FIGURE 4. ASSET AND LIABILITY CATEGORIZATION MATRIX (FROM TAB H)

Asset and Liability Category Matrix*

Assets	
Cash & Cash Equivalents (C&CE)	- Cash - Fed Funds Sold - If investments with original maturity of 90 days or less are reported, otherwise report in Investments
Loans	- All Loans including ALLL
Investments	- All Investments excluding what is reported in CCE
Other Assets	- All Other assets not recorded in prior categories to equal Total Assets - Gain(Loss) associated with Derivatives if hedging Assets (fair Value hedge)
Reported Effective DUR (+300)	- Record the CU =+300 total asset Effective Duration

Liabilities	
Share Drafts	- Checking accounts (i.e., high yield checking, club checking, honors checking, advantage checking, privilege checking, etc.) - Non-interest bearing accounts - Non-interest bearing deposits (NIB deposits) - Demand deposits accounts (DDA) - Business sweep accounts - Business accounts (i.e., business checking)
Regular Shares	- Regular shares - Share account - IRA (i.e., IRA only, IRA savings, IRA shares, IRA Roth) - Wealth builder account - Health savings accounts (HAS) - Saving accounts - Short durations saving accounts (i.e., club savings, summer holiday savings, etc.) · Escrow accounts - Deferred compensation - Custodial shares
MMA (Money Market Accounts)	- Money market shares - MMA (i.e., investment plus accounts and value plus money market) - Deferred compensation money market
Certificates	- Certificate of deposits (CDs – 6 month, 1 year, 2 year, etc.) - Time deposits - Non-member deposits - Rate builders (i.e., 60 months, other terms) - IRA certificates (i.e., 6 month, 1 year, 2 year, etc.)
Borrowings	- Borrowings - Notes payable - Advances - Affiliate deposits - FHLB (type of advanced / borrowing) - Loan participations sold
Other Liabilities	- Other liabilities - Gain(Loss) associated with derivative instruments if hedging liabilities (cashflow hedge) - Interest payables - Non-interest bearing current liability (NIBCL)
Reported Effective DUR (+300)	- Record the CU =+300 total Liability Effective Duration
CU NW %	- Credit Union Net Worth Ratio as of Report Date

***Detailed products were grouped on the basis of similar IRR sensitivities**

NEV Supervisory Test

The NEV Supervisory Test is a capital-at-risk measure, or "shock test," used to evaluate the change in the economic value of a credit union's balance sheet for an instantaneous, parallel, and sustained shock in market interest rates.

There are two conditions of the test, both of which determine a credit union's supervisory classification with respect to IRR:

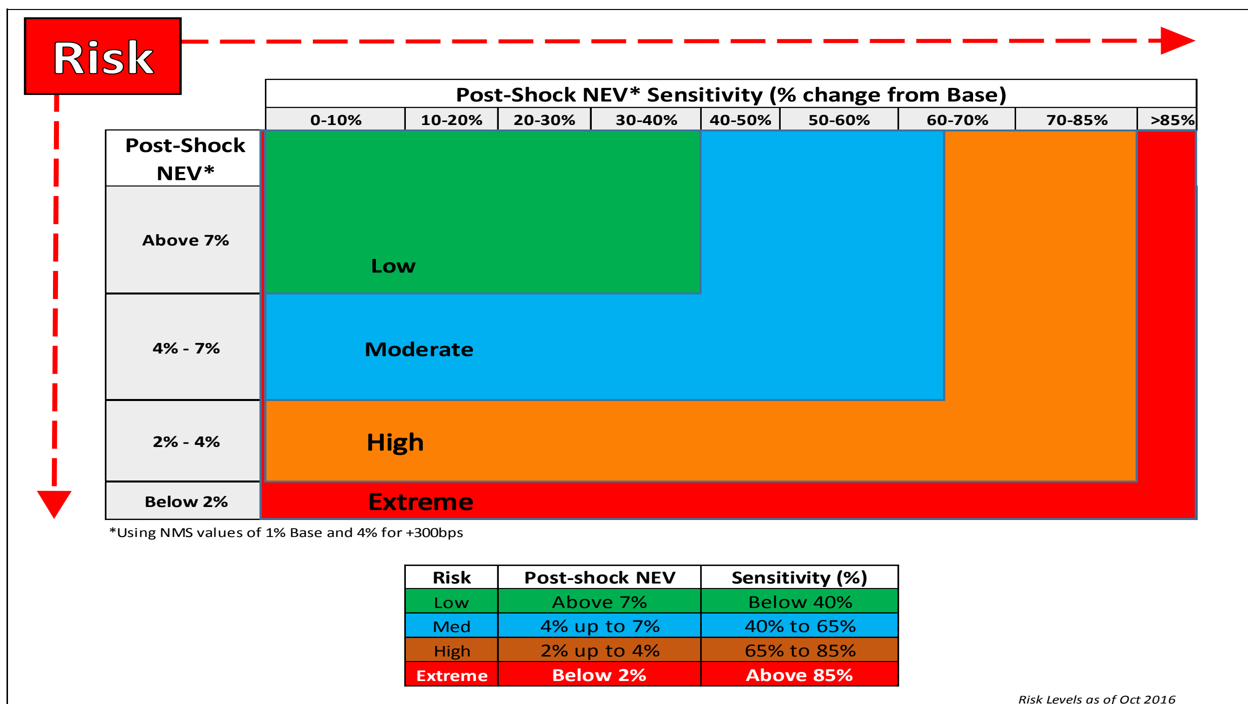
1. The post-shock NEV ratio (vertical axis)
2. The post-shock NEV sensitivity (horizontal axis)

For both test conditions, a credit union will be assigned a low, moderate, high, or extreme classification. See *Figure 5* for risk classifications.

Both tests apply in all circumstances, and a credit union's assigned NEV Supervisory Test result will be the more severe rating of the two. For example, if a credit union's post-shock NEV ratio falls into the low range, but its post-shock sensitivity is moderate, the risk classification defaults to moderate (that is, the more severe of the two outcomes).

The test outcomes always determine the classification. The result of the NEV Supervisory Test risk classification is used whether the source of the data is a credit union's IRR report or NCUA's Estimated NEV Test.

FIGURE 5. SUPERVISORY CLASSIFICATION FOR IRR (BASED ON RESULTS OF NEV SUPERVISORY TEST)



Risk	Post-shock NEV	Sensitivity (%)
Low	Above 7%	Below 40%
Med	4% up to 7%	40% to 65%
High	2% up to 4%	65% to 85%
Extreme	Below 2%	Above 85%

Source: Estimated NEV Tool (ENT)

Not all credit unions generate internal NEV reports, and those that do may not produce reliable reports. When a credit union's IRR reporting for NEV does not exist or is insufficient or inaccurate for NEV Supervisory Test purposes, examiners should use the ENT residing in Exam.xls workbook.

WHAT IS NCUA'S ESTIMATED NEV TOOL?

NCUA's ENT approximates an NEV measure using a credit union's Call Report data, as well as valuation and sensitivity estimates developed by NCUA. The tool also serves to estimate the level of IRR in a credit union's balance sheet. The ENT requires no user input. The worksheet resides in the AIRES Exam Workbook and automatically populates when an exam is created.

WHEN WILL EXAMINERS USE THE ESTIMATED NEV TOOL?

The ENT is used:

- When a credit union does not internally estimate its NEV; or
- When a credit union's NEV report is materially deficient for the use of the NEV Supervisory Test; or
- For credit unions with assets less than $50 million.

NCUA prefers to use the NEV Supervisory Test wherever practicable for credit unions with greater than $50 million in total assets.

HOW DOES THE ESTIMATED NEV TOOL WORK?

The ENT automatically populates select information from a credit union's current Call Report into the AIRES Exam Workbook when an exam is created. The tool estimates a credit union's NEV based on aggregate Call Report data and pre-established duration estimates assigned for the main asset and liability accounts held in the credit union's portfolio.[6] As with the NEV Supervisory Test, the ENT estimates book NEV, base NEV, and shocked NEV. The shock scenario is an instantaneous, parallel, and sustained 300 basis point increase in interest rates. The tool also generate NEV sensitivity for the +300 shock scenario.

Consistent with the risk-level rating scale from NCUA's NEV Supervisory Test, the ENT assigns a risk rating of low, moderate, high, or extreme for both the post-shock NEV ratio and post-shock NEV sensitivity. The risk rating assigned is the more severe of the two test conditions.

[6] It is important to note that the starting NEV will not always match regulatory net worth because NEV is intended to show an approximated fair value of a credit union's equity to total assets. Regulatory capital, on the other hand, is calculated off net worth (retained earnings per GAAP) to total assets.

HOW IS THE ESTIMATED NEV TOOL STRUCTURED?

Figure 6 is an illustration of the ENT worksheet as it resides in the AIRES Exam Workbook. (**NOTE:** The risk levels in this example are for demonstration purposes only, and may not be the risk levels at the time of the examination.)

ASSETS

The tool assigns no premium or discount for a credit union's cash or other assets. The tool presents the devaluation for loans and investments separately from cash and other assets. Sensitivities for all assets are then combined on a weighted average basis to produce a total asset sensitivity.

NOTE: The base asset valuation includes the fair value of investments available-for-sale (AFS) and held-to-maturity (HTM) by the credit union. Currently, the tool assumes no difference between book and base loan values. This model assumption is based upon prior data that revealed the difference to be immaterial in the current rate environment. This model assumption will be periodically evaluated going forward, and modified if necessary.

FIGURE 6. ESTIMATED NEV TEST WORKSHEET (FROM EXAM.XLS) ILLUSTRATED AS TWO TABLES (ASSETS, LIABS/EQUITY)

Charter Number ####### | **Credit Union Name** | Effective Date: __/__/____

Estimated NEV Tool

Balance Sheet Category	Book	Base[1]	Up 300	Book vs. Base	Base vs. 300	Book vs. 300
Cash						
Cash on Hand	3,500,000	3,500,000	3,500,000	0.00%	0.00%	0.00%
Cash on Deposit	200,000,000	200,000,000	200,000,000	0.00%	0.00%	0.00%
Cash Equivalents	0	0	0	0.00%	0.00%	0.00%
Total Cash & Equivalents	203,500,000	203,500,000	203,500,000	0.00%	0.00%	0.00%
Investments[2]						
< 1 Year	125,000,000	126,383,400	124,487,649	1.11%	-1.50%	-0.41%
1-3 Years	140,000,000	144,460,794	136,948,832	3.19%	-5.20%	-2.18%
3-5 Years	0	0	0	0.00%	-10.80%	-10.80%
5-10 Years	0	0	0	0.00%	-17.60%	-17.60%
>10 Years	0	0	0	0.00%	-26.80%	-26.80%
Total Investments	265,000,000	270,844,194	261,436,482	2.21%	-3.47%	-1.34%
Loans						
Credit Cards	25,000,000	25,000,000	23,675,000	0.00%	-5.30%	-5.30%
New Autos	65,000,000	65,000,000	61,685,000	0.00%	-5.10%	-5.10%
Used Autos	55,000,000	55,000,000	53,405,000	0.00%	-2.90%	-2.90%
First Mortgages						
Fixed Rate > 15 years	600,000,000	600,000,000	505,200,000	0.00%	-15.80%	-15.80%
Fixed Rate < 15 years	100,000,000	100,000,000	90,200,000	0.00%	-9.80%	-9.80%
Balloon/Hybrid > 5 years	125,000,000	125,000,000	113,125,000	0.00%	-9.50%	-9.50%
Balloon/Hybrid < 5 years	75,000,000	75,000,000	70,050,000	0.00%	-6.60%	-6.60%
Other Fixed Rate	0	0	0	0.00%	-4.50%	-4.50%
Adjustable Rate < 1 year	7,000,000	7,000,000	6,930,000	0.00%	-1.00%	-1.00%
Adjustable Rate > 1 year	6,000,000	6,000,000	5,418,000	0.00%	-9.70%	-9.70%
Other Real Estate						
Closed-End Fixed Rate	20,000,000	20,000,000	17,540,000	0.00%	-12.30%	-12.30%
Closed-End Adjustable Rate	0	0	0	0.00%	-6.40%	-6.40%
Open-End Adjustable Rate	10,000,000	10,000,000	9,770,000	0.00%	-2.30%	-2.30%
Open-End Fixed Rate	0	0	0	0.00%	-22.10%	-22.10%
Other Loans[3]	0	0	0	0.00%	-4.50%	-4.50%
Total Loans	1,088,000,000	1,088,000,000	956,998,000	0.00%	-12.04%	-12.04%
Other Assets						
Foreclosed & Repossessed Assets	1,000,000	1,000,000	1,000,000	0.00%	0.00%	0.00%
Fixed Assets[4]	25,000,000	25,000,000	25,000,000	0.00%	0.00%	0.00%
Other Assets	26,000,000	26,000,000	26,000,000	0.00%	0.00%	0.00%
Total Other Assets	52,000,000	52,000,000	52,000,000	0.00%	0.00%	0.00%
TOTAL ASSETS	**1,608,500,000**	**1,614,344,194**	**1,473,934,482**	**0.36%**	**-8.70%**	**-8.37%**

LIABILITIES

For liabilities, the tool uses the account categories as presented in the credit union's Call Report (for example, non-maturity shares, certificates/IRAs, and borrowings, and other deposits and liabilities). These deposit accounts are valued in the tool based on predetermined levels. The value benefit assigned to non-maturity shares is identical to those used in NCUA's NEV Supervisory Test. All 'Other' liabilities with contractual maturities are valued in the model at book value. For shares and borrowings, the premium is specified for both the base case and +300, allowing for comparisons of base versus +300, book versus base, and book versus +300.[7]

For credit unions that hold interest rate derivatives, the base and shocked values are reported on a separate liability line in the Estimated NEV tool. Derivatives with a net positive fair value reduces total liabilities while derivatives with a net negative fair value increases total liabilities.[8]

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[7] As with the NEV Supervisory Test, book equity is measured by subtracting liabilities from total assets; book equity may differ from the statutory measure of net worth used for Prompt Corrective Action.

[8] The book values for derivatives are currently reported in Other Assets and Liabilities as per the call report. The Base value for the "Derivatives" line represents the reported values from Schedule "D", Section 5 in the call report.

The value of the derivatives in the +300 scenario are calculated using an estimate for how much the contract value would change based on the maturity of the derivatives.[9]

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[9] The Up300 values of pay-fixed swap derivatives are estimated as 2.7% of the notional value for each additional year in the maturity of the derivatives. (e.g., $1 Million notional on a five year maturity pay-fixed swaps would increase by 13.5% for a 300 basis point increase in interest rates.) Receive fixed swaps decrease by 2.7% of the notional value for every additional year of maturity. Caps increase by 1.2% of the notional value for every year increase in maturity assuming an option strike price of 100 basis points above the at-the-market Strike rate.

Charter Number ####### | **Credit Union Name** | Effective Date: __/__/____

Estimated NEV Tool

Balance Sheet Category	Book	Base[1]	Up 300	Book vs. Base	Base vs. 300	Book vs. 300
Liabilities						
Non-Maturity Shares						
Regular Shares	225,000,000	222,750,000	213,840,000	-1.00%	-4.00%	-4.96%
Share Drafts	200,000,000	198,000,000	190,080,000	-1.00%	-4.00%	-4.96%
Money Markets	650,000,000	643,500,000	617,760,000	-1.00%	-4.00%	-4.96%
Total Non-Maturity Shares	1,075,000,000	1,064,250,000	1,021,680,000	-1.00%	-4.00%	-4.96%
Certificates & IRA/Keogh Shares						
Certificates & IRAs < 1 Year	200,000,000	200,500,000	197,492,500	0.25%	-1.50%	-1.25%
Certificates & IRAs 1 - 3 Years	100,000,000	100,250,000	94,235,000	0.25%	-6.00%	-5.77%
Certificates & IRAs > 3 Years	40,000,000	40,100,000	35,288,000	0.25%	-12.00%	-11.78%
Total Certificates & IRA/Keogh Shares	340,000,000	340,850,000	327,015,500	0.25%	-4.06%	-3.82%
Borrowings						
Borrowings < 1 Year	0	0	0	0.25%	-1.50%	-1.25%
Borrowings 1 - 3 Years	0	0	0	0.25%	-6.00%	-5.77%
Borrowings > 3 Years	0	0	0	0.25%	-12.00%	-11.78%
Total Borrowings	0	0	0			
Other Maturity Shares & Deposits						
Other Shares & Deposits < 1 Year	730,000	731,825	720,848	0.25%	-1.50%	-1.25%
Other Shares & Deposits 1 to 3 Years	0	0	0	0.25%	-6.00%	-5.77%
Other Shares & Deposits > 3 Years	0	0	0	0.25%	-12.00%	-11.78%
Total Other Maturity Shares & Deposits	730,000	731,825	720,848	0.25%	-1.50%	-1.25%
Other Liabilities						
Total Other Liabilities	22,092,123	22,092,123	22,092,123	0.00%	0.00%	0.00%
Derivatives[5]		4,331,603	(46,278,685)	0.00%	-1168.40%	
TOTAL LIABILITIES	**1,437,822,123**	**1,432,255,551**	**1,325,229,786**	**-0.39%**	**-7.47%**	**-7.83%**
NET ECONOMIC VALUE[6]						
Net Economic Value (NEV)	170,677,877	182,088,643	148,704,696			
NEV Ratio	10.61%	11.28%	10.09%	Low		
NEV Sensitivity			-18.33%	Low		
Overall Rating (highest of two ratings)				Low		

[1] At present, the base scenario uses book-value for most asset groups. Non-maturirty share premiums reflect the values used in the NEV Supervisory Test, while DCCM provided estimated premiums for other shares and liabilities.

[2] Base investment values reflect unrealized gains and losses on AFS and HTM securities. The gains and losses are allocated on a duration-weighted basis. The base value of the remaining investment categories are measured at book value.

[3] Other loans combines all loan types specifically listed above, including other unsecured, PALs, student, and all other loans, and leases receivable.

[4] Fixed assets includes land & buildings, NCUA share insurance capitalization deposit, and other fixed assets.

[5] The estimated Base and Up300 are reported in the Liability section of ENT (negative balances representing an increase in value). The book values for derivatives may be represented in Other Assets/Liabs as per the call report. The Base value for the "Derivatives" line represents the reported values from Schedule "D", Section 5 in the call report. The Up300 values of pay-fixed swap derivatives are estimated as 2.7% of the notional value for each additional year in the maturity of the derivatives. (e.g., $1 Million notional on a five year maturity pay-fixed swaps would increase by 13.5% for a 300 basis point increase in interest rates.) Receive fixed swaps decrease by 2.7% of the notional value for every additional year of maturity. Caps increase by 1.2% of the notional value for every year increase in maturity assuming an option strike price of 100 basis points above the at-the-market Cap rate.

[6] Net economic value is measured off equity, not statutory net worth.

	NEV Supervisory Test Risk Levels			
NEV INDICATOR	Extreme	High	Moderate	Low
Post Shock NEV Ratio	≤ 2%	2% - 4%	4% - 7%	> 7%
Base to Shock NEV Sensitivity	≤ -85%	-65% to -85%	-40% to -65%	> - 40%

HOW WAS THE ESTIMATED NEV TOOL (ENT) DEVELOPED?

NCUA determined that a rough proxy for NEV was necessary in order to estimate and evaluate IRR for those credit unions that do not internally model NEV. The ENT uses Call Report information and generalized assumptions regarding the average duration for asset and liability categories to generate this NEV proxy.

Initial model assumptions were derived through industry research and based upon the average levels of value sensitivity found in data samples compiled by NCUA. To the extent practicable, NCUA relies on observed levels of credit union and industry data to establish and/or modify its standardized parameters.

Balance sheet asset accounts are organized as shown in *Figure 7*. The corresponding estimate of asset sensitivity in a +300 basis point rate shock is also presented.

While asset valuation and sensitivity techniques were highly consistent among observed credit unions, the valuation and sensitivity treatment of liabilities was not. In order to cohere the ENT model output to the NEV Supervisory Test results and make these two models relatively consistent, the same value assumptions for non-maturity shares are used in both (i.e., a 1 percent value benefit on NMS for the base case and a 4 percent value benefit on for the +300 shock scenarios).

The sensitivity of maturity shares and borrowings in the base case and +300 shock scenarios may differ between the ENT model and the NEV Supervisory Test. The NEV Supervisory Test uses the sensitivity estimates of term deposits from the credit union. The ENT model provides sensitivities for the maturity deposits based on the length of maturity as reported by the credit union in the Call Report. Certificates, IRA/Keogh accounts, borrowings, and other shares and deposits with maturities less than 1 year, between 1 and 3 years, and greater than 3 years, provide the credit union with a value benefit of 1.5 percent, 6 percent, and 12 percent, respectively, in the +300 shock scenario. The base case value for these maturity shares adds 25 basis points to the book value of these liabilities.

FIGURE 7. ASSET AND LIABILITY SENSITIVITY ASSUMPTIONS

Balance Sheet Account	Estimated Sensitivity Assumptions (+300bps)
Loans (First Mortgages)	
Fixed Rate > 15 years	-15.8%
Fixed Rate < 15 years	-9.8%
Balloon/Hybrid > 5 years	-9.5%
Balloon/Hybrid < 5 years	-6.6%
Other Fixed Rate	-4.5%
Adjustable Rate < 1 year	-1.0%
Adjustable Rate > 1 year	-9.7%
Loans (Other Real Estate)	
Closed-End Fixed Rate	-12.3%
Closed-End Adjustable Rate	-6.4%
Open-End Adjustable Rate	-2.3%
Open-End Fixed Rate	-22.1%
Credit Cards	-5.3%
New Autos	-5.1%
Used Autos	-2.9%
Other Loans*	-4.5%

Balance Sheet Account	Estimated Sensitivity Assumptions (+300bps)
Investments	
< 1 Year	-1.5%
1-3 Years	-5.2%
3-5 Years	-10.8%
5-10 Years	-17.6%
>10 Years	-26.8%
Other Assets	0.0%
Cash	0.0%
Deposits and Other Liabilities	
Non-Maturity Shares	-4.0%
Maturity Shares and Borrowings	
< 1 Year	-1.5%
1-3 Years	-6.0%
3-5 Years	-12.0%
Other Liabilities	0.0%
* Other loans includes: 1) all other unsecured loans/lines of credit, 2) payday alternative loans, 3) leases receivable, and 4) total all other loans/lines of credit.	

WHAT ARE THE BENEFITS TO USING THE ESTIMATED NEV TOOL?

The greatest benefits are speed, simplicity, and consistency.

- The data used to populate the ENT flows automatically from a credit union's latest Call Report.
- Since the data and formulas are housed in Exam.xlsm, no user input is required for this test. Since no user input is required, there is essentially no risk of user-input error.
- The test can be performed for all credit unions that do not have an NEV model (and for those that do, should a need arise).
- The examiner can view the results of the test immediately. New ENT output results are available as soon as new Call Report data becomes available.
- The ENT is simple to use. The credit union's balance sheet is aggregated per the Call Report fields, and a factor is applied to obtain the result. The examiner can also look at the asset accounts individually to determine the impact of a single account on the overall results.
- The use of a standardized methodology makes it straightforward to compare results across credit unions.

WHAT ARE THE LIMITATIONS OF USING THE ESTIMATED NEV TOOL?

It is important to understand that results from the ENT are a general proxy for risk. The tool contains aggregated data and generalized assumptions about value and sensitivity for broad balance sheet categories (both assets and liabilities). It is not based on instrument-level cash flows the way the NEV Supervisory Test is. Because it is less precise, it is only suitable for smaller, less-complex balance sheets. The tool's parameters are fixed, and need to be evaluated over time for possible changes to ensure the model output remains reliable as a gauge of overall sensitivity to changes in market rates.

- The ENT model uses average sensitivity estimates derived from a sample of credit union IRR reports. The portfolio of the credit union being examined may differ from the sample average. For example, the credit union's investments may have a relatively high degree of optionality. While the ENT applies the same loan book to base assumptions for all credit unions, in reality each credit union has a unique premium or discount.
- ENT incorporates the market value of available-for-sale (AFS) and held-to-maturity (HTM) investments as reported by the credit union into the base valuations of investments.
- The balance sheet accounts in the model are only as detailed as the content of the Call Report. This means the model is based on highly aggregated data and not as precise or

rigorous as analyses that generate actual NEV measures from instrument-level cash flows.

- The model's underlying assumptions for liability values and sensitivities are also standardized and may require adjustment over time.

CAN EXAMINERS ASSIGN AN IRR RATING BASED ONLY UPON RESULTS FROM THE ESTIMATED NEV TOOL?

Yes. If the exam scope requires the examiner to use the IRR Workbook, then the ENT result can serve as the basis for the Market Risk rating. However, unlike the NEV Supervisory Test, the Market Risk rating for an ENT exam is not a required rating floor for the IRR supervisory rating. The examiner may adjust the overall rating based on how the other components of the IRR review are rated but he/she also has the flexibility to use only the ENT result to make a ratings determination and, in those cases, the rating would be the ENT outcome.

NCUA examiners will view the ENT model's output in the Exam.xlsm workbook in AIRES. For IRR Workbook users, the "Market Risk" risk score automatically populates as the assigned risk level.

Steps B, C, and D

b)	**NEV Test**	Post-Shock +300bps		**<=2%**	**2% - 4%**	**4% - 7%**	**>7%**
		NEV Ratio Measure	***Risk Level***	**Extreme**	**High**	**Mod**	**Low**
					OR		
c)	**NEV Sensitivity**	NEV +300bps Sensi-		**>=85%**	**65% - 85%**	**40% - 65%**	**< 40%**
		tivity Measure	***Risk Level***	**Extreme**	**High**	**Mod**	**Low**

d)	**Final NEV Supervisory Test Risk Level**	The final NEV Supervisory Test Risk level is the most unfavorable risk level from the two NEV measurements in Market Risk 1b and 1c above. Sourced from NEV Supervisory Test tab "G".

Examiners will use the NEV Supervisory Test (Tab G) to calculate the post-shock NEV ratio and post-shock NEV sensitivity. The NEV Supervisory Test standardizes the value benefit for all non-maturity shares at -1.0 percent for the base case and -4.0 percent in a +300 bps parallel shock.

The shocked NEV Supervisory Test results are the primary driver for evaluating and assigning a rating to a credit union's Market Risk. The test results flow automatically to Tab A for most of the questions/review steps and permit the examiner to easily verify the results.

The quantitative tests for post-shock NEV and NEV sensitivity are not combined risk measurements. Each is a binding result, and the more severe of the two outcomes becomes the credit union's Market Risk level.

The IRR workbook formulas will automatically take the quantitative results of the NEV Supervisory Test and generate the Market Risk rating based on the criteria described above. Of course, the test results are only usable after the examiner has gone through a data verification process to ensure the data inputs are reasonable and supportable, as described in Section II.

Section II: Verification of Supervisory Test Results (using NEV Supervisory Test results)

- Step A: *Book to Base NEV*
- Step B: *Base to Shock NEV*
- Step C: *Asset Review*
  - Prepayment Speed Analysis
  - Discount Rate Assumption Analysis
  - Investment Assumption Analysis
- Step D: *Funding Review*
- Step E: *Account Aggregation and Data Completeness*
- Step F: *Analysis*

Step A: *Book to Base NEV*

Book to Base	Attribute the variance from Book values (Assets minus Liabs, not NWR) to the Base NEV without consideration to the underlying assumptions and pricing methodologies. Identify the account groups that are contributing to the Premium or Discount using the CU IRR Report. *(e.g. if Loans are the primary group contributing to the change, what sub-account(s) of loans are the largest contributor(s))(AFS securities and Derivatives should have little impact from book to base given the accounting requirement for Fair Value)*

Using the results of the NEV Supervisory Test, examiners will attribute the variance from book to base NEV. What are the book and base case metrics? What is the credit union's change in book to base case?

FIGURE 8. TAB A: *MARKET RISK* – CHANGE IN BOOK TO BASE NEV RATIOS

Book Ratio	11.01%	**Assets Contribution to change:**	*-0.05%*	**Products:**	Loans	-0.05%	Invest	0.00%
Base Ratio	11.46%	**Liab Contribution to change:**	*0.50%*	**Products:**	NMS	0.61%	Non-NMS	-0.11%
Change	***0.45%***							

By comparing the book measure of net worth to the base case NEV, one can observe if there is a reported increase or decrease in economic value of the current balance sheet. This helps determine whether the base NEV (that is, the starting point from which shock scenarios are run) is reasonable. It is important that base NEV be realistic and supportable because an overstated base NEV can lead to understated and misleading post-shock test results.

Examiners need to attribute the change between book ratio and base ratio. Specifically, did assets or liabilities have largest impact on the change? This is a critical step in understanding the valuations assigned to assets and liabilities (with the exception of NMS) and how their economic value compares to the book value. This attribution can be done by reviewing NEV drivers in Tab G: NEV Supervisory Test.

In *Figure 8*, for example, Tab A: *Market Risk* indicates that the book to base change in ratio was 45bps (11.01 percent to 11.46 percent).

The table in Tab A will also identify which major account category(s) is contributing to the change. In the example in *Figure 8*, loans contribute -5bps, investments have zero impact, NMS contribute 61bps, and other contractual liabilities contribute -11bps, all netting/totaling to a change of +45bps.

Figure 9 is a sample of model results as presented in the NEV Supervisory Test. This figure illustrates the Net Ratio attribution from book to base.

FIGURE 9. SAMPLE RESULTS FROM NEV SUPERVISORY TEST

		Credit Union		
		Book ($ in thousands)	Base ($ in thousands)	Up 300 ($ in thousands)
NEV Ratio Drivers	Cash		0.00%	0.00%
	Loans		-0.05%	-6.10%
	Investments		0.00%	-0.60%
	Other Assets		0.00%	0.00%
	Total Assets		-0.05%	-6.71%
	Total NMS Accounts		0.61%	2.05%
	Total Non-NMS Accounts		-0.11%	0.97%
	Total Liabilities		0.50%	3.02%
	Net Ratio Attribution		0.45%	-3.69%
EV Stats	Estimated DUR Mismatch (+300)			1.28
	Estimated DUR Gap (+300)			1.38
	CU NEV $ (Book / Base / +300)	238.94	248.59	155.43
	CU NEV Ratio (Book / Base / +300)	**11.01%**	**11.46%**	**7.77%**

Examiners' review of these results need to assess the key account groups that contribute to any change from book net worth to base case NEV. Four key metrics are provided in the Market Risk tab: loans, investments, NMS, and non-NMS.

Unusual or high premiums/discounts in any of these account groups should be further explained by referring to the credit union's IRR report. Examiners may need to review sub account groups (that is, real estate loans, consumer loans, indirect loans, investment types, etc.) in greater detail to explain and isolate the underlying source of sensitivity that is impacting the main account group(s) variance. Here, examiners do not need to provide an assessment of the reasonableness and supportability of the discount or premium. Rather, he/she is capturing data to help explain which assets or liabilities create the most impact on the variance between book net worth and base case NEV.

Step B: *Base to Shock*

b)	**Base to Shock**	Attribute the variance from base values to the shocked NEV without consideration to the underlying assumptions and pricing methodologies. Identify the account groups that are contributing to the premium or discount using the CU IRR Report. *(e.g. if Loans are the primary group contributing to the change, what sub-account(s) of loans are the largest contributor(s)).*

Using the results of the NEV Supervisory Test from Tab G, examiners will attribute the variance from base to post-shock NEV. What are the base and post-shock case metrics? What is the change in base to post-shock scenario? What are the key drivers affecting the change from base to post-shock? Four key metrics are provided: loans, investments, NMS, and non-NMS.[10]

FIGURE 10. TAB A: *MARKET RISK* – CHANGE IN BASE TO POST SHOCK NEV RATIOS

Base Ratio	11.46%	**Assets Contribution to change:**	*-6.71%*	**Products:**	Loans -6.10%		Invest -0.60%
Shocked Ratio	**7.77%**	**Liab Contribution to change:**	*3.02%*	**Products:**	NMS 2.05%		Non-NMS 0.97%
Change	***-3.69%***						

A table like the one in *Figure 10* resides in the Market Risk tab and flows up automatically from the NEV Supervisory Test tab. Examiners will review and compare the base case versus post-shock values for each balance sheet component to identify the primary contributors to the change in post-shock NEV. Examiners will identify the asset categories that are most sensitive to rate shocks. In *Figure 11*, the attribution for the -3.69 percent variance between base NEV and post-shock NEV (11.46 percent to 7.77 percent, respectively) is summarized.

FIGURE 11. SAMPLE RESULTS FROM NEV SUPERVISORY TEST

		Credit Union		
		Book ($ in thousands)	*Base ($ in thousands)*	*Up 300 ($ in thousands)*
NEV Ratio Drivers	Cash		0.00%	0.00%
	Loans		-0.05%	-6.10%
	Investments		0.00%	-0.60%
	Other Assets		0.00%	0.00%
	Total Assets		-0.05%	-6.71%
	Total NMS Accounts		0.61%	2.05%
	Total Non-NMS Accounts		-0.11%	0.97%
	Total Liabilities		0.50%	3.02%
	Net Ratio Attribution		0.45%	-3.69%
EV Stats	Estimated DUR Mismatch (+300)			1.28
	Estimated DUR Gap (+300)			*1.38*
	CU NEV $ (Book / Base / +300)	238.94	248.59	155.43
	CU NEV Ratio (Book / Base / +300)	**11.01%**	**11.46%**	**7.77%**

[10] Non-NMS refers to other liability accounts that are not classified as NMS. In the example in *Figure 11*, loans are the asset category that drive most of the variance on the asset side, while the NMS accounts are the primary driver on the liability side.

In *Figure 11*, observe the changes in valuations for assets in the rate shock and observe the changes at the category line.

The overall percentage change from the base NEV to the post-shock NEV is a -369bps, attributed by combining -671bps from assets and +302bps from liabilities. The primary attribute in the assets section is loans (-610bps), with investments showing a modest -60bps, and no contribution (as expected) from cash and other assets.

To understand which types of loans or investments are causing the percentage change, examiners will need to review the credit union's detailed IRR report. The report should disaggregate the loans and investments in greater detail. It is important to understand which assets are the most sensitive in the shock scenarios. Products with cash flows that do not reprice quickly (for example, fixed rate mortgages) or reprice to a limit (for example, adjustable-rate mortgages with caps) are more sensitive to interest rate shocks than those with shorter maturities.

For this step, examiners do not need to provide an assessment of the reasonableness of the discount or premium. The objective of this step is simply to attribute and capture assets or liabilities that generate the most sensitivity.

Step C: *Asset Review*

c)	**Asset Review**	Determine the reasonableness of the material asset categories price or value changes (% movement) for Base and Shock using the CU IRR report. Are Asset valuations, durations and sensitivity measures reasonable, supportable and observable? *The analytics to the right are the changes in values from book-to-base and base-to-shock, however, examiners should review the valuations that support these changes.*

Examiners will review the reasonableness of the credit union's IRR model output for each unique asset category for book versus base and base versus shock.

The *NEV Supervisory Test* tab presents four asset categories: cash, loans, investments, and other assets. Examiners should focus on the three main account groups in the assets category: cash, loans, and investments. The "other assets" category will usually represent an insignificant portion of total assets. Unusual or high premiums or discounts in any of these account groups should be further explained by referring to the credit union's IRR report. Examiners should review the sub account groups (e.g., real estate loans, consumer loans, investment types) to determine whether the effects of these sub account groups on the main account group(s) are reasonable. This can be accomplished by analyzing the changes from book to base case scenarios and base case to shock scenarios.

Examiners will review and compare the book and base values for each balance sheet component to determine the primary contributors to the base case NEV premium or discount. Large premiums or discounts at the base level will have a significant impact on the post-shock measurements and the NEV Supervisory Test results. If such large premiums/discounts are not reasonable and supported, then the NEV measures become distorted and unreliable. *Figure 12* illustrates how the sensitivities of the general asset groups are presented to show how much each is contributing to the base case and shocked valuations.

FIGURE 12. SAMPLE OF ASSET SENSITIVITIES

Asset Group	% of Assets	Base Δ	Shock Δ
CCE	3.53%	0.00%	0.00%
Loans	85.08%	-0.05%	-8.35%
Investments	7.38%	0.00%	-9.49%
Other	4.01%	0.00%	0.00%
Total	**100.00%**	**-0.05%**	**-7.81%**

By looking at these results, examiners can determine whether to look at underlying sub accounts to determine what is driving the higher sensitivities within an asset category. Examiners may wish to review these categories when they see large or unreasonable sensitivities. There are multiple factors that can account for higher sensitivity and these include the estimated timing of cash flows and the respective discount rates used to present value them. Sensitivity is a function of an instrument's average life and the discount rate used to calculate the present value of its future cash flows. For assets, shorter maturities and lower discount rates raise values (and higher asset values benefit NEV). For liabilities, longer maturities and higher discount rates bring down liability values (and lower liability values benefit NEV). All things remaining equal, maximizing aggregate asset values maximizes the calculated base case NEV (and higher NEV values are indicative of financial strength).

In *Figure 12*, loans are marked down at a discount of -.05 percent. Normally, the loans and investments will have a change from book to base (either a premium or discount). In some instances, if a credit union only has available-for-sale (AFS) securities, the book and base values will be equal because they are reported at fair value on the balance sheet. Valuations for AFS portfolios should be consistent between accounting and risk management; however, differences may occur. If the differences are significant, they should be explained by the credit union. Review the Equity section of the Call Report to identify the credit union's net unrealized gains (losses) associated with the AFS portfolio.

Again, the objective of this step is to determine if the credit union is using reasonable and supportable values and to identify the account components that may materially impact the NEV results. Establishing reasonable and supportable values for assets may involve the use of market or matrix prices in the case of investments and/or modeled fair value estimates in the case of loans. Examiners should be comfortable with the sources for price/value estimates.

For example, an observable input for investments would be a price quote or estimate from an industry recognized pricing service and a modeled fair value estimate for real estate loans could be derived from observed values of instruments issued by government-sponsored enterprises (for example, Fannie Mae or Freddie Mac).

NCUA (OIS) pricing tables can help examiners understand current valuation and shock sensitivities for mortgage loans.

To gauge the reasonableness of a credit union's price/value assumptions, it is important to understand how certain embedded options will impact the estimated values of instruments. A credit union's cash flow estimates, earnings-at-risk, and NEV measures need to sufficiently capture these effects. A common example of an embedded option in investment assets is a callable bond, one that can be "called" prior to the stated legal final maturity at the discretion of the issuer (mature early). For callable securities, the strike price or strike yield (the price or yield at which the security will be called) may be reached under a falling rate scenario. This reduces the amount of price appreciation as compared to a non-callable bond with the same legal final maturity. For earnings simulation models, this will result in reduced earnings (due to reinvestment at reduced yields). For valuation models, asset appreciation in a falling rate environment will be restricted by the call. The cash flows and valuation estimates must capture option risk.

In rising rate scenarios, the callable security's performance will resemble a fixed-rate Treasury of similar legal final maturity.

Embedded options also exist in loans. For example, the option to make unscheduled principal payments (prepayments) on a mortgage. Credit unions will need a reliable means to establish the estimated cash flows and values for loan assets. This is a major input for NEV because the majority of most credit unions' assets are held in loans, and a significant portion of those loans are mortgage related. For credit unions lacking advanced ALM models, there are additional methods for measuring IRR in mortgage loans. Using mortgage-backed securities as a proxy, credit unions can obtain estimates of risk exposure on their mortgages. Industry-recognized information providers (such as Bloomberg and CMS BondEdge) also provide estimated price sensitivity of individual securities.

For most securities, current and shocked values can readily be obtained through industry-recognized pricing sources or from a primary market maker such as a broker/dealer. Many securities have embedded options and, if the feature is available, the price source should be generated in an Option Adjusted Spread (OAS) mode so as to more accurately treat embedded options consistent with market convention. If the credit union's source is Bloomberg, for example, this service has an OAS pricing capability if the user activates it. The underlying risk management objective is to use reasonable and supportable prices, discount rates, and cash flow assumptions whenever practicable. This process becomes more dynamic as instrument holdings become more material, complex, and risky (especially embedded options).

If the model computes investment valuations, it should consider the impact on principal and interest cash flows of all types of embedded options and payment structures. Such options include calls and interest rate caps and floors. Furthermore, the model should be able to accommodate those investments with structured features (such as real estate mortgage investment conduit (REMIC) securities), prioritized cash flows, or subordinated classes of bonds within a deal. A model that fails to accurately forecast expected cash flows will reduce the accuracy and reliability of the risk measures and may materially misstate the level of risk.

If unusually high asset premiums or discounts are observed in the book versus base case, examiners should review the model assumptions for reasonableness. If the loan or investment portfolios are incorrectly valued in the model, the credit union needs to correct the deficiency and re-run the model to ensure model results and the revised NEV Supervisory Test are accurate; otherwise, these results will cause the NEV Supervisory Test to produce unreasonable and inaccurate results.

If the credit union is unable to correct and re-run the model during the examination, examiners should consult with a supervisor, regional capital markets specialist (RCMS), or senior capital markets specialist (SCMS) from the Division of Credit and Capital Markets (DCCM) to review the situation and assess the potential need for additional supervision in the future. A credit union's inability to correct and re-run a model during an examination may also require an examiner to utilize the ENT for NEV Supervisory Test purposes. While the ENT is less dynamic, it does provides a risk proxy that can help identify the potential level of market risk inherent in a balance sheet.

Effective duration for total assets can be found in cell G27 of Tab G: NEV Supervisory Test. The lower the effective duration, the more favorable the IRR risk level will be. This metric is optional and not required for the calculation of the NEV Supervisory Test.

In general, the longer the loan term, the higher its duration (for example, the duration of a newly issued mortgage will be greater than that of a new auto loan). Also, the longer the duration, the more sensitive the asset's value becomes for a given interest rate shock (for example, mortgage values decline more than car loans in a +300bps shock). Examiners should look for price changes that don't appear consistent with the asset maturity or type. Unusual duration estimates or shocked-value changes may indicate a model weakness and should be discussed with the credit union. If the credit union cannot provide a reasonable explanation for the durations and shocked changes in the IRR model report, this may be an indication of weak IRR management. Not all ALM models in the marketplace provide effective duration for each asset type. Examiners' review should focus on the valuation and shocked sensitivity of each asset class and duration, if available.

Asset valuations, sensitivity, and duration measures are distinct but have similar ways to gauge the level of IRR. Because not all ALM models provide results for these three measures, examiners can choose to analyze the credit union's assets using any one of these measures.

For more guidance, see NCUA Letter to Credit Unions 99-CU-12, Real Estate Lending and Balance Sheet Management (August 1999).

To develop an intuition about the factors that drive value sensitivities and risk, the table below provide some general guidance in the form of short-hand observations. These are helpful reminders of how key drivers of risk impact asset values and NEV results.

Assets
Higher NEV could be the product of higher market values or from lower discount rates and/or shorter cash flows.
Lower NEV could be the product of lower market values or from higher discount rates and/or longer cash flows.

As a guideline for understanding how much duration is inherent in different asset types, examiners would benefit from reviewing *Figure 7*, Asset and Liability Sensitivity Assumptions, to understand the typical asset devaluations expected for a +300bps shock.

Prepayment Speed Analysis

Retail amortizing loans and mortgage-related investments contain embedded prepayment options, where the borrower has the right to make unscheduled principal payments or pay off a loan entirely without penalty. Commercial loans may contain prepayment penalties or contractual clauses deterring prepayments, but prepayments will occur if the incentive is sufficient. If the credit union's model does not account for prepayments, or does not account for them properly as addressed in the following questions, the results will be inaccurate. This is true for both earnings-at-risk and NEV measures.

To accurately capture the projected cash flows of these instruments, prepayment of principal should be estimated under static, positive, and negative rate shocks. Estimating prepayments under these different interest rate scenarios is important because prepayments tend to decline in rising rate scenarios, and increase in falling rate scenarios due to the refinancing incentive.

Credit unions are likely to obtain prepayment estimates from a recognized industry source. Information providers can provide prepayment estimates for mortgage-related securities. These estimates can also be used as proxies for mortgage loans with similar terms and characteristics. Prepayment behavior is dynamic and estimates change over time in response to market factors, such as rate levels and home prices. It is important for modelers to keep current with prepayment estimates and recognize that different types of loans can have very different prepayment behavior.

Stale prepayment data can lead to inaccurate prepayment assumptions and an inaccurate IRR measurement. Accordingly, a credit union should assess its prepayment assumptions no less

frequently than once each year to determine if the assumptions are still valid. For complex institutions, the prepayment estimate may need to be updated more frequently.

The prepayment estimates must be consistent with the characteristics of the asset (such as loan or structured investment). Prepayment estimates may be created on a highly segregated basis (where a separate prepayment estimate is developed for each account) or on an aggregated basis. If the credit union develops a prepayment table on an aggregated basis, the prepayment data should reflect the aggregate prepayment history for each type of loan. For example, if the credit union aggregates its fixed-rate real estate loans for modeling purposes, the prepayment table should incorporate the prepayment performance for each type and maturity of fixed-rate real estate loans in portfolio. Applying an inappropriate prepayment estimate will lead to less reliable results.

It is preferable if the prepayment estimates come from a source independent from the risk modeler. The lending officer or third-party information provider (for example, Bloomberg or CMS BondEdge) should be a suitable source. It is also preferable that estimates are documented with empirical evidence (such as a regression analysis). However, the observed borrower type's historical experience with prepayments can be sufficient if the estimates appear reasonable. For example, a high prepayment estimate may be valid if the credit union's membership consists of transitory members (for example, loans will be repaid with the sale of the property). Conversely, if a credit union's portfolio consists of seasoned loans with low loan-to-value ratios made to a stable membership, then the prepayments may be low even in a falling rate scenario. These factors tend to reduce the member's refinancing incentive, thus precluding high prepayments.

If a credit union cannot support its prepayment assumptions with empirical evidence or reasonable assumptions, exception should be taken. The prepayment assumptions should be considered questionable and the results are likely to be unreliable.

At a minimum, prepayments should increase in declining rate environments and decrease in rising rate environments. In crude models, the prepayment rate is not adjusted to reflect changing prepayments in rising and falling interest rate environments (meaning that the prepayment rate for the static rate scenario is maintained for the shocked interest rate environment). This does not adequately reflect the true prepayment behavior of mortgages and is unacceptable. At a minimum, the prepayment factor should be adjusted to reflect the static and stressed interest rate scenarios.

A static prepayment factor is one where a single prepayment rate is applied to an account (for example, assuming that mortgages will prepay at 10 percent until maturity). Because loans do not generally exhibit the same prepayment rate over their entire maturity, maintaining a constant prepayment rate for the entire horizon of expected cash flows will lead to increasingly less reliable results.

A better way to project prepayments of amortizing cash flows is to use a prepayment table. In this case, the credit union (or third-party information provider, such as Bloomberg) develops a prepayment matrix to estimate the potential prepayment rate based on factors such as refinancing (most common), defaults, curtailments (additional principal payments made by members), and insurance payoffs. For example, to determine the prepayments due to refinancing, the prepayment model may compare the mortgage portfolio's weighted average coupon rate with the current market rates.

For each period that cash flows are calculated, the model will apply the prepayment factor from the table to determine the amount of unscheduled principal that is paid down. Thus, rather than assuming a constant rate, prepayments will change from period to period.

Discount Rate Assumption Analysis

Each account being valued should be assigned a distinct observable market discount rate/source. The discount rate should reflect the current market offering rate for an asset or liability with similar characteristics. For example, a 5-year Treasury note with 3 years to maturity should be discounted by the current 3-year Treasury yield, and a mortgage portfolio with a weighted average remaining term of 15 years should be discounted by the current market rate on 15-year mortgages.

In general, the discount rate used in the model should be tied to an observable market rate for a similar product type to ensure that the estimated value is consistent with how market participants would consider a similar fair value transaction. Using the loan's coupon rate as the discount rate would be inappropriate because a loan's coupon rate does not incorporate readily observable market inputs. Similarly, it would be inappropriate to use the credit union's current offering rates on loans/shares as discount rates if the offering rates are not reflective of the market. Using implausible or unreasonable discount rates (those at significant variance from observable market proxies) will provide unreliable valuation results.

Examiners should considering the following effects of discount rates on NEV when evaluating asset valuations:

Lower Discount Rates
Lower discount rates generate a higher present value of assets.
Higher asset values result in higher NEV.
Higher Discount Rates
Higher discount rates generate lower present value of assets.
Lower asset values result in lower NEV.

Investment Assumption Analysis

For most securities, current and shocked values can be readily observed and obtained through a market source such as Bloomberg, CMS BondEdge, or another industry-recognized information provider. As indicated above, AFS securities should have a similar value in the book versus base case given that generally accepted accounting principles (GAAP) require AFS securities to be presented at fair value on the balance sheet.

Step D: *Funding Review*

d)	**Funding Review**	Determine the reasonableness of the material contractual liability categories (e.g. CDs, borrowings and derivatives) price or value changes (% movement) for Base and Shock using the CU IRR report. Are the valuations, durations and sensitivity measures reasonable, supportable and observable? *The analytics to the right are the changes in values from book-to-base and base-to-shock, however, examiners should review the valuations that support these changes.*

Examiners will review the reasonableness of the modeled output for each unique contractual liability category[11] for book versus base and base versus shocked liability valuations, sensitivity, or effective duration. Again, for the purpose of this review, NMS review is simplified because the NEV Supervisory Test standardizes the value benefit applied to these liability types.

FIGURE 13. SAMPLE OF LIABILITY VALUES

Liab Group	% of Liabs	Base Δ	Shock Δ
NMS	66.44%	-1.00%	-4.00%
Certificates	22.50%	0.68%	-3.31%
IRA/Keough	2.15%	1.01%	-5.24%
Borrowings	7.94%	-0.54%	-5.72%
Other	0.97%	0.00%	0.00%
Total	**100.00%**	**-0.55%**	**-3.97%**

Figure 13 represents a standard extract from the data template and it illustrates an example of values for a credit union's liabilities. In this example, the credit union has a -0.55 percent value on total liabilities for the base case.[12] Contractual funding (such as certificates of deposit and term borrowings) also contributes to the liability value. The book to base amount on certificates

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[11] For example, liabilities with explicit maturities, such as certificates of deposit and term borrowings.

[12] For liability values, negative numbers will be referred to as "premiums" and positive numbers will be referred to as "discounts."

is a discount of 0.68 percent. Examiners will review premiums on contractual funding for reasonableness. Examiners are to use this same process for all remaining liabilities (like IRA/Keogh certificates, borrowings, and other liabilities).

Member share certificates have generally observable values because they are term deposits with known contractual cash flows and are typically present valued using the relevant discount rates for market funding (such as advance rates for Federal Home Loan Banks member borrowing). Share certificates are still susceptible to early redemption risk, however, and if there is a large concentration of members who call (or withdraw) their share certificates early, these liabilities can experience a reduced value benefit. One reason why members may call certificates could be to take advantage of alternative income opportunities during a rapid rise in market interest rates. This may become a relevant modeling issue when a credit union has a sizable concentration of certificates (that is, >20 percent of shares) with longer maturities (for example, 1–5 years). Examiners should keep in mind that longer term liabilities produce more favorable NEV outcomes. The model assumptions should take early-redemption risk into account when projecting cash flows if there is a reasonable expectation that early redemptions will occur.

Borrowings with call options are likely to be called in rising rate scenarios because the lender can reissue debt at a higher interest rate. For NEV, liability depreciation in a rising rate environment should be restricted by the call option. This is an example of how optionality in the balance sheet needs to be captured in the model.

In falling rate scenarios, the callable liability's performance will resemble a non-callable liability of similar maturity (for example, the liability's interest cost will fall modestly, as principal paydowns result in funding at lower costs, and valuation will be more favorable).

If a credit union uses derivatives to hedge IRR, examiners will confirm where the impact of these instruments is reported on the ALM report. If derivative values are embedded in the NMS categories, then the impact needs to be isolated and recorded onto the Other Liability line. For questions about derivatives, examiners can contact their supervisor, an RCMS, or E&I specialized staff.

Step E: *Account Aggregation and Data Completeness*

e)	**Account Aggregation and Data Completeness**	Are the account aggregations for risk assessment suitable for consistent risk characteristics and is there a documented reconciliation of the data in the ALM model vs the call report and general ledger?

Examiners will review the account aggregation in the credit union's ALM model and determine if the aggregation is suitable for the balance sheet complexity. Examiners will confirm that the account information in the ALM report is complete and reconciled to the credit union's general

ledger. At a minimum, examiners should compare the ALM report data to the credit union's financial statements to ensure all accounts are captured.

Account aggregation is the process of grouping together accounts of similar types and cash flow characteristics. This is an important component of the data input process as account aggregation improves the measurement system's efficiencies. Typically, loans of similar rate, maturity, and type are aggregated. For example, credit unions may group 6 percent, 30-year fixed rate residential loans together, but it would be inappropriate to group 6 percent, fixed-rate residential loans with 6 percent, adjustable-rate residential loans.

The degree of account aggregation will vary from one credit union to another. Credit unions should ensure the model allows for a sufficient separation of accounts with significantly different cash flow patterns. For example, models that aggregate information based on Call Report data may not provide the granularity necessary for institutions with significant levels of embedded options. When applicable, credit unions should ensure their systems have the ability to model highly structured instruments and credit union-specific products.

Both contractual and behavioral characteristics should be considered when determining the cash flow patterns of accounts to aggregate. The process of determining which accounts are combined should be transparent, documented, and periodically reviewed. Furthermore, requests for changes to existing groups or new account aggregations should be formalized and documented. Credit unions should maintain documentation disclosing the characteristics of aggregated assets and liabilities (including all derivative instruments) and off-balance sheet items.

Step F: *Analysis*

f)	**Analysis**	How does the Supervisory Test NEV and NEV Sensitivity metrics compare to the credit union NEV results. *The difference between the two measurements will be the valuations assigned to NMS. Describe the base and shock difference and how the difference contribute to the differences in NEV.*

Examiners will compare the NEV Supervisory Test results to the credit union's NEV model outputs. Because both models use the same data inputs except for NMS, any variance should only be attributed to the difference between the credit union's NMS values and the standardized values used in NCUA's valuation assumptions for base and shock scenarios. Also, examiners will compare the results of the credit union's measures to its IRR policy limits.

Depending on the degree of variance between the credit union's results and the IRR test, examiners will apply judgement on what corrective action will be taken, if any. For excessive variances, examiners should report on the difference. The NEV Supervisory Test is meant to help the agency rank-order risk and identify outliers by measuring all institutions on a relative

basis. When large variances exist between a credit union's internal NEV measure and the results of the NEV Supervisory Test, NCUA seeks to understand the underlying source of the difference and whether a high Market Risk score result is cause for concern. An NEV Supervisory Test that results in high market risk will require a commensurate elevated level of risk management expertise, measurement systems, contingency planning, and liquidity. A credit union with high market risk may possess a sufficiently commensurate program, but its burden of proof will be significantly higher than for moderate or low market risk rated institutions.

Figure 14 presents such a variance. This example shows how a credit union's model may generate favorable IRR results, yet the NEV Supervisory Test indicates that the credit union's IRR position is significantly higher. The variance does not necessarily indicate a problem with the credit union's model input or results. However, the examiner should ensure premiums assigned to assets and liabilities are supported with observable data and that the credit union's scenario analysis is focused on identifying key drivers of risk in the balance sheet through thoughtful sensitivity analysis around their key assumptions, including the behavior of NMS.

FIGURE 14. ILLUSTRATION OF VARIANCE BETWEEN RESULTS OF CREDIT UNION'S NEV TEST AND NCUA'S NEV SUPERVISORY TEST

	Base NEV	Shock	NEV Change
CU Results	14.09%	11.71%	-23.40%
Sup Test Single	11.46%	**7.77%**	**-37.48%**
Difference	***-2.63%***	***-3.94%***	***-14.08%***

Scoring Guidelines

The credit union's Market Risk score will automatically populate using the risk level results from the NEV Supervisory Test. However, the IRR indicators shown in *Figure 15* are additional balance sheet factors that can contribute to the level of market risk.

FIGURE 15. MARKET RISK INDICATORS FOR IRR

Interest Rate Risk Indicators				
	Low	**Moderate**	**High**	**Extreme**
Market Risk	• Balance sheet valuations and interest rate sensitivities indicate there is a minimal (low) IRR exposure.	• Balance sheet valuations and interest rate sensitivities indicate there is a moderate IRR exposure.	• Balance sheet valuations and interest rate sensitivities indicate there is a significant (high) IRR exposure.	• Balance sheet valuations and interest rate sensitivities indicate an extreme potential that the capital position will be adversely affected.
	• The level of net worth provides substantial support for the degree of IRR exposure taken by the credit union.	• The level of net worth provides adequate support for the degree of IRR exposure taken by the credit union.	• The level of net worth may not be adequate to support the level of IRR exposure taken by the credit union.	• The level of net worth may not be adequate to support the level of IRR exposure taken by the credit union.
	• Accounts are well stratified and there are appropriate settings to support valuations for IRR reporting.	• Accounts are adequately stratified with material accounts detailed using appropriate settings to support valuations and sensitivities for IRR reporting.	• Accounts do not adequately stratify the material accounts on the balance sheet, nor are the settings appropriate to support the valuations for IRR reporting.	• Accounts do not adequately stratify the material accounts on the balance sheet, nor are the settings appropriate to support the valuations for IRR reporting.

The Market Risk scoring tab will automatically populate with the score that results from the NEV Supervisory Test as a "Ratings Floor" for the Overall Rating (see Ratings Guidance in the Market Risk section).

MR Score	**Automatic Scoring of Risk Score from NEV Supervisory Test results**

Tab B: *Earnings at Risk (EAR)*

Credit unions generate multiple income simulations for a variety of scenarios in order to assess the EAR exposure that can arise from changing interest rates. The EAR review delves into the credit union's income simulation analyses and is an important complement to NEV. EAR information provides insights into the actual structure and timing of cash flows for assets and liabilities and allows the user to get behind what the NEV number conveys and understand when IRR impacts the credit union's earnings stream. Credit unions should be utilizing multiple scenarios to understand how IRR will impact its earnings stream over a multi-year horizon. Examiners will verify the assumptions, rate scenarios, and results of EAR measurements versus the credit union's internal IRR policy limits. Examiners will also use income simulation information to get a more comprehensive understanding of the credit union's liquidity and contingent capability to address any concerns that may be raised by the results of the Market Risk score.

An income simulation analysis projects interest cash flows of all assets, liabilities, and off-balance-sheet instruments in a credit union's portfolio to estimate future net interest income over a chosen timeframe. Generally, income simulations focus on short-term time horizons (for example, one to three years). Forecasting income is sensitive to a number of assumptions; thus, the reliability of simulation results becomes more uncertain as the forecast horizon period gets longer. Simulations typically include evaluations under a base case scenario and for stressed conditions including an instantaneous, parallel, and sustained rate shock. Many credit unions generate other alternate interest-rate scenarios, such as more gradual or "ramped" changes in rates, changes in the shape of the yield curve, or any other stressed rate environments devised by a user or provided by a vendor.

Tab B: *EAR and Other IRR Measurements Risk* is broken into two sections containing six steps.

- Section I: Earnings at Risk
- Section II: Earnings at Risk Verification
- Scoring Guidelines

Section I: Earnings at Risk

- Step A: *Base Simulation Results*
- Step B: *Shocked Simulation Results*

Step A: *Base Simulation Results*

a)	**Base Simulation Results**	How do the Base Case results compare to the credit union's actual performance? How do the projected interest income levels and earnings metrics (NII, NIM) compare to results historically achieved by the credit union? If management uses other means to measure the earnings risk exposure, explain the credit union's approach and how the results compare to the results historically achieved by the credit union.

Examiners should evaluate base case results relative to a credit union's actual earnings performance based on the most recent annual Financial Performance Report (FPR). The credit union's projected net interest income and net interest margin (NIM) should generally be in line with results historically achieved by the credit union. For example, an examiner should question a credit union that projects a base case net interest margin of 4.00 percent when the FPR shows that the highest NIM achieved by the credit union in recent years is only 3.50 percent. The base case income simulation for the near-term horizon should be highly consistent with credit union's corresponding pro forma earnings forecast, since both represent an expected (or most likely) earnings amount.

The starting point for income simulations needs to be firmly rooted in accurate, reasonable, and supportable conditions. Similar to overstated base case NEV results, overstated base case EAR results could lead to an understatement of earnings sensitivity in the shocked and alternative EAR scenarios. Examiners that find unreasonable base case EAR results (in relation to the credit union's historical performance) should review carefully the asset and liability assumptions described in the Earnings at Risk Verification section.

Not all ALM models measure EAR in the same way. One common method projects a credit union's net interest income for a 12-month period under base case and alternative interest rate scenarios, and then calculates the percentage change in net interest income relative to the base case results. However, other variations and time horizons do exist and are acceptable approaches. The review of EAR will note a credit union's basic approach and explain how the results compare to those historically achieved by the credit union. In addition to running scenarios for parallel rate shocks, credit unions should be encouraged to run income simulations that incorporate yield curve shape changes (that is, steepening and flattening scenarios), as well as sensitivity analysis for assumptions that have a largest impact on EAR results, such as changing prepayment speeds, NMS behavior, and spread widening from key market index rates.

Step B: *Shocked Simulation Results*

b)	**Shocked Simulation Results**	How do the Shocked results compare to Policy limits? Compare the earnings simulation NII/NIM levels of base case to the shocked scenarios and review the results to determine if reasonable and supportable.

Examiners should evaluate the shocked EAR results relative to internal policy limits and determine if any policy limits have been breached. Preferably, the policy limits are based on the industry standard: an instantaneous and parallel shift in interest rates of +/- 300 bps. If policy limits have been breached, examiners should determine if the violation has been reported to the ALCO and board of directors in a timely manner and whether management has elected to take corrective action to reduce the credit union's EAR exposure.

An important indicator of effective risk management is how credit union staff monitor and react to IRR measures. Credit unions that use risk measurement information to make business decisions (whether it be purchases, sales, or some other kind of risk mitigation such as hedging) are more likely to optimize their net worth and earnings performance over time. Examiners should take into account the degree to which the credit union is conducting EAR analysis for proactive risk management purposes as opposed to generating test results to meet compliance expectations.

Section II: *Earnings at Risk Verification*

- Step A: EAR Results - Assets
- Step B: EAR Results - Liabilities
- Step C: EAR Scenarios
- Step D: Assumption Changes

Step A: *EAR Results - Assets*

a)	**EAR Results Assets**	Evaluate if the interest income generated by the material asset account categories are reasonable for base case and shocked scenarios relative to the credit union's current and historic levels. Evaluate the material assumptions used to generate interest income (e.g. prepay speeds, maturity distribution, key rates, spreads).

Interest income projections under EAR simulations are generated from a combination of both a credit union's existing asset product mix and its new business volume attributes. This is because the modeler must decide whether or not to replace maturing and runoff activity. If it is replaced,

the modeler must decide whether to keep the portfolios unchanged (static) or incorporate new business (like planned reallocations or growth).

The reasonableness of the interest income generated by the credit union's existing asset product mix is dependent on the type of processing performed within the model (instrument level or portfolio level), the accuracy and completeness of the core data input into the model (contractual cash flows, repricing dates, repricing spreads, rate sensitivity factors, caps, floors, or others), and the reasonableness of prepayment assumptions. As with NEV, the model's rigor and precision is a function of how detailed or granular the data inputs for assets and liabilities are. If the model uses instrument-level cash flows, the model output is considered more precise and reliable.

The reasonableness of the interest income generated by the credit union's new business volume is largely dependent on additional factors, such as the maturity distribution of new business (like the percentage of car loans made for 36-months, 60-months, and 72-months, or other maturity terms) and the rates received on the new business. These assumptions can also be assessed for reasonableness by looking at them in relation to historical pricing, the market in which they operate, and recent trends in member behavior.

To evaluate the reasonableness of the existing asset product mix, an examiner should review the results of any independent model validation or review that the credit union might have. This validation or review may have been performed by an outside vendor or the credit union's internal auditor. If a model validation or review has not been performed, examiners should ask the credit union to provide a list of the account fields that are input (automatically or manually) into the model in order to determine if any key fields are missing. For example, an adjustable-rate mortgage loan should have fields for repricing date or interval, repricing index and spread, and periodic and lifetime caps and floors, among others.

If the credit union is not populating these fields with actual account data, interest income will not be correctly computed in the different interest rate scenarios.

To evaluate the reasonableness of new asset volume assumptions, examiners should review reports from the credit union showing the recent and/or historical maturity distribution of new loan or investment security business and pricing reports to show the rates received on the different asset products.

Step B: *EAR Results - Liabilities*

b)	**EAR Results Liabilities**	Evaluate if the interest expense generated by the material liability account categories are reasonable for base case and shocked scenarios relative to the credit union's current and historic levels? Evaluate the material assumptions used to generate interest expense (e.g. RSF/Beta, decay, repricing lags, maturity distribution, key rates, spreads).

Like interest income projections, interest expense projections under EAR simulations are also generated from both a credit union's existing liability product mix and its new business volume attributes.

The reasonableness of the interest expense generated by the credit union's existing liability product mix is dependent on the accuracy and completeness of the core data input into the model (such as maturity dates) and the reasonableness of the NMS rate sensitivity factor and repricing lag assumptions.

The reasonableness of the interest expense generated by the credit union's new business volumes is largely dependent on additional factors such as the maturity distribution of new business (like the percentage of CDs made for 6-months, 24-months, and 60-months, or other maturity terms) and the rates paid on the new business.

To evaluate the reasonableness of new liability volume assumptions, examiners should review reports from the credit union showing the recent and historical maturity distribution of new certificate of deposit business and pricing reports to show the rates paid on the different certificate of deposit terms.

The most critical assumptions influencing the interest expense projections in an EAR simulation and the overall simulation results are the rate sensitivity factors and repricing lags assigned to non-maturity shares. Non-maturity shares are typically a significant portion of a credit union's total liabilities and represent a material driver of risk in EAR simulations.

To evaluate the reasonableness of the NMS assumptions, examiners should review any NMS study performed by the credit union, or a third-party ALM vendor, if applicable. Because past rate-setting behavior provides a guide, the credit union's historical rates for NMS can be compared to market interest rates (like a three month T-Bill) over a historical period covering both rising and declining market interest rates. The ratio between the change in the credit union's NMS rates and the change in market interest rates provide an estimate of the rate sensitivity factor.

Third-party ALM vendors typically calculate rate sensitivity factors are typically calculated by regressing the change in the credit union's offering rate on the NMS against the change in some key short-term market rate over a representative period of time. The representative period of time should include instances where short-term market rates both increased and decreased.

While a detailed study of the historical performance of the credit unions' NMS by a qualified third party may provide reasonable assumptions, this can be quite costly. In the absence of a formal NMS study, examiners should determine if the credit union has internal documentation to support its rate sensitivity factor assumptions. ALCO or Pricing Committee meeting minutes may evidence discussions on proposed NMS rate changes relative to recent (at the time of the committee minutes) or anticipated interest rate changes.

Another option to evaluate the reasonableness of NMS rate sensitivity factors is to review a series of the credit union's rate sheets over time to see how the credit union has changed its NMS pricing relative to changes in short-term market rates.

NOTE: The most important consideration with NMS assumptions (from a supervisory oversight perspective) is to determine whether the credit union recognizes that NMS behavior is a key driver for EAR results and whether the credit union conducts meaningful sensitivity analysis surrounding the NMS rate sensitivity and decay assumptions to see how sensitive EAR results are to those changes. Volatility in the sensitivity analysis for NMS provides important risk information and should be the focus of discussion (as opposed to debating the individual assumptions themselves).

Step C: *EAR Scenarios*

c)	**EAR Scenarios**	Identify what balance sheet scenario (e.g. time horizon, static, dynamic) the credit union uses to generate earnings simulations and are EAR simulations run under parallel rate shock or ramp scenarios? If ramp scenarios, how long to reach maximum rate change (e.g. 12 months, 24 months)?

At a minimum, earnings-at-risk simulations should be run under an instantaneous, parallel, and sustained rate shock of +/- 300 bps using a static balance sheet over a period of at least two years. This expectation is consistent with FFIEC interagency guidance issued in 2010. In very low interest rate environments, like the extended period during which the term structure of rates was below 3 percent, some downward rate shocks may be temporarily waived, although credit unions should research and monitor developments in those market economies where negative interest rates have been introduced as a monetary stimulus. Negative interest rates have not occurred in the U.S. system, but practitioners should be aware of how instrument values could be affected if U.S. Treasury yields became negative because they are a dominant market benchmark.

EAR simulations are not pro forma accounting forecasts. They are intended to reveal the potential IRR exposure in a credit union's balance sheet and to identify key drivers of risk that could adversely affect earnings under select risk scenarios. With the exception of the base case earnings forecast, EAR simulations are not meant to represent a "most likely" income scenario.

The longstanding convention for bank supervisors to assess EAR is through objective stress scenarios using instantaneous, parallel, and sustained rate shocks. NCUA advocates the use of +/- 300 bps generated in increments of 100 bps. Ramp scenarios, where a credit union models an absolute change in rates staged over a discreet period of time (for example, if rates change 25 bps per month for 12 months to arrive at a total 300 bps rate movement at the end of one year) may not be sufficiently stressful to identify potential IRR exposure. Ramp scenarios like this should be discouraged if they are the only EAR measure by which a credit union measures, monitors, and manages its IRR.

If a credit union only runs ramp scenarios, examiners should disregard the results during the ramp-up period, and concentrate on the results for the year after which the ramp is completed. Furthermore, if a credit union only projects EAR for the ramp-up period (like a 12-month ramp and 12-month time horizon, or 24-month ramp and 24-month time horizon), examiners should direct the credit union to extend the time horizon for the EAR simulation to at least one year beyond the ramp-up period. It should be noted that extending the EAR scenario horizon out beyond 2–3 years introduces significant replacement assumptions because much of a credit union's balance sheet can change over this span. This makes the outlying years of a longer-term simulation analysis less certain and reliable.

A static EAR simulation assumes the balance sheet structure (mix of assets and liabilities) remains constant with no additional growth. Again, this approach, at a minimum, is advocated in the 2010 FFIEC interagency guidance for all depository institutions. Asset and liability cash flows that mature or prepay during the forecasted time horizon are replaced with an equal amount of new business volume for the particular loan, investment, share, or borrowing product. As an example, when $3 million in principal from a 30-year, fixed-rate mortgage runs off in month three of the simulation period, but then another $3 million in new 30-year, fixed-rate mortgages are booked in month three that replace the runoff at the then prevailing 30-year, fixed-rate mortgage interest rate for the specific interest rate scenario.

Dynamic balance sheet scenarios (incorporating growth scenarios and different asset/liability mixes) are useful for conducting "what if" scenarios and provide additional information to help credit unions think about how their risk profile changes when the balance sheet changes. Used on their own, dynamic EAR scenarios may disguise potential IRR by assuming a more favorable (or lower risk) balance sheet composition than the existing portfolios. While not necessarily intentional, a dynamic balance scenario could inadvertently mask the IRR inherent in the current mix of assets. For example, a credit union may project overly optimistic growth in longer-term, fixed-rate share certificates of deposit during a rising interest rate environment to lock in the cost of some funding and thereby curb rising dividend costs.

Step D: *Assumption Changes*

d)	**Assumption Changes**	If management changed any assumptions since the last examination what were the changes, what was the impact of those changes, and how did management support the changes?

It is necessary for risk modelers to review and modify their underlying assumptions over time to reflect changes in the composition of portfolios, market conditions, and observed asset and liability behaviors. It is sound practice to perform a comprehensive review of material modeling assumptions at least annually to ensure major assumptions remain relevant. An appropriate simulation process includes sensitivity analysis that isolates the major risk drivers within a balance sheet and, in turn, reveals the assumptions with the greatest materiality to the risk

measurement results. Assumptions don't have to change but there should be evidence that a decision to leave things unchanged was based on an analysis that determined the assumptions remain reasonable.

It is also possible for credit unions to improperly alter modeling assumptions (like arbitrarily reducing NMS rate sensitivity factors) to improve results or to avoid exceeding policy compliance. To avoid this scenario, credit unions should have a well-documented, transparent process for tracking assumption changes. Assumption changes should be supported and be reported to the ALCO and/or board of directors for approval or subsequent ratification. Failure to document assumption changes is an unacceptable practice and can lead to concerns about the validity of modeling results. By documenting and justifying changes to key assumptions, credit unions enhance the integrity and reliability of their modeling process.

It is important for credit unions to document impact of changes to key assumptions on EAR results. Tracking this information can help risk management staff isolate any factors that pose a threat or vulnerability to the credit union's earnings stream, and can inform decision making about how best to mitigate IRR, if necessary. Credit unions should generate the pre- and post-modeling results when changing assumptions and review the comparison. Best practice would be to run the model with original assumptions and then with adjusted assumptions based on the same effective date. Additionally, when making several assumption changes, credit unions should apply the changes incrementally in order to fully understand the impact to the credit union's IRR exposure from each assumption change.

Section Scoring Guideline

Examiners will indicate a score for the EAR section using the information from the review steps. The IRR indicators shown in *Figure 16* are EAR and Other IRR Measurement factors that can contribute to the overall IRR.

Figure 16. EAR and Other IRR Measures Indicators for IRR

	Interest Rate Risk Indicators		
	Low	**Moderate**	**High**
EAR and Other IRR Measures	• Measurements and scenarios supporting the income simulations result in a minimal exposure to earnings volatility.	• Measurements and scenarios supporting the income simulations result in a moderate exposure to earnings volatility.	• Measurements and scenarios supporting the income simulations result in a high exposure to earnings volatility.
	• Methodologies and assumptions are	• Methodologies and assumptions require some enhancements, but still	• Methodologies and assumptions are not adequate and contain

	appropriate and supportable.	provide reasonable reliability as a supportable risk measure.	material weaknesses that undermine the reliability of the EAR results. The process is not commensurate with the size and complexity of the CU portfolios.

Examiners will use the dropdown box to score this section (that is, low, moderate, or high).

EAR Score	**Use Drop Down Menu in this box for Risk Scoring of High, Moderate or Low**

Tab C: *Stress Testing*

In addition to the standard shock tests run for internal IRR policy compliance, it is prudent to stress the balance sheet using other rate scenarios. Static parallel NEV shock tests are meaningful, but they do not capture certain risks that may be relevant to a credit union's balance sheet. For example, parallel rate shocks do not reveal how a change in the shape of the yield curve impacts capital-at-risk and earnings-at-risk measures. Other relevant stress scenarios can include shocks to the level of prepayments, rate sensitivity factors for non-maturity shares, and credit spreads.

The use of stress testing is an essential discipline within the IRR management process. By generating a variety of stress test results, a credit union gains critical insight into the specific factors which have a material impact on the risk measurement results. Risk management decisions are better supported when the decision makers have a range of information available to guide risk mitigation actions.

Stress testing, which includes both scenario and sensitivity analysis, is an integral component of IRR management. In general, scenario analysis uses the model to show the financial effects from a macro event, such as "boom" or "bust" scenario. On the other hand, sensitivity analysis shows the impact of changes to one or a select number of risk factors (for example, changes in pre-payment speeds on mortgages, or decay rates on NMS accounts) on the credit union's financial position as reflected through the risk measurement results.

The *Stress Testing* tab consists of one section containing three steps to complete.

Section I: Stress Testing

- Step A: *Rate Scenarios*
- Step B: *Sensitivity Testing*
- Step C: *Limit Monitoring*
- Scoring Guidelines

Section I: Stress Testing

Step A: *Rate Scenarios*

a)

Rate Scenarios	What are the interest rate (e.g. changing slopes and twist of the yield curve), and shocked rate scenarios (e.g. severe but plausible rate shocks relative to existing level of rates), the CU uses to evaluate the IRR exposure of the balance sheet? Specify the frequency of testing. Is the frequency of testing sufficient? *For Baseline II review, does the credit union conduct interest rate stress testing, if so, describe and determine if commensurate with the size and complexity of the balance sheet?*

Examiners should request all scenario analytics performed since the prior exam. When conducting scenario analyses, credit unions should assess a range of alternative future interest rate scenarios in evaluating IRR exposure. This range should be sufficiently meaningful to fully identify basis risk, yield curve risk, and the risks of embedded options.

In most cases, static interest rate shocks consisting of parallel shifts in the yield curve of +/-300bps may not be sufficient to adequately assess a credit union's IRR exposure. As a result, credit unions should regularly assess IRR exposures beyond typical industry conventions, including changes in rates of greater magnitude (e.g., +/-400 bps and +/-500bps) across different tenors to reflect changing slopes and twists of the yield curve. Credit unions should ensure their scenarios are severe, but plausible, in light of the existing level of rates and the interest rate cycle.

For example, in low-rate environments, scenarios involving significant declines in market rates can be de-emphasized in favor of increasing the number and size of alternative rising-rate scenarios. By generating stress test scenarios with periodic frequency, credit unions will hone their understanding of the particular alternative scenarios and assumptions to which they should be more sensitive. In turn, this will guide a more strategic and effective stress-testing discipline.

The frequency and extent of testing is dependent on complexity and risk found on the credit union's balance sheet. Furthermore, the credit union should select a model that is capable of running scenarios based on the credit union's complexity.

Step B: *Sensitivity Testing*

b)	**Sensitivity Testing**	What assumptions has management determined to influence the model output most (RSF/Beta, Lag, Decay, Prepays)? Has the credit union performed sensitivity analysis to identify what degree of change in these assumptions cause model results to fall outside of management's risk tolerance level? Specify the frequency of testing. Is the frequency of testing sufficient? *For Baseline II review, does the credit union conduct sensitivity stress testing, if so, describe and determine if commensurate with the size and complexity of the balance sheet?*

Examiners will request all sensitivity tests since the last exam, and confirm that the ALCO reviewed sensitivity analysis reports. Examiners should look for evidence that ALCO discussions utilize sensitivity information to assess portfolio activities and guide risk mitigation strategies, if any.

In addition to scenario analysis, stress testing should include a sensitivity analysis to help determine which assumptions have the most influence on model output. Credit unions will generally focus more of their efforts on verifying the most influential assumptions. If the credit union has not made this determination, a few key assumptions that generally affect the model results include prepayments, changes in credit spreads, and NMS behaviors (like rate sensitivity factors and decay rates).

Sensitivity analysis can be used to determine the conditions under which key business assumptions and model parameters break down or when IRR may be exacerbated by other risks or earnings pressures. Credit unions should focus their sensitivity analysis around the assumptions that underlie larger balance sheet concentrations. For example, a credit union with a significant concentration in real estate-related assets may choose to test prepayment speed assumptions by varying speeds at faster and slower rates than expected. Another example on the liability side: A credit union with a large concentration in money market accounts may choose to stress the rate sensitivity factors above and below expected levels to capture sensitivity on NEV and earnings.

Each credit union should address the frequency and extent of testing in its policies. A credit union should also address whether its model platform can adequately capture the risk of any complex instruments. Testing is dependent on the relative complexity and levels of risk inherent in balance sheet portfolios; complexity can exist in both assets and liabilities. For sensitivity testing to be reliable, the model a credit union uses must be sufficiently robust to handle the complexity of all instruments.

Step C: *Limit Monitoring*

c)	**Limit Monitor-ing**	Does management evaluate stress tests that fall outside of policy limits? How relevant are these stress tests to the credit union and, what has management done to address stress tests that fall outside of limit? Are they discussed and reported to the board and/or ALCO?

Examiners should review the ALCO minutes to determine if management compares stress test results to policy IRR limits. Such reviews enable credit unions to properly measure and monitor key variables with volatility that significantly affects IRR sensitivity results. Look for evidence of how sensitivity testing is being utilized. An absence of sensitivity testing indicates a weakness in the risk management program. Some credit unions generate results only for compliance purposes and this may be minimally effective, especially if risk exposures are significant. Credit unions with stronger risk management disciplines will use their sensitivity analyses to challenge management's thinking and influence actions taken to deliberately increase or mitigate measured risks. Additionally, in conducting stress tests, management should closely evaluate instruments or markets in which concentrations exist, because such positions may be difficult to unwind or hedge during periods of market stress.

If limits have been breached, examiners should determine whether the credit union has assessed those stress results to determine whether those scenarios or assumptions are within a close range of the credit union's foreseeable future. It is important to remember that stress tests do not necessarily have to comply with policy limits, but they should be part of the information considered by senior staff responsible for risk oversight. When an adverse stress test result is realistic and may constitute a plausible threat to near-term earnings or net worth, a credit union should be diligent in developing plans of action in a timely manner to address the exposure. Strong policies will address how to handle circumstances where policy guidelines and limits are breached (some examples are requiring mandatory reporting or having pre-established risk mitigation actions).

In addition to covering the role and requirements of sensitivity testing in the risk management policies, the board and/or the ALCO need to be involved in the decision making process.

Scoring Guidelines

Indicate a score for the *Stress Testing* tab using the information from the review steps.

FIGURE 17. STRESS TESTING INDICATORS FOR IRR

Interest Rate Risk Indicators			
	Low	**Moderate**	**High**
Stress Testing	• The credit union produces a wide range of alternative interest rate scenarios consistent with the size and complexity of the credit union's portfolios.	• The credit union produces an alternative interest rate scenarios consistent with the size and complexity of the credit union's portfolios.	• Stress testing analysis is not sufficiently dynamic to capture plausible events and risk outcomes adequately.
	• Sensitivity analysis is an integral component of IRR management. Management has a strong understanding of the key drivers of risk in the balance sheet. Management is fully aware of how results compare to policy limits and utilizes test results to guide management decisions.	• Management uses sensitivity analysis to quantify modeling risk and has a basic understanding of key risks. Policy limits are taken into consideration and information is reviewed on a regular basis.	• Management does not have a good understanding of stress-testing discipline or key drivers of risk. Management has a weak understanding of how the underlying assumptions affect results or how the analysis relates to policy limits and are not using test results to guide risk decisions.

Examiners will use the dropdown box to score this section (that is, low, moderate, or high).

ST Score	**Use Drop Down Menu in this box for Risk Scoring of High, Moderate or Low**

Tab D: *Measurement Systems*

Overall, each credit union's IRR measurement system should be appropriate for the credit union's unique risk profile. The measurement system should capture all material sources of IRR and generate meaningful reports for senior management and the board of directors. Management should ensure risks are measured over a relevant range of interest rate changes, including meaningful stress situations. Further, the measurement system must be subject to appropriate internal controls and periodic independent reviews. The IRR measurement process should be well documented and administered by individuals with sufficient technical knowledge.

IRR measurement systems vary in their rigor and complexity. They can range from simple methods to sophisticated programs that include stochastic data modeling. However, all measurement systems should use generally accepted financial concepts and risk measurement techniques and have an adequate level of transparency. If a third-party model is used, management should review the adequacy and comprehensiveness of the vendor's model-validations and internal control reviews. Also, management should consider the capabilities of the software to meet the credit union's future needs and the adequacy of ongoing vendor support and training.

A credit union's IRR measurement system is a critical part of its overall risk management process and an important objective of examiners' review is to assess whether a credit union has chosen a system that is adequate to address the risk and complexity of its holdings. The reliability of the model's estimation techniques and the veracity of its output are particularly critical to NCUA's examination of the IRR management program. Since the IRR review begins with the Market Risk assessment, and this relies on data generated from the credit union's model, it is imperative that examiners gain a comfort with the reasonableness of the input and output of the measurement system. A review of the system should address the following items:

- Capabilities (i.e., rigor and sophistication) of the measurement system
- Controls surrounding the modeling process
- Accuracy of system inputs
- Reasonableness and documentation of material assumptions
- Usefulness of system output/reports
- Adequacy of periodic variance analysis

Tab D: *Measurement Systems* consists of one section containing five steps.

Section I: ALM Vendor Model

- Step A: *Model Capability*
- Step B: *Model Validation*
- Step C: *Assumptions and Inputs*
- Step D: *Controls*
- Step E: *Changes*
- Scoring Guidelines

Section I: ALM Vendor Model

Step A: *Model Capability*

a)	**Model Capability**	Is the ALM model sufficient in its level of depth and capability to adequately capture the complexity and magnitude of the interest rate and liquidity risks being taken? (i.e. Is the ALM model an appropriate fit for the credit union's asset/liabilities product types and characteristics?)

Many ALM models available to credit unions are adequate to properly measure IRR. However, the institution's management of the measurement system process can introduce model risk. For this reason, NCUA examiners will review and assess a credit union's process for setting up and using the model. If the model is not properly employed and controlled by the risk measurement staff, confidence in the model output is reduced. Similarly, if the model itself lacks the rigor and sophistication to analyze unique balance sheet attributes (such as failing to take into account embedded options), it may not be appropriate for measuring IRR. Examiners must determine if the model environment, staff controls, and results are sufficiently reliable to be used for managing risk and, in turn, for use in the NEV Supervisory Test.

Also, examiners need to assess whether the standard interest rate scenarios (like instantaneous shock, ramp rate, stair step, etc.) used in the credit union's model are relevant for the credit union. The prevailing supervisory expectation is for institutions to perform an instantaneous, parallel, and sustained rate shock.[13] However, the measurement systems available to credit unions have expanded over time and, in many cases, have added to the variety of scenarios and conditions that can be run. If a credit union has increased its risk, but has not made corresponding changes to its measurement system, examiners should encourage management to evaluate alternatives that are commensurate with the risks the credit union needs to capture.

[13] More experienced risk managers will perform additional rate and balance sheet scenarios. For example, they may run a dynamic simulation or a ramped interest rate shock scenario.

Step B: *Model Validation*

b)	**Model Validation**	Has the ALM model been validated by the credit union (i.e., mathematical integrity, user inputs, system output and reports, etc.) to confirm that the model produces accurate forecasts of earnings and valuations? If so, what documentation is available to support the validation?

Examiners will request the most recent ALM model validation report. Examiners should ask for a new validation report ***only*** if there have been material changes to the balance sheet, loan or share pricing methodology, a change of ALM models, or a merger. Examiners should not place too much emphasis on validating the mathematical accuracy of the model used (sometimes referred to as a certification). The model validation report should provide a review of the model set up, inputs, reasonableness of assumptions (including NMS, which may be supported by a historical regression analysis), and accuracy of results. The validation standards should ensure that it is performed by an independent and skilled party, communicated in writing, and delivered to the appropriate personnel.

The level and depth of the independent reviews should be commensurate with the credit union's risks and activities. Credit unions with a more complex balance sheet should have a more rigorous independent review process. Credit unions with a less complex balance sheet may rely upon less formal reviews. At a minimum, large, complex credit unions should obtain independent validations that review the input process, assumptions used, and system output reports.

It is acceptable for an ALM vendor to perform the validation for inputs and underlying assumptions, as long as the examiner does not have reasonable concerns that the model is inadequate and unable to capture all material IRR elements.

System-input reviews should evaluate the adequacy and appropriateness of:

- The knowledge and skills of individuals responsible for input to the measurement system
- The reconciliation of the measurement system's data to the credit union's general ledger
- The rules and methods of account aggregation used in the measurement system
- The accuracy of contractual terms captured within the measurement system
- The source, completeness, accuracy, and procedures for external data feeds

Assumption reviews should evaluate the following issues:

- The process of developing assumptions for all material asset, liability, and off-balance-sheet exposures
- The process for reviewing and approving key assumptions
- The periodic review of assumptions for relevance, applicability, and reasonableness

- The completeness of assumption analysis and its supporting documentation

System output and reporting assessments should evaluate the following:

- Inclusion of a sufficiently broad range of potential rate scenarios
- Accuracy of the IRR measurement and assurance that all material exposures are captured
- Timeliness and frequency of reporting to management and the board
- Compliance with operating policies and approved risk limits
- Performance and documentation of variance analyses (i.e., back-testing)
- Translation of model output into understandable management reports that support decision making

Benchmark assessments should evaluate the following:

- Theoretical underpinnings, methodologies, and inputs that are as close as possible to those used in the model being validated
- Inclusion of side-by-side comparison of benchmark's model output to the credit union's model output

Examiners may make recommend refinements to improve the modeling process, but if broad recommendations are necessary to address a wide range of deficiencies, there may be a need for the credit union to consider changes to the model itself or to personnel. Examiners should determine whether the board and ALCO were made aware of errors that would significantly misrepresent the model results.

Step C: *Assumptions and Inputs*

c)	**Assump-tions and inputs**	What are the credit union's procedures for assessing inputs and outputs for accuracy and relevancy? If the credit union relies on a model validation to complete this task, under what instances will the credit union verify accuracy and relevancy when periodic changes in the assumptions are made? What are the assumptions in the credit union's written Assumption Summary?

Examiners will ask management to provide any documented procedures used to ensure that model inputs are properly made within the ALM model. While the credit union may choose to entrust an outside vendor to help with the modeling process, the credit union should not pass on the responsibility of checking that all inputs and assumptions are reasonable and supported. Oftentimes, a credit union will rely on the validation process to assess completeness of model inputs. However, in the event that model assumptions are made before the validation, the credit union should have a procedure for verifying accuracy and relevancy when periodic changes are made to the model.

Ideally, a credit union will maintain an Assumption Summary document that details each key model assumption, provides an explanation/rationale supporting why the assumption is used, and lists the inputs that will be made by entrusted credit union staff or outside vendors. This document can be used to track assumption changes over time. (Most often, examiners will need to refer to the IRR model report to find the model assumptions.) In the event that the Assumption Summary includes a change, examiners should determine whether changes to assumptions have been approved by the ALCO or management and documented for board review.

Step D: *Controls*

d)	**Controls**	Is the internal control process comprehensive enough to ensure the accuracy and completeness of the data inputs and assumptions?

Examiners will determine what internal controls are in place to ensure that data loaded into the IRR models is complete and accurate and that the assumptions used are documented and supportable. Examiners will also confirm that the credit union separates the IRR measurement function from the risk taking function.

A credit union should have adequate internal controls to ensure the integrity of its IRR management process. These controls should promote reliable financial reporting and compliance with internal policies and relevant regulations. Internal control policies and procedures should address appropriate approval processes, adherence to exposure limits, reconciliations, reporting, reviews, and other mechanisms designed to provide reasonable assurance that the credit union's IRR management objectives are achieved. Internal control policies and procedures should clearly define management authorities and responsibilities and identify the individuals and committees responsible for managing sensitivity to market risk.

A sound control environment should also ensure adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. In other words, credit unions should have clearly defined roles and responsibilities to ensure that risk-measurement functions are sufficiently independent from risk-taking functions. Additionally, IRR exposures should be reported directly to senior management and the board of directors. The nature and scope of such safeguards should reflect the structure of the credit union, the volume and complexity of IRR exposure, and the complexity of the balance sheet. Credit unions with a more complex balance sheet should designate an independent unit responsible for the design and administration of its IRR measurement, monitoring, and control functions.

Step E: *Changes*

e)	**Changes**	Were there any significant changes to the model or functionality provided by the service provider since last exam?

Examiners will determine whether a credit union's ALM vendor has made any changes to the IRR model, assumptions, or functionality since the last exam. Examiners will review the Assumption Summary from the most recent model run and compare it to the Assumption Summary for the last completed exam. Any observed changes to assumptions should be discussed with management. Examiners will verify that management is aware of the changes and understands why the changes were made.

Scoring Guidelines

Examiners will indicate a score for the *Measurement Systems* tab using the information from the review steps.

FIGURE 18. MEASUREMENT SYSTEMS INDICATORS FOR IRR

Interest Rate Risk Indicators			
	Low	**Moderate**	**High**
Measurement Systems	• Measurement systems support the accounts, methods, and assumptions under defined and reasonable rate scenarios.	• Measurement systems adequately support the accounts, methods, and assumptions under defined and reasonable rate scenarios.	• Measurement systems do not support the accounts, methods, and assumptions under defined and reasonable rate scenarios.
	• Management completes an independent model validation periodically to assess data integrity and the reasonableness of assumptions. The mechanics and mathematics of the measurement model were tested.	• Management has reasonable oversight practices and adequate processes to confirm the integrity of modeling analysis. Validation practices could include constructing an identical model to test assumptions and outcomes.	• The depth and extent of model validation processes is not commensurate with the materiality and complexity of risk exposure.

Use the dropdown box to score this section (that is, low, moderate, or high).

MS Score	Use Drop Down Menu in this box for Risk Scoring of High, Moderate or Low

Tab E: *Risk Management*

A credit union's board of directors is responsible for ensuring the adequacy of its IRR policy and limits. The IRR policy should be consistent with the credit union's business strategies, balance sheet structure, and risk tolerance, and should take into account the credit union's financial condition and risk measurement systems and methods. The policy should clearly state that actions and authorities required for any exceptions to policy, limits, and authorizations.

Credit unions have the option either to a) create a separate IRR policy or b) incorporate IRR management into an existing policy (for example, an investments, ALM, funds management, liquidity, or other policy). Regardless of the form, credit unions must clearly document their IRR policy in writing.

Management should utilize the results of the credit union's IRR measurement systems to make operational decisions, such as changing balance sheet structure, funding, pricing strategies, and business planning. This is particularly the case when metric results show a high level of IRR or when results approach board-approved limits.

Internal controls are an essential part of a safe and sound IRR program. If possible, there should be separation between those responsible for the risk-taking and risk-measuring functions.

Staff responsible for maintaining controls should periodically assess the overall IRR program, as well as compliance with policy. Internal audit staff would normally assume this role; however, if there is no internal auditor, management or a supervisory committee member that is independent of the IRR process may perform this role.

Where appropriate, management may also supplement the internal audit with outside expertise to assess the IRR program. This review should include policy compliance, timeliness, and accuracy of reports given to management and the board. Oftentimes, this is completed in conjunction with an ALM model validation.

Audit and model validation findings/recommendations should be reported to the board and asset/liability committee (ALCO) or supervisory committee with recommended corrective actions and timeframes. The individuals responsible for maintaining internal controls should periodically examine adherence to the policy related to the IRR program.

Tab E: *Risk Management* is broken into two sections containing 13 steps.

- Section I: Board and Senior Management Oversight
- Section II: Risk Monitoring and Management Reporting
- Scoring Guidelines

Section I: Board and Senior Management Oversight

- Step A: *BOD/ALCO Meetings*
- Step B: *Policies & Procedures*
- Step C: *IRR Triggers & Tools*

Step A: *BOD/ALCO Meetings*

a)	**BOD/ALCO Meetings**	What IRR information does the BOD and ALCO receive that demonstrates oversight of the IRR limits and policies? Are meeting minutes prepared and do they reflect the decisions made and discussions held?

Generally, examiners can make an assessment of board and ALCO oversight by collecting and reading through minutes and attached board/ALCO packets. These are usually in the form of monthly board meeting minutes, ALCO meeting minutes, or equivalent relevant meeting documentation. The existence of minutes establishes a formal record of ALCO meetings and member attendance. If minutes are not prepared, it 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.

The meeting discussion should ensure that ALM policies are reviewed at least annually, and revised whenever there are changes to business practices (such as new loan types, shares, or investments), the credit union's complexity or asset size, or changes in senior management.

The ALCO should have representation in strategic planning meetings or have the opportunity to comment on proposed plans. If the ALCO is excluded from strategic plan development, ALM integration into the planning process is impaired and possibly inadequate.

An ALCO's failure to meet as required should be documented and addressed with the credit union, not only for violating board policies, but also because this is an indication that the ALCO does not monitor risk on a regular basis. It may also signify the ALCO is not meeting other responsibilities with respect to ALM.

The ALCO should receive sufficient information from which it can make intelligent decisions (like risk output reports, summary of key model assumptions, measurement method). Examiners will determine whether the ALCO has developed and/or recommended changes that have not

been adopted by the board (such as using a different model, restructuring the ALM responsibilities, or adding additional internal controls). If the board is not receptive to recommendations for improvement from the ALCO, it could indicate the board does not understand ALM or is unwilling to embrace it as a management tool.

If the ALM process is weak and the ALCO is unaware of problems the examiner has identified, the ALCO may be ineffective. Likewise, if the ALCO is aware of weaknesses but unable to resolve them, the ALCO may not be meeting its responsibilities.

Minutes should adequately address discussions related to IRR management, compliance with policies, sensitivity and scenario analytics, model assumptions reviews, and risk mitigation strategies.

Risk measurement reports included in the minutes should be received and reviewed so the ALCO can monitor IRR in relation to policy limits and make effective recommendations. If the ALCO or BOD minutes do not reflect discussion of risk measurement reports, it should be considered a red flag.

Step B: *Policies & Procedures*

b)	**Policies & Procedures**	Who has the primary responsibility for IRR policies and does senior management or ALCO ensure that all policies and procedures are being monitored and are sufficient to identify risks?

NCUA rules and regulations Part 741 – Appendix B requires credit unions with assets greater than $50 million to develop a written IRR policy and an effective IRR management program as part of Asset Liability Management. A credit union's board of directors is responsible for ensuring an IRR policy has been established commensurate with the size and complexity of the credit union, and that it is adhered to. The scope of the policy will vary depending on the size and complexity of the credit union's balance sheet. For example, a credit union that offers short-term loans, invests in non-complex or short-term bullet investments,[14] and offers basic share products may not need to create an elaborate IRR policy.

Credit unions with more complex balance sheets, especially those containing products with uncertain cash flows (like mortgage loans and complex investments), should develop a comprehensive IRR policy.

The policy should set forth responsibilities and procedures for identifying, measuring, monitoring, controlling, and reporting balance sheet risk (liquidity risk and IRR), and should establish risk limits.

The form of the policy is not as important as its scope. That is, there is no requirement that the IRR policy be independent of other policies, even for large, complex credit unions. Thus, it is

[14] A bullet investment is a debt security that returns 100 percent of principal on the maturity date.

acceptable to incorporate IRR elements within policies that cover investments, concentration risk, liquidity risk, etc. Regardless of form, the credit union should clearly articulate its IRR management program in writing.

The IRR policy should establish responsibilities and procedures for identifying, measuring, monitoring, controlling, and reporting IRR, and should establish risk limits. A written policy should:

- Identify committees, persons, or other parties responsible for review of the credit union's IRR exposure.

> **NOTE:** It is preferred that there is at least one board member on the ALCO to improve communication between the ALCO and the board and to improve board members' knowledge of ALM. The ALCO should consist of representatives across the credit union's divisions of responsibility (loan department, investment office, marketing department, CFO, and CEO) because ALM decisions affect the entirety of a credit union's operations.
>
> While individual qualifications may vary, the ALCO should be composed of persons who are knowledgeable about IRR. The complexity of the balance sheet should also be reflected in the composition of the ALCO. For simple balance sheets, a basic understanding of IRR should be sufficient. For complex balance sheets, members of the committee should understand the specific sources of risk in the balance sheet, know how to measure risks, understand what the risk measurement results indicate, and be able to develop risk mitigation strategies.

- Outline training requirements and frequency of training.
- Outline the frequency of relevant committee meetings (like ALCO) and required minutes documentation.
- Direct appropriate actions to ensure management takes steps to manage IRR, so that IRR exposures are identified, measured, monitored, and controlled.
- State the frequency with which management will report on measurement results to the board to ensure routine review of information that is timely (such as prior month and at least quarterly) and in sufficient detail to assess the credit union's IRR profile.
- Set risk limits for IRR exposures based on selected measures for short- and long-term IRR exposures (such as limits for changes in repricing or duration gaps, income simulation, asset valuation, or NEV).
- Provide guidance on the reporting, frequency, and actions/triggers to remediate policy violations.
- Identify IRR measurements (like interest rate shocks, instantaneous and parallel, ramps, twisted yield curve, flattener, steepener, etc.) that the credit union will perform using the selected measures.

- Provide for periodic review of material changes in IRR exposures and compliance with board-approved policy and risk limits.
- Provide for assessment of the IRR impact of any new business activities prior to implementation (meaning, evaluate the IRR profile of introducing a new product or service).
- Provide for the frequency of performing independent ALM model validations, internal audit reviews, and/or overall ALM program management reviews (policies, ALCO, reporting, scenario and sensitivity analysis).
- Provide for at least an annual evaluation of IRR policy to determine whether it is still commensurate with the size, complexity, and risk profile of the credit union.

NCUA rules and regulations Part 741 – Appendix B provides detailed guidance for creating an IRR policy and an effective IRR program.

Step C: *IRR Triggers & Tools*

c)	IRR Triggers & Tools	What triggers does management use to identify when IRR exposure is approaching or exceeding limits? What strategies and tools (e.g. balance sheet changes, derivatives, sales) are considered in managing IRR exposure within policy limits?

A credit union should proactively establish strategies describing actions to be considered when policy limits are breached. Oftentimes, credit unions establish thresholds that trigger formal deliberation and/or mitigating actions prior to reaching a policy limit.

Unforeseen circumstances can necessitate prompt remedial action. The policy should address procedures for alerting senior management, the ALCO, and board, and for bringing swift resolution.

ALCO meeting minutes should reflect that the ALCO is taking proactive steps to mitigate risk ***before*** limits are approached or exceeded. If action is not taken until limits are exceeded, the ALCO is not effectively directing the ALM program. Furthermore, the credit union may not be able to implement corrective action timely (such as selling loans or participating out loans) or the costs associated with a corrective action may be excessive (such as divesting of AFS securities in a rising rate environment at a loss).

Acting proactively requires the ALCO to develop potential alternative courses of action and to prioritize those actions based on cost/benefit relationships, long-term effectiveness, and time to implement. Credit unions should establish contingency plans to adjust balance sheet structures proactively (such as mechanisms to sell mortgage loans, or initiate hedge transactions) to ensure actions can be taken to reduce IRR exposure in a timely fashion.

Section II: Risk Monitoring and Management Reporting

- Step A: *Policy Limits*
- Step B: *Policy Limits Violations*
- Step C: *Process Validation*
  - Internal Controls
  - Independent Reviews
- Step D: *Reporting*
- Step E: *Policies and Planning*
- Step F: *Planning and Back-Test*
- Step G: *Business Forecast*
- Step H: *Qualified Staff*
- Step I: *Internal Controls*
- Step J: *Balance Sheet Risk Management*

Step A: *Policy Limits*

a)

Policy Limits	What policy IRR limits does the CU use for management reporting purposes? Are the limits suitable for the size and potential risk exposures of the CU? Has there been any changes to the IRR Policy since the last exam and what was the basis of the changes?

Examiners will request and evaluate the policy limits, compliance status of each limit, and appropriateness of the chosen limit in relation to risk profile and underlying modeling assumptions.

Risk limits should reflect the board's tolerance of IRR exposure by restricting the volatility of earnings and capital (NEV) for given rate movements and applicable time horizons. Risk limits should be explicit dollar or percentage parameters, or both. IRR exposure limits should be commensurate with the complexity of the credit union's activities, balance sheet structure, and off-balance-sheet items. At a minimum, income-related limits should be expressed over one- and two-year time horizons, correspond to the internal measurement system's methodology, and appropriately address all key IRR risks and their effect on earnings and capital.

Examiners should carefully evaluate policy guidelines and board-approved risk limits. Credit unions should establish limits that are neither so high that they are never breached, nor so low that exceeding them is considered ordinary exposure that does not warrant any mitigating action. Effective limits will provide management sufficient flexibility to experience some volatility

around expected levels for changing economic conditions, yet be sufficient enough to prevent excessive risk-taking.

Policies should be in place to ensure that excessive IRR exposures receive prompt attention. Controls should be designed to help management identify, evaluate, report, and address excessive IRR exposures. Policies should require management to regularly monitor risk levels, and controls should be altered as needed when economic conditions change or the board alters its risk tolerance level. Reports or stress tests that reflect significant IRR exposure should be promptly reported to either the board or an appropriate board committee. Regardless, the credit union's board should review all risk limit exceptions and management's proposed actions.

Step B: *Policy Limits Violations*

b)	**Policy Limits Violations**	Were there any violations to the IRR limits since the last exam, what was the violation and what remedial action was taken in moving the risk back within limits?

Examiners will determine whether there were any policy violations during the exam period. If violations occurred, examiners will determine what action(s), if any, that management took to remedy the exposure and bring levels back within compliance. If management's remedy to a policy violation is to change the policy limit, this likely indicates weak or poor IRR management and a potential failure of governance.

Step C: *Process Validation*

c)	**Process Validation**	Does the CU obtain an independent validation of the IRR measurement process and assumptions that generate the IRR reporting? Did management implement the recommendations?

Examiners will request the most recent independent review of the credit union's IRR measurement process and assumptions. Examiners will determine whether management implemented any recommendations.

Internal Controls

Establishing and maintaining an effective system of internal controls and independent reviews is critical to the risk management process and the general safety and soundness of a credit union. Credit unions should have adequate internal controls to ensure the integrity of their IRR management process. These controls should promote reliable financial and risk reporting and compliance with internal policies and relevant regulations. Internal control policies and procedures should address appropriate approval processes, adherence to exposure limits, reconciliations, reporting, reviews, and other mechanisms designed to provide a reasonable assurance that the credit union's IRR management objectives are achieved. Internal control policies and procedures should clearly define management authorities and responsibilities and identify the individuals and committees responsible for managing sensitivity to market risk.

A sound control environment should also ensure adequate separation of duties in key elements of the risk management process to avoid potential conflicts of interest. In other words, credit unions should have clearly defined roles and responsibilities to ensure that risk-measurement functions are sufficiently independent from risk-taking functions. Additionally, IRR exposures should be reported directly to senior management and the board of directors. The nature and scope of such safeguards should reflect the type and structure of the credit union, the volume and complexity of IRR incurred, and the complexity of the credit union's transactions and commitments. Larger and more complex credit unions should have dedicated staff or team responsible for the design and administration of IRR measurement, monitoring, and control functions.

Independent Reviews

Regular independent reviews of IRR management process are an important element of a credit union's internal control system. Internal reviews of the IRR measurement system should include assessments of the assumptions, parameters, and methodologies used. The purpose of an independent review is to ensure that the IRR measurement and management processes are sound. Such reviews should seek to understand, test, and document the current measurement process; evaluate the system's accuracy; and recommend solutions to any identified weaknesses. The independent review should be tailored to the type and complexity of a credit union's activities. It should encompass a set of standards that include:

- **Independence** – Parties performing the independent review should not be involved in the day-to-day IRR measurement/management process. Credit unions may use internal staff, an outsourcing arrangement, or a combination of the two to independently review the measurement system. Management may find that the internal audit department (or other staff independent of the measurement system) has the knowledge and skills to perform certain aspects of the review, while using external resources for other areas. When the assessment of the measurement system is outsourced, senior management and the board should ensure that the procedures used meet the same standards required of a satisfactory internal review.

  Regardless of whether the review is performed by internal staff or external entities, it is important these parties be independent of any operational responsibility for the measurement and management processes. They should not perform any of the routine internal control functions, such as reconciling data inputs, developing assumptions, or performing variance analysis.

- **Skills and Knowledge** – Senior management and the board must ensure that individuals performing the independent review have the knowledge and skills to competently assess the measurement system and its control environment.

- **Transparency** – The procedures used in the independent review of the measurement system should be clearly documented, and workpapers should be available to management, auditors, and examiners for review. Senior management should ensure that they have access to work papers even when external parties perform the review.

- **Communication of Results** – Procedures should be established for reporting independent review findings to the board or board-delegated committee.

Findings of the review should be reported to the board on a periodic basis, along with a summary of the credit union's IRR measurement techniques and management practices.

- Independent reviews should be performed periodically. The scope, responsibility, and authority for the reviews should be clearly documented and encompass all material aspects of the measurement process. The scope of the independent review should generally be defined by the internal audit staff and approved by the audit committee. However, subject to board approval, it is acceptable for another department of the credit union, separate from the group that measures IRR, to define, perform, and document the independent review.

Step D: *Reporting*

d)	**Reporting**	How often do they generate IRR results and report them to ALCO and the BOD (with explicit IRR measurements against limits) and the comparative analysis on changes from period to period?

Examiners will assess how often a credit union runs its IRR model. Examiners will verify that the results are reported to ALCO and board of directors, and are reviewed over time (for trend analysis).

For credit unions with complex balance sheets (like those with mortgage-related assets or other complex structured instruments), reports should be provided to the board at least quarterly. If the balance sheet incurs significant change, monthly reports may be more appropriate. The board may only receive reports less frequently if reports are being provided to an ALCO (preferably, at least one board member will be on the ALCO) and the ALCO is charged with alerting the board to significant events (such as when a policy limit is approached).

Consistent measurement between periods is essential to understanding the changing risk structure of the balance sheet and to identify the underlying causes.

If assumptions are changed from period to period without reasonable cause, comparison between measurement periods will probably not be meaningful, and an exception should be taken. The results are likely to be misleading to decision makers (like the ALCO and board), resulting in

inappropriate decision making. Any assumption changes need to be clearly documented with analysis of the impact to the modeling results.

Step E: *Policies and Planning*

e)	**Policies and Planning**	Is the CU budget forecasting consistent with the IRR risk limits? How does modeling the credit union's budget compare to the IRR limits?

ALM practices should be closely aligned with the strategic planning and budgeting process. This includes identifying components of the balance sheet that cause IRR exposure. This should impact the strategic planning process as it relates to product growth plans.

For example, a credit union's strategic plan and budget indicates large growth in fixed-rate real estate loans, but the current NEV results are approaching policy limit. This is an example of the ALM process being inconsistent with the strategic planning process. The credit union's key strategists responsible for business planning should understand the IRR implications of new business activities and determine that the projected IRR exposures will remain within the board's risk policy limits. Examiners can request and review a credit union's budget forecast and compare it to the net interest income simulation. The forecasted base net income should be in alignment with the budget forecast (1 year). Interest income should tie out with the budget.

Examiners can determine whether there are any material mismatches between ALM modeling/management and the strategic planning/budgeting process.

Step F: *Planning and Back-Test*

f)	**Planning and Backtest**	How does the credit union's NII backtest compare to actual results?

Variance analysis (also known as back-testing) can provide valuable insights into the accuracy and reasonableness of IRR models and is an integral part of the control process for IRR management.

In an environment where rates have not changed, variance analysis should generally not produce materially different results compared to the credit union's actual performance. Nevertheless, a credit union needs to demonstrate readiness and should have this tool in place for when the market environment does change.

Step G: Business Forecast

g)	**Business Forecast**	Are there any future events forecasted by the credit union that may have a material impact on the balance sheet structure (e.g., new loan, share, or investment strategies, merger, aggressive growth strategy) and what interest rate risk analysis (e.g. What-if) was done to support the proposed changes?

Examiners should review a credit union's strategic plan and discuss any forecasted events that would impact the balance sheet structure and IRR profile of the credit union (such as new loan types, rapid growth, change in investment strategies, mergers).[15] Examiners should determine what type of proactive analysis the credit union has performed and confirm the credit union has run scenario tests to determine the potential impact to IRR from the strategic plan initiatives.

Examiners may review evidence of testing for new or expanded product lines, mergers, and other events that can impact a credit union's balance sheet structure and IRR profile.

Credit unions should perform proactive risk analysis with the use of "what if" scenario testing. "What if" tests are intended to assist management in understanding the impact of business decisions or events on IRR exposure, and should be performed prior to making any business decision that could materially impact the balance sheet structure.

For example, prior to purchasing a participation in a pool of fixed-rate mortgages, a credit union can run NEV and NII simulations with the new participation loans added to the balance sheet to determine the incremental impact to IRR position. This is an effective way to ensure business decisions do not cause the credit union to fall out of compliance with the board's risk tolerance (its NEV and/or NII policy limits).

Examiners should determine whether the analysis addressed the characteristics of the product and whether or not assumptions and analysis were documented. For example, implementing a mortgage program would necessitate a comprehensive understanding of prepayment risk and a proper analysis of IRR. Similarly, if a credit union currently offers personal loans and decides to offer home equity lines of credit (HELOCS), it needs to understand uncertainty of cash flows (from prepayments and draws on the lines of credit) and variable rate features that may not exist in the current portfolio or may not be handled properly within the existing data processing system.

If the credit union does not evaluate risk/reward relationships or set appropriate limits on new or expanding programs, it is not effectively managing IRR.

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[15] A merger in particular can significantly change the continuing credit union's IRR profile if the merging entity has a different asset/liability mix. Pre-merger risk analysis is prudent.

Step H: *Qualified Staff*

h)	**Qualified Staff**	Is staff capable of managing the IRR program including having the experience and capability to support the IRR modeling and reporting?

Examiners will:

- Review the qualifications of staff responsible for monitoring and measuring IRR;
- Assess whether the credit union has received any ongoing ALM training since the last exam; and
- Assess the separation of duties.

Credit union staff should be familiar with the assumptions driving the model and experienced with the model's basis for measurement (such as earnings simulation or NEV). Examiners should assess whether staff has the institutional knowledge to verify that the model's results are reasonable and regularly makes improvements to the model or its assumptions. It is prudent for credit unions to designate back-up staff and to ensure that this person is adequately trained to use the model without supervision of the individual(s) with first line responsibility.

The complexity of the credit union's balance sheet and risk measurement model will drive the need for experienced ALM program staff. The more complex the model, the more experienced the staff should be. Also, the experience of ALM program staff may reflect the credit union's commitment toward implementing a strong ALM program. If staff knowledge is lacking, the modeling results may be unreasonable, likely warranting further training. Conversely, experienced program staff would likely develop reasonable risk reports and make recommendations to improve the risk measurement process.

The following discussion points can be used to determine if IRR modeling staff is qualified.

- Where do the prepayment speeds come from (are they externally sourced or internally generated)?
- What products do the prepayment speeds cover (such as FHLMC or FNMA 30 year or 15 year, ARMs, balloons)?
- Do the speeds change over the age of the loan and are these speeds reasonable and supportable?
- Do the speeds change according to interest rate scenarios and are these speeds reasonable and supportable?

Program staff should be able to understand and explain how the model works and the key assumptions that drive the results.

Step I: *Internal Controls*

i)	**Internal Controls**	Are the internal controls documented and approved (Governance by who?) and has a review of IRR internal controls highlighted any deficiencies? Are the staff responsible for inputs/assumptions independent from other major functions(e.g. Accounting, cash operations) in the CU?

Examiners will determine whether internal control reviews have taken place and if there any deficiencies with the process.

Strong internal controls are integral to an effective ALM program. If the risk-taker (such as investment officer or CEO) is not separate from the persons responsible for measuring risk (like an ALM program person) and assessing risk (the ALCO), it is possible that the risk measurement results will be biased toward optimistic and potentially inaccurate, resulting in inappropriate decisions. Combined, these shortcomings may exacerbate a high IRR exposure.

Among smaller credit unions, it is not uncommon for risk taking and risk measurement responsibilities to be performed by a single individual due to a lack of available resources. For small, non-complex credit unions with limited staff resources, segregation of duties may not be feasible and the credit union may consider outsourcing the model to a qualified third-party vendor. However, if this is not possible, the board and supervisory committee should take an active role in monitoring the activities of the individual(s) and/or individual authorities may need to be limited.

Step J: *Balance Sheet Risk Management (BSRM)*

j)	**BSRM**	How does management consider the impact that other risks such as credit, liquidity, strategic, and operational may have on IRR?

Examiners will determine what types of risk analysis are documented within the ALCO package related to credit, liquidity, strategic, and operational risks. Has the credit union performed advanced analytics to incorporate multiple risks simultaneously (for example, does the credit union evaluate IRR in conjunction with credit risk)? As an example, the credit union could assume heightened credit default rates and increased provision expenses within the ALM model to simulate a rising rate environment and recession simultaneously.

Scoring Guidelines

Examiners will indicate a score for the *Balance Sheet Risk Management* tab using the information from the review steps.

FIGURE 19. RISK MANAGEMENT INDICATORS FOR IRR

Interest Rate Risk Indicators			
	Low	**Moderate**	**High**
Balance Sheet Risk Management	• Management effectively understands and is regularly informed about the level and trends of IRR exposure.	• Management reasonably understands implications of the IRR strategies they pursue, including their potential impact on IRR exposure.	• Management does not understand or ignores key aspects of IRR. Regular reporting of key risk indicators is not taking place.
	• Comprehensive IRR management governance of policies and procedures is in place. Policies specify IRR tolerances in the context of plausible stressed market rate scenarios and other performance metrics.	• Policies and procedures are adequate to control all material components of IRR. Policies ensure the IRR implications of significant new strategies, products, and businesses are integrated into IRR management process.	• IRR tolerances are not clearly articulated. Policies do not address the potential impact of changing interest rates on earnings and capital from a short-term and a long-term perspective.
	• There is complete separation between those who measure risk and those who make risk-taking decisions. Internal audit regularly reviews the IRR process.	• There is reasonable separation between those who measure risk and those who make risk-taking decisions. Management has implemented appropriate oversight practices where enhanced separation of duties is not possible.	• There is a lack of separation between those who measure risk and those to make risk-taking decisions. Internal reviews do not cover any aspect of the IRR management program.
	• Management clearly defines income simulation and NEV IRR limits under an appropriate range of plausible stressed market rate scenarios.	• IRR limits are adequate to control the risk to earnings and NEV under defined stressed market rate scenarios.	• IRR limits are not reasonable or do not reflect an understanding of the risks to earnings and NEV.
	• Effective reporting of IRR exists. Comprehensive systems and standards for measuring IRR, valuing positions, and assessing performance are in place, and are accurate, complete, and reliable. The board receives reports on the	• Adequate reporting of IRR exists. Material components of IRR are measured and results are reported. Reports are generally accurate, complete, and reliable. Reports to the board are timely and concisely	• IRR monitoring and reporting are inadequate. Current measurement techniques do not capture all material risks.

	credit union's IRR profile on a regular basis. The frequency and detail of reporting is commensurate with the size and complexity of the balance sheet.	summarize IRR measurement results.	
	• Management anticipates and responds to market conditions effectively.	• Management adequately responds to changing market conditions.	• Management does not anticipate or take timely and appropriate actions in response to changing market conditions.
	• IRR is well understood at appropriate levels of the credit union and risk information is proactively used in the decision-making process and clearly documented on a continual basis.	• Knowledge of IRR exists at appropriate levels of the credit union. Risk information is reviewed on a regular basis by senior management and discussions are documented.	• Knowledge of IRR may be limited to too few individuals and risk information is only generated for compliance purposes and is not well documented or used to guide decision making.

Use the dropdown box to score this section (that is, low, moderate, or high).

RM Score	**Use Drop Down Menu in this box for Risk Scoring of High, Moderate or Low**

Tab F: *Overall IRR Rating*

Tab F: *Overall IRR Rating* is broken into three sections.

- Section I: Section IRR Scores
- Section II: Overall IRR Rating
- Section III: Supervisory Action

Section I: Section IRR Scores

Scores in this section will automatically roll up to the *IRR Overall Rating* tab.

FIGURE 20. SCORING TABLE

Section	Market Risk	EAR and Other IRR	Stress Testing	Measurement Systems	Risk Management
Score	Low	Low	Moderate	Moderate	Low

Section II: Overall IRR Rating

Examiners will use a dropdown box to score this section (that is, low, moderate, or high).

Overall IRR Rating	Use Drop Down Menu in this box for IRR Supervisory Rating of High, Moderate or Low

Each of the scores that an examiner has assigned in tabs A through E will automatically populate into the summary scoring table (see *Figure 20*). Then, examiners must assign the overall IRR rating in Tab F as the basis for the Final Assessment (AIRES Scope).

Tab A: *Market Risk* provides a "rating floor" for the overall IRR rating, meaning that the Overall IRR Rating can never be lower than the Market Risk score. Scores from Tabs B through E cannot *improve* a credit union's Overall IRR Rating; however, these scores can *lower* a credit union's Overall IRR Rating. For example, a credit union with a low or moderate Market Risk rating could see its Overall IRR Rating elevated to high if it receives unfavorable scores in tabs B through E. (See Overall IRR Rating Scenarios below.)

Importantly, if the result of an NEV Supervisory Test is extreme, unless extenuating circumstances exist, examiners will issue a DOR or other administrative action requiring management to submit a plan to reduce the credit union's IRR position to the relevant Regional

Director within 45 days. The plan must include a strategy to reduce the IRR position to a less than extreme level based upon the results of the NEV Supervisory Test.

Below, five scenarios (ordered from low to extreme) are provided to illustrate possible paths towards an Overall IRR Rating. These scenarios are for illustrative purposes only and do not encompass all possible scenarios. The scenarios use the assumptions and suggested rating definitions included in Tabs A through E as discussed above.

Overall IRR Rating Scenarios

1) Good infrastructure (systems, staff, data) and strong controls
2) Good infrastructure (systems, staff, data), but deficiencies in EAR and control environment; more stress testing is needed
3) Infrastructure, risk management, and stress testing are acceptable, but need to be strengthened
4) Infrastructure is adequate, but the controls and stress testing are weak and need improvement immediately
5) The validated NEV Supervisory Test result is extreme; the credit union needs to provide a plan to lower the risk within 45 days

Simulation #1: Credit union has a good infrastructure (systems, staff and data) and strong controls.

#1 Strong Infrastructure and Controls							
Section	**A**	**B**	**C**	**D**	**E**		**F**
Name	**MR**	**EAR**	**ST**	**MS**	**RM**		**Overall**
Strong Infrastructure and Controls	H	L	L	L	L		H
	M	L	L	L	L		M
	L	L	L	L	L		L

Notes to Overall IRR Rating for Simulation #1:

1. The first line in Simulation #1 verifies a **high** level of quantitative risk from Tab A and low levels of risk in the other tabs, concluding with a **high** Overall IRR Rating.

2. The second line in Simulation #1 verifies a **moderate** level of quantitative risk from Tab A and low levels of risk in the other tabs, concluding with a **moderate** Overall IRR Rating.
3. The third line in Simulation #1 verifies a **low** level of quantitative risk from Tab A and low levels of risk in the other tabs, concluding with a **low** Overall IRR Rating.

Simulation #2: Good infrastructure (systems, staff, data), but deficiencies in EAR and the control environment; more stress testing is needed.

#2 "Strong MS, but some weaknesses identified in EAR, ST and RM"

Section Name	A MR	B EAR	C ST	D MS	E RM	F Overall
Scores & Ratings	H	M	M	L	M	H
	M	M	M	L	M	M
	L	M	M	L	M	M

Notes to Overall IRR Rating for Simulation #2:

1. The first line in Simulation #2 verifies a **high** level of quantitative risk from Tab A and moderate or low levels of risk in the other areas, concluding with a **high** Overall IRR Rating.
2. The second line in Simulation #2 verifies a **moderate** level of quantitative risk from Tab A and moderate or low levels of risk in the other areas, concluding with a **moderate** Overall IRR Rating.
3. The third line in Simulation #2 verifies a **low** level of quantitative risk from Tab A and moderate or low levels of risk in the other areas, concluding with a **moderate** Overall IRR Rating.

Simulation #3: Infrastructure, risk management, and stress testing are acceptable, but need to be strengthened.

#3 "Weaknesses identified in EAR, ST, MS, and RM"

Section Name	A MR	B EAR	C ST	D MS	E RM	F Overall
Scores & Ratings	H	M	M	M	M	H
	M	M	M	M	M	M/H
	L	M	M	M	M	M

Notes to Overall IRR Rating for Simulation #3:

1. The first line in Simulation #3 verifies a **high** level of quantitative risk from Tab A and moderate results for the other review areas, concluding with a **high** Overall IRR Rating.
2. The second line in Simulation #3 verifies a **moderate** level of quantitative risk from Tab A and moderate results from the other review areas, concluding with an Overall IRR Rating of **moderate** or **high**.
3. The third line in Simulation #3 verifies a **low** level of quantitative risk from Tab A and moderate results from the other review areas, concluding with a **moderate** Overall IRR Rating.

Simulation #4: Infrastructure is adequate, but the controls and stress testing are weak and need improvement immediately.

#4 "Significant weaknesses identified in ST and RM with moderate weaknesses identified in EAR and MS"

Section Name	A MR	B EAR	C ST	D MS	E RM	F Overall
Scores & Ratings	H	M	H	M	H	H
	M	M	H	M	H	H
	L	M	H	M	H	M/H

Notes to Overall IRR Rating for Simulation #4:

1. The first line in Simulation #4 verifies a **high** level of quantitative risk from Tab A and high or moderate levels of risk in the other review areas, concluding with a **high** Overall IRR Rating.
2. The second line in Simulation #4 verifies a **moderate** level of quantitative risk from Tab A and high or moderate levels of risk in the other review areas, concluding with a **high** Overall IRR Rating.
3. The third line in Simulation #4 verifies a **low** level of quantitative risk from Tab A and high or moderate levels of risk in the other review areas, concluding with an Overall IRR Rating of **moderate** or **high**.

Simulation #5: The validated NEV Supervisory Test result is extreme; the credit union needs to provide a plan to lower the risk within 45 days.

#5 Extreme Risk Scenario							
Section Name	**A MR**	**B EAR**	**C ST**	**D MS**	**E RM**		**F Overall**
Sup Test Extreme	E	Other Recommendations to be included in the DOR as part of "De-Risk" Plan					H

Note to Overall IRR Rating for Simulation #5:

1. In the event that a verified Tab A indicates an **excessive** level of quantitative risk, the credit union will be required to provide a plan or corrective action plan to lower the risk within 45 days of notification. If any other assessments (that is, in Tabs B through E) need remediation or improvement, they are included in the DOR or Examiner's Findings. The Overall IRR Rating would be **high**.

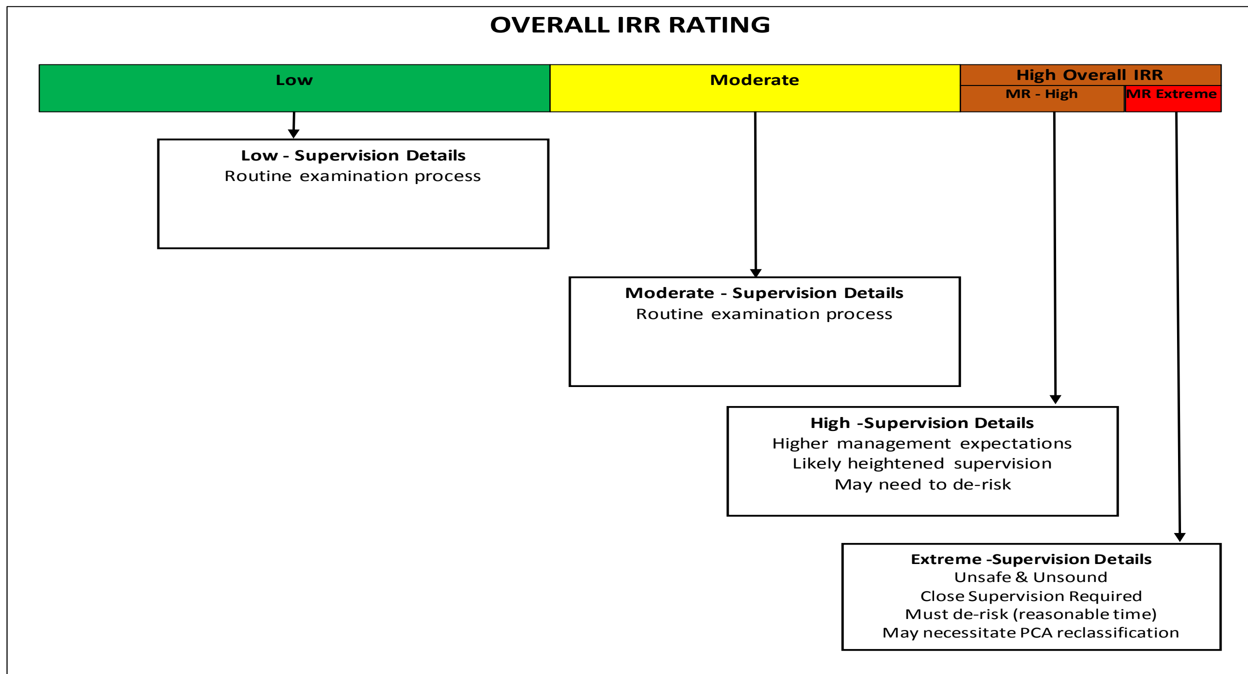
Narrative for the Scope Module

The *Overall IRR Rating* tab includes a narrative box, where examiners will provide narrative regarding the Scope Module (results of review and final assessment).

Section III: Supervisory Action

Figure 21 illustrates the potential supervisory action related to a credit union's Overall IRR Rating. As the IRR risk level increases, supervisory expectations for management increase as well.

FIGURE 21. SUPERVISORY EXPECTATIONS BASED ON OVERALL IRR RATING



As indicated previously in *Figure 1*, once the IRR review is complete, the examiner must perform the Total Analysis Process and BSRM (Balance Sheet Risk Management) evaluations to understand and conclude on the interrelationships among the risk categories and how they relate to the CAMEL component and composite ratings. Once the examiner has a comprehensive understanding of the credit union's overall risk profile, he/she can determine whether supervisory actions (such as a Document of Resolution (DOR) or Examiner Findings (EF)) are necessary. The *National Supervision Policy Manual* (NSPM) provides the framework for developing a DOR and EF, as well as for determining which action is necessary to correct an issue.

While typically a correlation exists between an elevated IRR category and the need for a DOR or EF, examiners should understand the drivers of the rating because these may influence the need for supervisory action. For example, a credit union with high market risk score (like a high result on the NEV Supervisory Test), a modest level of net worth, and significant credit and liquidity risk exposures would likely require a DOR or EF because its net worth level is not sufficient to support the collective risk exposures. However, a credit union with a high market risk score, a significant net worth position, and low levels of other risk in the other risk categories (historically, currently, and prospectively) likely will not require a DOR or EF.

In the unusual case of an extreme Market Risk score, management will be required to develop a plan to lower the risk to at least a level less than extreme within a reasonable time. If a credit union is unable or unwilling to do so, the examiner and his/her supervisor should discuss with

regional management the need to provide a recommendation to the NCUA Board to reclassify the credit union's net worth category, based on safety and soundness, as well as to pursue any other applicable enforcement actions to correct the problem, provided in the existing authority in NCUA rules and regulations §702.102.

Glossary

Assumptions: Postulations that are used as factors in IRR measurement. Assumptions are typically derived using a combination of internal/external sources. In IRR measurement, assumptions are typically made about interest rate trends, member behavior, and economic factors. Assumptions can greatly influence measurements, so it is crucial that assumptions accurately reflect operational management's and the board's expectations and are reasonable and supportable.

Base Value: The current market value as determined of a specific balance sheet account assuming no change to the level of interest rates.

Basis Point (bps): A unit of measurement used to describe changes in interest rates or other financial percentages. One basis point is equal to 1/100 of one percent.

Basis Risk: The risk to earnings and economic value when a change in one interest rate differs from that of another interest rate (relationship between two indices). 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).

Beta Factor: Assumption about non-maturity share (NMS) that is used to measure interest rate changes relative to market rate changes. (Also see Rate Sensitivity Factor.)

Book Value: The GAAP-compliant presentation of an account as it appears on the financial statements.

Cap: The maximum interest rate a variable rate product can adjust to, given a rising market rate environment. A cap, which is established at origination of the product, is generally used to protect a borrower from unlimited rate adjustments. If a cap is not used, a borrower could be subject to ever increasing payments as their variable rate product adjusts to higher rates. For depository institutions, caps present a form of option risk.

Convexity: Convexity is a measure of the curvature in the relationship between an asset price and yield that demonstrates how the duration of an asset changes as the interest rate changes.

Core Shares: A portion of shares and deposits that are not sensitive to changes in interest rates, or are less sensitive than other products. These are shares that management does not expect members to withdraw (or reinvest 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 shares. Generally, money market share accounts and share certificates are less likely to be considered core shares.

Decay Rate: The assumed cash flows for non-maturity shares (NMS), expressed as a percentage. Also called the "run-off rate" or "prepayment rate" for shares.

Discount: The current market rate or the shocked market rate of interest at the time a measurement is made.

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 the present value of a cash flow. Measurement system models may offer other methods for assigning a discount rate, but two methods are commonly used by credit unions: 1) using a static discount rate or 2) basing the discount rate on an index, plus a spread.

Using a static discount rate means using a single discount rate for all cash flows of a particular account. The rate should represent the market offering rate for a like asset or liability. For example, when valuing its 30-year, fixed-rate mortgage portfolio, the credit union should obtain the current rate offered by the market for 30-year, fixed-rate mortgages. The credit union's current offering rate should not be used, unless management determines that the credit union's rate is equivalent to a market rate. Because credit unions typically try to offer more favorable rates on loans and shares, the current offering rate may not equal the market rate.

Basing a discount rate on an index plus a spread requires a user to establish a spread to the index to represent the risks inherent in the asset or liability being valued. For example, mortgage loans can default, and can also be prepaid by the member. Due to the credit risk and cash flow uncertainty, the mortgage portfolio's discount rate should reflect a spread over the index (e.g., Treasury curve index). The credit union should be able to support the indices and spreads used to discount each account.

Floor: The lowest interest rate a variable-rate product can adjust to given a decreasing market rate environment. A floor, which is established at origination of the product, is generally used to protect a credit union's variable-rate products from unlimited rate adjustments. If a floor is not used, then a credit union's NII could decrease as its variable-rate products adjusts to lower rates. Floors present a form of option risk.

Deterministic: A modeling technique, which allows operational management to specify the direction, amount, and timing of future interest rates in order to measure the potential impact the changes may have on earnings and capital.

Dynamic Simulation: Detailed assumptions regarding changes in existing business lines, new business, and changes in management and customer behavior. The assumptions change the existing balance sheet to reflect expected business changes.

Duration: The amount by which an asset price increases or decreases as the result of a 1 percent change in interest rates. Duration measures how much the price changes and, for that reason, is a measure of an asset volatility to price changes.

Gap Analysis: A simple IRR measurement method that reports the mismatch between rate-sensitive assets and rate-sensitive liabilities over a given time period. Gap can only suffice for simple balance sheets that primarily consist of short-term bullet-type investments and non-mortgage related assets. Gap analysis can be static, behavioral, or based on duration.

Income Simulation: An IRR 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.

In-House Model: An asset-liability management (ALM) model developed, operated, and/or controlled by a credit union with little to no help from third-party vendors other than for maintenance purposes.

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 potential that changes in market interest rates will adversely affect a credit union's earnings and net worth (also referred to as market risk). This risk is present to some degree in all credit union balance sheets and can be an important source of earnings and membership value. IRR generally arises from a mismatch between the timing of cash flows from fixed rate instruments, and interest rate resets of variable rate instruments, on either side of the balance sheet. Thus, as interest rates change, earnings or net worth may decline.

Measurement Model: An analysis used to measure a credit union's level of IRR. The most common measurement models include net economic value (NEV) analysis and net interest income (NII) simulations.

Measurement System: The platform and model used to capture all material sources of IRR and generate meaningful reports that quantify the risk for consideration by operational management and a credit union's board of directors. Credit unions need to utilize a measurement system that is appropriate for the size and complexity of its balance sheet, but all measurement systems require a credit union to gather and input data and make assumptions about possible future interest rate environments and member behavior, so as to quantify IRR exposure.

Model Risk: The potential for adverse consequences from decisions based on incorrect or misused model outputs. This may be the result of model error from an incorrect mathematical calculation, input error that causes an inaccurate model output, an inadequate reporting component that fails to translate model estimates into useful business information, or from a lack of model complexity that results in the model's inability to capture all relevant risks. In all situations, it is important to understand a model's capabilities and limitations given its simplifications and assumptions.

NMS Premium: The fair value of non-maturity shares (NMS); typically, a function of the effects of NMS life, dividend rate, discount curve, and rate sensitivity factor(s). A premium is often expressed as a percentage over the change from book to base values.

Net Economic Value (NEV) Analysis: An IRR 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.

NEV Volatility: A measure of the change (either in dollar or percentage terms) in NEV resulting from a change in interest rates. The volatility is measured from a base case scenario. A high level of NEV volatility reflects a high level of IRR.

Non-Parallel Yield Curve Shift: A shift in the yield curve in which yields do not change by the same number of basis points for every maturity. When running various interest rate scenarios, management may set non-parallel shifts in a manner similar to deterministic rate scenarios (e.g., rate shock, rate ramp). The scenarios often have a pivot point on the yield curve from which longer-term and shorter-term rates change in different amounts. (See also Parallel Yield Curve Shift.)

Outsourced Model: An ALM model that is provided and run by a third party. Credit unions may use an outsourced model to conduct periodic ALM modeling.

Observable Inputs: Inputs that reflect the assumptions market participants would use to price an asset or liability, developed based on market data obtained from sources independent of the reporting entity. There are three levels of observability:

- Level 1 - Quoted prices in active markets for identical assets or liabilities that can be accessed at the measurement date
- Level 2 - Other than Level 1 measures that are observable for an asset or liability, either directly or indirect
- Level 3 – Unobservable inputs for an asset or liability

Option Risk: The risk that a financial instrument's cash flows (timing or amount) can change at the exercise of the option holder, who may be motivated to do so by changes in market interest rates.

Parallel Yield Curve Shift: A shift in the yield curve in which yields change by the same number of basis points for every maturity (e.g., fixed assumption that all points on the yield curve shift by the prescribed shock amount). The results of a parallel interest rate shock would measure the impact on a credit union's earnings and economic value if all interest rates increased, for example, by 300 basis points as well as the impact if all interest rates decreased 300 basis points. The results allow the user to compare the magnitude of change (i.e., the sensitivity) for various rate moves. (See also Non-Parallel Yield Curve Shift.)

Prepayment: The early repayment of principal, in advance of scheduled amortization or maturity.

Pricing: An action by credit union management to set interest rates and terms on loan and deposit products offered to members.

Rate Sensitivity Factor (RSF): A measure of how much the rate on an asset or liability will fluctuate as a result of changes in the interest rate environment. (See also Beta Factor.)

Rate Ramp Scenario: A gradual increase in interest rates over a specified time period, usually 12 months. Rate ramps are generally used for management forecasts of future earnings in income simulations. For example, when measuring the effects of a 300 basis point rate increase during a 12-month period, rates would be increased 25 basis points each month. (See also Stair-Step Scenario.)

Rate Shock Scenario: An immediate and sustained change in the level of interest rates for all assets and liabilities. Generally, a permanent and parallel rate shock of 100 to 300 basis points is applied. For example, in a +300 basis point scenario, the full effect of the rate increase would be administered in the first period measured and remain in effect for all periods.

Repricing: The change in interest rates 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.

Shocked Value: A fair value for a financial instrument given a change in interest rates (positive or negative). The difference between the current value (base) and the shocked value informs management of the price sensitivity of a financial instrument to a change in interest rates.

Spread risk: The risk to earnings and/or value resulting from variations through time of the spread between assets or liabilities to an underlying index, such as the Treasury curve.

Stair-Step Scenario: A scenario in which rate changes are administered at less frequent intervals over a measured period. For instance, in a +300 basis point rate environment measured over a two-year time period, rates may be increased 50 basis points each quarter of the first year and 25 basis points each quarter of the second year. (See also Rate Ramp cenario.)

Static Simulation: An earnings technique based on current exposures and assuming a constant, no-growth balance sheet. In order to simulate no growth in balance sheet accounts, some static models assume that all principal cash flows from a particular account are reinvested back into that same account. This assumption is sometimes referred to as replacement growth.

Stochastic Model: A technique that models an uncertain variable over time using a random selection process. The model recognizes that market variables, such as interest rates, exhibit a general trend (i.e., drift) and some degree of volatility around that trend. Stochastic models provide a framework for the evaluation of the impact of embedded options in financial instruments.

Variance Analysis (or "back-testing"): The process of identifying material differences between actual and forecasted income statement and balance sheet amounts, and ascertaining the causes of the differences. Variances can be readily identified by direct comparison of the financial statements for a particular forecast period, or by using key financial indicators, such as net interest margin, cost of funds, or asset-yield comparisons.

Variance analysis can help management understand the primary reasons for material differences between projected and actual results. It can also provide a means to improve the precision of the IRR measurement system. Periodic variance analysis helps management and the board acknowledge that the system is accomplishing its primary goal of providing meaningful information on the level of IRR. Variance analysis provides an opportunity for a deeper understanding of both the system and its results.

Valuations: The present value of future cash flows of assets and liabilities, expressed in terms of dollars or price. Valuations will differ based on the set of assumptions applied to calculate the present value.

Volatility: The change in measures of IRR, 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.

Yield Curve: The term structure of interest rates over a maturity spectrum. In a normal yield curve, longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time.

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Interest Rate Risk > References

IRR References

Internal (NCUA) References

- **NCUA** Letter to Credit Unions 12-CU-11, Interest Rate Risk Policy and Program Frequently Asked Questions (August 2012)

  *Addresses questions regarding the **IRR** rule and the appendix to the rule.*

- NCUA Letter to Credit Unions 12-CU-05, Interest Rate Risk Policy and Program Requirements (May 2012)

  Discusses the implementation of the IRR Rule and the appendix to the rule that includes comprehensive guidance. Also provides the exam questionnaire associated with the appendix to the rule.

- NCUA Supervisory Letter 14-02, Derivatives Examination Guidance (February 2014)

  Describes the NCUA regulations and guidelines for credit unions that use derivatives to manage risk. It also establishes a consistent framework for field staff to examine and supervise derivative programs.

- NCUA Letter to Credit Unions 10-CU-06, Interagency Advisory on Interest Rate Risk Management (May 2010)

  *Includes **FFIEC** Interest Rate Risk (IRR) Advisory that reminds institutions of supervisory expectations for sound practices to manage IRR.*

- NCUA Letter to Credit Unions 10-CU-03, Concentration Risk (March 2010)

  Discusses the evaluation of concentration risk as it relates to the credit union's current balance sheet, how strategic plans may affect the level of concentration risk, and to ensure risk management practices are commensurate with the level of risk.

- NCUA Letter to Credit Unions 03-CU-15, Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios (September 2003)

  Reemphasizes the importance of properly monitoring and managing an increasing portfolio of fixed-rate mortgage products.

- NCUA Letter to Credit Unions 03-CU-11, Non-Maturity Shares and Balance Sheet Risk (July 2003)

Provides guidance on sound practices for evaluating behavior of non-maturity shares in the context of managing risk.

- NCUA Letter to Federal Credit Unions 02-**FCU** -09, Risk-Focused Examination Program (May 2002)

  Introduces the risk-focused examination program and the seven risk areas.

- NCUA Letter to Credit Unions 01-CU-19, Managing Share Inflows in Uncertain Times (October 2001)

  Discusses importance of exercising diligent management practices while analyzing available options and objectives resulting from an inflow of funds (issued as a result of share inflow credit unions experienced after 9/11 terrorist attacks).

- NCUA Letter to Credit Unions 01-CU-08, Liability Management - Highly Rate-Sensitive & Volatile Funding Sources (July 2001)

  Emphasizes the importance of managing risk within a total balance sheet perspective, while focusing on the funding side of asset-liability management.

- NCUA Letter to Credit Unions 99-CU-12, Real Estate Lending and Balance Sheet Risk Management (August 1999)

  Emphasizes the importance of interest rate risk management, while focusing on mortgage-related assets.

- NCUA Letter to Credit Unions 00-CU-10, Asset Liability Management Examination Procedures (November 2000)

  *Provides guidance on asset liability management (**ALM**).*

- NCUA **IRPS** 98-2, Investment Securities and End-User Derivatives (April 1998)

  Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities

- NCUA rules and regulations §741.3 ("IRR Rule")

- NCUA rules and regulations Part 741, Appendix B, Guidance for an Interest Rate Risk Policy and an Effective Program

External and Interagency References

- FFIEC Interagency Advisory on Interest Rate Risk Management, (January 6, 2010)

- FFIEC Interagency Advisory on Interest Rate Risk Management -Frequently Asked Questions (January 12, 2010)

- FRB and OCC (SR Letter 11-7) Supervisory Guidance on Model Risk Management (April 4, 2011)
- FDIC Risk Management Manual of Examination - Sensitivity to Market Risk
- OCC Comptroller's Handbook - Interest Rate Risk
- FRB Commercial Bank Examination Manual
- Bank for International Settlements: Basel Committee on Banking Supervision, Interest rate risk in the banking book
- Bank for International Settlements: Basel Committee on Banking Supervision, Principles for the Management and Supervision of Interest Rate Risk

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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

14-8 Blank

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) depositary; a depositary of federal taxes, a depositary 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 depositary 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 depositary. The examiner should determine that copies exist of the application and board of directors' resolution authorizing the credit union to be a TT&L depositary 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 reconcilement);
- 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 percent + 1.175 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 x 1.15 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 x -0.9 percent = $18,000 / 12 months = $1,500 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:

Net Worth Ratio = Net Worth/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 Conservatorship 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	*By weighted average life*:	
		0 to 1 year	.03
		>1year 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)

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.

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
Fixed-rate MBLs 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
Variable-rate MBLs 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

Weighted-Average Life = Sum of (Time*Principal)=200 = 2 Years
Total Principal 100

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

Weighted-Average Life = Sum of (Time*Principal)=400 = 4 Years
Total Principal 100

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*].

New

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

	Projected						
Quarter Ending	Total Assets	Gross Income	Opera-ting 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 Board of Directors	Date	Chief Financial Officer Board of Directors	Date

____________________ ____

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

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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.

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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 the 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 (FISCUs) as to RegFlex eligibility. State regulators are also responsible for subsequent monitoring of all FISCUs 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 *NCUA Rules and Regulations*. [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

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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.

- 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.

- 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.

Cash Management

- 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 vise 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 (traverlers 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 funs 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.

Other Activities

- 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.

- 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 of 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;
- 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 regarding 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.

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.

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.

Regional compliance analysts serve as the regional point of contact. They monitor training needs, provide applicable training, and perform in-depth compliance reviews.

The compliance program officer serves as the agency contact in the area of consumer compliance regulation and enforcement.

Examination Procedures

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. A discussion of the credit union's compliance policies and practices with staff responsible for ensuring compliance and monitoring requirements may suffice. In contrast, the focus at smaller credit unions or credit unions with limited internal controls may include verifying information through more extensive transaction testing.

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;
- A new consumer compliance regulation affecting the credit union industry;
- A change in credit union staff responsible for compliance with consumer laws;
- The length of time since an NCUA examiner performed a review of the area;
- The 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

Table 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 http://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 http://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 http://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 http://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 http://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 compliant 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 http://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 Determin-ation 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

- Assess the credit union's compliance management system for the Consumer Leasing Act
- Determine whether the credit union provides required disclosures to lessees
- 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.
- Reputation risk can occur when non-compliance with Regulation M or inadequate disclosures result in increased liability and risk of loss that may harm the credit union's reputation.

Overview

The Federal Reserve Board issued Regulation M (12 C.F.R. Part 213), the Consumer Leasing Act (15 USC 1667 et.seq.), 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. NCUA Rules and Regulations §714 and Appendix 10A of this Guide contain more guidance on leasing programs.

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:

Adjusted capitalized cost: the gross capitalized cost less the capitalized cost reduction is the amount used by the lessor in calculating the base periodic payment.

Capitalized cost reduction: the total amount of any rebate, cash payment, net trade-in allowance, and non-cash credit that reduces the gross capitalized cost.

Closed-end lease: a consumer lease other than an open-end lease. This type of lease allows the member to "walk away" at the end of the contract period, with no further payment obligation, unless the property has been damaged or has sustained abnormal wear and tear.

Consumer lease: a contract between a lessor and a lessee:

- For the use of personal property by an individual (natural person);
- To be used primarily for personal, family, or household purposes;
- For a period of more than four months (week-to-week and month-to-month leases do not meet this criteria, even though they may be extended beyond four months); and
- Has a total contractual cost of no more than $25,000.

The Consumer Leasing Act and Regulation M cover a lease that meets all of the above criteria. The Consumer Leasing Act and Regulation M do not apply if the lease fails to meet any one of the above criteria.

The following are not consumer leases:

- A lease that meets the definition of a credit sale in Regulation Z §226.2(a)(16);
- A business or agricultural lease, or one made to an organization or government;
- A lease made for real property; and
- A lease for personal property, which is incidental to the lease of real property, subject to certain conditions.

Gross capitalized cost: the amount agreed upon by the lessor and lessee as the value of the leased property, plus any items that are capitalized or amortized during the lease term (e.g., taxes, insurance, service agreements, and any outstanding prior credit or lease balance).

Lessee: a natural person who enters into or is offered a consumer lease.

Lessor: a natural person or organization who regularly leases, offers to lease, or arranges for the leasing of personal property under a consumer lease. A person who leases or offers to lease more than five times in the preceding or current calendar year is subject to Regulation M.

Open-end lease: a lease in which the amount owed at the end of the lease term is based on the difference between the residual value of the leased property and its realized value. The consumer may pay all or part of the difference if the realized value is less than the residual value, or the consumer may get a refund if the realized value is greater than the residual value at scheduled termination.

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 of the leased property at disposition, 2) the highest offer for disposition of the leased property, or 3) the fair market value of the leased property at the end of the lease term.

Residual value: the value of the leased property at the end of the lease, as estimated or assigned at consummation of the lease by the lessor.

Disclosures

All disclosures required under Regulation M must be accurate, clear and conspicuous, in writing, and in a form the consumer can keep. Certain pieces of information must be kept together and segregated from other lease information. The lessee may agree to electronic disclosures. Credit unions must provide disclosures as follows:

- Prior to or due at lease signing. The lessor must provide a dated disclosure containing all required information to the lessee before signing the lease.

- Renegotiations and extensions. The lessor must also provide new disclosures when a lessee renegotiates or extends a lease, subject to certain exceptions.

- Multiple lessors/lessees. In the event of multiple lessors, one lessor on behalf of all the lessors may make the required disclosures. If the lease involves more than one lessee, the lessor should give the required disclosures to any lessee who is primarily liable.

Advertising

All advertisements for consumer leases must be accurate and must comply with certain disclosure requirements. If a printed advertisement includes any reference to certain "trigger terms" (i.e., the amount of payment, statement of a capitalized cost reduction [i.e., down payment], other payment required, or that no such payment is required), then the advertisement must also state the following:

- The transaction is for a lease;
- The total amount due prior to or at lease signing, or delivery;
- The number, amounts, and due dates or periods of scheduled payments; and
- A statement of whether or not a security deposit is required.

An advertisement for an open-end lease must also include a statement that the lessor may impose extra charges at the end of the lease based

on the difference between the residual value and the realized value at the end of the lease term.

If lessors give a percentage rate in an advertisement, the rate cannot be more prominent than any of the other required disclosures. They must also include a statement that “this percentage may not measure the overall cost of financing this lease.” The lessor cannot use the term, “annual percentage rate,” “annual lease rate,” or any equivalent term.

Some fees (license, registration, taxes, and inspection fees) may vary by state or locality. An advertisement may exclude these third-party fees from the disclosure of a periodic payment or total amount due at lease signing or delivery, provided the advertisement states that these have been excluded. Otherwise, an advertisement may include these fees in the periodic payment or total amount due, provided it states that the fees are based on a particular state or locality, and indicates that the fees may vary.

Limits on Balloon Payments

In order to limit balloon payments that a lessor may require of the lessee, certain sections of the regulation call for reasonable calculations and estimates. These provisions protect the lessee at early termination of a lease, at the end of the lease term, or in a delinquency, default, or late payment status. The provisions limit the lessee’s liability at the end of the lease term and set reasonableness standards for wear and use charges, early termination charges, and penalties or fees for delinquency.

Penalties and Liabilities

Criminal and civil liability provisions of the Truth in Lending Act also apply to the Consumer Leasing Act. Actions alleging failure to disclose the required information, or otherwise comply with the Consumer Leasing Act, must be brought within one year of the termination of the lease agreement.

Record Retention

Lessors must maintain evidence of compliance with the requirements imposed by Regulation M, other than the advertising requirements imposed under Section 7 of the regulation, for a period of not less than

two years after the date required for the disclosures or the date of a required action.

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 accurate, conspicuous, written in a form the consumer may keep, and consistent with the model disclosure forms; alternatively, that they are provided electronically where agreed to by the consumer;
- Complete the Regulation M Questionnaire in AIRES (the checklist provides informative guidance on the requirements of the regulation for each question); and
- 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 also furnishes 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 Consider- ations

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.

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.

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 advance notice required.	No notice required. New disclosures if renewed.
Greater than 1 month but 1 year or less	Timing: (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. Content: 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 either: (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.	No notice required. New account disclosure if renewed.
Greater than 1 year	Timing: Same as for accounts greater than 1 month but 1 year or less. Content: Full disclosures for account (§707.4(b)) and maturity date for existing account.	Timing: 10 (calendar) days before maturity. Content: Maturity date, and whether or not dividends will be paid after maturity. New disclosures if renewed.

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.

Examination Report Writing

Examination reports should convey the purpose, scope, identified problems, corrective actions, and conclusions reached during the examination process. The examiner's written product is an essential communication tool and part of the formal administrative record.

The **AIRES** examination workpapers and schedules are also an important part of the administrative record, designed to support the examination report and the examiner's conclusions.

Last updated July 29, 2015.

Examination Report Components

For credit union examinations and supervision, the official examination report is comprised of the following documents, as applicable:

Document	Requirement
Cover Letter	Required
Table of Contents	Required
Examination Overview	Required for a **FCU**
Document of Resolution	If applicable
DOR Status Report	If applicable
Examiner's Findings	If applicable
Loan Exception Schedule(s)	If applicable
Supplementary Facts	If applicable
Status Update	If applicable
FISCU CAMEL Disclosure	Required for a FISCU

In addition to the official examination report documents, examiners may upload additional workpapers, schedules, checklists, forms, or notes that support their conclusions with the **AIRES** examination upload. Examiners will also prepare the Confidential Section (required) and Supervision Chronology Report (if applicable) documents for **NCUA** 's internal use only, as directed in the District Management section of the NSPM. Specific AIRES workpaper requirements for each type of examination or contact are outlined in the following **NSPM** sections:

- District Management
- FCU Program and Procedures
- FISCU Program and Procedures

State regulator examination reports may contain different key documents and workpapers. NCUA examiners must follow FISCU Program and Procedures when conducting examinations and contacts in a FISCU.

Last updated July 29, 2015.

Cover Letter

The cover letter:

- Explains the risk-focused or defined-scope examination process
- Explains the examination appeal process
- Provides a description of the key documents included in the examination report

Examiners will include the appropriate cover letter with the official written examination report presented to credit union officials. **AIRES** provides standard cover letter templates for each type of examination or contact.

Last updated January 27, 2016.

Citation Guidelines

When citing problems identified, examiners will:

- Cite the highest, most specific authority
- List multiple citations, if necessary
  - For example, while you would cite (missing or bad snippet) §741.3(b)(5) for violations of the Interest Rate Risk rule, you can also cite Letter to Credit Unions 12-CU-11, Interest Rate Risk Policy and Program Frequently Asked Questions, which provides the credit union additional information regarding the rule.
- Refrain from citing "safety and soundness" or "unsound business practice" by citing §741.3 of **NCUA** rules and regulations as appropriate.
- Use "Part" when referring to the entire part of a rule or regulation ("Part 723" or "Part 702")
- Use "Section" or the section symbol "§" when referring to a specific section of a rule or regulation ("Section 723.8" or "§723.8")

For more information about citations, see Writing a DOR.

Hierarchy of Frequently Used Citations

1. Federal Credit Union Act
2. State law
3. Consumer compliance laws
4. NCUA rules and regulations
5. Credit union bylaws
6. Preamble to NCUA rules and regulation
7. NCUA Interpretive Ruling and Policy Statement (**IRPS**)
8. IRPS preamble
9. **GAAP** /**FASB** rules
10. **FFIEC** guidance
11. Interagency guidance

12. NCUA Accounting Bulletin
13. NCUA Letter to Credit Unions
14. NCUA Risk Alert
15. NCUA Examiner's Guide
16. NCUA General Counsel Opinion Letter
17. NCUA Merger Manual
18. NCUA Chartering and Field of Membership Manual
19. NCUA Accounting Manual for Federal Credit Unions
20. NCUA Supervisory Committee Guide

Last updated December 1, 2016.

Document of Resolution

The Document of Resolution (**DOR**) outlines the problem(s) identified and corrective action plan(s) that represent agreements reached with officials to correct problems of the highest priority and concern arising from the examination or supervision contact. Examiners will detail the person(s) responsible, a citation for the problem, and the timeframe for taking corrective action in the DOR. The **NCUA** expects faithful performance from credit union management on all agreements reached and documented in the DOR. Credit union management's failure to address DOR items may result in administrative action.

Problems included in a DOR must be significant enough that the examiner would recommend escalating to the next level of elevated enforcement action (for example, Regional Director letter, Letter of Understanding and Agreement) for failure to correct the problem. DOR items are those that management must begin to address immediately or within a compressed timeframe due to the risk associated with the problem. Sometimes, the problem may take significant time to be fully resolved. In these instances, the credit union must initiate action to address the items quickly, even if it may take a year or more to fully resolve the problem or comply with the corrective action item.

Last updated July 29, 2015.

DOR Development Process

The development of a **DOR** is shown in the development flowchart for DORs. The first step is to discuss the identified problem or problems with management and work to reach agreement that the problem(s) exists.

If management agrees with the identified problem(s), examiners will ask credit union management to develop an acceptable corrective action plan, or plans, to resolve the problem(s).

- Acceptable corrective action plan(s) developed by either a credit union or an examiner are included in the DOR

When management does not agree with the identified problem(s), examiners will evaluate the reasons for the disagreement and ensure they have identified the core problem(s). Once the core problem(s) has been identified and agreed upon, examiners will proceed with asking management to develop an acceptable corrective action plan(s) as outlined above.

If management still does not agree with the identified problem(s) and cannot provide an acceptable corrective action plan, the examiner will develop a plan and strive to get management's agreement:

- Acceptable corrective action plan(s) developed by either a credit union or an examiner are included in the DOR

If management does not agree to comply with an examiner-developed corrective action plan, examiners will:

- Weigh management's failure to identify and resolve problems in the management CAMEL component and overall composite ratings.
- Incorporate the following language into the DOR, along with the examiner-developed corrective action plan: ""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, (ADDRESS), by (DATE), of the actions to be taken."

For problems an examiner determines to be particularly severe, examiners will notify their supervisor and consider drafting a Regional Director letter urging the credit union officials to either accept the resolution offered in the DOR or to formulate an acceptable alternate plan that recognizes and resolves the problems. However, when the overall risk to the credit union so warrants and agreement cannot be reached, it may be necessary to recommend escalated administrative action.

The Confidential Section should document all cases of disagreement and the intended steps to ensure proper resolution and follow-up of the problems identified. Additionally, if an examiner suspects or has identified fraud or ethical concerns, a more unilateral

approach may be necessary. In these instances, examiners should notify the Supervisory Examiner.

When presenting the final report to the officials, examiners should request the board of directors enter a formal board resolution into the minutes to document agreement to resolve all DOR items.

Last updated July 29, 2015.

Writing a DOR

The **DOR** concisely describes the problem (including all supporting facts) and outlines the corrective action necessary to resolve the problem. Examiners must use the **AIRES** DOR module to draft a DOR. This module allows DORs to be tracked until they are marked "Resolved" or "NLA".

When entering DOR items in the AIRES module, examiners will:

- Describe the root problem concisely, including any corresponding details and facts that support the conclusion that the problem warrants a DOR item in the Problem section of the AIRES DOR module
    - For example, in a credit union with multiple accounts that are out of balance, the DOR should address the cause of the poor recordkeeping rather than only requiring the credit union to balance the accounts. The credit union must not only balance all accounts, but also ensure staffing, controls, and procedures are in place to prevent future out-of-balance situations
- Outline appropriate corrective action to resolve the identified problem in the Agreed Upon Corrective Action section
    - Examiners should use corrective actions suggested by credit union management if the action will adequately resolve the problem.
- Cite the agreed upon timeframes for completion
    - Do not cite "ongoing" as the timeframe for correction.
- Cite the specific section of the Federal Credit Union Act, **NCUA** rules and regulations, Federal Credit Union Bylaws, or other authority (including NCUA-issued guidance such as a Letter to Credit Unions)
    - For problems not specifically addressed in law, regulation, or other specific regulatory guidance, examiners should cite §206(b)(1) of the Federal Credit Union Act or §741.3 of NCUA's rules and regulations. If a credit union violates more than one of the above, cite the highest authority.
- Identify the specific person(s) or committee(s) responsible for correcting each DOR item by name and title, where applicable

> Section 206(b)(1) of the Federal Credit Union Act gives NCUA the ability to terminate insurance for unsafe and unsound practices. Even though a DOR may not lead to termination of insurance, the Act implies credit unions must operate in a safe and sound manner as a condition of insurance. Section 741.3 of NCUA rules and regulations also requires credit unions to operate in a safe and sound manner as a condition of insurance.

When drafting a DOR, examiners will:

- Use the "SMART" principle when developing corrective action plans
    - Specific
    - Measurable
    - Achievable
    - Results-oriented
    - Timely
- Begin the corrective action plan with an action verb
- Tailor the DOR and the corrective action plans specifically to the credit union and the competence of the management team
    - Corrective action plans will generally be more detailed and specific in credit unions that have more complex problems and/or less sophisticated management.
- Prioritize the order of DOR items with the most critical problems up front
    - Examiners should ensure the DOR focuses only on the most critical items at that contact.
- Categorize similar or related DOR items into logical groups when practical
    - For example, group four separate DOR items related to credit risk weaknesses under a "Credit Risk Management" sub-heading in the DOR.

Last updated July 29, 2015.

What to Include in a DOR

Problems requiring immediate attention that examiners will address in the **DOR** include:

- Unsafe or unsound practices that reasonably threaten the stability of the credit union. This means any action or lack of action that, if left uncorrected, may result in substantial loss or damage to the credit union or its members. Conditions or practices considered "unsafe or unsound" include, but are not limited to:
    - Operating with an inadequate level of net worth or capital for the kind, quality, and concentration of assets held
    - Engaging in lax lending and/or collection practices that include, but are not limited to:
        - Extending inadequately secured credit
        - Originating credit without obtaining current financial information
        - Extending credit without adequate controls
        - Extending credit with inadequate diversification of risk
    - Operating without adequate liquidity
    - Operating without adequate internal controls. Examples include internal control weaknesses that can lead to persistent recordkeeping errors, numerous loans granted outside of policy, or manipulation of records
    - Failure to keep accurate books and records. This includes an accounting and control structure that does not provide for accurate full and fair disclosure of financial statements, which may lead to or mask severe financial problems
    - Operating without a credit risk management program commensurate with the types of credit extended to the membership
    - Operating without an asset/liability risk management process commensurate with the complexity of the balance sheet
    - Inadequate corporate governance
- Compliance violations that are systemic, recurring, or that result from willful neglect
- **BSA** violations, in accordance with the agreement between the **NCUA** and **FinCEN**

When determining whether a problem qualifies as a DOR, consider the following:

- If left unresolved, could the violation or problem cause serious financial or operational damage to the credit union?
- Does the problem result in fundamental noncompliance with laws and/or regulations?
- Is the problem something that would need to be escalated to the next level of enforcement action (PWL, LUA, etc.) if unresolved?
- Is the problem a result of management's inability or unwillingness to properly identify, measure, monitor, and control the risk?
- Is the problem widespread through the organization?

Problems that meet the criteria above likely warrant a DOR. However, examiner judgment is necessary to determine whether a problem meets the definition of a DOR. Examiners will consider the circumstances surrounding the problem and the relative impact on the credit union when determining if a practice is unsafe or unsound at that particular credit union.

If a problem has been ongoing for many years, examiners must use judgment to determine whether it meets the definition for a DOR. Examiners should take the appropriate action, which may include marking the DOR as no longer applicable (NLA) because it has not caused harm to the financial or operational condition of the credit union, issuing a new corrective action plan that better addresses the root cause of the problem, moving the problem to the Examiner's Findings, or recommending escalated enforcement action.

Last updated July 29, 2015.

What to Exclude from a DOR

Examiners should refrain from documenting every problem in a **DOR** . The DOR should be reserved for problems that meet the standards outlined in the Examiner's Guide. In addition, examiners should exclude the following items from the DOR.

- Suggestions or items for management to consider. Sometimes it is appropriate to provide the credit union suggestions and recommendations, or present options they should consider. Examiners can include such suggestions and recommendations in the Supplementary Facts.
- Broad or general statements that require the credit union to "comply with the examination report" or to correct problems included in the Examiner's Findings section. The cover letter attached to each examination report outlines management's responsibilities, which include acting on the report to correct all deficiencies. CAMEL and risk ratings should reflect management's ongoing failure to correct problems noted in the DOR or Examiner's Findings, if necessary.
- Escalated Examiner's Findings merely because they have gone unresolved. Numerous uncorrected Examiner's Findings can be indicative of uncooperative or ineffective management and may impact a credit union's CAMEL and/or risk ratings. A DOR to address uncooperative or ineffective management may be warranted in these circumstances. If circumstances change and the unresolved Examiner's Finding subsequently meets the criteria for a DOR, examiners should document the problem and corrective action in the DOR.
- Blanket statements that require the credit union to comply with the LUA. By signing, credit union management agrees to correct the deficiencies noted within the LUA. To maintain the administrative record, examiners must document the status of the LUA in the examination report.
    - A DOR issued to a credit union with an outstanding LUA may only include new problems and corrective action plans that are not already addressed in the LUA.
    - For DORs that are issued and then incorporated into an LUA, the examiner may continue to include them in the DOR provided to the credit union or include them under the "Items excluded from DOR" section of the **AIRES** module for tracking purposes.
    - If a credit union fails to comply with an LUA, examiners should discuss the need for additional enforcement action with the **SE** . At a minimum, the CAMEL and risk ratings should reflect management's failure to comply with an LUA.

Last updated July 29, 2015.

Requesting a Response to a DOR

Under certain circumstances, examiners are required to obtain written responses to the **DOR** from credit union officials. To fulfill this obligation, examiners may include an action item in the DOR requiring the credit union to provide a written response to the examination report by a specific date. Examiners may also address this request in any open section of the examination report as necessary. When including this action item in the DOR, examiners will utilize the Non-Risk (Housekeeping) option under the risk areas in the DOR module.

Following up on DOR Items

Generally, examiners should follow-up on DOR items within 120 days after the timeframe for completion has passed. In the case of CAMEL 3, 4, and 5 credit unions, the current follow-up supervision requirements outlined in the District Management section of the NSPM will allow for adequate follow-up on DORs.

In CAMEL 1 and 2 credit unions with a DOR, the examiner should evaluate whether a CAMEL 1 or 2 rating is warranted. If it is, the examiner can set the timeframe for completion to coincide with the next scheduled contact or examination. If the DOR is so time-sensitive that it needs to be completed sooner than before the next scheduled contact or examination, examiners will follow-up within 120 days of the timeframe for completion.

Examiners need to follow-up on outstanding DOR items through both onsite and offsite supervision. Examiners must follow national policy outlined in this manual (see the FCU Program and Procedures and FISCU Program and Procedures sections of the NSPM) for completing onsite and offsite supervision.

Examiners should track DOR timeframes for completion and follow-up with credit union management via phone call or e-mail to discuss the status of DOR items as part of offsite supervision. For DORs that can be confirmed offsite, examiners should mark them as "resolved" or "unresolved" in the DOR module accordingly and upload the **AIRES** file. For other items that need to be reviewed onsite, examiners should determine their status and update the DOR module at the next scheduled onsite contact. For simplicity, examiners may consider using the next scheduled contact date to determine the timeframe for completion.

When on site for a follow-up contact or at the following examination, examiners should include review of the prior DOR in the examination scope. If unresolved DOR items are identified, examiners should first identify why the item is unresolved to properly address and resolve the recurring problem. The reason a DOR item remains unresolved will determine the subsequent steps necessary.

The first step is to identify why credit union management did not resolve the problem. Consider the following:

- Did management make a good faith effort and comply with a majority of the corrective action plan?
- Did the corrective action plan prove to be unachievable or unreasonable?
- Did management resolve the root problem in a different manner than was agreed upon in the DOR?
- Did management comply with the corrective action plan, but the action did not resolve the problem?
- Did management ignore the corrective action plan?

There may be additional reasons the credit union did not comply with a corrective action plan. Examiners should consider these reasons when determining the best way to address unresolved problems. For example, if management willfully neglects to address the problem the examiner should consider how management's inaction affects the credit union's CAMEL and risk ratings and whether escalated administrative action is necessary.

In instances where management completed a majority of the corrective action plan, the original DOR item was unachievable, or management complied with the corrective action plan but it did not solve the problem, examiners should develop a new corrective action plan to resolve the problem. Examiners should use judgment to determine whether it is a repeat DOR item or if the original DOR item is "NLA".

In instances where management made a good faith effort or has completed a majority of the elements of a corrective action plan, a repeat DOR may not be warranted if the remaining items can be corrected in the normal course of business. Examiners should use the DOR definition outlined above to determine whether a problem should remain a DOR. Examiners must mark DOR items resolved when a credit union has implemented the corrective action, even if the financial trends do not yet reflect the improvements the actions were intended to correct.

For example, a credit union has a high operating expense to average asset ratio and negative earnings. The DOR corrective action plan requires the credit union to reduce operating expenses. When the examiner follows-up, they note the credit union has made adequate expense cuts; however, the operating expense to average asset ratio remains high and will not reflect the full impact of the expense cuts for two more quarters. In this case, the examiner should mark the DOR as resolved. The examiner has multiple options to address the ongoing risk including, but not limited to:

- Documenting the credit union's compliance with the DOR in the DOR Status Report and note management should continue to monitor the operating expense to average asset ratio until the financial ratios reach the agreed upon goal.
- Documenting the credit union's compliance with the DOR in the Examination Overview and noting management should continue to monitor the operating expense to average asset ratio until the financial ratios reach the agreed upon goal. Create a new DOR for the credit union to achieve the agreed upon ratio goal (for example, "achieve an operating expense to average asset ratio of X.XX%") with timeframe for resolution in two quarters to provide the financial ratios time to reflect the operating expense cuts.

For DOR corrective action items that will take more than one year to reflect full compliance, examiners should consider issuing individual DORs to achieve quarterly goals, with the applicable timeframe for completion. Examiners should work with credit union management to develop reasonable goals to include in the DOR.

Last updated July 29, 2015.

Requesting Monthly Financial Statements

The FCU Program and Procedures and FISCU Program and Procedures sections of the NSPM instruct examiners to obtain monthly financial statements for all troubled institutions where the financial condition is a problem and the credit union represents significant risk to the share insurance fund. Because credit unions requiring monthly monitoring generally have material concerns, examiners may document the requirement to send monthly financial statements and/or board packets in the **DOR** . This provides documentation that management has agreed to submit these items to the examiner by a specified time each month. When including this action item in the DOR, examiners will utilize the Non-Risk (Housekeeping) option under the risk areas in the DOR module.

Last updated July 29, 2015.

Examiner's Findings

The Examiner's Findings reflect problems that management must address, but can do so in the normal course of business. Since these problems do not currently threaten the viability of the credit union or represent systemic violations, management may determine the timeframe and approach for correcting these problems. Repeated failure to resolve problems in the Examiner's Findings could indicate a serious underlying management deficiency and result in a **DOR** addressing management's lack of controls to ensure problem resolution. However, failure to resolve these problems does not automatically warrant escalating the finding to a DOR. Examiners should determine the root problem and determine if that meets the definition of a DOR.

Generally, Examiner's Findings will only include a statement of the problem. The examiner may provide the credit union with a recommended corrective action to resolve the problem when necessary, such as when a credit union needs specific direction or asks for guidance on correcting certain problems.

When drafting an Examiner's Finding, the examiner should cite the specific section of the Federal Credit Union Act, **NCUA** rules and regulations, Federal Credit Union Bylaws, or other authority (including NCUA-issued guidance such as a Letter to Credit Unions). In the event the credit union violates more than one authority, the examiner should cite the highest authority. See more information on citations.

Last updated July 29, 2015.

Examination Overview

The Examination Overview (overview), at a minimum, discloses both the component and composite CAMEL ratings and each final risk rating as outlined in the Risk Focused Examination section of the Examiner's Guide. If no material risks exist, the overview will usually be brief. It should:

- Include a high-level summary of risks identified during the examination
- Summarize the credit union's overall condition
- Discuss the credit union's current and future risk profile
- Relate the applicable risks to the CAMEL ratings
- Present a professional, concise discussion of key issues in context of the credit union's overall condition
- Be easy for credit union officials to read and understand

Last updated July 29, 2015.

Loan Exceptions Schedule(s)

Examiners should list weaknesses in loan underwriting, lack of compliance with credit union underwriting policies, regulatory compliance issues, etc. on the loan exceptions schedule(s).

If used, examiners will include the loan exceptions schedule(s) in the official examination report. If the loan review reveals material or systemic weaknesses, the examiner should address these issues in other portions of the examination report as needed.

Last updated July 29, 2015.

Status Update

Field staff will use the Status Update template to document a credit union's compliance with outstanding administrative actions (LUA, PWL, etc.) and net worth restoration plans. For each document, field staff should provide a separate Status Update. For example, if a credit union has an outstanding LUA and NWRP, field staff will create two Status Update templates, one for each of the outstanding documents.

At a minimum, field staff will include each outstanding corrective action or goal and the most current status of each in the Status Update. Field staff will include the Status Update(s) in the official examination report provided to credit union officials. However, if the credit union does not have any outstanding enforcement actions or an NWRP, field staff should exclude this document from the report.

> When upgrading a credit union from a CAMEL 4 or 5, or removing an LUA, field staff must complete the status report.

Last updated July 29, 2015.

Supplementary Facts

The primary purpose of the Supplementary Facts document is to provide additional detailed information that enhances or supports issues already discussed in the Overview or other portions of the examination report. Examples of items to discuss in the Supplementary Facts include:

- Further background information related to specific examination concerns documented in the Overview or other portions of the examination report. For example, a detailed analysis of interest rate risk (**IRR**) modeling concerns which may not be appropriate for an overview discussion but still needs to be documented and communicated with credit union officials.
- Communicating detailed information on new laws or regulations impacting or soon to be impacting the credit union.
- Additional background information on more detailed or complex accounting issues affecting the credit union.
- Other issues such as bond claims, fraud concerns, or contingent liabilities warranting enhanced discussion.

If used only for informational purposes (for example, to provide recommendations or suggestions), examiners have the option to exclude the Supplementary Facts document from the official examination report, and only provide it to daily management. If the Supplementary Facts document includes discussion of issues affecting the operations of the credit union or information supporting other documents in the examination report, examiners must include it with the official examination report provided to the officials.

Last updated July 29, 2015.

Table of Contents

Examiners will use the **AIRES** Table of Contents to organize the report and document the official examination report components and workpapers given to the officials. Examiners will provide the credit union copies of the Examination Cover Letter, Examination Overview, and other report documents as applicable.

Examiners may informally provide the credit union any schedules, optional workpapers, questionnaires, or examiner-designed workpapers needed to support their conclusions and assist in gaining resolution to problems uncovered during the examination or supervision process. However, only those workpapers and documents listed in the Table of Contents are considered part of the official examination report.

Last updated July 29, 2015.

Unresolved Prior Examiner's Findings

If an examiner discovers that previous Examiner's Findings are not corrected, he or she must determine the reason behind the lack of resolution and the materiality of the concern. Numerous uncorrected Examiner's Findings can be indicative of an uncooperative or ineffective management which may also suggest the need for other administration actions.

At a minimum, examiners should list Examiner's Findings noted during previous examinations, but not yet corrected, under a heading such as "Examiner's Findings Noted at Previous Examination That Are Not Yet Corrected" or by identifying the Examiner's Finding and footnoting it with similar wording. Repeat Examiner's Findings are not automatically escalated to a **DOR** .

Section 206(b)(1) of the Federal Credit Union Act gives the **NCUA** the ability to terminate insurance for unsafe and unsound practices. Even though a DOR may not lead to termination of insurance, the Act implies credit unions must operate in a safe and sound manner as a condition of insurance. Section 741.3 of NCUA rules and regulations also requires credit unions to operate in a safe and sound manner as a condition of insurance.

Last updated July 29, 2015.

Examination Report Objectives

Examiners will write reports and prepare documents in accordance with the *NCUA Communications Manual* and plain writing guidelines. Examiners must develop a professional and concise examination report that communicates all problems and risks in an easy to read and understandable format for the credit union officials. The examination report must:

- Properly identify all material examination concerns related to the seven risk areas (credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risk)
- Relate the applicable risk areas to the CAMEL ratings
- Support all conclusions reached regarding problems identified
- Outline proper corrective actions to ensure problems are resolved in a timely manner
- Establish a documented administrative record to support future administrative action and problem resolution, if necessary
- Be properly supported by required documentation

The examination report is the **NCUA** 's official report to the credit union and an important communication tool between the NCUA and credit union officials. The examiner-in-charge receives pertinent information from team members on the areas reviewed, prepares the report, and typically delivers the report to the board of directors at the conclusion of the examination. The credit union board of directors and senior management comprise the report's primary users, so examiners should write the report with the officials as the audience.

Examiners should set aside time throughout the examination to discuss problems identified during the examination with management and officials. It is important to provide management a draft copy of the DOR, Examiner's Findings, and Loan Exceptions with sufficient time to review before the joint conference or exit meeting. New information not provided to credit union management in advance will not be introduced at the joint conference, exit meeting, or in the final examination report.

Key assertions may be withheld from management in the event they merit discussion directly with a credit union board of directors. An example of such a circumstance is suspected fraud. More information about joint conferences and exit meetings is available in the NSPM.

Last updated December 1, 2016.

Supporting Workpapers

In addition to the examination report documents provided to the credit union, examiners must complete and upload sufficient **AIRES** workpapers to support the examiner's conclusions, and the **NCUA** 's administrative record. National guidance, as outlined in the **NSPM** , dictates the required workpapers for each type of examination or contact.

Scope Module

The examination scope describes the type, depth, and results of review conducted within each risk area during a credit union examination and, in some cases, supervision contact. Additional guidance on completing the Scope module can be found in the following:

- FCU Program and Procedures section of the NSPM
- FISCU Program and Procedures section of the NSPM
- Scope Development and Planning section of the Examiner's Guide

The most recent NCUA Instruction 5000.20, Examination Scope, discusses expectations for conducting reviews of specific areas in more detail.

Exam Management Console

The Exam Management Console (EMC) captures basic information for all contact types. There are three main tabs on the EMC screen:

1. General Exam Information
2. Time Detail
3. Completion Information

Consumer Compliance Violations Module

Examiners must document violations of federal regulation detected during the examination and supervision process on the Consumer Compliance Violations module in AIRES. Examiners will follow the procedures for **BSA** violations outlined in the BSA Enforcement section of the NSPM.

AIRES Questionnaires

AIRES questionnaires are available to assist examiners in completing examination steps. Examiners must include all questionnaires required by the most recent (missing or bad snippet).

Examiners must use their judgment to determine when best to use questionnaires and optional questionnaires.

Confidential Section

The Confidential Section is for the agency's internal use only. Examiners should document the following in this section:

- Any actions taken during the examination that are not discussed elsewhere in the report
- Details of new or unique programs or services not discussed elsewhere in the report or in the AIRES Scope module
- Candid discussions of management's ability and willingness to correct areas of concern
- Whether management developed and provided the **DOR** corrective action items

The NSPM outlines a list of items examiners are required to address in the Confidential Section.

Last updated January 27, 2016.

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.

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.

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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 may require that examiners expand the procedures outlined in this appendix and provide additional documentation.

At a minimum, the NCUA examiner-reviewer (reviewer), after analyzing the state supervisory authority's (SSA) examination report, scope workbook, 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, identified material risk areas during the current examination, addressed weaknesses, and reached agreement with the officials to resolve the problems and appropriately manage the risk.

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.

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. NCUA examiners should demonstrate a courteous, professional, and cooperative attitude in all communications (including state report reviews) and contacts with the SSAs and their staff members.

Processing and Reviewing State Examination Reports and Scope Workbooks

Upon receipt of the report and scope workbook, reviewers will:

- Review the state examination report, scope workbook, financial performance, and any other information pertinent to the credit union (e.g., risk reports, Consolidated Balance Sheet, Financial Performance Reports);
- Complete the Examiner Contact Information and upload it to the host system within regional time frames;
- Complete a state examination report review within the scope workbook and any other work papers required by the regional director; and
- Upload the scope workbook within regional time frames.

State Examination Review Scope Workbook

Examiners will use the Code 26 function within the scope workbook to document their analysis of state examinations and the review process. The scope workbook contains instructions for specific steps on completing and uploading the Code 26 scope workbook.

Reviewing the state examination report and scope workbook should enable the reviewer to answer the following questions:

- Did the SSA examination report identify material risk areas?
- Did the SSA examination report offer appropriate solutions to reduce unacceptable risks?
- Was the scope of the examination appropriate given the risk profile of the credit union?
- Did the examination report provide adequate documentation supporting the work performed and the conclusions drawn?

- Are the supervision plans outlined by the SSA adequate given the credit union's risk profile?

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 inform their supervisory examiners when 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.

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

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

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 Depositaries accounts, and (3) Depositaries 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. <u>They must obtain approval of the technical assistance grant before committing to, or contracting for, the service or purchase</u>. 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 Responsibility

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*

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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 Regul*ations
- 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)

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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)

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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* speifies 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 unpreapproved 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* Part712
- *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 ____

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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):

  $$\frac{\text{Cash \& Equivalents + Net Trade Receivables}}{\text{Total Current Liabilities}}$$

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:

$$\frac{\text{Net Profit + Depreciation + Depletion + Amortization Expenses}}{\text{Current Portion of Long-Term Debt}}$$

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.

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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 FISCU;
- 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 FISCUs 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 FISCUs 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. Secondarily, 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 FISCU'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 FISCU. 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 FISCU. 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 AIRES 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 FISCU 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 FISCU 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 FISCU 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 FISCU 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

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 perpetuator 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 reconcilement 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.

Fidelity Bond Coverage

Fidelity bond coverage (also known as blanket, surety, or discovery bonds) provides protection against losses caused by fraud, dishonesty, theft, and similar activities committed by credit union employees, directors, officers, supervisory committee members, and credit committee members. Credit unions may obtain optional bond endorsements that cover directors' and officers' liability, audit expenses, and other fraud-related losses.

A fidelity bond may also cover losses incurred as the result of burglary, robbery, larceny, theft, mysterious disappearance, forgery, counterfeit money, and other perils.

Typically, fidelity 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 (less the deductible). However, the bond would not cover the interest income that the credit union might have earned on this $10,000.

The Federal Credit Union Act Part 112, §113(2), and §120(h) set forth the statutory requirements for the bonding of employees and appointed and elected officials of federal credit unions. Section 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.

Faithful Performance Coverage

Faithful performance covers losses resulting from an employee's or director's failure to faithfully perform their trust, or from their conscious disregard for acredit union's established and enforced policies. Credit unions may purchase faithful performance coverage to supplement their fidelity bond coverage, but they are not required by statute or regulation to do so.

Why NCUA Examines a Credit Union's Fidelity Bond Coverage

In order to obtain federal insurance through the National Credit Union Share Insurance Fund, §741.201 of NCUA rules and regulations requires all federally insured credit unions to possess the minimum fidelity bond coverage stated in Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions. (Section 704.18 defines the bond requirements for corporate credit unions.)

Part 713 requires that credit unions' bond coverage, at a minimum:

- Be purchased in an individual policy from a company holding a certificate of authority from the Secretary of the Treasury, and
- Include fidelity bonds that cover fraud and dishonesty by all employees, directors, officers, supervisory committee members, and credit committee members

This section of the Examiner's Guide includes the following sections:

- Primary Risks
- Managing Risk Exposure
- Impact on Credit Union Financial Position
- Endorsements and Riders
- Additional Bond Coverage
- Bondable Losses and Fraud
- Reporting to the Bond Company
- Letter of Notification
- Notice and Proof of Loss
- Follow Up
- Review Procedures

Workpapers & Resources

- NCUA rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions
- NCUA rules and regulations §741.201, Minimum fidelity bond requirements
- NCUA List of Bonds Approved for Use by Federally Insured Credit Unions
- NCUA Legal Opinion Letter, RE: Fidelity Bonds - Joint Coverage (September 26, 2017)
- NCUA Letter to Credit Unions 01-CU-12, e-Commerce Insurance Considerations (October 2001)

Last updated May 21, 2018

Primary Risks

Compliance Risk

Compliance risk is the current and prospective risk to earnings or net worth arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards. Compliance risk exposes a credit union to fines, civil money penalties, payment of damages, and the voiding of contracts. This risk can lead to a diminished reputation, limited opportunities, reduced potential to expand the field of membership, and lack of contract enforceability.

As stated above, bond coverage is required by the Federal Credit Union Act and **NCUA** rules and regulations. Failure to obtain bond coverage as required exposes a credit union to compliance risk. The NCUA may revoke a credit union's charter if it fails to obtain bond coverage. Recurring issues with respect to bond coverage may lead to a higher insurance premium, which may prove cost prohibitive.

Additionally, if a credit union does not follow its own policies, its bond coverage may be impacted. For example, if a credit union's board of directors approves loans outside of the lending policy, and those loans turn out to be fraudulent, the bond company may deny claims attempting to recover any resulting losses.

Reputation Risk

Reputation risk is the current and prospective risk to earnings or net worth 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.

A credit union's reputation may be damaged if it experiences losses because it does not have bond coverage or does not have adequate bond coverage.

Transaction Risk

Transaction risk is the risk to earnings or net worth arising from fraud or errors that result 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.

Transaction risk exposures with respect to bond coverage, may include:

- Not paying its bond coverage premium as required, leading to loss of coverage
- Not making timely notification of potential losses pursuant to the bond requirements, leading to denied claims

Last updated October 11, 2016

Managing Risk Exposure

People

Board of Directors

It is the responsibility of a credit union's board of directors to ensure that adequate bond coverage is obtained pursuant to the requirements of the Federal Credit Union Act and **NCUA** rules and regulations §713.5. Section 713.2 of NCUA rules and regulations requires a federal credit union's board of directors to review the extent of coverage at least annually to ensure that it is adequate in relation to the potential risks facing the credit union and the minimum requirements set by the Board.

> **FISCUs** are subject to state laws, which may or may not require an annual board review. FISCUs must be in compliance with any relevant state law that addresses bond coverage.

The board may consider the credit union's loss exposure, internal controls, and financial resources when determining the amount and the type of coverage necessary.

For example, the board may consider:

- 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, as well as their levels of experience and authority, and the employee turnover rate,
- The reliability and security of the information system (IS),
- The types of services offered (for example, plastic cards, electronic banking services), and
- The overall risk of the institution.

Management

A credit union's management is responsible for:

- Timely payment of the bond premium
- Making any bond claims in accordance with the requirements of the bond

- Reporting bond claims to the credit union's board of directors
- Reporting bond coverage on the CU Online Profile
- Ensuring that the credit union obtains insurance through an approved bond form, pursuant to NCUA rules and regulations §713.4(a)
- Assessing the credit union's coverage needs and recommending endorsements or riders, as appropriate, to the board

Supervisory Committee

As credit union officials, all supervisory committee members must be bondable by the credit union's bond company.

The supervisory committee is responsible for reviewing any audits performed by the bond company and responding to any related recommendations.

Policies and Procedures

Anti-Fraud Policy

A credit union's anti-fraud policy may outline the action the credit union will take in the event that fraud is discovered, including notifying surety and filing a bond claim if losses are determined. The policy may also identify the person(s) responsible for making notifications to the bond company.

Hiring Policy

A credit union's hiring policy should outline standard hiring practices. The policy may require criminal record, credit report, background check, and drug testing of prospective employees. It should also require management to confirm in writing a prospective employee's bondability. The policy should also address nepotism (hiring relatives, friends, or business associates of current employees) and institute probationary periods for all employees.

Credit unions may consider obtaining credit checks on all new employees, employees considered for promotion, and periodically (annually) on all employees and volunteers, and should have a plan in place in the event adverse information is discovered.

In addition, credit unions should have a process for monitoring all key employees with civil judgments or bankruptcies. A credit union should have its legal counsel review its processes to ensure they comply with all federal and state laws.

Procedures

It is considered a best practice for a credit union to have procedures in place to ensure that:

- The credit union's bond coverage is adequate and in effect
- Bond claims and other notifications are filed with the bond company in accordance with the bond requirements

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Last updated October 11, 2016

Impact on a Credit Union's Financial Position

There are several ways that fidelity bond coverage can impact a credit union's financial position:

- The cost of obtaining bond coverage (the premium) is an expense that reduces earnings and, potentially, net worth.
- If the bond coverage is inadequate, any expenses that are not covered by the bond (for example, legal or audit expenses) will reduce earnings and may reduce net worth.
- Any claims denied by the bond company will result in expenses or losses that reduce earnings and, potentially, net worth.

Last updated October 11, 2016

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.

Bond insurance generally does not cover expenses of recovery, such as legal fees or audit expenses, but because these expenses can be significant, credit unions may opt to purchase an endorsement to the bond that does cover them. An 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.

Workpapers & Resources

- **NCUA** rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions

Last updated October 11, 2016

Fidelity Bond Coverage > *Additional Bond Coverage*

Additional Bond 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.

A credit union's board of directors should review the extent of coverage at least annually (§713.2). It should consider the credit union's loss exposure, internal controls, and financial resources when determining the amount and the type of coverage necessary.

Specifically, the board should consider:

- 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, as well as their levels of experience and authority, and the employee turnover rate,
- The reliability and security of the information system (IS),
- The types of services offered (for example, plastic cards, electronic banking services, etc), and
- The overall risk of the institution.

Last updated October 11, 2016

Bondable Losses and Fraud

In the course of an examination, an examiner may determine that criminal activity or a bondable loss has occurred that may affect the bondability of an employee or official. In these cases, the examiner should inform their **SE** , 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 relevant **NCUA** regional office.

In addition, a credit union must complete a Suspicious Activity Report (**SAR**) whenever it suspects criminal activity. Examiners should determine whether or not the credit union has filed a SAR within the required time, when necessary. Regional offices can obtain a report of SARs filed from the Financial Crimes Enforcement Network (**FinCEN**); examiners may check with the regional office to verify that SARs have been filed, when warranted.

Workpapers & Resources

- NCUA rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions
- NCUA rules and regulations §748.1, Filing of Reports

Last updated October 11, 2016

Fidelity Bond Coverage > Reporting to the Bond Company

Reporting to the Bond Company

The question of whether or not a reportable loss has occurred will often arise during an examination or supervision contact. Credit union directors may ask the examiner to help them arrive at a decision about reporting or giving notice of loss to the bond company, recovering the funds, or filing a claim.

In all cases, examiners should direct credit union management to refer to the bond requirements, which will state, among other things, when the credit union is required to make a report or notification to the bond company (that is, what constitutes a "reportable condition") and how quickly notifications must be made (that is, the timeframe for reporting or notifying the bond company once a reportable condition is discovered).

The table below outlines a series of scenarios and the appropriate action indicated in each case.

Scenario	Action
Credit union discovers that an employee has violated a policy that could cause future loss to the credit union (for example, has made member business loans not included in the credit union's lending policy).	1. Credit union should send a letter of notification to the bond company within the timeframe specified by the bond. (This will help protect the credit union in the event of any future losses from the MBLs or any other incident tied to that particular employee.)
Credit union experiences losses because an employee violated policy.	1. Credit union should send a letter of notification to the bond company within the timeframe specified by the bond. 2. Credit union should file a faithful performance bond claim to recover those losses.
Credit union experiences a loss of an identifiable amount due to a fraudulent act (for example, an employee steals cash from the teller drawer).	1. Credit union send a letter of notification to the bond company within the timeframe specified by the bond. 2. If losses exceed the deductible, the credit union should file a fidelity bond claim for the identified amount.

Scenario	Action
Credit union experiences a loss of an *unidentifiable* amount due to a fraudulent act (for example, an employee has issued fraudulent credit cards).	1. Credit union should send a letter of notification to the bond company within the timeframe specified by the bond. 2. Credit union should commence an investigation into the fraudulent activity. This may include hiring a forensic auditor to determine the exact amount of the fraud-related losses. 3. Once the investigation is complete and the amount of the fraud loss is determined, the credit union should file a fidelity bond claim to recover losses.

Ultimately, a credit union's board of directors must make the decision about what action to take. However, the examiner may guide the directors in protecting the credit union's interests under the bond. The examiner should warn the directors that a bonding company could refuse to pay a claim for losses suffered by the credit union if the directors fail to file a claim or make a notification in accordance with the requirements of the bond.

Workpapers & Resources

- **NCUA** rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions

Last updated October 11, 2016

Letter of Notification

A 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
- 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, examiners 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.

Workpapers & Resources

- **NCUA** rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions

Last updated October 11, 2016

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 funds/payment.

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

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. The credit union may need to request Proof of Loss forms from the bond company.

Workpapers & Resources

- **NCUA** rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions

Last updated October 11, 2016

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 maintain 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 & Resources

- **NCUA** rules and regulations Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions

Last updated October 11, 2016

Review Procedures

Part 713, Fidelity Bond and Insurance Coverage for Federal Credit Unions, of **NCUA** rules and regulations sets the minimum bond coverage and the maximum deductible for credit unions. These figures are based on a credit union's asset size and, in the case of the deductible, the credit union's level of capitalization and composite CAMEL ratings.

For each credit union, examiners should use the Bond Calculation worksheet in the **AIRES** Exam workbook to determine:

- the minimum required bond coverage, and
- the maximum deductible.

Examiners should verify that the credit union has obtained the appropriate bond coverage for its asset size and has not exceeded the maximum deductible required by regulation.

If an examiner finds that the coverage does not meet the regulatory minimum, this information should be conveyed to credit union management and corrected immediately. Typically, a credit union can increase its bond coverage quickly and easily by calling the insurance company. If the credit union hesitates to do so, an examiner should address insufficient bond coverage in the appropriate section of the exam report.

The NSPM details when problems should be included in a DOR or in another section of the exam report. Inadequate fidelity bond coverage may put a credit union at risk of account insurance suspension or even revocation of its charter. 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.

Some writers of credit union bonds have a risk management division whose auditors will, upon request, perform a risk management audit designed to detect internal control weaknesses. Examiners can review these reports and confirm whether or not the credit union has adequately addressed the weaknesses identified. Material issues that have not been resolved by the credit union may present transaction risk that the examiner should address.

Documenting Fidelity Bond Coverage

During the course of an examination, an examiner may:

- Determine that the bond is in force in an amount at least equal to regulatory minimums
- Document in the examination workpapers the bond type, bonding company name, amount of coverage, and any deductibles
- Be alert to any unprotected areas of risk for the credit union

Last updated October 11, 2016

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.

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

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, (3) 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.

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[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).

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.

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

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 lease 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

- *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

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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 Depositary 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. <u>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</u>.

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 undercapitalizd, 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*

Chapter 32

INCIDENTAL POWERS

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Chapter 32

INCIDENTAL POWERS

Examination Objectives

- Determine whether the legal authority for the expanded activities exists under Part 721 of the *NCUA Rules and Regulations*
- Evaluate adequacy of policies, practices, procedures, and internal controls over the incidental powers activity
- Determine that personnel operate in conformance with sound business practices and board approved guidelines
- Determine that management has performed the necessary due diligence for the services and products offered under the incidental powers provision
- Assess promptness of corrective action initiated by management when deficiencies or violations in policies, practices, procedures, or internal controls arise

Associated Risks

Activities permitted by the incidental powers provision could subject the credit union to one or more of the seven risks. Some activities involve more risk than others; therefore, the risk to the credit union largely depends on the type of activity chosen.

Overview

An activity under the incidental powers provision, which applies to federal credit unions, is one that is necessary or requisite to enable the credit union to effectively carry on the business for which it was incorporated (§721.2). An activity meets the definition of an incidental power if it meets the following three-prong test:

- Convenient or useful in carrying out the mission or business of credit unions consistent with the FCU Act;
- Functional equivalent or logical outgrowth of activities that fall within the mission or business of credit unions; and
- Involves risks similar in nature to those already assumed as part of the business of credit unions.

Management is responsible for developing proper safeguards such as management oversight, internal controls, and quality control. Credit

unions must examine the strategic, reputation, transaction, and compliance risks before engaging in any new activity. Management must exercise due diligence before devoting resources to a new activity or entering into any third-party arrangements. Credit unions must adjust their risk management process and insurance coverage to correlate with the additional risk of any new activities.

Examiner Review

Examiners should tailor their incidental powers review to the existing and potential risks associated with the activity. At a minimum, examiners should review the credit union's analysis supporting its decision to engage in the activity. This may include reviewing the business plan, applicable contracts (including recourse and/or liability position), legal opinions, licensing and insurance requirements, feasibility studies, and cost benefit analysis.

The following may assist the examiner in determining the scope:

- Concerns noted in previous examination or audit reports;
- Interviews with management and staff to determine the extent and quality of management's due diligence regarding the credit union's products, services, systems, and risk mitigation procedures;
- Review of internal audit work, if available;
- Review of the credit union's internal controls; and
- Review of the credit union's periodic analysis of the vendor's financial and contractual performance.

Categories of Preapproved Activities

Before engaging in any of the activities authorized under incidental powers, credit unions must comply with applicable conditions or restraints established by federal and state law, NCUA regulations, and legal opinions. Credit unions must further ascertain whether they need to obtain licenses or meet other legal requirements before engaging in an activity.

The following broad categories are preapproved activities under the incidental powers provision:

- **Certification services** – when the credit union attests or authenticates a fact for its members' use. Certification services may

include notary services, signature guarantees, certification of electronic signatures, and share draft certifications.

A credit union acting as a certification authority bears similar risks to a notary's risk of improper verification, or to those risks inherent to providing electronic services. The credit union's policies should set forth identification and verification methods.

- **Correspondent services** - when the credit union provides services it is authorized to perform for its members, or as part of its operation, to other credit unions. These may include loan processing, loan servicing, member check cashing services, disbursing share withdrawals and loan proceeds, cashing and selling money orders, performing internal audits, and automated teller machine deposit services.

  Correspondent services entail the same risks as those assumed by the credit union for its own operation. Parties to a correspondent arrangement must establish a written agreement addressing the credit unions' responsibilities under the service arrangement. Correspondent relationships allow credit unions to assist other credit unions lacking resources or expertise; however, credit unions cannot be in the business of managing other credit unions.

- **Electronic financial services** - any services, products, functions, or activities the credit union is otherwise authorized to perform, provide, or deliver to its members but performed through electronic means. Electronic services may include automated teller machines, electronic funds transfers, online transaction processing through a website, website hosting, account aggregation, or Internet access to perform services or deliver products to members.

  Credit unions are authorized under incidental powers to engage in new activities or services due to the changing commercial environment, such as Internet access. By providing financial services over the Internet, the credit union confronts risks similar to those associated with providing these services by electronic means. Members using the credit union's Internet access and transactional web site can retrieve account information and process transactions just as they would through tellers, ATMs, or audio response

systems. Additional information may be found in the Management chapter of this Guide.

- **Excess capacity** - the excess use or capacity remaining in facilities, equipment, or services properly invested in or established by the credit union, in good faith, with the intent of serving its members, and which it reasonably anticipates will be taken up by future expansion of services to its members. Credit unions may sell or lease the excess capacity in facilities, equipment or services such as office space, employees and data processing.

  Opportunities to sell excess capacity may involve leasing office space, sharing employees, or using data processing systems to process information for third parties. Incidental powers permit the sale of excess capacity under two conditions: (1) the credit union properly established the service or made the investment with the good faith intent of serving its members; and (2) the credit union reasonably anticipates that the future expansion of services to its members will take up the excess capacity. Credit unions investments in fixed assets are limited by §701.36 of the NCUA Rules and Regulations.

- **Financial counseling services** - advice, guidance, or services the credit union offers to its members to promote thrift, or to otherwise assist members on financial matters. These services may include income tax preparation, electronic tax filing, estate and retirement planning, investment counseling, or debt and budget counseling.

  Depending on the activity, a credit union may be subject to other federal, state, or local laws. The credit union must apprise itself of any legal requirements associated with the activity.

  This category applies only to financial counseling provided by a credit union to its members. It does not encompass activities that require SEC registration as a broker, dealer, or investment adviser. A credit union may be able to make these services available to its members from a third party under its authority to act as a finder, discussed in the next section.

- **Finder activities** - when the credit union introduces, or otherwise brings together, outside vendors with its members to enable both parties to negotiate and consummate transactions. Finder activities may include offering third-party products and services to members through the sale of advertising space on the credit union's website, account statements, and transaction receipts, or by selling statistical or consumer financial information to outside vendors to facilitate the sale of their products to members.

  Credit unions may act as an intermediary between their members and outside parties for the sole purpose of bringing the parties together. Although identifying particular vendors to its membership could subject a credit union to reputation risk, the credit union does not represent the vendor or the member in either the negotiation process or the resulting transaction. Finder activities differ from the category of marketing activities because, as the "finder," a credit union simply identifies an outside party with a product or service it believes its members would have interest in obtaining. Marketing activities consist of a credit union promoting or marketing its own products and services.

  Section 721.3(f) does not limit the types of products credit unions may introduce to their members. Rather, a credit union must exercise judgment and due diligence when introducing or bringing together an outside vendor with its members. For example, if a federal credit union finds, under its finder authority, investment advisors or brokers for its members and receives commissions from these third-party vendors, then it must comply with all applicable state and federal laws, regulations and guidance. It should identify all regulatory restrictions that may apply to commissions or fees paid in conjunction with the sale of mutual funds, or other nondeposit investment products.

  Credit unions must comply with NCUA's Privacy of Consumer Financial Information regulation (§716), the Fair Credit Reporting Act, and any applicable state laws before selling or otherwise communicating consumer information to third parties.

- **Loan-related products** - products, activities or services the credit union provides to its members in a lending transaction that protects

it against credit-related risks, or are otherwise incidental to its lending authority. These may include debt cancellation agreements, debt suspension agreements, letters of credit and leases. The Loan chapter of this Guide contains additional information on debt cancellation/suspension agreements.

- **Marketing activities** - activities or means used to promote membership in the credit union and the products and services it offers. These may include advertising and other promotional activities such as raffles, membership referral drives, or sponsorship of civic and charitable causes. Credit unions must comply with NCUA's Privacy of Consumer Financial Information regulation (§716).

- **Monetary instrument services** - services that enable members to purchase, sell, or exchange various currencies. These may include the sale and exchange of foreign currency and U.S. commemorative coins. Credit unions may maintain deposits in foreign financial institutions to facilitate member transactions, including members' transfers and negotiation of checks denominated in foreign currency, or engage in monetary transfer services for their members. However, credit unions may not maintain foreign accounts for speculative purposes. Credit unions involved in foreign currency transactions must establish appropriate controls to mitigage exchange risk.

- **Operational programs** - programs offered by credit unions to establish or deliver products and services that enhance member service and promote safe and sound operations. These may include electronic funds transfers, remote tellers, point of purchase terminals, debit cards, payroll deduction, pre-authorized member transactions, direct deposit, check clearing services, savings bond purchases and redemptions, tax payment services, wire transfers, safe deposit boxes, loan collection services, and service fees.

- **Stored value products** – an alternate media to currency in which the credit union transfers monetary value to the product and creates a medium of exchange for its members' use. Examples include stored value cards, public transportation tickets, event and

attraction tickets, gift certificates, prepaid phone cards, postage stamps, electronic benefits transfer script, and similar media.

- **Trustee or custodial services** - where the credit union is authorized to act under any written trust instrument or custodial agreement, created or organized in the United States, and forming part of a pension or profit-sharing plan, as authorized under the Internal Revenue Code. These services may include acting as a trustee or custodian for member retirement and education accounts.

  Credit unions can provide individual retirement accounts (IRAs), education saving accounts (Roth IRAs), and other savings opportunities as provided in Part 724 of NCUA's regulations. However, the FCU Act does not provide the authority for federal credit unions to act in a fiduciary capacity for their members; therefore, federal credit unions may not offer full trust company services to their members.

Non Preapproved Activities

The NCUA Board intends the activities listed under the broad categories of the incidental powers rule as illustrations, not an exhaustive list of what is permissible. Although NCUA does not require federal credit unions to seek NCUA's approval before engaging in an activity that is not listed, they should be cautious.

If it is not clear that an activity falls within one of the categories, a credit union should consult informally with NCUA's Office of General Counsel or formally request a legal opinion from the Office of General Counsel. Section 721.4 specifically provides for seeking an advisory opinion from NCUA's Office of General Counsel, which has the authority to issue legal interpretations of the rule. The rule also provides a credit union the option of applying to the NCUA Board, which may subsequently result in a rule amendment, but is likely to be a lengthy process.

Workpapers and References

- References
  - *NCUA Rules and Regulations*
    - §721 - Incidental Powers
    - §701.36 – FCU Ownership of Fixed Assets

§716 – Privacy of Consumer Financial Information
§724 – Trustees and Custodians of Pension Plans