, its members, its creditors, and the NCUSIF. NCUA consults with SSAs before taking any administrative action.

Before placing a FISCU in conservatorship or liquidation, NCUA will seek the views of the appropriate SSA and will give the SSA an opportunity to place the credit union in conservatorship or liquidation.

APPLICATION AND AGREEMENT FOR INSURANCE - APPENDIX 26A

Application and Agreements for Insurance of Accounts

TO: The National Credit Union Administration Board Date
The _____ Credit Union,
Insurance Certificate Number _____ (if applicable)
(Mailing Address) _____, _____ (City) _____ (State) _____ (Zip Code)

applies for insurance of its accounts as provided in Title II of the Federal Credit Union Act, and in consideration of the granting of insurance, hereby agrees:

1. To permit and pay the cost of such examinations as the NCUA Board deems necessary for the protection of the interests of the National Credit Union Share Insurance Fund;
2. To permit the Board to have access to all records and information concerning the affairs of the credit union, including any information or report related to an examination made by or for any other regulating authority, and to furnish such records, information, and reports upon request of the NCUA Board;
3. To possess such fidelity coverage and such coverage against burglary, robbery, and other losses as is required by Parts 701.20 and 741 of NCUA's regulations;
4. To meet, at a minimum, the statutory reserve and full and fair disclosure requirements imposed on federal credit unions by Section 116 of the Federal Credit Union Act and Parts 702 of NCUA's regulations, and to maintain such special reserves as the NCUA Board may by regulation or on a case-by-case basis determine are necessary to protect the interests of members. Any waivers of the statutory reserve or full and fair disclosure requirements or any direct charges to the statutory reserve other than loss loans must have the prior written approval of the NCUA Board. In addition, corporate credit unions shall be subject to the reserve requirements specified in Part 704 of NCUA's regulations;
5. Not to issue or have outstanding any account or security the form of which has not been approved by the NCUA Board, except accounts authorized by state law for state credit unions;
6. To maintain the deposit and pay the insurance premium charges imposed as a condition of insurance pursuant to Title II (Share Insurance) of the Federal Credit Union Act;
7. To comply with the requirements of Title II (Share Insurance) of the Federal Credit Union Act and of regulations prescribed by the NCUA Board pursuant thereto; and
8. For any investments other than loans to members and obligations or securities expressly authorized in Title I of the Federal Credit Union Act, as amended to establish now and maintain at the end of each accounting period and prior to payment of any dividend, an Investment Valuation Reserve Account in an amount at least equal to the net excess of book value over current market value of the investments. If the market value cannot be determined, an amount equal to the full book value will be established. When, as of the end of any dividend period, the amount in the Investment Valuation Reserve exceeds the difference

between book value and market value, the board of directors may authorize transfer of the excess to Undivided Earnings.

9. When a state-chartered credit union is permitted by state law to accept nonmember shares or deposits from sources other than other credit unions and public units, such nonmember accounts shall be identified as nonmember shares or deposits on any statement or report required by the NCUA Board for insurance purposes. Immediately after a state-chartered credit union receives notice from NCUA that its member accounts are federally insured, the credit union will advise any present nonmember share and deposit holders by letter that their accounts are not insured by the National Credit Union Share Insurance. Also, future nonmember share and deposit fund holders will be so advised by letter as they open accounts.
10. In the event a state-chartered credit union chooses to terminate its status as a federally insured credit union, then it shall meet the requirements imposed by Sections 206(a)(1) and 206(c) of the Federal Credit Union Act and Part 741.6 of NCUA's regulations.
11. In the event a state-chartered credit union chooses to convert from federal insurance to some other insurance from a corporation authorized and duly licensed to insure member accounts, then it shall meet the requirements imposed by Sections 206(a)(2), 206(c), 206(d)(2), and 206(d)(3) of the Federal Credit Union Act.

In support of this application, we submit pages 1-6 and Schedules described below:

Schedule No.	Title
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Certifications and Resolutions

We, the undersigned, certify that we are duly elected and qualified presiding officer and recording officer of the credit union and that at a properly called regular or special meeting of its board of directors, at which a quorum was present, the following resolutions were passed and recorded in its minutes:

We, the undersigned, certify to the correctness of the information submitted.

Be it resolved that this credit union apply to the National Credit Union Administration Board for insurance of its accounts as provided in Title II of the Federal Credit Union Act.

Be it resolved that the presiding officer and recording officer be authorized and directed to execute the Application and Agreement for Insurance of Accounts as prescribed by the NCUA Board and any other papers and documents required in connection therewith and to pay all expenses and do all such other things necessary or proper to secure and continue in force such insurance.

We further certify that to the best of our knowledge and belief no existing or proposed officer, committee member, or employee of this credit union has been convicted of any criminal offense involving dishonesty or breach of trust, except as noted in attachments to this application. We further agree to notify the Board if any existing, proposed, or future officer, committee member, or employee is indicted for such an offense.

(Signature) Presiding Officer, Board of Directors (Print or type Presiding Officer's Name)

(Signature) Recording Officer, Board of Directors (Print or type Recording Officer's Name)

Chapter 27

SHORTAGES

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Chapter 27

SHORTAGES

- Examination Objectives**
- Determine whether a shortage exists in the credit union
 - Determine whether the credit union has take appropriate action to identify the shortage, notify surety, and to correct underlying problems that caused the shortage

- Associated Risks**
- Reputation Risk – includes the risk that management did not establish adequate internal controls to detect or deter shortages, resulting in poor publicity or administrative action;
 - Liquidity Risk – includes the risk that adequate liquidity is not available due to reliance on inaccurate financial reports; and
 - Transaction Risk – includes the risk that financial reports are not accurate due to manipulation of financial transactions.

Overview A shortage is any loss of funds or property belonging to a federally insured credit union caused by dishonesty such as embezzlement, robbery, burglary, kiting, mysterious disappearance, and larceny.

NCUA provides guidance to all federally insured credit unions that discover a shortage. However, credit union officials must take ultimate responsibility for providing adequate internal controls, detecting shortages, and taking appropriate action when they discover shortages.

Examiner's Role Examiners should not approach every examination believing a shortage exists or that employees or officials are dishonest. However, if examiners suspect a shortage, they should determine whether one exists. Audit procedures are not a normal part of the examination process and are beyond the scope of this Guide; therefore, examiners may find it necessary to perform certain audit steps to determine whether shortages are occurring.

Credit union officials, the regional office, the examination process, or some other source may alert examiners to a possible shortage. The

procedures described in this and other chapters will assist the examiner in determining whether a shortage exists, the extent of the shortage, and the necessity of further action, such as an audit. Follow-up on shortages is part of district management.

Examiners should be cautious about what they say regarding possible shortages. Before confronting an individual suspected of a shortage, informing credit union officials of a suspected shortage, or taking any action regarding the removal or suspension of any employee or official, the examiner should contact the supervisory examiner. Upon discovering a shortage, the examiner should suggest that officials mail the Suspicious Activities Report (SAR) to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN), and notify surety. Many types of shortages also require the officials to notify the local police authority and the Federal Bureau of Investigation (FBI).

**Examination
Scope**

If the examiner discovers or learns of an internal shortage, the examiner should expand the examination as necessary to determine the facts surrounding the alleged embezzlement. After discovering and documenting the pattern, the supervisory committee must investigate and resolve the shortage.

The examiner should document in the report any material shortage and actions taken by management to resolve the shortage.

**Notifying
Credit Union
Officials**

As soon as examiners determine with reasonable certainty that a shortage exists, they should discuss the matter with the supervisory examiner. After concurrence from the supervisory examiner, the examiner should contact the board chairperson and arrange for a board meeting. The directors should invite members of the supervisory and credit committees. The examiner should consider inviting the supervisory examiner or another available examiner to attend and witness this meeting. At that meeting:

- The examiner should present directors with evidence that indicates the shortage. The board may give the person allegedly responsible the opportunity to be heard.

- The examiner should discuss the surety bond provisions, the filing of a bond claim, and should encourage the officials to contact surety in a timely manner.
- If proven, the board should suspend or terminate the official or employee responsible for the embezzlement. Ultimately, it is the board's responsibility to take appropriate action. The examiner's goal is to ensure that the person responsible no longer has the ability to cause losses or destroy credit union records. However, examiners should not act before contacting the supervisory examiner for concurrence.
- The officials usually will suspend or terminate an alleged embezzler during the meeting, and should contact surety in a timely manner. The person responsible may volunteer to resign before the board meeting.
- If an embezzler makes full restitution, the directors might fail to take action against the alleged embezzler. The examiner should explain the board's fiduciary responsibility to the members and point out that failure to act may result in release of surety from liability for any future shortages. In addition, the directors may be personally liable for losses sustained because of their failure to act.
- The examiner should make certain that the officials clearly understand their responsibilities to update records and to perform (or cause to be performed) an audit. In some cases, they should explore using a qualified fraud audit firm.
- Under most surety bond policies, credit unions have an obligation to mitigate damages by taking reasonable steps to reduce their loss. If the perpetrator offers restitution, officials should contact legal counsel and surety for an opinion and concurrence before acceptance. Officials should be skeptical of accepting any restitution other than cash. If the perpetrator offers a check, the officials may accept it subject to collection. Any receipt given should only acknowledge the amount and manner of payment and should not allege to be "payment in full." If the directors accept restitution, the minutes should document the acceptance. If the

question arises, the examiner should encourage the directors not to change the credit union's surety during presentation of the claim.

- The examiner should caution the officials against agreeing, in writing or orally, not to prosecute the responsible person in consideration of repayment or promise of repayment. The officials should not release the credit union's claim against the responsible person without legal counsel's advice.
- The examiner should inform the directors about the harm that publicity regarding a shortage often does to a credit union and advise them to avoid it if possible. Conversely, rumors sometimes do more harm to member confidence than the actual facts. When information about a shortage becomes publicly known, the directors may call a special meeting of the members and present the facts concerning the shortage. In most instances, however, such a meeting is not necessary or desirable.
- Other matters the examiner should consider discussing with the board include (1) reviewing the alleged embezzler's loan and share accounts, (2) changing combinations or locks, (3) changing access and passwords to all electronic systems, (4) changing signatures at banks or other institutions, (5) revoking investment redemption authority, (6) stopping payment on checks that contain known forgeries, and (7) pinpointing the responsibility of the person designated to maintain the records.

Notifying Surety

It is the officials' responsibility to send notice of loss to surety. If the credit union officials refuse to notify surety, the examiner should discuss the refusal with the supervisory examiner. The examiner should inform the credit union officials that their failure to file a notice of loss could result in loss of the bond claim and, therefore, breach their fiduciary duties. The credit union should request Proof of Loss forms from the surety bond company.

The exact amount of the shortage need not be known before giving notice of loss to surety. (A delay until the officials know the specific amount could jeopardize recovery of the claim from the surety company.) The examiner should review pertinent provisions of the

surety bond and refer to the Bond Coverage section of this Guide before advising officials or sending the notice of loss to surety.

The surety bonds currently in use in credit unions differ in respect to the notice of loss provisions, so it is very important to review the credit union's surety bond. Officials must provide notice to surety within a specified number of days of discovery (as specified in the bond notification requirements.) When the claim is significant in relation to credit union reserves, credit unions should consider seeking legal assistance from an attorney familiar with surety bond law.

Examiners should review prior bonds in effect during the period of the shortage to determine if the officials should provide notice to more than one surety company. If credit union files do not contain complete copies of the bonds, officials should contact surety bond companies and request a copy.

Once the auditor has completed the audit and verification, officials should submit a proof of claim to surety within the time limits specified. Please refer to the Bond Coverage chapter for additional guidance.

**Notifying the
U.S.
Department
of Treasury
(FinCEN)**

The FBI investigates and the local US Attorney prosecutes cases involving violations of federal criminal statutes. As set forth in §748.1 of the *NCUA Rules and Regulations*, the officials must complete the SAR and mail the report to FinCEN.

In cases of criminal activity, the officials notify the FinCEN by completing and submitting a SAR, which includes the instruction for completion. (If the officials indicate reluctance to completing the form, the examiner should discuss with the supervisory examiner whether or not the examiner should notify FinCEN.)

**Establishing
Accounts
Receivable**

The credit union may establish an account receivable in accordance with generally accepted accounting principles, taking care not to unreasonably anticipate a recovery. If properly established, the account remains on the credit union's records until surety pays the claim, or recovery is a reasonable certainty.

Contacts with the Press

After learning of a possible shortage, the press may contact the credit union or examiner for information. Examiners should point out to reporters that they may not release any information and that the credit union's officials are the proper source of information. In rare instances, the examiner may refer a persistent reporter to the regional office. Where significant shortages exist or when obvious criminal activity occurs, the credit union should develop a plan for dealing with the press that includes appointing a single credit union spokesman.

Unrecorded Shares

The potential exists for unrecorded shares in a credit union, which can cause losses to the National Credit Union Share Insurance Fund (NCUSIF.) The following steps may assist in revealing unrecorded shares:

- Review adequacy of verification of member accounts;
- Review internal controls over printing and mailing of statements;
- Review supervisory override reports for management overrides of cash transactions;
- Review volume of transactions in credit union's checking account. A high volume of transactions during the month may warrant further review; and
- Review supervisory committee's or head teller's role in performing surprise cash accounts.

Embezzlements

The term embezzlement, defined as acts by officials or employees for the purpose of diverting funds for their own or a third party's benefit, includes all internal shortages. Appendix 27A contains a list of "Warning Signals" that might indicate a shortage.

Some of the most common embezzlements include:

- Fictitious or unauthorized loans;
- Unreported loans to employees and family members;
- Unrecorded shares;

- Theft of member shares (especially dormant or inactive accounts);
- Overdrawn accounts;
- Theft of insurance proceeds;
- Theft of receipts by collection agencies;
- Theft through unauthorized expenses;
- Misappropriation of travelers checks or money orders;
- Theft of closed accounts;
- Misappropriation of loans from other credit unions;
- Misappropriation of credit union checks;
- Misappropriation of deposits in transit;
- Misappropriation by manipulating payroll deductions;
- Misappropriation through the information processing system;
- Misappropriation of credit union investments;
- Computer crime;
- Repossessed collateral; and
- Non-payroll deduction transfers to credit union employee accounts.

**Fictitious and
Unauthorized
Loans**

A fictitious loan exists when the credit union disburses funds to an account in the pretense of granting a loan, but no actual loan was made. Unauthorized loans are loans made in the name of real members without their knowledge or consent. General characteristics are:

- The embezzler creates some or all the documentation creating the loan, forging signatures as necessary.

- The address used for mailing member statements and account verifications is under the control of the embezzler (a post office box, the embezzler's home address, or the credit union's own address). The AIREs loan and share download allows examiners to perform various share queries for determining if possible shortages exist. Sometimes the embezzler simply destroys the statements before they leave the credit union.
- The embezzler usually uses a direct payment method (i.e., cash payment) rather than payroll deduction.

Methods of detecting unauthorized or fictitious loans include:

- Reviewing loan documentation for discrepancies in the documents, such as validity of dates, legitimacy of signatures, or evidence of tampering;
- Verifying the borrower's name and address from non-credit union documents, such as telephone books, city address directories, credit reports, and certificates of title, sponsor records, or directory assistance;
- Comparing the address in the loan file with the address in the credit union's computer records;
- Comparing the address listed in the loan documentation against the addresses of credit union officials or employees;
- Comparing the signatures on loan documents, including signatures approving the loans, with the credit committee members' signatures or those of any other employees authorized to approve loans;
- Comparing the member's signature on the note with the signature on the membership card; and
- Verifying by telephone the accuracy of loan information with the purported borrower.

In most credit unions, examiners find it impossible to review all loan files for evidence of unauthorized or fictitious loans, and a random

sample of loans may not uncover such a scheme. The following red flags may indicate that there is a cause to examine certain loans:

- "Next payment due date" more than 60 days in the future;
- Loans not reported as delinquent, but the records indicate interest due;
- Repayment of principal not current, but records indicate no interest due;
- The original and the current loan balance approximately the same when the payment schedule indicates that the current balance should be significantly less;
- Unusual loan payment, interest rate, or balance or one that differs significantly from the typical credit union loan (i.e., zero interest rate loans);
- No payment for 90 days but loan not listed as delinquent;
- Member's share balance less than the current loan balance on a share secured loan; and
- Collateralized loan, but no outside third party documentation in the files confirming the existence of the collateral or the credit union's lien. (Credit union-generated documents and other form letters are not acceptable documentation.)

**Loans to
Employees and
Family
Members**

Another type of internal shortage is a fraudulent loan in the name of the embezzler or the embezzler's family members. Generally, the perpetrator has not followed loan policies and procedures and ignores repayment and collateralization criteria.

Procedures that might assist the examiner in uncovering fraudulent loans include:

- Reviewing loan policies that relate to loans to employees, officials, and their family members;

- Reviewing loans to current employees and officials for current payments, valid approval signatures, and adequate share balances for share secured loans.

**Theft of
Member Shares**

The following steps detail how theft of member shares can occur. First, the embezzler drafts a withdrawal check payable to the member, forges the endorsement, and cashes the check. Second, the embezzler completes a cash withdrawal voucher, which the credit union posts to the member's account. Finally, the credit union transfers funds from the member's account to an account under the embezzler's control. This type of embezzlement generally occurs in relatively inactive accounts (no loans) and conceals the embezzlement by diverting the member's statement before it leaves the credit union, altering it, or preparing a new statement.

To verify theft of member's shares, the examiner should:

- Scan accounts with relatively large balances, no loans, and significant withdrawals or transfers. For withdrawals, verify the signature on the check with those on the membership card. If the signature is questionable, pull other documents signed by the member to test authenticity. If the signature is still doubtful, consider first whether the signature may be by a party with authorization to sign, for example those with a power of attorney;
- Compare records of inactive accounts from a year ago with current inactive accounts. Then check the member statements for those member accounts that do not appear on the most recent inactive list;
- Review the other account if a withdrawal is by transfer to another account. Generally these transfers go to another account of the member or the account of a family member; and
- Contact the member directly or by telephone to determine the legitimacy of the withdrawals.

**Overdrawn
Accounts**

A relatively simple method for creating a shortage is to overdraw a share or share draft account with no intention of repaying the overdrawn amount. Indicators of this type of embezzlement include negative balances in accounts, nonassessment of nonsufficient funds (NSF) fees or reversal of such fees, posting of drafts out of sequence, manual clearing of checks, and frequent appearance of insider names on the NSF check listing. Examiners should analyze the negative share and share draft report during the examination at various cut-off dates rather than just at month-end to uncover overdrawn amounts that credit union staff may have “fixed” at month end. The accounts most likely to contain unresolved amounts include those of credit union management, accounting department personnel, and family members of these individuals.

**Theft of Loan
Protection/Life
Savings
Insurance Claim
Proceeds**

Theft of loan protection/life saving insurance claim proceeds takes several forms:

- The embezzler increases the share or loan balances of a deceased member and steals the insurance proceeds once the credit union files and receives a claim;
- If the embezzler believes the beneficiary is unaware of the insurance, he steals the credit union check for the insurance proceeds, forges the endorsement, and cashes the check in the credit union; or
- The embezzler creates a fictitious account for a deceased nonmember, files a claim with the carrier, and keeps the proceeds check for his own use.

When the examiners suspect this type of shortage, they may obtain confirmation by requesting from the insurance carrier a copy of the claims register for the credit union. They compare this register to the credit union's records. Through spot-checking, they contact the beneficiaries to verify disbursements indicated in the credit union's records.

Theft of Credit Disability/Credit Life Insurance

Misappropriating credit life or credit disability claim checks, refunds, or dividends constitutes theft. Although the member pays premiums for this insurance, the insurance company makes dividends and refund checks payable to the credit union and sends them directly to the credit union. The procedure for detecting this form of shortage involves requesting the appropriate registers from the insurance company, tracing the proceeds through the credit union's records, and verifying with beneficiaries the actual receipt of the funds.

Theft of Receipts by Collection Agencies

This shortage involves misappropriation of credit union receipts from collectors of delinquent or charged-off loans by either credit union employees after remittance to the credit union or by the collectors themselves. To confirm these shortages, the examiner should secure a register of all collection loans from the collector and compare the balances with the credit union's records for discrepancies. To determine whether collectors are misappropriating funds, the examiner should contact the member directly to verify that the credit union applies all payments to the loan balance.

Embezzlement through the Credit Union's Expense Ledger

Embezzlement through the expense ledger usually occurs through overpayment of salaries, payment of personal bills or other personal expenses. Comparing credit union salaries, confirmed through board minutes or other documentation, with amounts paid per the expense ledger can detect this embezzlement. The examiner should check disbursements for proper invoices in the credit union's name.

Theft of Closed Accounts

In another common form of embezzlement, the embezzler steals an entire account balance and closes out the account. The embezzler usually targets retired or out-of-town members with no outstanding loans or account activity. The embezzler either forges the endorsement on the share withdrawal check or transfers the money from the member's account to an account under the embezzler's control.

To document theft of closed accounts, the examiner should obtain a list of recently closed accounts, examine the final member statement for unusual transactions, compare the signatures on the final withdrawal check with those on the membership card, and, if

necessary, verify the closing of the account directly with the member. For accounts closed by share transfer, the examiner should review the account of the transferee and, if necessary, confirm the transfer with the original member.

Deposits in Transit

The embezzler can conceal a shortage by increasing deposits in transit to cover the amount stolen. A detailed examination of bank reconciliations can confirm this shortage. Embezzlers can also use deposits in transit to conceal kiting (discussed later in this chapter.)

Unapplied Data Processing and Suspense Accounts

Inflating the unapplied data processing suspense accounts by individuals with responsibility for reconciling or correcting these accounts can also conceal a shortage. These accounts show the amount of unprocessed transactions rejected by the information processing system, often due to timing differences. The examiner should determine whether the amount in the unapplied data processing suspense account appears large relative to the size and operation of the credit union. Moreover, examiners should ensure that they can identify individual items in the account and that these items clear in a timely manner.

Kiting

Kiting is depositing a check from an account with non-sufficient funds to cover a withdrawal of funds from another account with non-sufficient funds. Kiting may involve one or more persons and can be internal or external. It usually involves credit union employees, because they have access to the records daily and are familiar with policies and procedures. The credit union should design internal controls to prevent kiting. Types of kiting are:

- Internal kiting - usually involves credit union employees. The most common forms of employees kiting are:
 - Two share draft accounts - continually writing drafts between the two accounts without sufficient funds to cover all drafts written.

- Regular share and share draft accounts - continuous transfer of funds between the two accounts without sufficient funds to cover all transactions.
 - Share draft and Line of Credit - writing share drafts to pay amount due on a line of credit without sufficient funds in the draft account and then accessing the line of credit to pay share draft overdrafts.
 - Share draft - delay in processing transactions to prevent an overdraft.
 - ATM - delay in processing transactions to prevent a negative balance.
 - Share account - negative balance without fees or interest being charged.
- Employee kiting – reviewing employees' account statements or transaction history for the most recent two to three months will usually detect employees' kiting. If the statements contain numerous transactions in a short time, the examiner should make a more in-depth investigation.
 - External kiting - pertains to members' accounts. External kiting schemes usually involve the credit union and one or two other financial institutions. A member writes share drafts or checks against one or both of the other financial institutions. The member has insufficient funds in that institution to cover the check. Credit union employees should analyze any account that indicates large check deposits and equally large cash withdrawals within a short time. If they uncover a kiting scheme, management should not release large cash withdrawals before receiving the actual funds from the deposits made. Telephone verification will not catch external kiting as the member may immediately withdraw funds from the institution on which the check was written.

**Burglary,
Robbery, and
Larceny**

Except when the loss presents a material risk to the credit union and to the NCUSIF, an examiner normally need not make a contact when learning of a burglary, robbery, or larceny. If examiners decide to make an on-site contact, they should contact their supervisory examiners. The examiner will determine that the officials have:

- Notified surety and made necessary claims; and
- Mailed the SAR to the FinCEN (if applicable).

During the examination or supervision contact following the burglary, robbery or larceny, the examiner should detail pertinent information about the incident in the report.

**False or
Fraudulent
Statements**

§1014 of Title 18 of the United States Code makes it a federal crime for anyone to knowingly make a false statement or report, or to willfully overvalue any land, property, or security, for the purpose of influencing in any way the action of a federal credit union on any application, advance, discount, purchase, purchase agreement, repurchase agreement, commitment, or loan or any change or extension of any of the same, by renewal, deferment of action or otherwise, or the acceptance, release or substitution of security therefore.

Among the most common acts coming under §1014 are forging of co-maker's signature on the note, making false statements as to ownership or value of property offered as security for a loan, and false statements as to the purpose of a loan. The officials should obtain as much evidence as possible to support a potential bond claim. A sworn affidavit from the person whose name was used is usually sufficient.

The credit union officials should use caution when they discover an instrument containing an apparent forgery of the name of a relative. Frequently, these persons will claim that they gave permission for use of their names. Consequently, proving the loss is difficult since the credit union could not proceed against the person.

The examiner should use extreme care in dealing with possible violations of §1014 of the US Code. Incorrect statements about

ownership or value of property or about the purpose of a loan may not necessarily represent a violation under §1014 unless the person making such statements knowingly makes them with willful intent to mislead the credit union. The examiner should contact the supervisory examiner if any doubt exists about an alleged violation.

When a violation occurs, the examiner should determine that the credit union has notified surety and filed a SAR with the FinCEN (if applicable). If the board of directors declines to report a violation to surety and the FinCEN, the examiner should ask the supervisory examiner about the process of reporting a violation.

**Mysterious
Disappearance**

Losses may occur in federal credit unions through the mysterious, unexplainable disappearance or misplacement of property. Credit union blanket bonds often cover the losses either as a standard feature or as a rider to the bond. If the credit union discovers a mysterious disappearance, it should review the bond to determine if surety covers the loss. On rare occasions, examiners may encounter credit unions that use mysterious disappearance rather than to name a person responsible for embezzlement in order to avoid confronting or taking action against that individual or to hide the real cause for a loss.

The surety and the FinCEN should be notified only when the circumstances of the mysterious disappearance lead officials to conclude that a criminal act occurred.

Federal credit unions' bonds do not cover tellers' overages and shortages. Management should avoid nuisance claims and must clearly identify the loss of the funds. For example, if the cash is short \$100 at the end of the day, this is a teller's shortage and therefore not a claimable item. On the other hand, a mysterious disappearance occurs if member John Doe gave the treasurer \$100 that the treasurer placed in a desk drawer and later cannot locate.

**Workpapers
and
References**

- Workpapers
 - Supplementary Facts
 - Suspicious Activity Report

- References
 - *Federal Credit Union Act*
§§107(6), 107(9)
 - *NCUA Rules and Regulations*
Part 703 - Investments and Deposits
§702.3 - Full and Fair Disclosure Required
 - *Accounting Manual for Federal Credit Unions*
 - Electronic Fund Transfer Act - Regulation E
NCUA Letter No. 96-CU-3, Suspicious Activity Report

WARNING SIGNALS - APPENDIX 27A

Warning Signals

- Attempts on the part of the treasurer, the manager, or an employee to postpone or delay the examination or the supervisory committee's audit.
- General conditions of books and records are unfavorable. Records not posted currently or out of balance for long periods of time.
- Failure of personnel to produce records for which they are responsible, or attempts on their part to delay access to records or cash on hand.
- Extreme nervousness or evasiveness in answering questions by personnel during examinations and audits.
- Failure of key personnel to share work or records with other employees. Attempts on the part of promoted employees to retain control of certain records because they "know the work."
- Failure of personnel to take vacations or attempts of personnel to retain control over records during vacation.
- Excessive personal spending habits of employees relative to the standard of living possible on their visible income, often indicated by heavy drinking, gambling, big cars, or expensive parties.
- Personal checks or IOUs used to balance petty cash or change funds.
- Inadequate bank records. No provision made for the reconciliation of cash received with bank deposits. Failure to deposit all collections intact so that they can be identified.
- No receipts for cash transfers between the credit union office and field collectors or between employees in the credit union office.
- Cash overages and shortages not recorded.

- Missing notes, ledger cards, or records of past transactions, particularly canceled checks and member share and loan ledger cards.
- Unusual and rapid increases in delinquent loans, without apparent accompanying causes such as strikes or layoffs, or long-term delinquencies for which there is not a satisfactory explanation.
- Unexplainable decreases in assets and in member share account balances at a time when the credit union should be growing.
- Credit union expenses unreasonably out of proportion with gross income.
- Loans to credit union officials, members of their families, or employees in excessive amounts.
- Inadequate information on loan papers of credit union officials, members of their immediate families, and employees. Excessive delinquency on these loans.
- High percentage of no-response accounts during positive account verifications mailed to the members' homes. Over a period of time, a pattern appears involving the same no-response accounts.
- Verification letters returned to the credit union office instead of to the supervisory committee. Lack of control by the supervisory committee.
- Failure of the board of directors to establish necessary and adequate control over operations.
- Failure of the supervisory committee to perform comprehensive audits as required by law.

Chapter 28

BOND COVERAGE

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Chapter 28

BOND COVERAGE

Examination Objectives

- Determine if the credit union has adequate bond coverage to comply with Part 713 of the *NCUA Rules and Regulations*
- Determine if bond claims were filed when appropriate

Associated Risks

- Compliance risk – Includes the risk that the bond coverage does not comply with the *Federal Credit Union Act* and *NCUA Rules and Regulations*; and
- Reputation risk – Includes the risk that bond coverage does not adequately cover losses resulting from employee or director fraud, dishonesty, theft or other similar activities, resulting in poor publicity or administrative action.

Overview

The *Federal Credit Union Act* §112, §113(2), and §120(h) set forth the statutory requirements for the bonding of credit union employees and appointed and elected officials. §120(h) requires that the NCUA Board approve bond forms and prescribe minimum bond coverage. The Act directs the NCUA Board to promulgate regulations setting forth both the amount and character of bond requirements for employees and officials. It also grants the NCUA Board the power to approve bond forms and to set minimum requirements for bond coverage.

Part 713 of the *NCUA Rules and Regulations* contains the NCUA Board's bond regulation, which is made applicable to state-chartered natural person credit unions by §741.201(a). Part 713 prescribes the form and the minimum schedule of bond coverage for natural person credit unions.

This chapter discusses the bonds used by credit unions, known as "fidelity" bonds, "blanket" bonds, "surety" bonds, or "discovery" bonds. Whatever the terminology, the bonds all provide the same type of coverage: primarily coverage against losses caused by fraud, dishonesty, theft, and other similar activities. The bond may provide

coverage for lack of faithful performance, but neither statute nor regulation requires that coverage.

Fidelity Bond Review

During the course of an examination, the examiner may (1) determine that the fidelity bond is in force in an amount at least equal to regulatory minimums; (2) document in the examination workpapers the bond type, bonding company name, amount of coverage, and any deductibles, riders, and other clauses; and (3) be alert to any unprotected areas of risk for the credit union.

Some writers of credit union fidelity bonds have a risk management division whose auditors will, upon request, perform a risk management audit designed to detect internal control weaknesses.

At times, examiners may determine that criminal activity or a bondable loss has occurred which may affect the bondability of an employee or an official. The examiner should provide details to the board of directors and obtain an agreement for immediate action. The board is responsible for notifying the bond company, federal and local authorities, the SSA, as appropriate, and the regional office. A credit union must complete a Suspicious Activity Report (SAR) whenever it reasonably suspects criminal activity. Examiners should determine that the credit union has filed a SAR within the required time, when necessary. If the board has not, or will not, complete the SAR the examiner should complete the SAR, file it in accordance with SAR instructions, and notify the regional office and SSA, as appropriate.

Background, Requirements and Approved Bond Forms

All credit unions must provide fraud and dishonesty coverage for employees and officials. NCUA mandates that each federal credit union board provide adequate coverage. The NCUA Board has the authority to require that a federal credit union obtain additional coverage when the coverage in force is not adequate (§713.7.) Adequate bond coverage may require coverage in excess of the prescribed minimums. The directors should review the extent of coverage at least annually (§713.2.) They should consider the credit union's loss exposure, internal controls, and financial resources when determining the amount and the type of coverage necessary. This determination is particularly critical since the credit union will need to

decide whether to purchase optional faithful performance coverage, if available.

The e-library and at www.ncua.gov under the Reference Information section, Credit Union Bonds, contain the list of currently approved bond forms for federal credit unions.

Undoubtedly, NCUA will approve additional bond forms in the future. The regional office has copies of each approved bond form. Examiners should check with the regional office if they have concerns about a form.

Endorsements and Riders

Bond companies issue endorsements or riders to the bond that add to, or delete from, the basic bond coverage. Examiners should carefully review any endorsements or riders that exclude coverage and determine if the endorsement or the rider reduces coverage below the minimum coverage in the approved bond form. If examiners cannot determine the effect of the endorsement or rider, they should contact their supervisory examiner and, if necessary, send a copy to the regional office with an accompanying memorandum. Riders that reduce coverage provided by the basic bond must have the approval of the NCUA Board. Riders that add coverage under the bond do not need NCUA Board approval.

Faithful Performance Coverage

The credit union's board of directors make a business decision regarding whether to purchase faithful performance coverage, although state law or regulation may require state-chartered, federally insured credit unions to maintain such coverage. The contract between the credit union and the bonding company determines the definition of the term "faithful performance." Not every company will sell faithful performance coverage.

Principles and Obligations for Fidelity Losses

While a fidelity bond represents a contract between the credit union and an insurance company, the act of a third party (employee or official) invokes the duties under the contract. The three party nature of the contract distinguishes it from other insurance contracts. (See the section on Insurance Losses for further discussion.)

The credit union should comply strictly with the terms of the bond to recover from the bond company. The time limits for filing a notice of loss, proof of loss, or filing of a lawsuit against the company should strictly adhere to those specified in the contract, unless the company waives these time limits in writing. If not, the credit union's rights may be prejudiced. Bonding companies measure most of the time limits from the date of discovery of either a wrongful act or a loss.

"Discovery" usually means specific knowledge, but more than mere suspicion, by a responsible person (manager, official, board member.)

A credit union owes a duty of good faith to the bond company. This includes disclosure to the bond company of acts of employees, of which it has knowledge, which increase the bond company's risk. Since the question of whether a reportable loss has occurred will often arise during an examination or supervision contact, the directors will frequently ask the examiner to help them arrive at a decision as to reporting or giving notice of loss to the bond company, to the recovery of the funds, or to the filing of a claim.

The board of directors must ultimately make decisions regarding these factors. The examiner may guide the directors in protecting the credit union's interests under the bond. The bonding company could hold directors personally liable for losses suffered by the credit union when they fail to file a claim in accordance with the requirements of the bond. If the directors disagree with the examiner that they should report an act, that a loss occurred, or that they should give a notice of loss to the bond company, the examiner should follow the guidance provided in the Shortages chapter of this Guide.

**Insurance
Losses**

Bonds authorized for use by credit unions also may contain insurance coverage for direct loss of property. This coverage protects the credit union against the direct loss of property caused by such things as larceny, burglary, robbery, mysterious disappearance, outside forgery, and the damage or destruction of property due to these incidents. These examples are not all inclusive, and each bond does not include all of them. Under these insurance clauses, the bonding company does not require the credit union to determine the identity of wrongdoers to recover losses, as it must do to recover for a loss of property caused by acts of its employees. However, the credit union should file insurance

type claims in a manner similar to claims for fraud or dishonesty (i.e., by filing a notice of loss followed by a proof of loss within the time frames called for by the policy.)

Covered Losses

The approved bonds cover only direct losses of property. For example, if an employee steals \$10,000 by creating a fictitious loan, the \$10,000 is a direct loss of property, which the bond covers. However, the bond does not cover the interest income that the credit union might have earned on this \$10,000.

For this same reason, the bond usually does not cover expenses of recovery such as legal fees, although the bond or a purchased endorsement to the bond often separately provides for audit expenses. The examiner may review the audit expense coverage, if purchased, for adequacy to protect the credit union from the unexpected expense of documenting a claim by outside auditors. The minimal audit expense coverage often seen in credit union bonds probably will not cover the costs of a proof of loss audit. Examiners may find it appropriate to suggest that the board of directors consider a higher audit expense limit.

Claims Under the Bond

The credit union needs to inform the bond company of the facts in all cases where fraudulent or dishonest conduct occurred, or, if it has purchased faithful performance coverage, in all cases which might meet the definition of faithful performance contained in the bond. Examiners should use caution in developing the facts and in making recommendations to the directors. Good judgment in making decisions in this respect is essential.

It is important to distinguish between the reporting of fraudulent or dishonest acts and the filing of a claim. The credit union need only file a bond claim when it has suffered a loss. For example, if a credit union has faithful performance coverage, and the manager knowingly makes several mortgage loans without getting appraisals, checking titles, or making credit checks, this might constitute a lack of faithful performance. Nevertheless, if the borrowers make the contracted payments on the loans, then the credit union has not yet suffered a loss and cannot file a bond claim.

The credit union should report fraudulent or dishonest acts, or conduct amounting to a lack of faithful performance (if the credit union has such coverage), whether or not the credit union has suffered a loss. If a loss has not yet occurred, the credit union should inform the fidelity company that it will file a bond claim at the appropriate time. Subsequently, when the loss occurs, the credit union should file a notice of loss, although it need not wait until it knows the exact amount of the loss.

Officials should always examine the bond itself to determine the scope of coverage. If examiners have questions about the coverage the bond provides, they should contact their supervisory examiner. Nevertheless, whether or not a particular set of circumstances represents a claim under a particular bond, the officials should notify the fidelity company of all fraudulent or dishonest acts, or acts indicating a lack of faithful performance (if the credit union has such coverage) to ensure continued coverage for the employee involved and to protect the credit union in the event a loss occurs.

Acts That May Terminate Bond Coverage - Letter of Notification

The credit union should report only facts to the bond company in a notice of improper acts by an employee or any other communication to the insurer. The credit union should not engage in speculation about how a loss or potential loss occurred. The following items can be included in the letter of notification (the bond itself contains specific requirements):

- Description of the act;
- Name and position of persons whose acts may have terminated bond coverage as it applies to them;
- If possible, specific law, bylaw, rule, regulation, policy, or standard of conduct violated;
- An explanation of the acts, which indicates whether they were fraudulent, dishonest, or unfaithfully performed;
- Action taken to correct the acts;
- Action taken to prevent recurrence of the acts; and
- Request to bond company for a statement of its willingness to continue bond coverage on persons whose acts are in question.

The examiner should encourage the credit union to specifically mention the names of all responsible persons in the letter when it can clearly determine responsibility. The examiner may assist the officials in drafting the letter, but should bear in mind that the credit union, not the examiner, writes the letter. In the event the credit union refuses to notify the insurer, then the examiner should follow the guidance contained in the Shortages chapter.

**Notice and
Proof of Loss**

The notice of loss is usually very short, factual, and contains no speculation or guesses. Credit unions need not know the exact amount of the loss before giving the notice. In fact, a delay until determination of the exact amount could jeopardize collection of the claim.

The following are items that the credit union should include in the notice of loss (refer to the bond for specific requirements):

- Statement specifying discovery of a loss;
- Date of discovery of the loss;
- The amount of the known loss at the time of the notice;
- A brief statement of the circumstances surrounding the loss;
- Name, position, and address of the person responsible for the loss;
- Information as to whether the responsible person was removed from office;
- Request for acknowledgment of the notice of loss; and
- The SAR, if filed, should not be included as an attachment to the notice.

The notice of loss puts the fidelity company on notice that a loss has occurred and that a claim may follow. Each bond requires filing of a proof of loss or claim within a specified period of time after the notice of loss. The proof of loss will usually require a more detailed and documented explanation of the loss suffered, the acts causing the loss, and why the credit union believes the bond covers the loss. As with the notice of loss, the credit union should refer to the policy to determine the specific requirements for the proof of loss.

**Bond Claim
Follow-up**

Bonds generally specify that the bond company has a certain number of days after a credit union files a proof of loss to investigate the loss.

Unless the directors receive payment within a short time thereafter, they should follow up and request prompt settlement. If the bond company denies a claim, it should do so promptly and advise the credit union of the reasons for the denial.

Examiners should keep in close contact with any credit union in their district that has filed a claim with the bond company. If the bond company delays paying a valid proven claim, the examiner should urge the directors to follow up promptly.

Since most bonds require the credit union to bring a lawsuit against the bond company within a specified time after discovery of the loss, the examiner may wish to recommend that the credit union engage legal counsel to help it in negotiating payment of the claim or to determine the advisability of filing suit to collect on the claim. If the credit union appears to be making progress in negotiating and settling the suit, but may not meet the deadline for filing suit, the credit union may wish to secure an extension of the time for filing suit from the bond company.

**Workpapers
and
References**

- References
 - *Federal Credit Union Act*
120(h) - Powers of the Board and Administration
 - *NCUA Rules and Regulations*
713 - Fidelity Bond and Insurance Coverage for
Federal Credit Unions
NCUA Letter No. 96-CU-3, Suspicious Activity Report
NCUA Letter No. 00-CU-04, Suspicious Activity Reporting
NCUA Regulatory Alert 96-RA-3 SAR Software Program
NCUA Regulatory Alert 01-RA-11 Suspicious Activity Report

Chapter 29

SPECIAL ASSISTANCE, LETTERS OF UNDERSTANDING AND AGREEMENT, CONSERVATORSHIP, AND SPECIAL ACTIONS

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Chapter 29

SPECIAL ASSISTANCE, LETTERS OF UNDERSTANDING AND AGREEMENT, CONSERVATORSHIP, AND SPECIAL ACTIONS

Examination Objectives

- Determine appropriate timing and type of special assistance for troubled credit unions
- Determine appropriate use, type, and language of Letters of Understanding and Agreement (LUAs) to resolve credit union's problems
- Determine the appropriate use of options of merger, purchase and assumption (P&A), or conservatorship to resolve credit union's problems
- Determine when to recommend supervision of the credit union to special actions

Associated Risks

- Liquidity risk can occur when members, vendors, and suppliers do not have sufficient confidence in the credit union to continue doing business;
- Strategic risk can occur when management does not institute proper planning or provide resources to carry out necessary credit union operations in a safe and sound manner; and
- Reputation risk can occur when problems escalate to the point of threatening the future viability of the credit union.

Overview

Resolving serious credit union problems can involve the use of various types of special assistance, the issuance of an LUA, merger, P&A, conservatorship, or the assignment of the credit union to special actions. The examiner must have fundamental knowledge of the types of special assistance available, and when to use each type. LUAs, a supervisory tool, clarify the actions a credit union agrees to take (or not take) to resolve identified problems. The examiner must have knowledge of the difference between a published and a non-published LUA.

Occasionally, efforts to resolve problems do not produce successful results. The examiner must then determine the appropriate remedy for the credit union, which may include merger, P&A, or conservatorship.

Regional staff may decide to recommend for assignment to special actions a credit union that (1) presents a risk of loss to the National Credit Union Share Insurance Fund (NCUSIF), and (2) needs complex and time intensive supervision. The regional director assigns cases to special actions based on the recommendations of staff.

Special Assistance

The *FCU Act* provides the NCUA Board, or its representative, the discretion and the authority to provide special assistance to federally insured credit unions. Normally, by the time NCUA considers special assistance, it has exhausted all other supervisory solutions. Credit unions request special assistance through the regional director. The approval of special assistance falls within delegated authority; however, the NCUA Board may, at their discretion, review these requests.

Special assistance is not a grant. Credit unions receiving special assistance to continue independent operations must justify receiving the special assistance, and demonstrate that the assistance will help make the credit union a financially viable, self-sustaining institution. NCUA carefully evaluates all assistance requests in terms of both the effect on the NCUSIF and the credit unions involved.

NCUA Instructions and the Office of Examination and Insurance's Special Assistance Manual contains detailed instructions regarding the use of special assistance and the processing of requests for special assistance.

Recommendation for Special Assistance

An examiner's on-site contact at the credit union should support each request for special assistance. When possible, NCUA examiners should make joint contacts at state credit unions with state examiners. Regional management and the state supervisor determine the scope of a contact in a state credit union.

If examiners determine the need for assistance during a normal examination or supervision contact, they will not recommend special assistance to credit union officials before discussing the case with the supervisory examiner and advising the regional director.

After deciding to recommend special assistance, the examiners or regional office staff should work with the credit union officials and employees to develop a workout plan that addresses the entire problem, provides for needed correction, and returns the credit union to normal operations within a reasonable period. Examiners submit the recommendation, including complete and comprehensive related data, to the regional director. The recommendation summarizes (1) the type and amount of assistance needed, (2) the basic problem causing the need for assistance, and (3) future prospects.

Charge to Reserve

§702.401(c) and §741.3(a)(2) of NCUA's Rules and Regulations allows the board of directors of a federally-insured credit union to authorize charges to the regular reserve for losses, provided the charges will not cause the credit union's net worth classification to fall below well capitalized.

All other charges to the regular reserve must receive the approval of the appropriate regional director or, if state-chartered, the appropriate state official.

208 Assistance

§208(a) of the *FCU Act* authorizes special assistance for the following purposes:

- Reopening a closed, insured credit union; preventing the threatened closing of an insured credit union; or assisting in the voluntary liquidation of a solvent credit union;
- Protecting the NCUSIF or the interest of the members of the credit union; or
- (1) Reducing risk, (2) averting a threatened loss to the NCUSIF and facilitating a merger or consolidation of one insured credit union with another, or (3) facilitating the sale of assets of an open or closed credit union to an assumption of its liabilities by another person.

NCUA may grant §208 assistance (208 assistance) when the NCUA Board determines that such action will protect the NCUSIF or the interests of the members of the credit union. A written agreement must accompany §208 assistance. Field staff monitors all §208 assistance cases monthly using SATEX and the Risk Management System (RMS).

NCUA may provide §208 assistance to (1) critically undercapitalized credit unions, (2) uncapitalized new credit unions, and (3) credit unions “in danger of closing.” The following characteristics define a credit union in danger of closing:

- A credit union subject to mandatory conservatorship, liquidation, or other corrective action provided in §702.204(c) or §702.305(c) of the *NCUA Rules and Regulations* and unable to increase net worth sufficiently through net income retention or other sources (e.g. secondary capital);
- A credit union subject to discretionary conservatorship or liquidation as provided by §702.203(c), or required to merge as provided by §702.203(b)(12);
- A new credit union subject to discretionary conservatorship or liquidation as provided by §702.304(c). (See the E&I Special Assistance Manual, Chapter 1, for specific information); or
- A credit union subject to a high probability of sustaining an identifiable loss (e.g. fraud, unexpected and sudden outflow of funds, operational failure, natural disaster, etc.) that would result in a critically undercapitalized status or subject it to conservatorship or liquidation under §702.304(c).

§208 assistance may be temporary or permanent in nature. Generally, NCUA limits temporary §208 assistance, in the form of temporary dividends, to two quarterly (or six monthly) dividend periods for all dividends including dividends on regular shares, non-member shares, share certificates, and other share accounts.

NCUA normally limits permanent §208 assistance (subsequent to any temporary assistance period) to a 24-month workout period.¹ For all

¹ Historical experience has shown that workout periods of longer than 24-months are not likely to succeed. The timeframe is also consistent with the timeframes included in PCA.

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approved permanent §208 assistance requests, the regional director issues an LUA outlining the terms and conditions of the assistance.

Permanent §208 assistance may consist of either non-cash or cash assistance. Non-cash assistance includes a Prior Undivided Earnings Deficit (PUED) - NCUSIF Guaranteed account, NCUSIF guaranteed line of credit, or an asset (loan) guarantee. Cash assistance includes a NCUSIF loan, NCUSIF share deposit, NCUSIF subordinated note, or an asset purchase.

The request for assistance must justify that the proposed plan reflects the best alternative for the credit union members and is in the best interest of the NCUSIF. The regional director ensures that the request includes documentation of the resolution alternatives considered, the estimated costs, and information to support cost estimates. If an alternative other than the one selected would cost the NCUSIF less, the region must specifically address and clearly support the reason for not selecting the least costly alternative.

**Temporary §208
Assistance
(Temporary
Dividends)**

Federally insured credit unions with deficits in undivided earnings may not disburse dividends without NCUA's approval. The credit union must submit to the regional director a written request for NCUA approval to pay reasonable dividends. NCUA approves temporary dividends to prevent the collapse of the credit union while providing time to correct root problems, make necessary management changes, provide clean financial statements, and/or prepare the credit union for merger, purchase and assumption, or liquidation. NCUA must not use temporary dividend authority to delay strong corrective action.

NCUA's approval of temporary §208 assistance allows the credit union to establish a temporary Prior Undivided Earnings Deficit (PUED) - NCUSIF Guaranteed account up to a maximum estimated deficit amount and to pay dividends for a maximum of two quarters or six months. Temporary dividends exceeding two quarters or six months require NCUA Board approval.

NCUA grants dividend authority in quarterly (three-month) increments and the credit union must make a separate request for each quarterly period. When the credit union declares and pays dividends monthly,

the regional director will approve each monthly dividend payment contingent upon receipt and approval of the credit union's proposed dividend rates, anticipated dividend expenses, and resulting PUED.

The NCUA Board delegated to the regional directors and the Office of Examination and Insurance authority to authorize a credit union with a deficit in Undivided Earnings to continue paying dividends. The estimated deficit in Undivided Earnings determines the amount of assistance provided. SUP 3 (2), Delegation of Authority outlines the amounts delegated and concurrence requirements.

NCUA grants temporary dividend authority as temporary §208 assistance with minimal documentation. Requests for temporary §208 assistance (temporary dividends) must contain enough information to demonstrate the benefit to both the credit union and the NCUSIF to continue operating the credit union. Refer to the Special Assistance Manual for details on preparation of a request for temporary dividends requiring concurrence from the Office of Examination and Insurance.

Permanent §208 Assistance

The NCUA may grant permanent special assistance to a credit union continuing independent operations, if the credit union proves it can maintain a viable, self-sustaining status.

The credit union must have in place the following nine preliminary requirements before requesting permanent special assistance:

1. Viable field of membership
2. Capable management
3. Accurate and current books
4. Full and fair financial disclosure
5. Proper written policies and procedures (or realistic plan to put them in place)
6. Approved net worth restoration plan or risk based plan (including the impact of repayment of assistance)
7. Positive track history of financial performance and resolving problems
8. Correction of root problems
9. System for monitoring on-going performance

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The Office of General Counsel should review cases where credit union officials need to replace ineffective or incompetent management before the credit union may receive permanent §208 assistance. The Office of General Counsel should also review cases when NCUA denies a request for permanent §208 assistance because the officials failed to remedy noted management deficiencies.

Non-Cash Assistance

Non-cash assistance includes Prior Undivided Earnings Deficit (PUED) - NCUSIF Guaranteed accounts and NCUSIF asset guarantees.

- **Prior Undivided Earnings Deficit (PUED) - NCUSIF Guaranteed Account.** Since no credit union with a deficit in undivided earnings may pay dividends, the credit union may request non-cash §208 assistance in the form of a PUED - NCUSIF guaranteed account. The credit union will transfer the deficit amount in undivided earnings to this account and footnote the assistance on its financial statements.
- **NCUSIF Asset Guarantee.** After exhausting all remedies, the best business decision for NCUA and the NCUSIF may involve arranging a merger or P&A. They may also explore liquidating the problem credit union using an asset guarantee when (1) they cannot readily determine the fair value of the assets, (2) they need to expedite the situation, or (3) they question whether they can recover the full value of the assets. The region must demonstrate and support significant savings to the NCUSIF in its documentation and justification.

NCUA approves asset guarantees only in rare situations and normally for short periods of time (less than twelve months.) The region must provide justification in the concurrence package if the requested asset guarantee exceeds twelve months. When considering levels of delegated authority, the total amount of the guarantee constitutes non-cash §208 assistance.

Cash Assistance

Cash assistance includes NCUSIF subordinated notes, NCUSIF share deposits, NCUSIF loans, and asset purchases. The LUA may restrict

the use of cash §208 assistance to specific purposes, such as funding of share withdrawals, short-term investments, the hiring of qualified management, etc.

**NCUSIF
Subordinated
Notes**

NCUA uses this assistance in problem credit unions when a cash infusion by the NCUSIF at minimal or no cost to the credit union will restore profitability and result in a financially viable, self-sustaining credit union.

An NCUSIF subordinated note is a subordinated liability with repayment terms that may include “incentive forgiveness.” The credit union may earn forgiveness by meeting pre-established goals tied to specific financial or operational performance benchmarks. Often, NCUA bases forgiveness provisions upon a percentage of quarterly net income.

Generally, NCUA provides cash infusions in the form of subordinated notes that the credit unions repay to the NCUSIF. However, as part of some workout plans for the most severe cases, credit unions may earn “incentive forgiveness” of part of the cash assistance by meeting performance goals and benchmarks defined in the assistance LUA.

When NCUA includes incentive forgiveness in assistance plans, the credit unions may write-off part of their undivided earnings deficits, or other types of losses, against the cash assistance. The credit union will not repay incentive forgiveness to the NCUSIF. Instead, it will record the incentive forgiveness as income to the credit union.

**NCUSIF Share
Deposits, Loans,
and Asset
Purchases**

In some cases, a §208 assistance workout plan may include (1) NCUSIF share deposits in the credit union, (2) NCUSIF loans to the credit union, or (3) NCUSIF purchases of specific credit union assets. The regional director defines the terms and conditions of these special assistance accounts in the LUA or other contractual agreement developed as part of the assistance plan.

**Liquidity
Assistance**

A credit union may need liquidity assistance when emergencies or situations such as sponsor problems, natural disasters, embezzlements,

or other problems arise. A credit union may request an NCUSIF guaranteed line of credit in cases where the corporate credit union or other credit provider refuses to extend or increase the credit union's available line of credit.

Credit unions receiving a guaranteed line of credit must be insolvent or in danger of closing. Delegated authority limits the term of the guarantee to two years and the amount to \$5 million. Requests that exceed the delegated limits require NCUA Board approval. The Special Assistance Manual contains details on requesting a NCUSIF guaranteed line of credit.

Returning a Credit Union to Solvency

No single workout plan exists for all the problems encountered in credit unions. Successful workout plans combine results-oriented management with results-oriented supervision. Successful resolution requires that everyone understand the nature of the problem and the urgency of resolving it. Success hinges on the quality of management and a viable field of membership.

Following is a general workout strategy:

- Retain capable management and operations personnel, whom the board of directors holds accountable for the results;
- Establish basic credit union operations;
- Generate current, accurate records including fully and accurately reconciled general ledger accounts;
- Meet full and fair disclosure provisions;
- Review all expenses and gain operational efficiencies;
- Establish the credit union's business strategy for lending and shares, fee income, and operating expenses and incorporate these into a net worth restoration plan or business plan; and
- Implement the net worth restoration plan or the business plan with the support of all levels of personnel.

Resource Sharing

Resource sharing takes known, proven managers or other professionals and involves them in resolving the credit union's problems. Examiners and regional office staff recruit people who know how to manage and invigorate operations to help troubled credit unions.

Each region should maintain a reference file of potential resource people, who have different areas of expertise. In troubled credit unions, potential management candidates must meet strict qualification standards and obtain NCUA approval pursuant to §701.14 of the *NCUA Rules and Regulations*.

Letters of Understanding and Agreement

Letters of Understanding and Agreement (LUAs) serve as supervisory tools. Regional offices sometimes use LUAs as informal administrative actions because other administrative actions often enforce violations of the terms of the LUAs.

An LUA is essentially a contract between NCUA and a credit union. The credit union agrees to take, or not take, certain specified actions. Regional directors issue LUAs when credit unions have not adequately responded to less severe measures, such as Documents of Resolution. NCUA also requires LUAs for newly chartered credit unions and to grant permanent special assistance.

Delegation of Authority SUP 16 authorizes regional directors to enter into LUAs with elected and appointed officials of FCUs and FISCUs. Regional directors discuss and negotiate publication of LUAs with the credit unions to prevent unfair surprises to credit unions and their officials. The regional directors will address the issue of publication in every LUA between NCUA and a federal credit union by including one of the following three provisions:²

1. This LUA will not be published;
2. This LUA will be published; or
3. The regional director is reserving for a reasonable time the right to publish this LUA.³

Specific and clear language in the LUA enables all parties to understand the expectations. As appropriate, examiners or the regional office staff prepares the proposed LUAs and tailors them to each case.

² Minor modifications and variations of the listed provisions that clearly communicate the same ideas are acceptable.

³ This third provision can also specify the period of time within which the RD will decide whether to publish the LUA or can correlate publication to a specified event (or the failure of an event to occur).

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Refer to the Special Assistance Manual for additional LUA details, guidance on LUA language, and procedures for publication.

In credit unions with outstanding LUAs, the examiner must determine compliance with the LUA and document compliance within the examination report. The examiner or credit union should support recommended changes to the LUA by attaching appropriate supporting workpapers and documentation for the regional office. For credit unions with special assistance, the regional director must approve material modifications to LUAs that affect the workout period or amount of assistance. Depending on the amount and terms, the modification may require concurrence and approval of the NCUA Board or the Office of Examination and Insurance.

Once the credit union has corrected the problem areas addressed by the LUA, the regional director removes the LUA.

Published LUA

The *Federal Credit Union Act* requires the NCUA Board to publish and make available to the public “any written agreement or other written statement for which a violation may be enforced by the Board unless the Board, in its discretion, determines that publication would be contrary to public interest.”⁴ The NCUA Board will publish an LUA if the Board can legally enforce the violations.

The NCUA Board may take administrative actions against credit unions or officials that fail to meet terms of published LUAs. Violations of the terms of a published LUA alone constitute grounds for administrative actions and, although not required, the LUA may include language to that effect. This provides evidence that the officials know, or should know, of the consequences of noncompliance.

**Non-Published
LUA**

NCUA may take an administrative action, even when it has not published the LUA if the credit union (1) fails to comply with the terms of the LUA, and (2) conducts itself in a way that constitutes a safety and soundness violation or violation of law or regulation.

⁴ 12 U.S.C. 1786(s)(1)(A).

LUAs in FISCUs An LUA issued to a Federal Insured State Chartered Credit Union (FISCU) by a state supervisory authority need not address publication unless required by state law or regulation. NCUA, together with the state supervisor, may jointly issue an LUA to a FISCU. In such instances, the requirement for publication applies if NCUA attempts to take action based on a violation of the terms of the LUA. Therefore, regional directors will include one of the three publication provisions discussed above in all LUAs issued jointly with NCUA and a state supervisory authority.

Merger, Purchase and Assumption A merger or P&A with or without special assistance may serve as an alternative when a credit union cannot feasibly continue operations. NCUA staff should make every effort to find a merger or P&A partner that will minimize loss to the share insurance fund and will allow service to continue to the field of membership. Examiners should avoid mergers that solve a short-term exposure to the NCUSIF but have the potential to create long-term exposure.

Crucial to every merger is management's ability to successfully deal with the problems in the merging credit union. A documented analysis of management's ability to handle the proposed consolidation should support information provided to the regional director and the Office of Examination and Insurance. Also, examiners should prepare a summary of the effect on the financial condition of the assuming credit union (i.e., pro-forma consolidated financial statements and key ratios.)

In a merger, the continuing credit union absorbs the rights of members and creditors and the credit union's assets and liabilities. The merging credit union simply becomes a part of the continuing credit union. Accordingly, the continuing credit union must honor all legal commitments, except a commitment or liability assumed before merger by a third party, usually the NCUSIF. In a merger, liquidation of the merging credit union never occurs.

In a P&A, the purchasing and assuming institution buys only specified assets and assumes only certain specified liabilities, which may include share accounts, after NCUA places the credit union into liquidation. Those assets not purchased and liabilities not assumed, including any

contingent or unrecorded, become the responsibility of the NCUSIF. The P&A alternative enables the NCUSIF to repudiate or invalidate various contracts that the assuming institution deems unacceptable.

Only credit unions can merge with one another. Statutorily, the operations of a credit union cannot merge into a bank or a savings and loan. However, as a legal and, in some cases, a practical alternative, a bank or an S&L can purchase and assume a credit union's assets and liabilities. Consequently, when necessary, NCUA may expand its consideration to banks and S&Ls. In such cases, the approval process will involve the bank or S&L regulator and insurer.

Negotiations for any special assistance to facilitate a merger or P&A start with the known and the estimated losses (estimated cost to the share insurance fund) as of the effective date. The assistance amount should not exceed the estimated loss to the NCUSIF in the event of a liquidation as of the same date. The field of membership and assets and deposits represent value that the continuing credit union should consider when negotiating a merger or a P&A.

The district examiner, working with the credit union, the supervisory examiner, and the regional staff, should contact potential merger or P&A partners. A competitive bidding process often reduces the ultimate cost to the NCUSIF. The examiner should refrain from discussing the type and amount of assistance, and should encourage the potential merger or P&A partners to perform their own due diligence. NCUA staff must take appropriate steps to control the disclosure of confidential information. The examiner will obtain the consent of the regional director before accepting or expressing approval of any proposal. Final approval of every merger rests with the regional director or the NCUA Board.

**Board Action
Memorandum
(BAM)**

The regional director requests authority not delegated and requiring action by the NCUA Board in the form of a board action memorandum or BAM. Prior to submission to the NCUA Board, the action requested by the regional director may require concurrence of other offices (Examination and Insurance and General Counsel). The regional director should also solicit the views of the Office of Credit Union

Development when one of these actions involves a low-income credit union.

The reviewing offices need adequate time to review and respond. (Refer to the NCUA Correspondence Manual and Board Meeting Schedule for further information.)

The Special Assistance Manual provides details on the appropriate backup material for inclusion in a special assistance request.

Conservatorships

Regional directors initiate conservatorship actions after obtaining concurrence of the Offices of General Counsel and Examination and Insurance and approval of the NCUA Board (refer to the *Federal Credit Union Act* §206(h)(2)(A) for FISCUs.)

Conservatorships generally should not exceed 12 to 24 months. To ensure recovery or resolution within a realistic time frame, the region develops a written plan to resolve immediate problem areas and documents its prospects for the credit union's future. The region's resolution plan includes estimated time frames for returning the credit union to the membership, merger, or liquidation. Normally, the regional director will present the resolution plan at the time of the request to the NCUA Board for approval of the conservatorship action. If the region has not completed the resolution plan at the time of the request for conservatorship approval, it must explain the reasons for the delay in the BAM. In these cases, the region must provide the resolution plan to the Office of Examination and Insurance within 30 days of the conservatorship order date.

If the conserved credit union, under the prompt corrective action regulation requirement, must file a net worth restoration plan or a revised business plan, the conservatorship manager, in consultation with the NCUA personnel supervising the credit union, will file the plan.

Conserved credit unions not subject to the prompt corrective action regulation must prepare a business plan within 90 days of the conservatorship order. The plan should include operational and financial goals and performance benchmarks with target dates.

**SPECIAL ASSISTANCE, LETTERS OF UNDERSTANDING AND AGREEMENT,
CONSERVATORSHIP, AND SPECIAL ACTIONS**

NCUA must secure capable operational management upon the initiation of conservatorship. Regions should maintain a list of potential conservatorship managers.

Using an advisory board of directors and supervisory committee during conservatorship provides a training ground for volunteers, a source for membership feedback and a resource for special projects. NCUA recommends, but does not mandate, using an advisory board of directors and supervisory committee.

Actions that will result in exposure of \$200,000 or more require the concurrence of the Office of Examination and Insurance (e.g., conversion of a computer system.) The agent of the conservator should provide sub-agents of the conservator with appropriate written authorization limits.

Under §207(c) of the *Federal Credit Union Act*, NCUA may disaffirm or repudiate any contract or lease within a reasonable period following appointment as conservator, provided:

- The conservator determines the performance of the contract or lease to be burdensome; and
- The disaffirmance or repudiation will promote the orderly administration of the credit union's affairs.

Responsibility for recommending contracts for repudiation rests with conservatorship management and NCUA personnel supervising the case. The conservator or the agent for the conservator has the legal authority to repudiate a contract. The Office of General Counsel can advise on repudiation of contracts and will assist in the preparation of necessary repudiation documents.

Examiners must perform an examination within twelve months of the order for conservatorship. The credit union must have an audit and a verification of accounts performed in accordance with the requirements of Part 715 of the *NCUA Rules and Regulations*.

The region will report on NCUA-operated conservatorship using the Risk Management System. They will input data into the system using the SATEX workbook and update the information monthly.

Ending a conservatorship and returning the credit union to the membership requires NCUA Board approval and the concurrence of the offices of General Counsel and Examination and Insurance. Examiners must complete an examination not more than 120 days before the proposed NCUA Board action to return control to the credit union membership.

Instituting an LUA may ensure performance of the credit union upon the termination of the conservatorship. In a conservatorship that has §208 assistance requiring repayment, the new LUA or the Order for Removal of Conservatorship must address the repayment.

The Special Assistance Manual contains a checklist that provides detailed action items beginning with the initiation of the conservatorship through the removal of the conservatorship.

Special Actions

Special Actions identifies, controls, and corrects serious problems in short periods of time to maintain the integrity and soundness of the NCUSIF. NCUA's commitment to strong and responsive problem resolution does not conform to regional borders, but represents a national concern. NCUA will use all available resources to accomplish this task.

Assignment of Special Action Cases

The regional director assigns cases to the special actions division in each region based on factors such as size, complexity of problems, effect on district or regional program, degree of potential risk of loss to the NCUSIF, and political sensitivity. The condition of the credit union cases assigned to special actions should not require the dissolution of the credit union, but should provide an opportunity for resolving the problems and maintaining independent operations.

Unless the regional director approves another examiner, a special actions problem case officer or capital market specialist should act as examiner-in-charge of credit unions with outstanding §208 assistance. The assigned problem case officer takes full responsibility and accountability for assigned cases. The regional director has discretion regarding the number of cases assigned to special actions and individual problem case officers; however, the regional director retains

**SPECIAL ASSISTANCE, LETTERS OF UNDERSTANDING AND AGREEMENT,
CONSERVATORSHIP, AND SPECIAL ACTIONS**

responsibility for ensuring adequate supervision of cases assigned to special actions.

Goals of Special Actions

The goals of special actions include the following:

- Detecting potential and emerging problems early through effective district management and evaluation of credit union data;
- Developing results-oriented supervision practices;
- Resolving problems in credit unions coded CAMEL 4, 5 and large, complex code 3;
- Reducing the risk to the NCUSIF;
- Ensuring placement of competent management;
- Achieving profitability within six months of assignment;
- Improving net worth of a new credit union to at least 2 percent within 23 months from the effective date a credit union was classified as critically undercapitalized or uncapitalized.

Training for Special Actions

Training is an integral part of the special actions role in minimizing risk of loss to the NCUSIF. A highly trained and motivated group with strong technical and decision-making skills ensures the soundness and consistency of problem resolution nationally. While experience remains an important "teacher," it cannot entirely replace education for such a specialized group of examiners.

NCUA holds periodic conferences for special actions personnel. Inter-regional work, especially in large, complex, and unique situations provides further training to enhance the different professional and experience levels in each region. This sharing of experience encourages consistency to problem resolution that positively affects the resolution of risk of loss to the NCUSIF.

Regions and the central office's Division of Training and Development provide examiners specialized training in the areas of commercial lending, investments, ALM, agricultural lending, and marketing strategies, as well as negotiation tools, motivation, stress management, and other courses critical to accomplishing the mission of special actions.

In addition to special actions personnel, district examiners should have access to special actions experience and training to improve the level of risk identification and problem resolution expected from all examiners. Regional directors encourage this at the regional level using various means including team jobs with problem case officers as team members, problem case officers working on examinations with individual examiners, and individually tailoring training sessions conducted by special actions staff. The Division of Training and Development offers specialized training such as the Problem Resolution Seminars at the national level. Examiners with more training and experience in the area of special actions can better minimize the potential for risk of loss to the NCUSIF.

The National Teams (TNT)

At times, a situation may demand too many of a specific region's resources (including experienced, responsible individuals). In these instances, NCUA has developed specialized national teams to work on these cases. The national teams receive training to quickly identify the problems, control losses, determine staffing needs, and resolve the problems. The national teams usually report to the requesting regional director, but may report to an alternative management hierarchy, if available.

NCUA may develop the national teams based upon the following thresholds:

- Asset size \$100 million or greater;
- Estimated potential losses exceed \$10 million;
- Regional identification of a peculiar situation not clearly definable without swift and significant supervision efforts; or
- At the request of the regional director.

References

- *FCU Act*
 - §206
 - §207
 - §208
 - §216

**SPECIAL ASSISTANCE, LETTERS OF UNDERSTANDING AND AGREEMENT,
CONSERVATORSHIP, AND SPECIAL ACTIONS**

- *NCUA Rules and Regulations*
 - §701.14
 - §702
 - §741.3(a)
- Special Assistance Manual
- NCUA Delegations of Authority
- NCUA Instruction No. 4900, Guidance on Release of Credit Union Financial Information
- NCUA Letter to Credit Unions 01-CU-01

Chapter 30

ADMINISTRATIVE ACTIONS

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Chapter 30

ADMINISTRATIVE ACTIONS

Objectives

- Determine the administrative actions available
- Determine the procedures of the various types of administrative actions

Associated Risks

- Reputation Risk. Although reputation risk is the primary risk, the need for administrative actions most likely results from high risk in any or all of the remaining six risk areas.

Overview

Administrative actions are available to the agency to prevent, alter, or eliminate serious operational problems in a credit union or, if correcting the problem is not feasible, to merge or liquidate the credit union. Administrative actions provide protection to the credit union, its members, its creditors, the NCUSIF, and the credit union industry in general. Administrative actions assist those credit unions that have serious operational or managerial problems that normal supervisory efforts have not, or cannot, resolve. They are not a convenient shortcut of NCUA's supervisory responsibilities.

Administrative actions represent the strongest supervisory tool available to NCUA. The actions generally used to correct problems and to ensure the continued existence of credit unions include:

- Cease and Desist;
- Civil Money Penalties;
- Removal of Officials;
- Prohibition; and
- Conservatorship used to correct problems.

Other more serious forms of administrative action include:

- Termination of Share Insurance (limited to federally insured state-chartered credit unions);
- Liquidation (insolvent federal credit unions);
- Revocation of Charter (solvent federal credit unions); and
- Conservatorship as a first step to liquidation.

In some cases, when NCUA initiates an administrative action (for example, cease and desist or removal actions) an administrative law judge hears both sides of the case. The administrative law judge recommends a decision to the NCUA Board. The Board then issues a final order that adopts, modifies, or rejects the administrative law judge's findings. The party subject to the order may appeal the final order through the federal court system. Certain other administrative actions may be directly challenged in court without an administrative law judge's involvement; for example, temporary cease and desist orders, immediate removal/prohibition orders, conservatorship actions, and involuntary liquidations under Title II.

Scope

The paragraphs that follow refer to the *NCUA Rules and Regulations* as 12 C.F.R., followed by the appropriate part or section number, and cite references to the *FCU Act* as "§206(h)" followed by an official citation (in most cases), for example "12 U.S.C. 1786(h)."

Examiner's Role

Because administrative actions are time-consuming and expensive for NCUA and quite serious for the credit union, examiners should try to resolve a credit union's problems informally whenever possible. Often, a realistic Document of Resolution and frequent examiner contacts will resolve problems with no need for administrative action. When realistic and workable plans do not result in corrective action or improved condition, however, the examiner should consult with the supervisory examiner.

Before deciding to take administrative action, the examiner and supervisory examiner must clearly understand the nature of the credit

union's problems and why any previous attempts to resolve the problems failed.

The administrative record must bear out the examiner's concerns about the credit union. The examiner must compile the administrative record and generally will serve as the principal witness in any administrative or judicial hearing. The administrative record is the total collection of information NCUA needs for decision-making purposes. The record must present a complete, factual, and fully documented history of the credit union's problems and the attempts by NCUA and the credit union to resolve them.

The following conditions generally indicate a persistent, serious problem that may warrant administrative action:

- An unsafe or unsound practice, i.e., any action or lack of action contrary to generally accepted standards of prudent operation (but not necessarily contrary to GAAP). The probable consequences of continuing the unsafe practice would be abnormal risk or loss to the credit union, its members, or the NCUSIF. Some courts require an additional factor, that the practice be reasonably related to the financial integrity of the credit union;
- A serious violation of law, rule, regulation, agreement with the board, or condition imposed in writing by the NCUA Board;
- Disclosure of the problem in at least one previous examination or follow-up report, or in the case of federally insured, state-chartered credit unions, in correspondence released by the state regulator or NCUA; and
- A practice or condition that one or more officials, who currently are unresponsive or are unwilling to take the necessary corrective steps, can resolve.

Note: These conditions do not exclude other conditions that may warrant administrative action. Examiner judgment is part of the evaluative process.

In deciding what, if any, action to take, the examiner should consider the:

- Financial condition of the credit union;
- Interests of the membership;
- Effect on the NCUSIF;
- Interest of management in continuing the credit union;
- Ability of management to run the credit union effectively;
- Sponsor's economic condition;
- Local economic conditions; and
- Creditors' interests.

When the examiner and supervisory examiner agree that administrative action is warranted, the examiner will prepare a memo to the regional office, noting the supervisory examiner's concurrence. The memo will usually include:

- Type of action recommended;
- Grounds for recommendation, based on *FCU Act*, *NCUA Rules and Regulations*, and this Guide;
- History and trend of operations since problems first appeared; supervisory efforts, agreements reached, and corrective action taken by officials;
- Probable asset share ratio computation; if insolvent, discussion of "escape clause" in *NCUA Rules and Regulations*, 12 C.F.R. §700.1(j)(1);
- Discussion of alternatives to the action, such as merger, special assistance, voluntary liquidation, where appropriate; and

- Discussion of why less severe forms of administrative action are inappropriate. For example, if the credit union is solvent and the examiner recommends revocation of charter, the memo should state reasons for not recommending a cease and desist or conservatorship.

The examiner may recommend administrative action at the conclusion of an examination or after a supervisory contact. In some cases, examiners need further information before making a recommendation. The Regional Office should contact the Office of General Counsel for an *Order of Investigation*, which will allow issuance of subpoenas for documents or testimony.

The regional office will review the recommendation for administrative action. If examiners discover any facts or findings subsequent to the recommendation they should promptly communicate the information to the supervisory examiner and regional director.

As the NCUA Delegations of Authority requires, the regional office will consult with the appropriate central office staff before processing the administrative actions. For administrative actions that require NCUA Board approval, the region will submit for review draft Board Action packages containing the proposed administrative actions to the Office of General Counsel, the Office of Examination and Insurance, and any other office that may have interest in the action. Regions must submit these packages within the timeframes established by the NCUA Board's guidelines for submission of draft Board Action Memorandums (BAMs).

Delivery

The regional director usually assigns the examiner to deliver the notice (or order) to the credit union or individual and to obtain a signed receipt (typed on copies of the notice) from the person who accepts delivery. The examiner will give the highest priority to the delivery of the enforcement action consistent with guidance provided by the regional director.

Refusal by credit union officials or an individual to accept the notice or order will not alter its force or effect. If the credit union refuses delivery, the examiner should place the original notice or order in a

conspicuous place, usually in the credit union's place of business, and if possible, in view of at least one official. The examiner should promptly report such an unorthodox delivery, or inability to effect delivery to the supervisory examiner and note the circumstances on a copy of the order. If the administrative action includes appointment of a liquidating agent or a conservator, and the officials refuse to release the records, the examiner should also promptly report this fact to the supervisory examiner.

The examiner may provide the credit union or individual being served general guidance about options and deadlines for response to the notice or order. Under no circumstances should the examiner discuss matters requiring legal interpretation of rights and alternatives. Instead, the examiner should advise the officials to consult Part 747 of the *NCUA Rules and Regulations*, the *FCU Act*, or their legal counsel.

**Contacts after
Delivery**

The examiner should not handle any inquiries from the media, but should direct any such inquiries to the regional director or an associate regional director. The supervisory examiner, with instructions from the regional director, will give specific guidance to the examiner regarding the supervision of the credit union that received a notice or order. In all cases, the supervisory plan will directly relate to both the type of administrative action served on the credit union or the person, and the timeframe for the credit union or the person to exercise the right to due process (i.e., administrative hearing or court challenge), as established in the *FCU Act* or the *NCUA Rules and Regulations*.

Examiners will often need to develop additional facts relating to the charges cited in the enforcement action for NCUA's use in a hearing or in a final decision on the action being sought. They should give high priority to these assignments. The examiner should refrain from making statements during the supervisory contacts that could prejudice the case or place NCUA in an untenable or insupportable position.

**Challenges in
U.S. District
Court**

In the case of a Temporary Cease and Desist Order, Immediate Suspension or Prohibition, Conservatorship, or Title II involuntary liquidation, the *FCU Act* permits a challenge of the Agency's action in U.S. District Court within 10 days of service of the order. A credit

union or individual may also sue NCUA even though the *FCU Act* does not provide for such.

The examiner must therefore have all findings and support documentation in order at the time of service. The Agency is represented in court by the Office of General Counsel and the Department of Justice or the various U.S. Attorneys' Offices, and these offices need time to process pleadings. An examiner with reason to believe that an administrative action will be challenged must notify the supervisory examiner or the regional office before serving the notice to allow for timely and effective legal assistance.

Institution-Affiliated Party

NCUA has the authority to bring removals, prohibitions, cease and desist, and civil money penalties against "institution-affiliated parties," defined in §206(r) of the *FCU Act*, 12 U.S.C. 1786 (r), as:

- Committee members, directors, officers, employees, and persons participating in the affairs of a credit union (either regulation or case-by-case decision may define person participating); and
- Independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in a violation of law, regulation, a breach of fiduciary duty, or any unsafe or unsound practice, and that violation or breach has caused or is likely to cause a more than minimal financial loss to the credit union, or a significant adverse effect on the credit union.

LUA Policy Issues

Letters of Understanding and Agreement (LUAs) are supervisory tools. Some credit unions equate LUAs with informal administrative actions, because NCUA has, at times, enforced violations of LUA terms through other administrative actions.

An LUA is essentially a contract between NCUA and a credit union. The credit union agrees to take, or not take, actions specified in the LUA. Regional directors issue LUAs when credit unions have not adequately responded to less severe measures, such as Documents of Resolution (DORs). NCUA requires LUAs for newly chartered credit unions and for granting permanent 208 assistance. (Refer to the

Special Assistance, Letters of Understanding and Agreement, Conservatorship, and Special Actions chapter of the Examiner's Guide for further guidance.)

- **LUA Publication.** The *FCU Act* requires that the NCUA Board publish and make available to the public "any written agreement or other written statement for which a violation may be enforced by the Board unless the Board, in its discretion, determines that publication would be contrary to public interest." NCUA must publish an LUA before it can enforce a violation of one of its terms. NCUA may enforce a published LUA by bringing an administrative action (e.g., a Cease and Desist Order or Civil Money Penalty), and proving noncompliance with the published LUA.

These publication requirements apply to all LUAs, including those issued to newly chartered credit unions, as well as those issued in connection with 208 assistance. NCUA may take an administrative action, even if the agency did not publish the LUA, if the credit union fails to comply with the terms of the LUA and the credit union's conduct constitutes a safety and soundness violation or violation of law or regulation.

Delegation of Authority SUP 16, authorizes regional directors to enter into LUAs with elected and appointed officials of FCUs and FISCUs. Regional directors discuss and negotiate publication with credit unions to prevent unfair surprises to credit unions and their officials.

The regional directors will address the issue of publication in every LUA between NCUA and an FCU by including one of the following three provisions:

1. This LUA will not be published;
2. This LUA will be published; or
3. The regional director is reserving for a reasonable time the right to publish this LUA.

The regional director forwards copies of all LUAs planned for publication to the NCUA Board and the Office of General Counsel. The Office of General Counsel oversees the details of publication.

The *FCU Act* provides that NCUA may enforce the terms of an unpublished LUA if the NCUA Board approves non-publication based upon a finding that publication would be contrary to the public interest. If the regional director recommends to the NCUA Board that an LUA not be published because publication would be contrary to the public interest, and the NCUA Board issues this determination, NCUA can still enforce the LUA. The regional director's recommendation must clearly show why publication would be contrary to public interest. The *FCU Act* requires a quarterly written report to Congress summarizing all non-published LUAs that are enforceable under this exception. NCUA expects rare use of this exception to publication to only those conditions that truly justify a conclusion that non-publication is in the public interest.

- LUAs with Federally Insured State-Chartered Credit Unions (FISCUs). An LUA issued to a FISCU by a state supervisory authority need not address publication, unless required by state law or regulation. NCUA, together with the state supervisory authority, may jointly issue an LUA to a FISCU. In such instances, the requirement for publication applies if NCUA attempts to take action based on a violation of the terms of the LUA. Therefore, regional directors will include one of the three provisions discussed above in all LUAs issued jointly with NCUA and an SSA.

Cease and Desist

12 U.S.C. §§1786(e) and (f) contain NCUA's authority to issue cease and desist orders; 12 C.F.R. 747, Subpart A contains the rules and regulations governing cease and desist administrative hearings. §206(e) of the *FCU Act* empowers the NCUA Board to issue a notice of charges and to arrange for an administrative hearing to determine whether NCUA should issue an order to a credit union or an institution-affiliated party ordering it or them to either stop certain activity or to take affirmative action to correct particular problems. Because there is a minimum of 30 days between serving of the notice and holding of the hearing, §206(f) authorizes the NCUA Board to

issue a temporary cease and desist order which takes effect immediately upon delivery. The NCUA Board uses this temporary order when significant conditions require immediate action. NCUA usually issues it at the same time it issues a notice of charges and hearing and it remains in effect until the NCUA Board withdraws it, the Board issues a final order after a hearing, or a U.S. District Court lifts it after a challenge.

Grounds

The grounds for a cease and desist action are set forth in §206(e) of the *FCU Act*. The examiner can recommend taking such action if any insured credit union or institution-affiliated party is:

- Engaging in or has engaged in, or the examiner has reasonable cause to believe that the credit union or the persons involved are about to engage in, an unsafe or an unsound practice in conducting the business of the credit union (see the Examiner's Role section for definition of unsafe and unsound practice); or
- Violating or has violated, or the examiner has reasonable cause to believe that the credit union or persons involved are about to violate a law, a rule, a regulation, any condition imposed in writing by the NCUA Board, or any written agreement entered into with the NCUA Board, as long as the agreement has been published in accordance with §1786(s) of the *FCU Act*.

A cease and desist order, whether permanent or temporary, is similar to an injunction. It is usually NCUA's first option when the agency needs formal action. Cease and desist is useful and effective because it allows NCUA to stop a current harmful practice or anticipate and prevent harmful practices from occurring.

Although a cease and desist order normally resolves a persisting or recurring problem, NCUA may use a cease and desist action for a first-time problem that could seriously affect the credit union's operations and where the officials have indicated they will not take corrective action.

While a cease and desist order most often prevents certain actions from occurring, it may accommodate purposes of affirmative action, including:

- Rescission of contracts;
- Limitations on growth of the credit union;
- Employment of qualified employees;
- Disposal of loans or assets; and
- Restitution, reimbursement, indemnification or guarantees against loss, which the examiner may order only if the credit union or institution-affiliated party was unjustly enriched or recklessly disregarded the law or regulation.

A cease and desist action allows resolution of problems in a solvent credit union while preserving and strengthening the credit union's corporate and managerial integrity. A cease and desist order is usually effective in compelling the credit union to take the needed action. If, however, examiners believe that issuance of a final order would not affect compliance, they should consider an alternative administrative action.

The administrative process for issuing a cease and desist order is as follows:

- The NCUA Board or regional director issues a Notice of Charges, setting out the allegations and statement of facts supporting the charges. The Notice establishes a time and place for a hearing between 30 and 60 days.
- The credit union or institution-affiliated party may consent, i.e., agree to a final order without contesting the charges. The NCUA Board then issues a final order without an administrative hearing. If there is no consent, a hearing is held before an administrative law judge.

- After the hearing, the administrative law judge sends a recommended decision and the hearing record to the NCUA Board.
- Within 90 days the Board must render its final decision. The Board may disagree with the administrative law judge, but the evidence must clearly support the decision.
- The credit union or institution-affiliated party may, if it disagrees, appeal to the U.S. Court of Appeals within 30 days after service of the final order. The court will uphold the NCUA Board's action unless it finds that action is arbitrary and capricious. The final order is in effect during the appeal unless stayed or modified by the court.
- The Order is effective 30 days after service on the credit union or institution-affiliated party. Violation of the order could result in civil money penalties of up to \$1,000,000 per day.

Notice of Charges and Hearing

The Notice of Charges and Hearing will contain the specific charges and supporting facts. The notice establishes a time and place for a hearing before an administrative law judge. The date for the hearing will be 30 to 60 days after service of the notice unless NCUA had set an earlier date at the request of the affected party. The examiner should advise the credit union or institution-affiliated party as to the seriousness of the notice upon its delivery. The examiner should make the officials aware of: (1) the timeframe in which they must respond by filing an answer to the allegations, and (2) the need to file a written notice of appearance with the administrative law judge. The notice will include this and other instructions.

Final Cease and Desist Order (Permanent)

NCUA will issue and serve a final cease and desist order:

- If the credit union or institution-affiliated party waives its right to a hearing and consents to the issuance of the cease and desist order; or
- If the NCUA Board, upon review of the hearing record and recommended decision of the administrative law judge, finds that

the charges specified in the Notice of Charges and Hearing have been established.

A cease and desist order becomes effective 30 days after service upon the credit union and it remains effective, except to the extent an action of the NCUA or a reviewing court stays, modifies, terminates, or sets it aside. A cease and desist order issued upon consent becomes effective at the time specified in the order.

If the credit union or institution-affiliated party is in violation of its terms, NCUA may enforce a final order (or temporary order) by filing a lawsuit seeking enforcement in U.S. District Court or imposing civil money penalties (see the Assessment of Civil Money Penalties section of this chapter.)

**Temporary
Cease and
Desist Order**

NCUA can issue a temporary cease and desist order before completing the normal administrative process when the violation or threatened violation as specified in the Notice of Charges and Hearing will likely:

- Cause insolvency;
- Cause a significant dissipation of the assets or the earnings of the credit union;
- Weaken the condition of the credit union; or
- Otherwise prejudice the interests of the insured members of the credit union.

The temporary cease and desist order usually accompanies the Notice of Charges and Hearing. In most cases, it will be part of the notice, but it may be a separate document. At times, facts developed after the serving of a Notice of Charges and Hearing may warrant issuing of a temporary cease and desist order, even though it did not previously appear appropriate. The examiner should immediately notify the supervisory examiner of any facts that would support such action.

The temporary cease and desist order becomes effective upon service and remains effective unless set aside, limited or suspended by a court

or the NCUA Board. The temporary order remains effective until completion of the administrative proceedings held as specified in the Notice of Charges and Hearing or until the NCUA dismisses the charges. When NCUA issues a final cease and desist order against the credit union, the temporary cease and desist order continues until the effective date of the permanent order. The credit union or the institution-affiliated party subject to a temporary cease and desist order may challenge the order by filing suit in a U.S. District Court within ten days after service. The credit union or institution-affiliated party may be subject to civil money penalties for violating the temporary order.

The NCUA Board may withdraw a cease and desist order at any time during the administrative process. This may occur, for example, after the credit union takes adequate corrective action, executes a letter of understanding, or otherwise convinces the NCUA Board that it can safely terminate the administrative proceedings. However, the fact that a credit union has ceased the practice leading to the Notice, or promises that it will not recur, does not necessarily mean that NCUA should terminate the action. The NCUA Board is free to pursue a final order to ensure that future violations do not occur, or to deter other credit unions from committing the same unsafe or unsound practices or violations.

**Assessment
of Civil
Money
Penalties**

12 U.S.C. §1786(k) contains NCUA's authority to issue civil money penalties; 12 C.F.R. 747, Subpart A contains the rules and regulations governing civil money penalty administrative hearings. The NCUA Board may assess civil money penalties against either a credit union or an institution-affiliated party (see definition of institution-affiliated party above). The *FCU Act* specifies three tiers of civil money penalties. For particularly serious violations, assessments may reach \$1,000,000 per day for each day the violation continues, although for credit unions the maximum is the lesser of \$1,000,000 per day or 1 percent of assets per day.

Grounds

- First tier. Any credit union or institution-affiliated party that violates a law or regulation, a final order of the NCUA Board, a published agreement with the Board (such as a Letter of

Understanding and Agreement), or a condition imposed in a published writing by the Board in connection with the granting of any application (such as the Insurance Agreement), may receive a fine of not more than \$5,000 for each day of the violation. First tier penalties may apply to credit unions that, even after warnings, repeatedly submit late or substantially inaccurate call reports.

- Second tier. If the credit union or institution-affiliated party commits a first tier violation, and exhibits reckless conduct or a breach of fiduciary duty, and the violation, practice or breach is part of a pattern of misconduct, or causes more than a minimal loss to the credit union, or results in a monetary gain or other benefit to the institution-affiliated party, then the NCUA Board may assess a civil money penalty of not more than \$25,000 per day for each day of the violation.
- Third tier. Any credit union or institution-affiliated party that knowingly commits the first tier violations, knowingly engages in unsafe or unsound practices, knowingly breaches any fiduciary duty, or knowingly or recklessly causes a substantial loss to the credit union or a substantial monetary gain or other benefit to a party because of the violation, breach, or practice, may receive assessment of a civil money penalty of not more than \$1,000,000 per day for each day of the violation, or in the case of a credit union, 1 percent of assets, whichever is less.

The normal administrative procedure for a civil money penalty action is as follows:

- The NCUA Board issues a Notice of Assessment, setting forth a statement of the law and facts on which it bases the assessment.
- The assessed party has 90 days to make payment, but may request a hearing within 20 days.
- An administrative law judge will hold a formal hearing if requested.
- After the administrative hearing, the administrative law judge submits a recommended decision to the NCUA Board.

- The NCUA Board issues its final order.
- An institution-affiliated party or credit union may appeal to the U.S. Court of Appeals within 20 days of receipt of the final order.

Removal of Officials

12 U.S.C. §1786(g) contains NCUA's authority to issue a removal order; 12 C.F.R. 747, Subpart A contains the rules and regulations governing removal administrative hearings. The administrative action to remove directors, officers, or committee members as provided in §206(g) of the *FCU Act* is available as an initial course of action or as a continuation of a cease and desist order if the officials refuse to comply as directed. Whether this enforcement action is an initial course or a continuation of a cease and desist order, it is separate and has its own applicability to particular situations.

In some cases involving a breach of fiduciary duty on the part of the director, the officer, or the committee member, discharge of the responsible person is an internal matter performed by the board of directors. On occasion, the director, the officer, or the committee member will voluntarily resign. It may be necessary to initiate formal removal proceedings, however, when internal or voluntary solutions do not work.

Removal of a director, an officer, or a committee member is not anticipatory in nature as in the cease and desist action. Removal is appropriate only when an official committed an act that constitutes grounds for removal, i.e., it cannot be imposed for future or threatened conduct. Removal can follow only if NCUA has issued a Notice of Intent to Remove or a Notice of Suspension and Intent to Remove and after completion of the appropriate administrative proceedings as provided in the *FCU Act* and *NCUA Rules and Regulations*.

NCUA may remove a person who voluntarily withdraws or whose services the credit union terminated. A removal action may be brought any time up to six years after resignation, termination of employment, liquidation, or any other termination of a relationship with the credit union (see §206(k)(3), 12 U.S.C. 1786(k)(3)).

Any party who has been removed or suspended from office is also automatically removed, suspended, and prohibited from participating in the affairs of any federally insured financial institution without the express written consent of the appropriate regulatory authority.

Grounds

NCUA can remove from office directors, officers, or committee members when they have:

- Directly or indirectly violated:
 - A statute or regulation; or
 - A provision of a final cease and desist order (but not a provision of an immediate, temporary cease and desist order); or
 - Any condition imposed in writing by the NCUA Board regarding the granting of any application or other request by the credit union (e.g., an application for insurance or 208 Assistance); or
 - Any published, written agreement between the credit union and the NCUA Board; or if they have
 - Engaged or participated in any unsafe or unsound practice in connection with the credit union; or
 - Committed or engaged in any act, omission, or practice which constitutes a breach of fiduciary duty; and
- Because of the violation, practice, or breach described above:
 - The credit union has or will suffer financial loss or other damage; or
 - The interests of the members have or could be prejudiced; or
 - The party receives financial gain or others benefit because of the violation, practice, or breach; and

- Such violation, practice, or breach:
 - Involves personal dishonesty by the party; or
 - Demonstrates the party's unfitness to serve the credit union or to participate in its affairs.

An official's past or current violation of the Depository Institution Management Interlocks Act is an additional ground for removal.

Following are the administrative procedures for removal:

- The NCUA Board issues a Notice of Intent to Remove.
- If the official or employee does not resign or consent, a hearing is held before an administrative law judge 30 to 60 days after service of the order.
- The administrative law judge sends the recommended decision and the hearing record to the NCUA Board.
- The NCUA Board issues a final order.
- The respondent may appeal to U.S. Court of Appeals, but the final order remains in effect unless modified by the NCUA Board or the Court.

Notice of Intent to Remove

The notice to remove an official from office contains a statement of facts constituting the grounds for removal and will establish a time and a place for holding a hearing before an administrative law judge, normally, between 30 days and 60 days serving the notice.

The rules and the procedures contained in Part 747, Subpart A of the *NCUA Rules and Regulations* apply to suspension and removal actions. The examiner should inform the official upon delivery of the notice that unless the official personally or an authorized representative appears at the hearing, the judge deems that the official has consented to the issuance of an Order of Removal. The party may also consent to the issuance of a removal order to save the time and expense of hiring

counsel or appearing at the hearing. In this case, rather than holding an administrative hearing, the matter will go directly to the NCUA Board for issuance of a final order of removal.

**Immediate
Suspension of
an Official**

An immediate suspension is similar to a temporary cease and desist order. If necessary to protect the credit union or the interests of its members, NCUA can immediately suspend an official from all official duties pending completion of the administrative hearing. This would be appropriate, for example, when it appears that the individual, once served with a notice, likely will cause further loss to the credit union or destroy credit union records before completion of the hearing or the issuance of the NCUA Board's final Order of Removal. Like a temporary cease and desist order, an Immediate Suspension will usually be a part of or will be served simultaneously with the Notice of Intent to Remove, although it may be served any time after the notice. It, too, becomes effective immediately upon service and remains in effect until dismissed or until the NCUA Board issues a final order. The official may challenge it in court within 10 days of service, and the NCUA Board may enforce the order by suing in U.S. District Court or by assessing civil money penalties.

Prohibitions

12 U.S.C. §1786(g) contains NCUA's authority to issue a prohibition order; 12 C.F.R. 747, Subpart A contains the rules and regulations governing prohibition hearings. A prohibition action is similar to, but broader in scope, than a removal proceeding. A removal action removes a person from a specified official position in a credit union, while a prohibition action stops any institution-affiliated party from participating in the affairs of a credit union. Because institution-affiliated parties are not always elected or appointed officials of an insured credit union, they may not always be removed as directors, officers, or committee members. Instead, NCUA must prohibit them from further participation in the affairs of an insured credit union.

The examiner prepares a recommendation for prohibition in the same manner as other administrative actions. The recommendation includes:

- Recipient of the prohibition action, i.e., name of the person, business address, and position with the company, group or

enterprise (including name of the proprietorship, partnership, or corporation) and the relationship with the credit union;

- Sufficient evidence to establish the grounds necessary for a prohibition action; and
- Specifics of the prohibition action, e.g., events causing the insured credit union's (or the other business enterprise's) realized or probable financial loss (or other damage) or events that allowed the institution-affiliated party to profit.

Prohibition of a person, like the removal of an official, is not anticipatory in nature as in a cease and desist action. Prohibition can follow only if NCUA issued a Notice of Intent to Prohibit and completed the appropriate administrative proceedings or the institution-affiliated party consented. NCUA may combine proceedings for removal and prohibition if appropriate. The procedures for a prohibition action are essentially the same as those for a removal action.

Grounds

The grounds are the same as those for removal.

Notice of Intent to Prohibit a Person from Further Participation

When NCUA determines that grounds for a prohibition action exist, it will serve a Notice of Intent to Prohibit upon the institution-affiliated party.

NCUA is not precluded from issuing a notice of prohibition where the person voluntarily withdraws or when the credit union terminates services after discovering financial loss or other damage. NCUA may bring a prohibition action any time up to six years after resignation, termination of employment, liquidation, or any other termination of a relationship with the credit union (see §206(k)(3) of the *FCU Act*, 12 U.S.C. 1786(k)(3)).

The examiner will inform the person served with the notice of the basic requirements regarding the hearing, which is held not less than 30 days and not more than 60 days after delivery, as stated in the notice. Usually, the region directs the examiner to complete a follow-

up supervision contact before the hearing date. However, if examiners do not make a contact or if the examiner learns before the hearing of additional pertinent information regarding the person and the charges cited in the notice, they should report this information to the regional office as soon as possible. The examiner should expect to participate in the hearing as a witness for NCUA.

**Immediate
Prohibition**

NCUA may issue an immediate prohibition order to protect the credit union or the interest of its members on the same basis and for the same reasons as an immediate removal of official order. The discussion in the section, Immediate Suspension of an Official, applies equally here.

**Removal or
Prohibition
Involving
Felony**

§206(i) of the *FCU Act*, 12 U.S.C. §1786(I) contains NCUA's authority to issue a removal or prohibition order for cases involving a felony; 12 C.F.R. 747, Subpart D contains the rules and regulations governing prohibition hearings. If examiners learn of any criminal charges brought against institution-affiliated parties involving dishonesty or breach of trust, they should report any evidence supporting a possible felony to their supervisory examiner. In no instance should the examiner proceed to investigate any complaints or indictments brought against institution-affiliated parties without first consulting with the supervisory examiner.

The examiner will report findings in support of a recommendation to suspend the official or to prohibit the person, if an official or other institution-affiliated party: (1) has been charged with a crime involving dishonesty or breach of trust; (2) the crime is punishable under federal or state law by imprisonment for more than one year; and (3) the continued service or participation by such party may pose a threat to the interests of the credit union's members or threaten to impair public confidence in the credit union. The examiner must develop tangible evidence to show that these grounds exist.

Examples of tangible evidence supporting suspension of the person as an official could include: (1) a membership meeting called in an attempt to force the resignation of the official or the termination of a person's participation; (2) share outflows; (3) membership cancellations directly attributed to general membership dissatisfaction

over the continuation of the person as an official; (4) significant adverse publicity; or (4) inability of the credit union to obtain loans from regular sources.

The examiner should refrain from expressing an opinion of guilt or innocence in the recommendation for suspension or for prohibition. The suspension or the prohibition remains in effect until the court finally disposes of the information, the indictment, or the complaint, or until NCUA terminates the administrative action.

If the final verdict is guilty, and the judgment is no longer subject to appeal, or if the individual enters a pretrial diversion or other similar program, NCUA may issue and have the examiner serve upon the person a final order removing or prohibiting that individual from participating further in the credit union's affairs. A not guilty verdict will not preclude NCUA from instituting removal or prohibition proceedings under the general removal and prohibition provisions previously discussed. The examiner will need to maintain close follow-up on the legal proceedings and immediately report to the supervisory examiner any new developments which may affect the order issued or pending.

The administrative procedures for felony removal or prohibition are as follows:

- The NCUA Board issues a Notice of Suspension and/or Prohibition, effective immediately.
- The NCUA Board holds no administrative hearing unless the official or other person requests one from the Board in writing within 30 days.
- If the institution-affiliated party requests, the NCUA Board or its designated hearing officer holds the hearing in Washington, DC. The hearing is not the type of formal administrative proceeding held for the other types of administrative actions and does not take place before an administrative law judge.

- If the court convicts the institution-affiliated party, and that conviction is no longer subject to appellate review, the Board may issue a final Notice of Removal or Prohibition.
- If the court acquits the institution-affiliated party, the Board may still proceed with a removal or prohibition, but it must be a §206(g)-type removal or prohibition.
- When a respondent requests an informal hearing, the presiding officer at the hearing makes his recommended decision to the Board within 10 days.
- The Board issues its decision within 60 days.
- There is no right to appeal the Board's final order.

Conservatorship

§206(h) of the *FCU Act*, 12 U.S.C. 1786(h) contains NCUA's authority to place an insured credit union into conservatorship. Conservatorship is a procedure whereby the NCUA takes immediate possession and control of a credit union's business and assets and may operate the credit union until:

- The NCUA Board permits it to resume business on its own, subject to any terms or conditions the Board may impose;
- The NCUA Board transfers possession and control to a state authority (in the case of a federally insured state-chartered credit union); or
- The NCUA Board liquidates the credit union.

Unlike the previous forms of action discussed, conservatorship does not involve an administrative hearing. The NCUA Board may act "ex parte without notice," meaning it need not notify the credit union of its intended action or provide it with the opportunity to contest the action before taking it. Within 10 days after the NCUA Board places a credit union into conservatorship, however, the credit union may challenge the action in U.S. District Court. Whether or not the credit union

challenges the conservatorship action, it is effective immediately upon service of the order to the credit union.

Conservatorship is a particularly useful tool in situations where management has abandoned the credit union or is totally inadequate to cope with severe financial problems that must be immediately brought under control. Conservatorship allows NCUA to influence more actively the operations of the credit union and to avoid or substantially reduce any further dissipation of assets.

Conservatorship is also useful when evidence exists of complex illegal or unsafe practices, but the examiners cannot readily determine the full ramifications of this activity. Conservatorship precludes management from having any access to records, and thus avoids the chance that management can tamper with or destroy vital records. At the same time, it permits either full or limited member services to continue.

Ideally, conservatorship will result in the credit union being returned to the members' control. This action requires NCUA Board approval. Prior to returning the credit union to the members' control, NCUA staff (other than those who had responsibility for managing the operations of the credit union) should complete an examination.

Grounds

NCUA may take conservatorship action whenever any of the following grounds are present:

- The credit union's assets require conserving;
- NCUSIF's funds are at risk;
- The members' interests need protection;
- The credit union consents to conservatorship by resolution of its board of directors;
- The credit union has willfully violated a final cease and desist order; or

- Management conceals or refuses to make available the books and records for inspection by an examiner or lawful agent of the NCUA Board.
- The Attorney General notifies the NCUA Board that the credit union has been found guilty of certain criminal provisions.

**State Credit
Unions**

In the case of a federally insured state credit union, the *FCU Act* provides that written approval of the state regulatory authority is a prerequisite to conservatorship action. However, if the state does not provide such approval within 30 days of the NCUA Board's notice to it that grounds for conservatorship exist, and the NCUA Board responds in writing to the state's written reason, if any, why the state is withholding approval, then, a unanimous vote of the NCUA Board can place the credit union into conservatorship without state approval.

**Termination
of Insurance**

§206(a) of the *FCU Act*, 12 U.S.C. 1786(a) contains the authority to terminate an insured credit union's share insurance; 12 C.F.R. §747 Subpart C contains the rules and regulations governing a termination of insurance action. Although the NCUA Board can theoretically take this action against a federal credit union, the Board most often reserves it for federally insured state-chartered credit unions. (Because federal credit unions must be federally insured, a termination of insurance would result in liquidation, unless the credit union could convert to a state charter before completing the proceeding.) Therefore, the recommended course of action for a federal credit union is immediate liquidation, if insolvent, or Notice of Suspension of Charter and/or Notice of Intent to Place into Involuntary Liquidation, for problems other than insolvency. (See the section of this chapter titled Revocation of Charter and Involuntary Liquidation of Solvent Credit Unions.)

For federally insured state-chartered credit unions, termination of insurance is the most severe action NCUA can initiate. It protects the NCUSIF when the credit union is unwilling or unable to take corrective action. In this regard, its purpose is similar to one of the basis for a conservatorship.

Termination of insurance will most likely force the state credit union into involuntary liquidation unless the credit union has an alternative share insurance program for which it can qualify and can thereby maintain member confidence. For these reasons, the regional office will closely communicate with the state regulatory agency whenever it contemplates this administrative action against any federally insured state-chartered credit union. Examiners will not discuss the potential for an administrative action with the credit union or with the state regulatory agency unless their supervisory examiners or the regional director specifically directs them to.

Grounds

The grounds for a termination of insurance action are essentially the same as those for a cease and desist action:

- Unsafe or unsound practices or conditions; or
- Violations of law, rule, regulation, any condition imposed in writing by the NCUA Board, or any written agreement entered into with the NCUA Board. To be enforceable, the Board must have previously published the agreement. Publication requires issuance of a press release and availability of the agreement to the public.

Termination of insurance action serves as an initial course of action or as a continuation of a cease and desist order if the officials refuse to comply as directed. Examples of conditions that might warrant a recommendation for termination of share insurance include:

- Insolvency as defined in §700.2(e) of the *NCUA Rules and Regulations*, and the unwillingness of the credit union's board of directors or state regulator to place the credit union into involuntary liquidation or to act appropriately to minimize risk and potential loss to the NCUSIF; or
- Abandonment of the credit union's operations by the elected and the appointed officials, and the state regulator's inaction to minimize risk and potential loss to the NCUSIF; or
- Plant closing, extended work stoppage, or breakdown in membership confidence that causes a major outflow of shares and

of liquidity, or general mismanagement of the operations by the officials that is causing or will cause an insolvent condition, and the officials or state regulator not acting to minimize risk and potential loss to the NCUSIF; or

- An unsafe or unsound practice or a serious violation of an applicable law, rule, regulation, order, or any condition imposed by the NCUA Board that is causing or will cause an insolvent condition, and the officials or state regulator not acting to minimize risk and potential loss to the NCUSIF.

Following are the administrative procedures for termination of insurance:

- The NCUA Board issues a Notice of Charges, with a request for corrective action. The credit union has 120 days to make such corrections, although the Board may reduce this time to not less than 20 days if the insurance risk is sufficient.
- If the credit union does not take corrective action, then the NCUA Board may issue a Notice of Intent to Terminate Insured Status. This sets out a statement of the facts justifying termination, and establishes a time and place for an administrative hearing within 30 to 60 days.
- An administrative law judge holds an administrative hearing.
- The administrative law judge files a recommended decision with the NCUA Board.
- The NCUA Board issues its final order.
- The credit union may appeal to the U.S. Court of Appeals, but the order is effective unless modified or lifted by the Board or the Court.
- NCUSIF insurance continues for one year from the date of termination on current shares; however, the NCUSIF does not insure new shares.

Notice of Charges

As a preliminary step to a Notice of Intent to Terminate Insured Status and if conditions warrant, NCUA will issue a Notice of Charges to the credit union, with a copy to the state regulatory agency. This notice will contain a statement describing the unsafe or unsound practices, conditions or relevant violations. This notice will request that the credit union correct the practices, the conditions, or the violations within 120 days after service of the notice. NCUA may set a shorter timeframe of not less than 20 days if it determines that any further delay may unduly subject the NCUSIF to greater risk or if the state regulatory agency requires a timeframe shorter than 120 days.

The Notice of Charges may motivate the officials to take the necessary corrective action. The region may assign the examiner to investigate the circumstances and the events in the case as a preliminary step in the process of issuing a Notice of Charges. In such an event, the examiner must identify the unsafe or unsound practices or serious violations and establish supporting facts that constitute grounds for the action. The examiner's analysis of the circumstances should provide sufficient evidence to proceed with the Notice of Intent to Terminate Insured Status if the credit union fails to correct the conditions cited in the Notice of Charges.

Notice of Intent to Terminate Insured Status

If NCUA pursues the Notice of Intent to Terminate Insured Status, the notice will contain a statement of the facts about the alleged unsafe or unsound practices or violations and will set the time and place for a hearing. The date of the hearing will be 30 to 60 days after service of the notice unless NCUA fixes an earlier date at the credit union's request. The examiner should caution the credit union about the seriousness of the notice upon its delivery. A copy of the notice is also sent to the state regulatory agency. The examiner informs the officials of the time limits for responding to the allegations and that the credit union or its representative must file a written notice of appearance with the administrative law judge. These instructions are included in the notice.

Notice of Termination of Insured Status

If a credit union cannot be returned to satisfactory operations and the danger of insolvency eliminated, the NCUA Board will terminate its insured status after an administrative hearing. Before the effective date

of termination of insurance, the credit union is required to mail to each member and to publish in a newspaper of general circulation the Notice of Termination of Insured Status. The format for this notice is specified in §747.207 of the *NCUA Rules and Regulations*. Specific duties of the credit union after termination of share insurance are specified in §747.208 of the *NCUA Rules and Regulations*.

The credit union is subject to the same duties and obligations of an insured credit union for one year after the effective date of the Notice of Termination of Insured Status; shares on deposit when insurance is terminated remain insured for the following year. Any shares purchased after the effective date of the final order are not insured by the NCUSIF. An examiner may be asked to follow up on the final order to determine if the credit union is fulfilling its duties and obligations to its members and to the NCUSIF.

**Involuntary
Liquidation
(Insolvency)**

§207(a)(1) of the *FCU Act* empowers the NCUA Board to close a federal credit union that is bankrupt or insolvent. This administrative action eliminates the credit union as a legal entity. NCUA cannot take this action against a federally insured state-chartered credit union.

Grounds

The grounds for this most severe action is insolvency or bankruptcy as defined in §700.2(e) of the *NCUA Rules and Regulations*.

The credit union has no right to a preclosure administrative hearing. The federal credit union's charter is immediately revoked and the credit union is placed into involuntary liquidation. The credit union may, however, challenge the action in U.S. District Court within 10 days. It is critical, therefore, that the finding of insolvency be based upon tangible evidence and indisputable circumstances using the most current information available. The examiner must prepare a supplemental memorandum for the liquidation package that contains all significant data to support the recommended action, including an analysis of the various exceptions set forth in §700.2(e) of the regulations.

Notice of Revocation of Charter and Involuntary Liquidation; Appointment of Agent

The notice will be served on the federal credit union in the same manner as previously discussed for notices or final orders involving solvent federal credit unions. The order is effective immediately upon service, and all assets, books and records of the credit union immediately become the property of the NCUA. Agents for the Liquidating Agent will be appointed as provided in §207(a) of the *FCU Act*.

Post Liquidation Challenge

A credit union placed into involuntary liquidation pursuant to §207(a) has the right to challenge NCUA's action in U.S. District Court within 10 days after liquidation. It is therefore imperative that the administrative record adequately supports insolvency. The examiner must be prepared to testify in court to establish the reasonableness of the insolvency calculation. For this reason, involuntary liquidations require the concurrence of the Office of General Counsel to ensure that the liquidation package is legally sufficient.

Revocation of Charter and Involuntary Liquidation of Solvent Credit Unions

The authority to place a solvent federal credit union into involuntary liquidation is contained in §120(b)(1) of the *FCU Act*, 12 U.S.C. 1766 (b)(1). The rules and regulations relating to these administrative proceedings are contained in 12 C.F.R. Part 747, Subpart E. The effect of this action is the elimination of a federal credit union as a legal entity after due process provided for by §120(b) of the *FCU Act* and Part 747, Subpart E of the *NCUA Rules and Regulations*. It is the most drastic enforcement action that can be taken against a solvent federal credit union.

Grounds

Pursuant to the authority in §120(b)(1) of the *FCU Act*, the NCUA Board may suspend or revoke the charter of a federal credit union that has violated any provision of its charter, its bylaws, the *FCU Act*, or NCUA regulations. This type of action may also be taken for reasons of bankruptcy, but generally is initiated under §207 of the *FCU Act*. Examples of conditions that may warrant recommending revocation of charter in a solvent credit union are:

- Abandonment of the credit union's operations and affairs by the officials; or

- Plant closing and officials refusing to vote to present the question of liquidation to the members. Such plant closing may force insolvency under the concept of an ongoing concern, or may cause a dissipation of the assets and expose the creditors and the NCUSIF to a greater than normal risk; or
- Other specific serious violations of its charter, its bylaws, the *FCU Act*, or regulations that cannot be reversed and that may cause insolvency; or
- Serious operational deficiencies that the officials have not acted to correct and which, if allowed to continue, may cause insolvency.

Abandonment shall be deemed to have occurred when all or most of the elected and the appointed officials have demonstrated by their actions, or failure to act, an intent to end operations. Proof is evidenced when an active quorum cannot or will not be formed by the remaining officials.

Because of the significant effect revocation of charter will have on the membership, the examiner should ensure that the grounds for revocation are indisputable and represent the most logical solution to the credit union's problems. For this reason, the revocation of a charter will not be initiated without a recent examination or supervision report. The examiner should prepare a supplemental memorandum to support the recommended action. Following are the administrative procedures for a revocation of charter:

- NCUA issues a Notice of Intent to Revoke Charter and Place into Involuntary Liquidation or a Notice of Suspension of Charter and Intent to Place into Involuntary Liquidation. If a Notice of Suspension is issued, operational control of the credit union is immediately transferred to NCUA. All subsequent administrative steps are the same for both a Notice of Intent and a Notice of Suspension.
- The credit union has 40 days in which to:
 - File a written statement stating why it should not be liquidated, or

- Request an oral hearing, or
- Consent to liquidation by a board of directors' resolution.

- If the credit union files a written statement, the NCUA Board will render a decision within 45 days. A Notice of Revocation of Charter and Involuntary Liquidation will be issued where the grounds for liquidation are found to exist.

- If the credit union requests a hearing, it will be held before an administrative law judge.

- The judge submits the recommended decision to the NCUA Board.

- The NCUA Board issues a final order.

Notice of Intent to Revoke Charter and Place Into Involuntary Liquidation

The examiner will recommend a Notice of Intent to Revoke Charter whenever the timeframe for due process will not create a greater risk of loss to the members, the creditors, and the NCUSIF than exists at the time of the recommendation. The examiner should be aware that the credit union will continue to conduct business during the effective time of this notice.

The examiner will determine whether or not a greater risk for loss exists by allowing the credit union to conduct business in the interim based on the conditions and the circumstances in each case. However, if a greater risk for loss is likely to exist, a recommendation for conservatorship or a Notice of Suspension of Charter and Intent to Revoke Charter and Place Into Involuntary Liquidation may be appropriate. This latter action is discussed in the following subsection.

The credit union has 40 days from the date the Notice of Intent is served to:

- File a written statement with NCUA setting forth the reasons why it should not be placed into involuntary liquidation; or

- In lieu of a written statement, request that an oral hearing be conducted in accordance with Part 747 of the *NCUA Rules and Regulations*; or

- Consent to the Notice by resolution of its board of directors.

The written statement, request for an oral hearing, or consent must be accompanied by a certified copy of a resolution by the board, signed by the president and the secretary authorizing such statement, request, or consent.

At the time of delivery of the Notice, the examiner will advise the officials of their options and of the timeframes within which their options must be exercised. The examiner must make it known to the officials that if the credit union fails to exercise any of its alternatives as provided in the *NCUA Rules and Regulations* within the prescribed timeframes, it will be deemed to have consented to the action being sought by NCUA.

**Notice of
Suspension of
Charter and
Intent to Revoke
Charter and
Place Into
Involuntary
Liquidation**

The examiner will recommend immediate suspension of charter whenever NCUA must act immediately to protect the interests of the members, the creditors, and the NCUSIF. All business by the credit union ceases except for the collection of loans, interest, and late charges; the collection of other funds legally due the credit union; and the payment of accounts payable and necessary operating expenses. NCUA will normally take immediate possession of all records and property of the credit union. Such immediate suspensions of charters are rare, since normally the same result can be achieved by placing the credit union into conservatorship.

The Notice of Suspension of Charter will contain a statement of the grounds for the immediate suspension and the authority upon which such grounds are based. Except for the statement of grounds supporting the need for immediate suspension of the charter and the restrictions placed on operations, the options available to the credit union will be the same as provided in a Notice of Intent to Revoke Charter.

**Appointment of
Agent**

A recommendation by the examiner that NCUA appoint an agent pursuant to a Notice of Suspension to take possession of all books, records, assets, and property of the credit union will be appropriate whenever it is apparent that the officials are unwilling or unable to

cope with their serious problems. A breakdown in the maintenance of the books and the records or abandonment of the credit union by the officials will be sufficient grounds to recommend appointment of an agent.

The appointed agent usually will be the district examiner, who will maintain, or have maintained, the records of the credit union and will open the credit union for restricted business activity. The credit union's surety bond coverage should be extended to cover the agents for the NCUA Board and arrangements should be made with the credit union's depository to honor the signature of the agents.

The duration of the agent's responsibility will extend until the credit union is placed into involuntary liquidation, the administrative action is withdrawn, or the appointment is rescinded, whichever comes first.

Notice of Termination

If the credit union officials have eliminated the serious problems cited in the Notice, a termination of the administrative action may be warranted. Documentation must be presented supporting the conclusion that the charges cited in the Notice no longer exist.

Notice of Revocation of Charter and Involuntary Liquidation; Appointment of Liquidating Agent

Once a Notice of Revocation of Charter is issued, NCUA ordinarily will appoint the Asset Management and Assistance Center (AMAC) liquidation specialist as the liquidating agent in involuntary liquidations for credit unions closed for reasons other than insolvency. In certain cases, examiners will be appointed as agents where geography or other factors preclude the liquidation specialist from handling the liquidation.

This final action will be taken after 40 days from delivery of the Notice of Intent to Revoke Charter or of the Notice of Suspension of Charter and Intent to Revoke Charter and Place Into Involuntary Liquidation. The examiner's recommendation to proceed with this final action will be supported by appropriate schedules and workpapers prepared on or about the fortieth day. The report should include specific comments and pertinent information on each charge cited in the notice.

The examiner also should report whether the credit union exercised any of the available options. If the credit union files a statement setting forth grounds and reasons why its charter should not be suspended, the examiner will analyze it objectively and provide factual evidence to support or reject the grounds.

**Order to
Establish
Special
Reserves**

Parts 116 and 201 of the *FCU Act* authorize the NCUA Board to require that special reserves be established when necessary to protect the interests of federal credit union members. In addition, Part 741 of the *NCUA Rules and Regulations* and the Agreement for Insurance require state-chartered federally insured credit unions to establish such reserves as the NCUA Board deems necessary.

The order requires that the reserves be established in an account entitled "Special Reserve for Losses" and that they not be transferred from that account or reduced in any way except by written permission of the NCUA Board or upon termination of the order. Generally, the order will affect the credit union's ability to pay dividends. An Order to Establish Special Reserve for Losses may be necessary under the following conditions:

- When the established reserves do not provide sufficient protection against a condition that threatens the credit union's soundness;
- When it is believed that the credit union may intentionally evade the need to establish sufficient reserves;
- When it is believed that the credit union may ignore the need for additional reserves; or
- When it is believed that the credit union may avoid establishing sufficient reserves by refinancing or extending loans or intentionally misrepresenting facts that, if properly disclosed, would have a material effect.

The Order to Establish Special Reserve is designed to prevent further deterioration of the credit union's financial condition. Before recommending such an order, the examiner should encourage the

board of directors to voluntarily transfer the appropriate amount to a special reserve account.

**Recommending
Special
Reserves for
Losses**

The examiner will recommend Special Reserve for Losses to the regional director, based on examination or supervision information and with the supervisory examiner's concurrence. The basis for the recommendation should be set forth in a separate memorandum and be part of the administrative record. Any order issued, along with the administrative record, should be retained.

Under Section 216 of the *Federal Credit Union Act* and Part 702 of the Rules and Regulations, NCUA may take supervisory actions that are similar to those available by using the foregoing administrative actions. These supervisory actions may include dismissing directors or senior management officials, ordering the employment of qualified senior executive officers, liquidation or conservatorship, and any other reasonable actions to carry out the purposes of prompt corrective action. Unlike many of the above administrative actions, the actions taken under prompt corrective action do not require administrative hearings before an administrative law judge. When considering administrative actions for a credit union which is undercapitalized, significantly undercapitalized, or critically undercapitalized, the examiner should therefore also consider whether or not the desired result could also be achieved by employing NCUA's powers under prompt corrective action.

References

- *Federal Credit Union Act*
 - 120(b) - Powers of the Board and Administration Personnel
 - Title II - Share Insurance
 - 201 - Insurance of Member Accounts
 - 206 - Termination of Insured Credit Union Status
Cease-and-Desist Orders; Removal or Suspension
From Office; Procedure
 - 207 - Payment of Insurance
 - 208 - Special Assistance to Avoid Liquidation
 - 216 - Prompt Corrective Action

- *NCUA Rules and Regulations*
 - 700.2-(e) - Insolvency
 - 702 – Prompt Corrective Action
 - 741 - Requirements for Insurance
 - 747 - Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations

Chapter 31

LIQUIDATIONS

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Chapter 31

LIQUIDATIONS

Liquidations Objective

- Determine the liquidation types available
- Determine the procedures of the various types of liquidations

Associated Risks

- Reputation risk can occur when the credit union sustains losses sufficient to result in liquidation. Although reputation risk is the primary risk, the liquidation process most likely results from high risk in any or all of the remaining six risk areas.

Overview

In order to carry out that part of district responsibility relating to liquidations, the examiner must have a thorough knowledge of the types of liquidations and the procedures governing each. Liquidations are classified as follows:

- **Voluntary.** Part 710 of the *NCUA Rules and Regulations* provides guidance for the voluntary liquidation of a solvent federal credit union. The credit union's board of directors or a duly appointed liquidating agent conducts voluntary liquidations. The board or liquidating agent fully disburses members' shares in a voluntary liquidation only after selling or collecting the assets and satisfying any liabilities. Also, in most cases the members receive a liquidating dividend. For these reasons, the board or liquidating agent should expedite the liquidation process.
- **Title I Involuntary.** Under §120 of the *FCU Act*, the NCUA Board can place a solvent federal credit union into involuntary liquidation for violations of its charter, its bylaws, the *FCU Act*, and the *NCUA Rules and Regulations*. Also, under §120, the NCUA Board can place a federal credit union into involuntary liquidation upon finding that the board or liquidating agent did not conduct a voluntary liquidation in an orderly or efficient manner or in the best interests of the members.

- Title II Involuntary. §207 of the *FCU Act* requires the NCUA Board to close for liquidation any federal credit union it deems bankrupt or insolvent. In these cases, the NCUA Board must also appoint itself as liquidating agent. In addition, the NCUA Board can accept appointment as liquidating agent of a bankrupt or insolvent federally insured state-chartered credit union.
- Purchase and Assumption. A purchase and assumption (P&A) is an action similar to a merger, but unlike a merger the NCUA Board places the credit union into involuntary liquidation. In a P&A, another credit union or another financial institution assumes all or part of the assets, liabilities, and shares.

Responsibility

The NCUA Board has delegated to the Asset Management and Assistance Center (AMAC) the responsibility of managing all involuntary liquidations of federally insured credit unions in all NCUA regions. AMAC processes in an orderly manner the payment of insured shares, sale or collection of loan portfolios, the liquidation of other assets, and the cancellation of charters or insurance certificates. In addition to the liquidation responsibility, AMAC can assist the examiner, if the regional director so requests, with evaluating real estate assets, bond claims, other major assets, records reconstruction, and management. These evaluations of operating credit unions can help develop alternatives to liquidation or help support the insolvency calculation.

When AMAC staff is onsite during an involuntary liquidation, the region retains full responsibility for a federal credit union up to the point of delivery of the Notice of Liquidation to the credit union officials. In the case of a federally insured state-chartered credit union, the state regulator retains full responsibility until NCUA has accepted the appointment as liquidating agent. Once delivery of the Notice of Liquidation takes place, or NCUA has accepted appointment as liquidating agent, the liquidation becomes the responsibility of AMAC. When AMAC staff is not onsite, the region retains full responsibility until the region ships and AMAC receives the records. At that time AMAC assumes responsibility.

The region is responsible for purchase and assumptions. AMAC usually performs the administrative activity necessary to complete the P&A. For example, AMAC can become involved in those cases in which expense payments are necessary (not including 208 Assistance to facilitate the action), when the continuing institution does not receive all assets and liabilities, and when NCUA retains bond claims. In these cases, AMAC takes responsibility for the remaining assets, liabilities, expense payments, and bond claims on the effective date of the purchase and assumption. The region must involve AMAC during the planning stages of the P&A, so that AMAC can promptly publish notices and AMAC can assume responsibility for any remaining assets and liabilities.

The region must also supervise voluntary liquidations. AMAC, if requested by the region, can provide assistance in the liquidation of assets or the payment of liabilities. AMAC can also accept appointment as liquidating agent and complete the entire voluntary liquidation. The region and AMAC determine the degree of AMAC involvement case by case.

The regional office and AMAC must closely coordinate liquidations. In most cases, staff from both the region and AMAC conducts involuntary liquidations. Generally, after the planning stage, regional staff performs much of the onsite phase and ship the records to AMAC. AMAC then conducts the share payout, prepares loan registers, arranges for the sale or collection of the loans, and concludes the affairs.

Voluntary Liquidation

AMAC or other designated liquidating agents or the credit union officials conduct a voluntary liquidation. Once credit union notifies the regional office of a voluntary liquidation, the examiner should contact the credit union to determine the current financial situation and to provide guidance on voluntary liquidation procedures. The examiner should ensure that the officials or liquidating agent understand and comply with Part 710 of *NCUA Rules and Regulations* and the *Voluntary Liquidation Procedures for Federal Credit Unions* (NCUA 8040).

**Considering
Voluntary
Liquidation**

Frequently, credit union officials will consult with the examiner regarding the advisability of liquidation. Examiners must carefully analyze all pertinent conditions to learn the true reason the officials are considering liquidation.

Some problems for which practical solutions short of liquidation may exist include: withdrawal of support by the parent organization, delinquent loans, lack of interest, or disputes between officials or factions within the credit union. Resolution of existing problems will depend on the examiner's ability to make use of the facts uncovered in the investigation.

The examiner may suggest reorganizing the officials, restructuring the operating procedures, and reviving interest among the officials and members as viable alternatives to liquidation. To accomplish this, the members or representatives of other local credit unions may decide to meet. The examiner should inform the supervisory examiner of the progress made.

The examiner or regional office provides a copy of the *Voluntary Liquidation Procedures for Federal Credit Unions* to the board of directors. The examiner should urge the officials to take all necessary steps to protect the members' interests and to complete the liquidation as rapidly as possible.

**Alternatives to
Voluntary
Liquidation**

The credit union and examiner should explore all alternatives to liquidation. In addition to reorganization of the officials, alternatives include changes to the field of membership and merger. An extension of the basic field of membership could result in a more viable group. For example, conversion from an occupational to a community or associational charter provides a broader membership base. (For further guidance, see NCUA's *Chartering and Field of Membership Manual*, NCUA 8007.)

Both NCUA and the credit union may prefer a merger option to liquidation since credit union service can continue. Regional and field staff must weigh continued credit union service against other factors, such as the costs to the NCUSIF. The examiner should investigate the

possibility of a merger and include all pertinent findings in a memorandum to the regional office.

**Solvency
Evaluation**

The examiner's memorandum regarding the voluntary liquidation proposal must document the credit union's solvency and support the solvency determination with current financial statements, a delinquent loan list, and a solvency evaluation workpaper. The examiner can use the Probable Asset/Share Ratio form as a solvency evaluation workpaper. The Credit Union Merger Procedures and Merger Forms Manual, (NCUA 8056) includes a copy of the Probable Asset/Share Ratio form. The examiner should determine the actual cash value of each asset and discuss in the memorandum any asset assigned a value less than book value with the reasons for the valuation. Examiners should report current loans that are probable losses, such as bankruptcies, on the list as classified. If the credit union is insolvent, the examiner should recommend that the regional director place the credit union into involuntary liquidation under §207 of the *FCU Act*. §700.1 of the *NCUA Rules and Regulations* defines insolvency. Insolvent credit unions cannot choose voluntary liquidation.

Commencement

The commencement date of the liquidation is the date the board of directors votes to submit the question of liquidation to the members. If, for some reason, the examiner feels this date would not result in an equitable distribution to the members, the examiner should contact the supervisory examiner to decide on appropriate action. The regional director has the authority to change the date of liquidation to provide equitable treatment of all members.

An example of inequity is a situation where the officials induce borrowers to transfer shares to current loans just prior to the board's announcement of the voluntary liquidation. By reducing the amount of shares at the commencement date, a select number of shareholders would receive a larger liquidating dividend. Inequity would also apply in a case where, just prior to the liquidation date, the officials pressure members with large share balances to close their accounts under the misconception of a prolonged period awaiting final distribution.

The examiner should instruct the liquidating agent to use the cash basis rather than the accrual basis of accounting during liquidation. The liquidating agent should follow procedures outlined in the *Accounting Manual for Federal Credit Unions*, except that the liquidating agent should not close income and expense accounts at year-end.

The examiner should determine that the liquidating agent closed the books and prepared commencement reports as of the liquidation commencement date in compliance with the *Voluntary Liquidation Procedures Manual*. If the liquidating agent cannot prepare and mail the reports and schedules to the regional office during the contact, the examiner should obtain a firm date from the liquidating agent for completion of these requirements. The examiner will follow up by telephone or other means to determine that the liquidating agent keeps the agreements.

The examiner may suggest that the board of directors authorize late charges on inactive accounts under par value, as provided by the bylaws, prior to closing the books. Also, staff should resolve out-of-balance conditions at this time, where possible.

Financial Assistance

In some cases, the credit union cannot convert assets to cash to facilitate a prompt share distribution. This may occur when the credit union cannot arrange a bulk sale of loans or when surety delays settlement of a bond claim. The examiner may consider requesting assistance under §208 of the *FCU Act*. In these cases, the NCUSIF can purchase the assets to expedite the share distribution. Before discussing such assistance with the officials, the examiner should contact the supervisory examiner.

When the NCUSIF acquires assets as a result of voluntary liquidations, AMAC is responsible for the sale, collection, or settlement of the assets.

Sale/Collection of Assets

Since the duration of the liquidation usually depends on the collection of loans, the examiner should emphasize that a bulk sale of loans will shorten the liquidation period and that the credit union might negotiate a more favorable price early in the liquidation. If the sale of loans or

other major assets will not produce sufficient funds to pay the shareholders at par (100 percent), the credit union may not consummate a sale without the written approval of the regional director.

Credit unions needing assistance in selling loan portfolios may contact AMAC through the regional office for marketing assistance. While the bulk sale of loans will, in most cases, be the practical way to provide a quick distribution to the shareholders, the examiner should not encourage the officials to sell at an excessive discount, especially if the credit union is financially sound. Under these conditions the officials may want to continue to collect the loans in order to provide the members a liquidating dividend.

**Partial
Distribution**

The examiner will occasionally receive inquiries concerning partial distributions. Current policy discourages partial distributions if the credit union will most likely fully liquidate within six months. However, in cases where conversion of all assets to cash will extend beyond six months, the examiner should encourage a partial distribution. A partial distribution generally is at least 25 percent of total shares, and any subsequent partial distribution normally is not less than 25 percent of commencement shares. Before payment of a partial distribution, the credit union must request and obtain the approval of the regional director. The voluntary liquidation procedures specify the reports, which should accompany this request.

Other Priorities

Auditing responsibilities of the supervisory committee do not cease because the credit union enters liquidation. Rather, internal controls take on greater importance with the conversion of the credit union's assets to cash and the responsibility for the liquidation frequently delegated to one individual.

Part 710 of the *NCUA Rules and Regulations* requires bond coverage for at least four months beyond the date of final distribution. The importance of surety coverage increases because of the accumulation of cash.

When the examiner or liquidating agent determines that the credit union can return members' shares at par, the credit union returns the NCUSIF capitalization deposit. Credit unions that do not start final distribution of the members' checks by December 31 must pay the annual operating fee for that year. For the purpose of assessing operating fees, NCUA considers the final distribution made when the liquidating agent mails the members' checks.

**Supervision
during
Voluntary
Liquidation**

A voluntary liquidation remains the district examiner's responsibility until cancellation of the charter. Voluntary liquidations normally conclude in one year or less, and examiners normally do not conduct examinations during liquidation. In rare cases, the regional office will assign necessary examinations. While examiners will ordinarily follow regular examination techniques, the regional director will determine the scope of the examination. Regional instructions will guide the examiner.

The examiner will make supervision contacts monthly throughout the liquidation unless the board appoints AMAC as liquidating agent. Onsite contacts will occur if the examiner cannot obtain sufficient information by mail and by telephone to properly monitor the liquidation. The examiner's duties will extend into such areas as:

- Determining that the records are current and in balance;
- Determining that prescribed procedures are being followed;
- Coordinating the sale of loans and other assets;
- Monitoring solvency;
- Submitting prompt and accurate reports to the regional office; and
- Bringing the liquidation to a prompt conclusion.

Immaterial differences between the individual share and loan ledgers and their control accounts should not delay distribution. If material differences exist, the examiner should obtain guidance from the supervisory examiner.

The examiner should conduct a joint conference at the conclusion of onsite contacts if the officials continue to run the credit union. Examiners should discuss any exceptions or irregularities with the responsible officials and take appropriate steps to ensure necessary

corrections. If unsatisfactory practices jeopardize the interests of the shareholders and NCUSIF, the examiner should ensure that the officials discontinue these practices immediately.

Examiners will report by memorandum to the regional office on each supervisory contact for a liquidation. The memorandum should briefly state:

- The conditions found;
- Instructions given to and agreements reached with the liquidating agent and the officials;
- Any information specifically requested by the supervisory examiner; and
- The anticipated date of distribution.

The examiner should continue to contact the credit union even after the final distribution. NCUA finalizes the liquidation only after receiving the final reports and canceling the charter.

Involuntary Liquidations

The Administrative Action chapter explains the procedures for placing an operating federal credit union into involuntary liquidation.

When the NCUA Board places a federal credit union into involuntary liquidation or NCUA accepts appointment as liquidating agent/receiver for a federally insured state credit union, the regional office notifies AMAC. The regional director and president of the AMAC should decide early in the planning process if AMAC staff must be onsite at commencement of liquidation. The *Field Examiners Liquidation Guide to On-Site Involuntary Liquidation Procedures*, (NCUA 9700) provides detailed guidance on the liquidation procedures.

Title I Involuntary Liquidations

Although Title I of the *FCU Act* provides that the NCUA Board may place a federal credit union into involuntary liquidation because of insolvency, Title I does not provide for the related payout. Therefore, NCUA conducts all liquidations of insolvent federal credit unions under the authority of §207 of the *FCU Act*, and uses Title I for liquidations involving violations of the charter, bylaws, *FCU Act*, and

NCUA Rules and Regulations. AMAC, as liquidating agent, conducts Title I involuntary liquidations.

Since Title I liquidation is not a commonly used administrative action, examiner involvement will differ from case to case. For this reason, the regional office will issue any needed assignments to examiners for each case. The examiner will discuss with the supervisory examiner the decision to recommend involuntary liquidation of a solvent federal credit union.

**Title II
Involuntary
Liquidations**

The examiner will submit to the regional director a recommendation to place an insolvent federal credit union into involuntary liquidation, who will request concurrence from the Office of General Counsel. The following data should support the recommendation:

- Summary of the credit union's history and background;
- Summary of the field of membership;
- Economic conditions of the local area;
- Merger feasibility;
- Officials' involvement; and
- Previous examination information such as, CAMEL, solvency evaluation ratio, delinquency, etc.

The recommendation should include the following current reports:

- Balance sheet;
- Income statement;
- Delinquency report;
- Classified loans;
- Solvency evaluation workpaper;
- Any outstanding Letter of Understanding and Agreement;
- All Preliminary Warning Letters; and
- Other administrative actions.

Current financial statements, the delinquent loan list, and a solvency evaluation workpaper should support the credit union's insolvency. The examiner should: (1) determine the actual cash value for each asset; (2) discuss in the memorandum any assets assigned a cash value less than book value and the reasons for the valuation; (3) mark the delinquent loan list to indicate the classified loans; and (4) report

current loans which are probable losses, such as bankruptcies, on the list as classified.

Basically, the instructions in the Administrative Actions chapter of this Guide dealing with an operating, solvent credit union will apply to a liquidating, insolvent credit union.

In the case of a liquidating credit union, it is not necessary to cite any other charges other than insolvency in the recommendation to the regional director. If the regional director so requests, AMAC can assist the examiner in evaluating complex assets, bond claims, and records reconstruction to make the solvency determination.

**Payout of
Federally
Insured State
Credit Unions**

When the appropriate state authorities declare an insured state credit union insolvent or bankrupt, the state usually appoints NCUA or the NCUA Board as liquidating agent, receiver, or conservator. Under delegated authority the president of AMAC, becomes the liquidating agent in these cases.

NCUA does not have the authority to place a state-chartered credit union into liquidation. NCUA cannot make the formal determination of insolvency. The regional director will make any examiner assignments in these liquidations. Examiners will follow NCUA's procedures to the extent that they do not conflict with state law.

**Preparing Credit
Unions for
Involuntary
Liquidation**

The primary goals of an involuntary liquidation are the prompt return of members' shares, payment to the creditors, and disposition of the remaining assets to the NCUSIF. Once the regional director has decided to liquidate the credit union, the examiner must ensure that the records are current and in balance. The regional director determines the examiner's role during the liquidation case by case. If the examiner is to conduct the onsite phase of the liquidation, he or she should use the *Examiners Liquidation Guide to On-Site Involuntary Liquidation Procedures* for detailed guidance.

**Failure to
Commence
Operations**

When the regional office receives notice that a new credit union will not start operations as scheduled, it will assign an examiner to determine if the region should liquidate the credit union. If the

examiner's efforts to commence operations are unsuccessful, the examiner should submit the following to the regional office:

- The original charter and share insurance certificate; and
- A letter or statement signed by a majority of the directors which includes:
 - Request for revocation of charter;
 - Reason for not beginning operations;
 - Information as to the disposition of the initial supplies.

**Workpapers
and
References**

- Workpapers
 - Solvency Evaluation Workpaper
- References
 - *Federal Credit Union Act*
 - Title I - General Provisions
 - Title II - Share Insurance
 - 120 - Powers of the Board and Administration
 - 207 - Payment of Insurance
 - 208 - Special Assistance to Avoid Liquidation
 - *NCUA Rules and Regulations*
 - 700.2(e)(1) - Insolvency
 - 709 - Involuntary Liquidations
 - 710 - Voluntary Liquidation of Federal Credit Unions
 - 745 Subpart B - Payment of Share Insurance
 - *Voluntary Liquidation Procedure for Federal Credit Unions (NCUA 8040)*
 - *Field Examiners Liquidation Guide to On-Site Involuntary Liquidation Procedures*
 - *Credit Union Merger Procedures and Merger Forms Manual*