



***THE CHANGING ROLE OF CREDIT
UNION OFFICIALS IN A CHALLENGING
ECONOMY***


Ron Parker, CPA
parkerconsult@cox.net
520-749-0813

MICHIGAN CREDIT UNION LEAGUE





**OBSERVATIONS AND
THOUGHTS--2009**







OBSERVATIONS-2009

4. In many areas we are in a **trend-less environment** (history may not be as valuable as it once was) which makes it difficult to **think and act strategically**...however, beware of failing to focus on how we will **successfully compete in the future** rather than **current results and operational areas**—
OF COURSE WE NEED TO BE IN EXISTENCE IN THE FUTURE TO COMPETE!
5. Will be more **consolidations, collaborations, joint ventures and will need to be more cooperation in our industry and trade groups.**



**A crisis is when you can't say:
"let's forget the whole thing".**






OBSERVATIONS-2009


6. Probably **can't be all things to all members** in the future. May not want all members either—see #7!
7. **Profitability** through the **reduction of operating costs** will be a focus—operating costs are a more controllable element than some other profitability drivers.
8. Decisions and rewards should be **measurable** and focus more on our ability to **successfully compete in the future rather than short-term results.**

OBSERVATIONS-2009


9. Need to question the viability of our **business model** and other tools and concepts—Fee structures, Cost of funds, ALM duration assumptions for example.
10. Most of us are going to be OKAY....there will be opportunities! **MORE PHILOSOPHICAL DECISIONS AND CHALLENGES FOR OFFICIALS!**





Other Thoughts About Officials Roles


- **Expect transparency**...a complete and **understandable** description of **significant problem areas from management**.
- **Don't over react** to negative information or problems.



Other Thoughts About Officials Roles


- For many of us this is **not business as usual** and we may need to make critical decisions as to our future!
 - Fields of membership, consolidations, management and staff changes, product..services..and delivery system changes...to name a few!





Other Thoughts About Officials Roles

- Focus on **strategic vs. operational** issues where possible.
- Remember that we have **professionals** managing operational areas. These professionals should be given clear direction...held accountable and properly evaluated and compensated!




Other Thoughts About Officials Roles

- Beware of Significant **Concentrations of Risk!**
(All Eggs in One Basket—Watch That Basket! hasn't always work)



– WHERE DO SIGNIFICANT CONCENTRATIONS OF RISK EXIST IN OUR CREDIT UNION?






CONCENTRATION RISK CAN BE A MAJOR CONCERN


- Credit unions focusing on making **longer duration loans**
- Many loans that credit unions want to do have increased in length, for example many car loans are now longer than 5 years
- The one area that is a growing loan area for credit unions is Real Estate, therefore that has become the focus



CONCENTRATION RISK CAN BE A MAJOR CONCERN


- Major concentration in the liabilities in the **Non-maturing deposits**
- Overall duration on liabilities has probably shortened because of the hot money
- How much do you have in Core Deposits?
- CD's concentration is short term





IMPROVE EFFICIENCY OF OPERATIONS

- **Best Practices**
- **Consistency and Standardization**
- **Utilization of Resources**
- **Technology Utilization—may require expenditures**




GOVERNANCE ISSUES






Merger Strategy Plans

- Up stream and down stream criteria and guidelines
- ***CHANGE IN OWNERSHIP PROVISIONS*** in management contracts
- Fundamentals---Best interest of membership and staff short and long term!



IMPROVE QUALITY OF MANAGEMENT, STAFF, OFFICIALS AND MEMBERS


- ***EVERYONE MUST GET BETTER AT WHAT THEY DO.***
- Training and Recruiting
- Key Operational Areas such as Collections
- ***MUST DO EFFECTIVE EVALUATIONS OF ALL STAKEHOLDERS!***





Other Thoughts About Officials Roles


- In which areas do **WE** as a Board or Supervisory Committee need to focus our attention?
- Where do **I** as an individual official need to focus my attention?

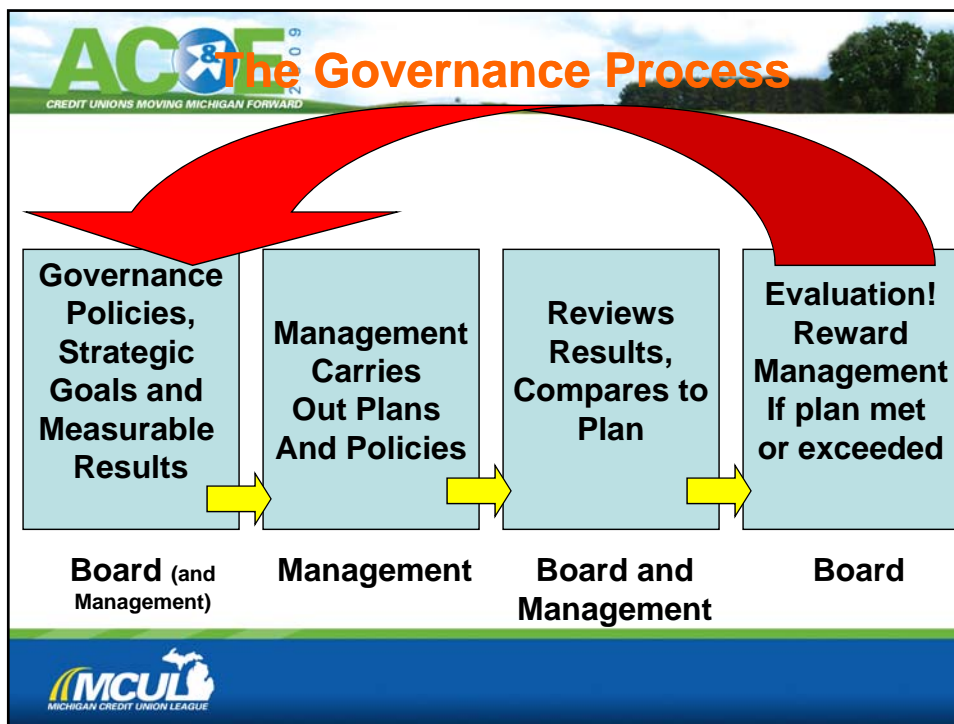



What is the Board's Role?


- **Oversee and guide the credit union so that the members' assets are as safe and productive as possible.**
- Hire/replace and evaluate management
- Provide supportive oversight and direction
- Remain independent of management

The role is to **govern**, not to **operate** the credit union





Working Board	Managing Board	Governing Board	Ratifying Board	Failing Board
No CEO or Acting CEO	Board assumes CEO needs help running org	Competent CEO and experienced staff that knows more than board	Hire a good CEO and stay out of his/her way	High board turnover
Small CU	Board involved in minutiae, manager of CEO	Clear division between Ops and Governance	Organization OK but board in decline	Financial soundness issues
Board doing job of CEO	Board assigns tasks to CEO	Focused on Board Work, concerned with values	Board approves what CEO brings	Strife and distrust among board and staff
Focus on day-to-day operations	Board hands on and proud of it	Operates on future/strategic level	Out of touch, complacent, delegating Gov.	Looking to the past, way behind staff
Short time horizon	Focus on administration & Ops	Delegates Ops to CEO	Stale policies, little accountability	Not strategic, crippled by in-fighting
Primary role is operations	Primary role is making decisions	Primary role is setting policy and general direction	Primary role is supporting CEO, rubber stamping	Primary role of board is keeping perks





Governance Process

“Board must be in full control of its own job before presuming to control anything else.”

John Carver

Board must stay focused on **big issues** of Strategy and Governance


Board must be disciplined in this process and not allow itself to stray.



Other Thoughts About Officials Roles


- **ASK QUESTIONS...MAKE SURE YOU UNDERSTAND THE LEVELS OF RISK BEING ASSUMED AND HOW THEY ARE *MONITORED AND MEASURED BY MANAGEMENT!***

- **What's next????**





IMPORTANT FUNDAMENTALS




Fundamental Accounting Concepts

- Most assets and liabilities are recorded at **cost**.
- Some assets are **marked to market** i.e. generally valued at the **lower of cost or market**.
 - Some investments, assets held for sale (loans) for example

Some assets require a **valuation account**

- Loans—not all are collectible so a valuation account is established for probable losses in the loan portfolio





Fundamental Accounting Concepts

Investment Accounting: Primarily Debt Securities


Management intention and ability at acquisition date:

- **Available for sale**—marked to market through member's equity (capital)
- **Held to maturity**—market values disclosed...no impact on net income or capital.



Fundamental Accounting Concepts

- If an **investment or other asset** is deemed to be **permanently impaired** then it is **marked to market with the results going through the income statement.**



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Fundamental Accounting Concepts

- MOST OF THE NUMBERS ON A CREDIT UNIONS FINANCIAL STATEMENTS ARE FAIRLY WELL DEFINED **(NOT MANY JUDGMENTS OR ESTIMATES) I.E.:**
 - COST OR COST LESS DEPRECIATION OR AMORTIZATION
 - LOWER OF COST OR MARKET—MARKET IS DETERMINED IN A FORMAL MARKET PLACE

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Fundamental Accounting Concepts

- ESTIMATES/JUDGMENTS BY MANAGEMENT ARE THE MOST SIGNIFICANT IN **THE VALUATION OF A CREDIT UNIONS LOAN PORTFOLIO.**
- LOANS ARE RECORDED AT COST... A VALUATION ACCOUNT—ALL (ALLOWANCE FOR LOAN AND LEASE LOSSES) IS ESTABLISHED BY MANAGEMENT FOR **PROBABLE LOSSES** IN THE LOAN PORTFOLIO **AT A GIVEN DATE.**
- THE LOAN PORTFOLIO (LOAN BALANCES OUTSTANDING) IS REPORTED ON THE BALANCE SHEET **NET OF THE ALL.**

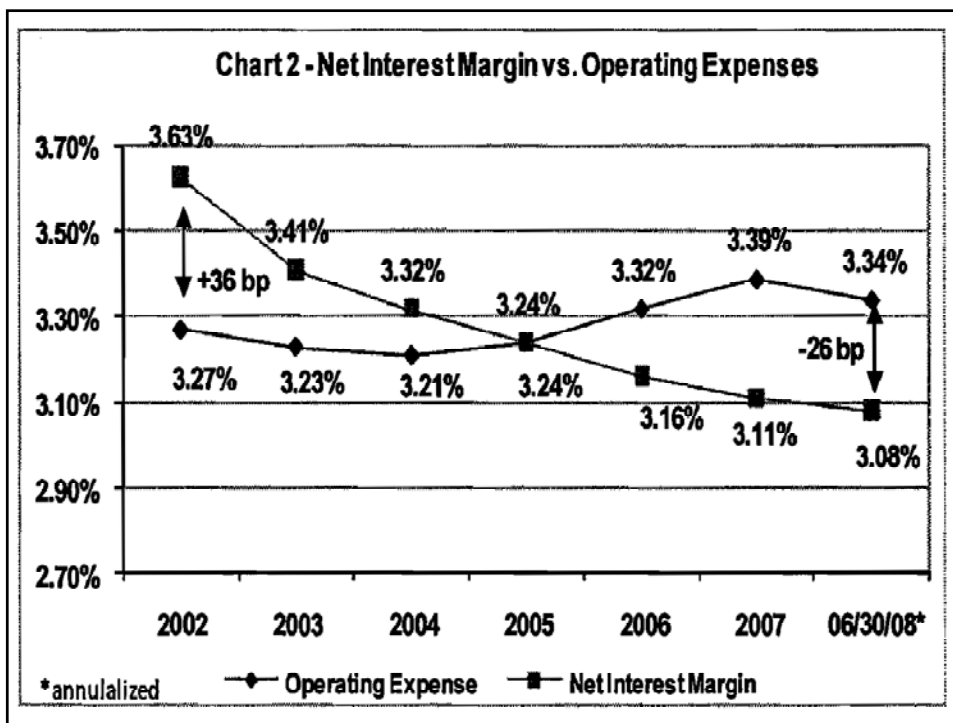
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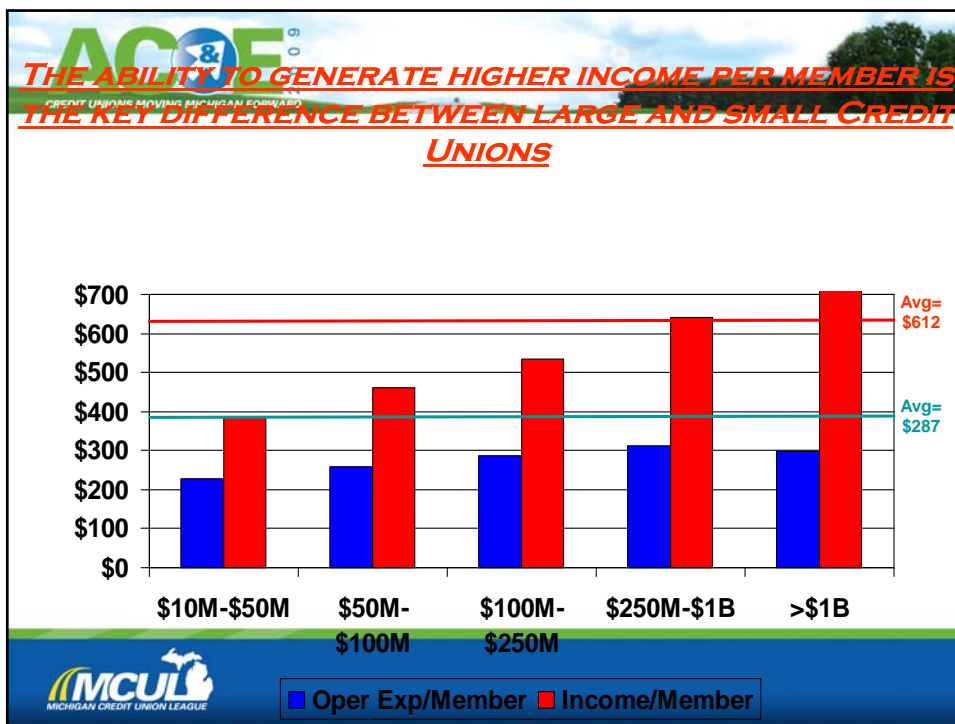


Net Interest Margin/Spread

INCOME FROM INTEREST—LOANS AND INVESTMENTS

LESS: COST OF FUNDS—DIVIDENDS ON SHARES

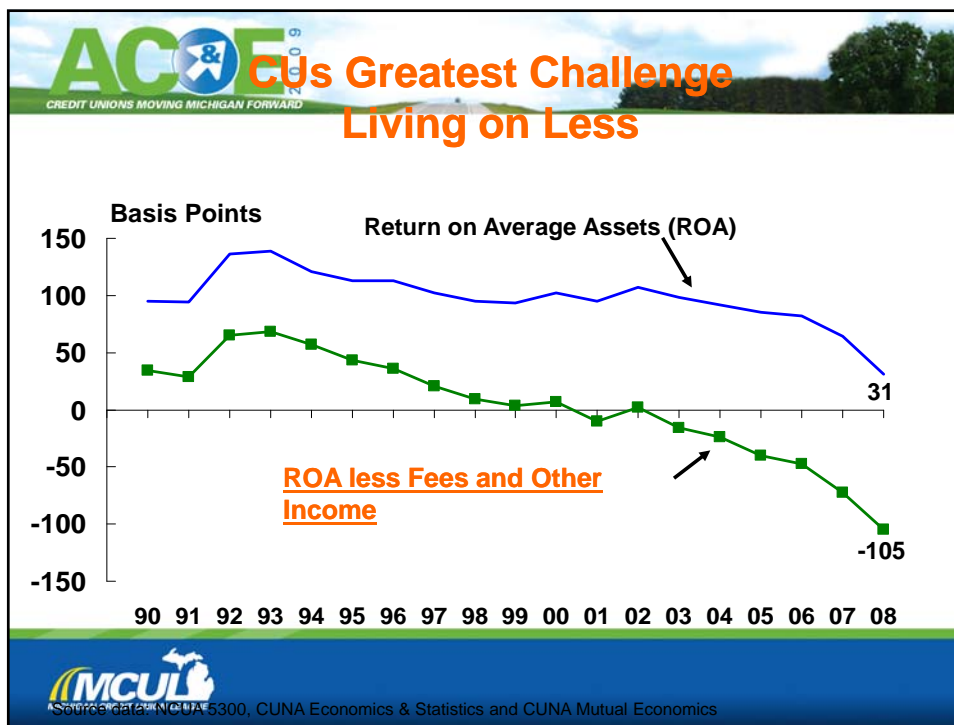
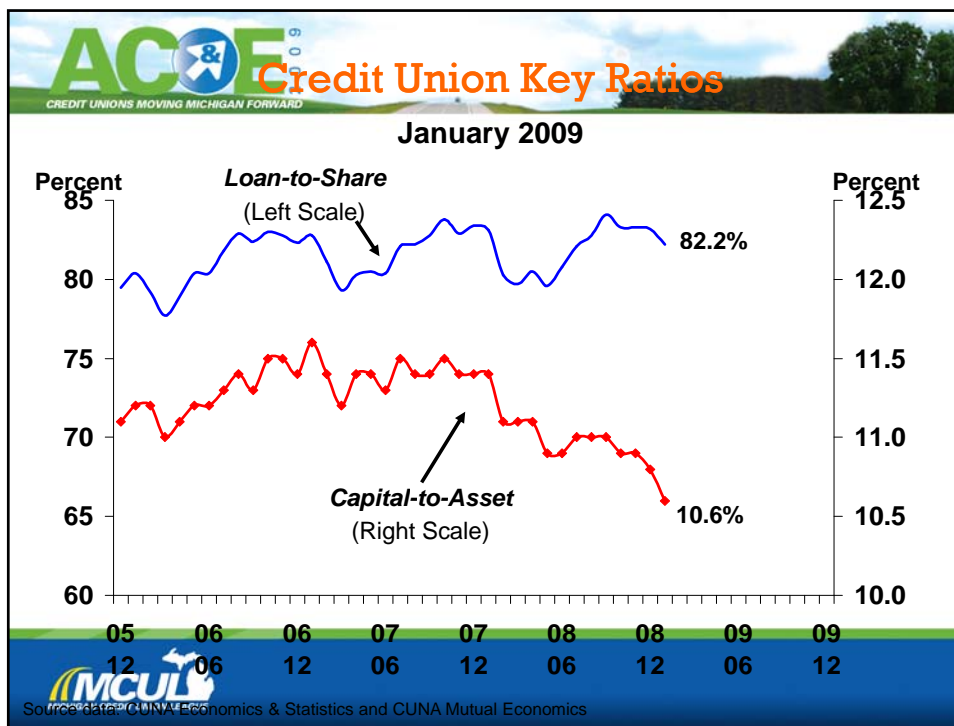



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Two Key Credit Union Ratios

- **Asset to Capital- (Capital ratio)**--Regulatory Capital (All Capital except Other Comprehensive Income) divided by Total Assets
- **Return on Assets (ROA)**—Net Income divided by Total Assets

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Net Worth and Earnings

- What are the Two ways to increase your **Capital ratio**?


_____ OR _____





Credit Union ROA and Capital Ratio

ROA necessary to maintain a given capital ratio under a given asset growth rate:



		Capital Ratio (Percent)					
		6	8	9	10	11	12
Asset Growth Rate (percent)	5	0.29	0.39	0.44	0.49	0.54	0.59
	7.5	0.43	0.58	0.65	0.72	0.80	0.87
Rate (percent)	10	0.57	0.76	0.86	0.95	1.05	1.14
	12.5	0.71	0.94	1.06	1.18	1.29	1.41
	15	0.84	1.12	1.26	1.40	1.53	1.67
	17.5	0.97	1.29	1.45	1.61	1.77	1.93
	20	1.09	1.45	1.64	1.82	2.00	2.18






Net Worth and Earnings


- Presently, a Credit Union's **ONLY** sources of Capital is _____?



Net Worth and Earnings

What are the 5 ways to increase earnings/net income?







Net Income


Which of these five ways of increasing Net Income may be the easiest?


The most difficult?



Allowance for Loan Losses and Provision for Loan Losses

- How many of our numbers require significant estimates by management?
 - **Not very many i.e. most numbers are recorded at cost or fair value!**







Allowance for Loan Losses and Provision for Loan Losses

Why all the interest in these two accounts??

Allowance for Loan Losses—An estimate of probable losses in the loan portfolio.


- A deduction from the loan portfolio amount **and an increase in an expense amount.**

Allowance for Loan Losses(ALL) and Provision for Loan Losses (PLL)

The Provision for Loan Losses is an expense/cost account on the Income Statement.


A increase in the ALL account will cause a corresponding increase in the PLL account and vice-versa. An increase in the PLL account reduces Net Income!







WHAT'S NEXT!!

- More Asset Impairments—NCUSIF, Corporate investments, CUSO investments and ????
- Contingent liabilities—pension plans, merger obligations
- Loan participations, commercial real estate loans, credit cards??





RISK






Other Thoughts About Officials Roles


- Gain an understanding of the seven regulatory risk areas and how management monitors and manages risk in each area.
 - We may have stressed tested the wrong risk!
 - Credit risk fluctuations rarely stressed and projected



HOW WOULD YOU RATE YOUR CREDIT UNION'S RISK TOLERANCE?

- HIGH
- IN LINE WITH OTHER CREDIT UNIONS
- LOW
- **How do you evaluate the risk tolerance in your credit union?**






ARE THERE CIRCUMSTANCES WHERE A CREDIT UNION SHOULD TAKE ABNORMAL RISKS? IF SO, WHAT ARE THEY?



WHAT RISK(S) ARE YOU AS A CREDIT UNION BOARD MEMBER MOST CONCERNED ABOUT?

- **In Your Credit Union**
- **In The Credit Union Industry**






REGULATORY RISK CATEGORIES

Risk is the **potential that events, expected or unanticipated**, may have an adverse effect on the credit union's **net worth and earnings**.

The seven categories of risk for credit union supervision purposes are **Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation**.


Any product or service may expose the credit union to multiple risks; **these categories are not mutually exclusive**.





REGULATORY RISK TERMINOLOGY

Risk Profile is made up of seven specific categories of risk:



1. **Credit Risk**—Risk of default on **total repayment of loans, investments or other assets!**
2. **Interest Rate Risk**—Risk that **changes in market rates will negatively impact the income statement and balance sheet.**





The Two Definition's of ALM


- ALM is concerned with balancing the volume, mix, rate and maturity of assets and liabilities to maintain **consistent interest margins despite changes in economic, legislative, competitive and membership conditions.**
- Management, but not the elimination of interest rate risk, while **generating returns that are commensurate with the risk taken.**

3. **Liquidity Risk**—Risk of inability to fund obligations as they come due.

Risks 4-7 are difficult to measure using financial data:


4. **Transaction Risk**—Risk of fraud or operational problems in transaction processing
5. **Compliance Risk**—Risk of violations and non-compliance with laws and regulations






6. Strategic Risk—Risk of adverse business decisions through management’s actions or inactions

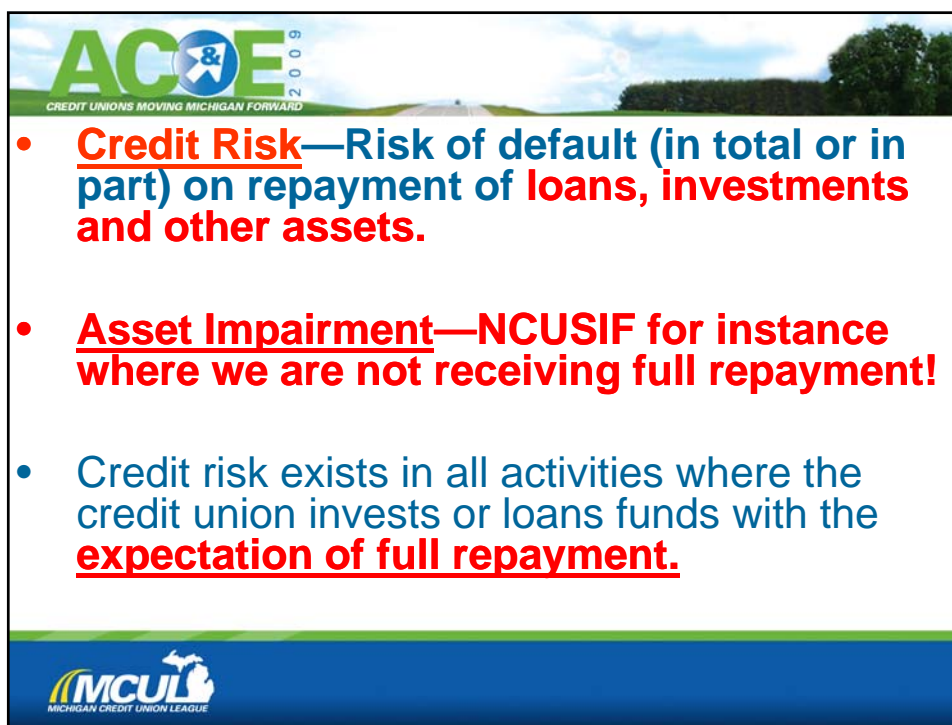
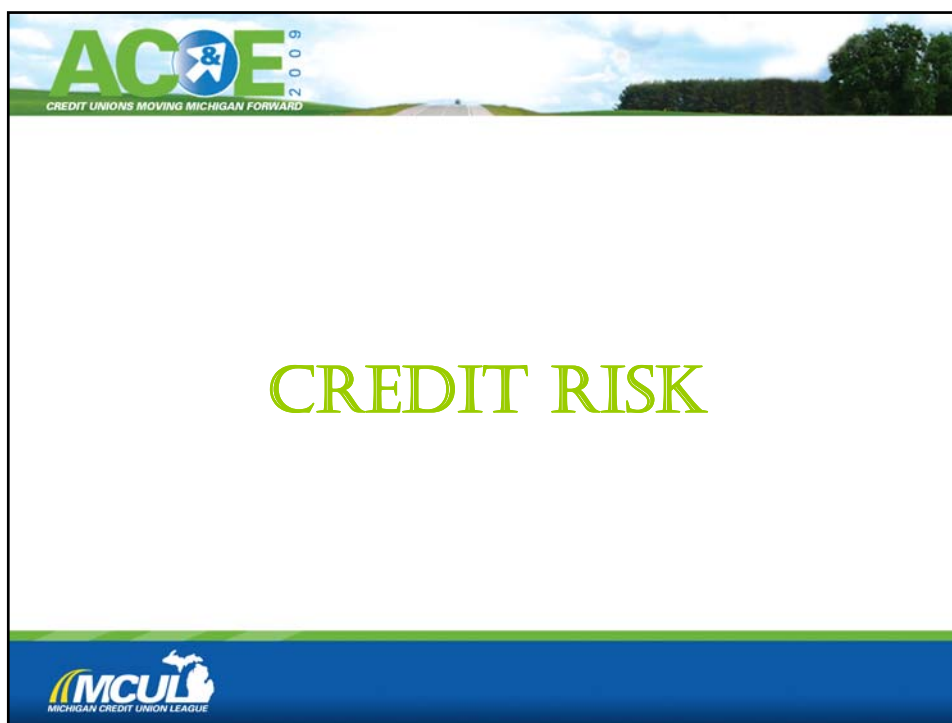
7. Reputation Risk—Risk of negative public opinion or perception leading to a loss of confidence and/or severance of relationships



HOW WOULD YOU RANK THESE RISKS IN ORDER OF IMPORTANCE IN YOUR CREDIT UNION?

- Credit Risk
- Interest Rate Risk
- Liquidity Risk
- Transaction Risk
- Compliance Risk
- Strategic Risk
- Reputation Risk







Credit Risk Stress Test


Credit Risk typically **not formally stress tested** i.e. what would be the impact on **net worth and earnings** if there were a substantial change in various economic and financial areas monitored and measured by management




Risk/Capital Stress Assessment

- **What if alternatives and impact on capital and capital ratios.**
- **Action steps and specific trigger points**
 - Operating losses
 - Increasing unemployment
 - Increasing delinquency and charge offs
 - Other asset impairment
 - Extraordinary costs—defined benefit plans for instance
 - Underlying collateral values decreased by
 - Other economic areas monitored by management decline by







How Does Management Assess and Monitor Credit Risk?

- Loan **mix and concentrations**—some loans inherently have a higher credit risk than others...how much is **total credit risk changing as the result of our mix and concentration of loans?**
 - **Loan types and concentrations**—for instance
 - indirect vs. direct auto loans
 - Used vs. new auto loans


Changes in underwriting criteria—loan to value; debt to income ratios etc.


- **Concentrations** by loan type, FOM, credit scores..geographical areas

Credit Risk Monitoring



- Delinquency and Charge Offs:
 - Delinquency and charge offs must be monitored by **concentration of credit risk!**
 - Beware of **inconsistent changes** in delinquency and charge offs!





Credit Risk Monitoring

- Delinquency and Charge Offs:
 - Delinquency and charge offs must be monitored by concentration of credit risk! For instance auto loans:
 - **NEW VS. USED AUTOS**
 - **INDIRECT VS. DIRECT**
 - **PRIME VS. SUB-PRIME**
 - **LOAN TO VALUES**
 - **DEALERS**
 - **FOM AND GEOGRAPHICAL CONCENTRATIONS**
 - **CREDIT SCORES/RATINGS**

Credit Risk Monitoring

- **DELINQUENCY AND CHARGE OFFS:**
 - **DELINQUENCY AND CHARGE OFFS MUST BE MONITORED BY CONCENTRATION OF CREDIT RISK! FOR INSTANCE CREDIT CARD LOANS:**
 - **PLATINUM VS. GOLD VS. SILVER—GROWTH AND CONCENTRATION**
 - **UNFUNDED COMMITMENTS BY TYPE**
 - **NUMBER OF MEMBERS ___% OF MAXIMUM**
 - **DELINQUENCY, CHARGE OFFS AND PROFITABILITY**






Other Lending Area Risks

FICTITIOUS LOANS

- LACK OF **SEGREGATION OF DUTIES** OVER **ORIGINATION, PROCESSING AND FUNDING—ASK AUDITORS AND EXAMINERS!**
- **LACK OF OVERSIGHT** OVER **ORIGINATION, PROCESSING AND FUNDING—ASK AUDITORS AND EXAMINERS!**






Other Lending Area Risks

ADVANCEMENT OF DUE DATES AND OTHER DELINQUENCY MODIFICATIONS CAN BE A PROBLEM!


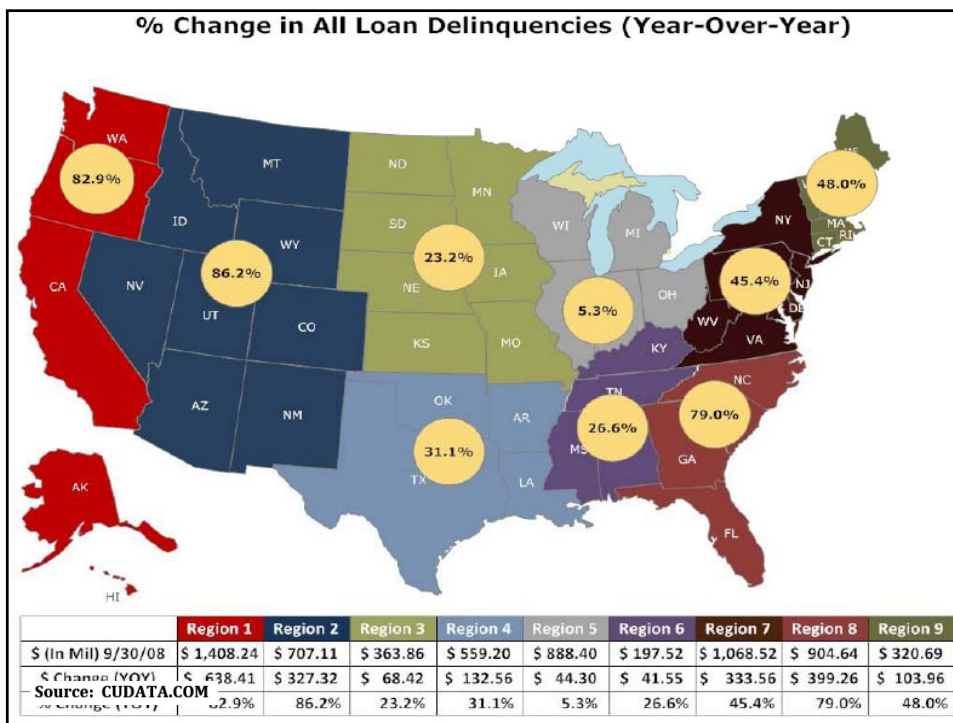
TROUBLED DEBT RESTRUCTURING

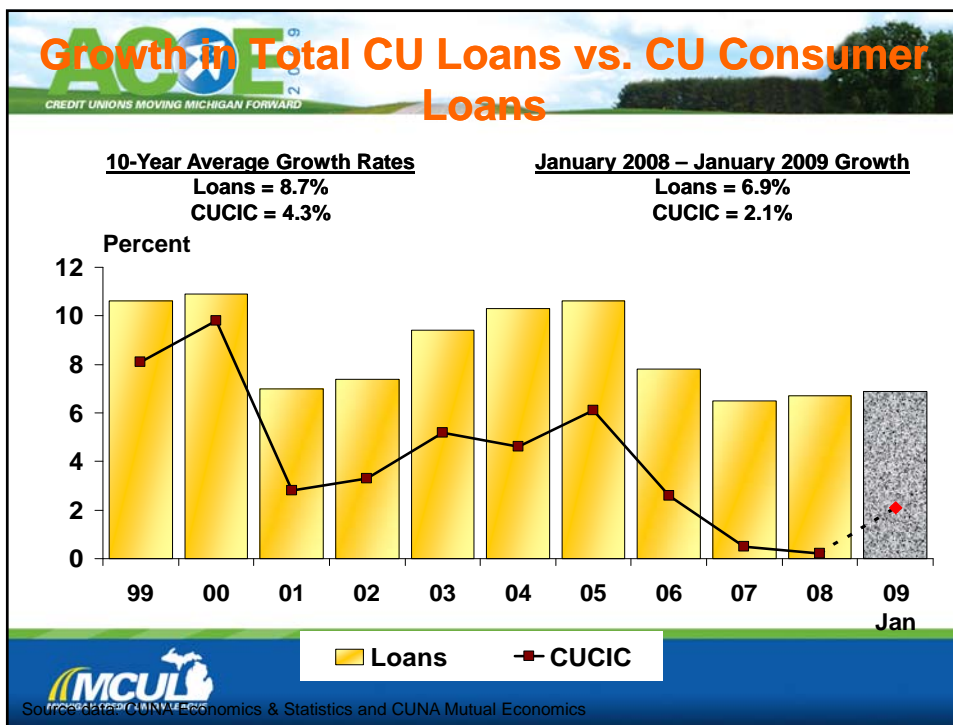
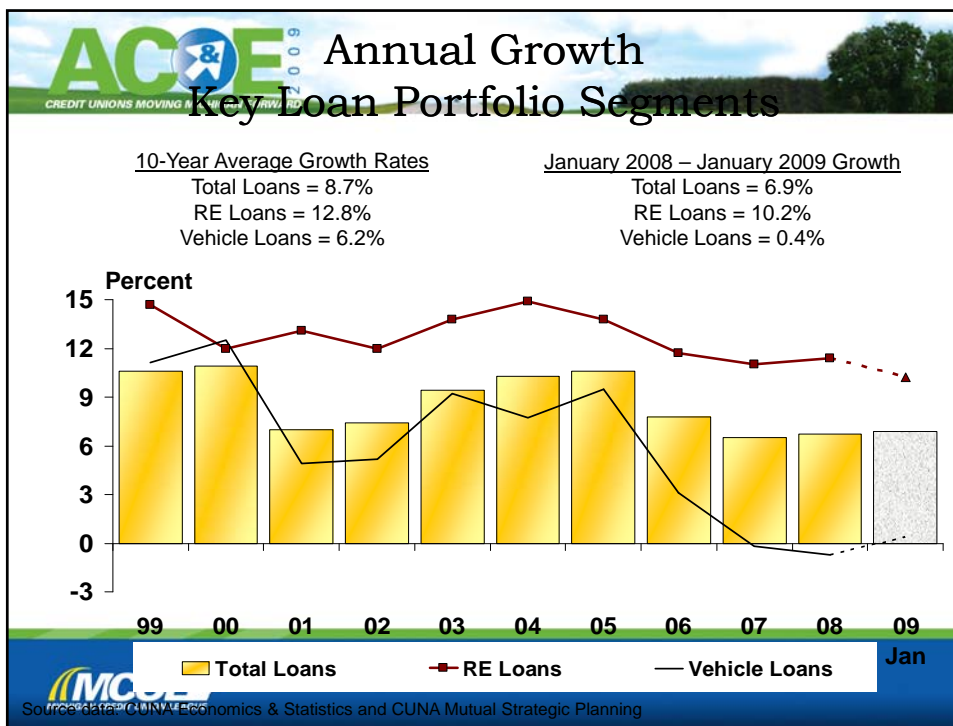
- HOW ARE **TROUBLE DEBT RESTRUCTURED, WATCH LIST AND OTHER TROUBLED LOANS** TRACKED AND MONITORED?
- WHAT IS THE TREND IN THE VOLUME OF THESE LOANS?

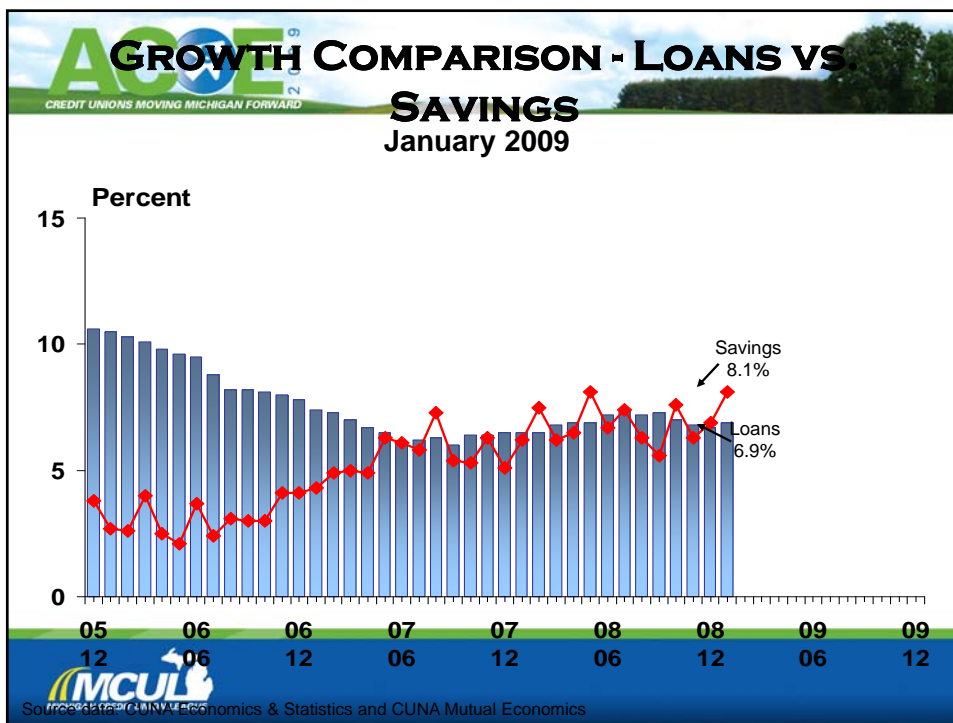
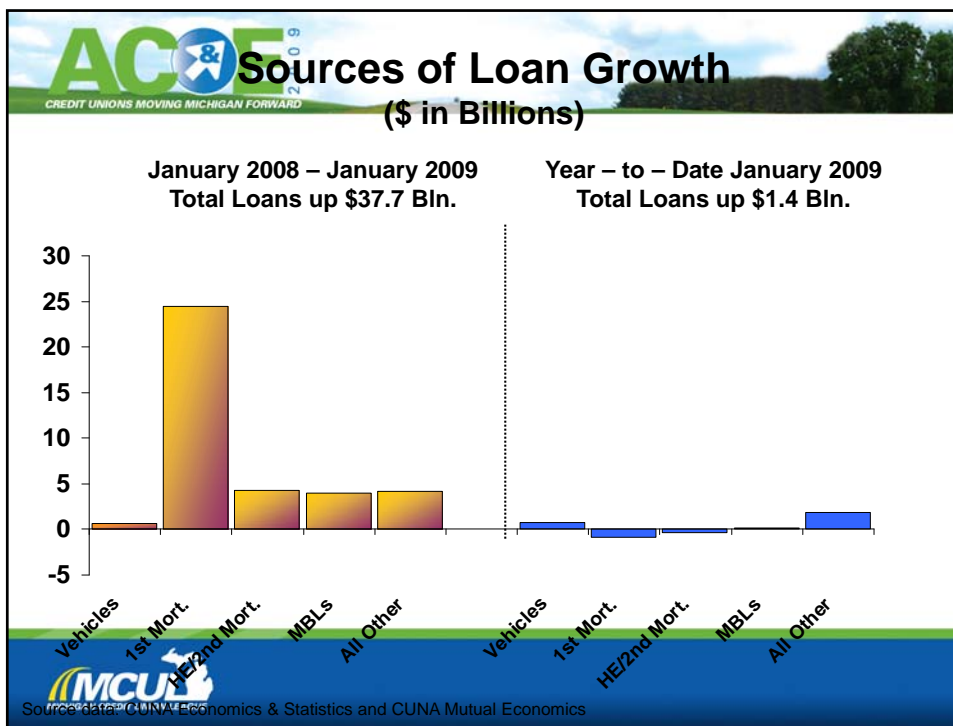


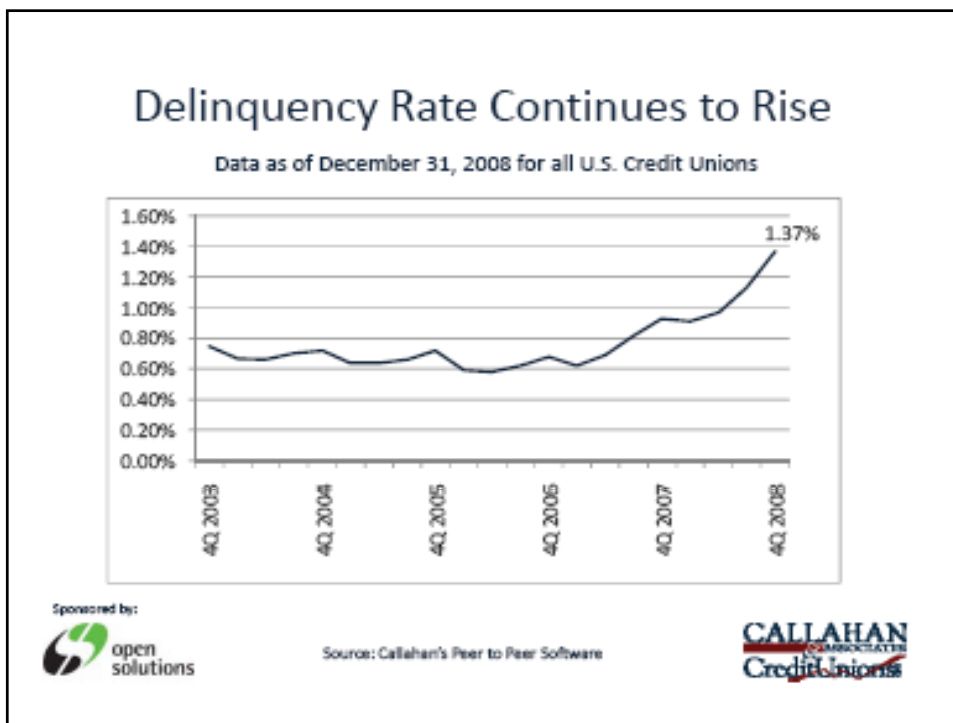
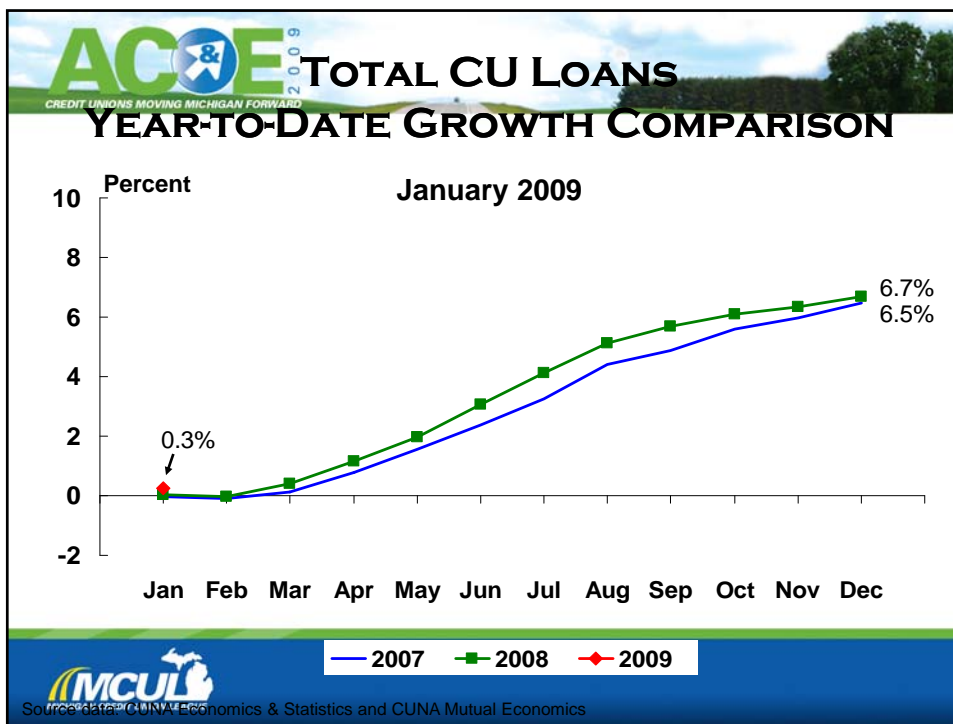


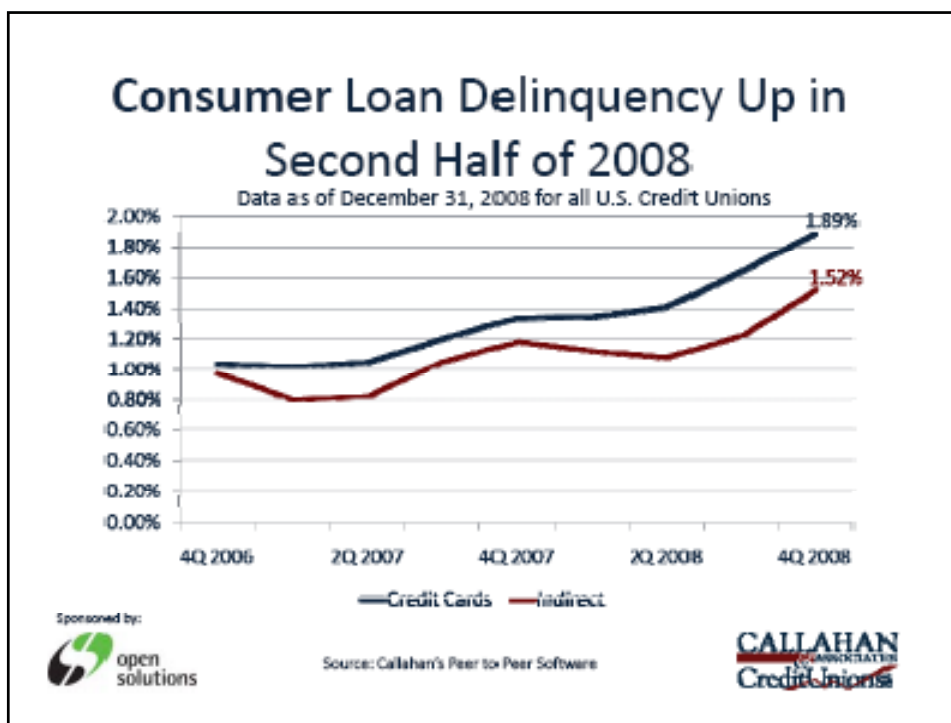
CU Lending Related Graphics










Suggestions


- Annually or more often (maybe in conjunction with your regulatory examination) **REVIEW AND DISCUSS THE ASSESSMENT AND MONITORING OF EACH RISK AREA BY MANAGEMENT.**
- In conjunction with the above, consider having an annual (or more often) **MEETING/REPORT WITH MANAGEMENT PERSONNEL RESPONSIBLE FOR MONITORING RISK IN EACH OF THESE AREA.**



MARK TO MARKET/FAIR VALUE ACCOUNTING

- **We are trying to determine a fair value for a security in a market environment where the seller doesn't want to sell and the buyer doesn't want to buy!**

Harvey Pitt, former chair of the SEC




Mark to Market

Five Investment Buckets:


1. **Non-FAS #115**—certificates of deposit, corporate accounts—**impairment testing only**
2. **Trading Investments**—declines reported as losses in P & L
3. **Available for Sale Investments**—declines reported as OCI in Capital—**not counted in regulatory capital computation!**
4. **Held to Maturity**—disclosure only
5. **OTTI/Permanent Impairment**—declines reported as **losses in P & L**






Investments

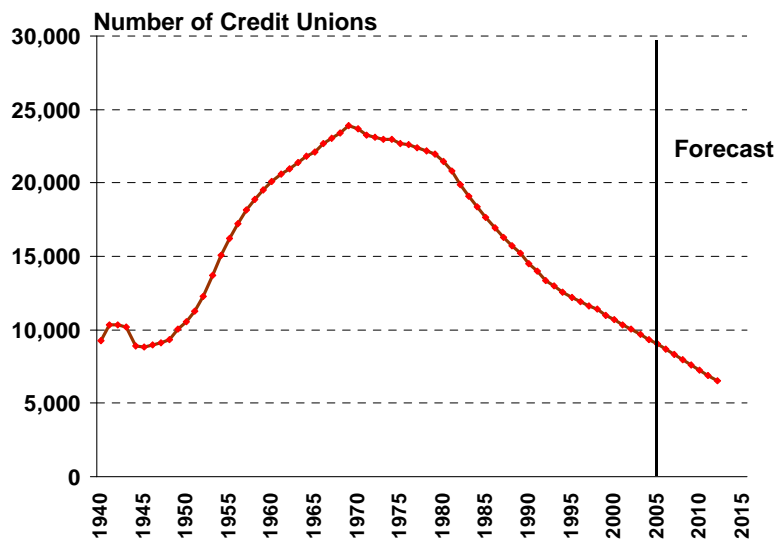
- Monitor Changes in Unrealized Losses and Gains in all Investment securities regardless of classification.
- How investments are monitored for possible permanent impairment?
- How many investments do not have a market price or are not readily marketable and how they are being valued and assessed for impairment.



STRATEGIC RISK

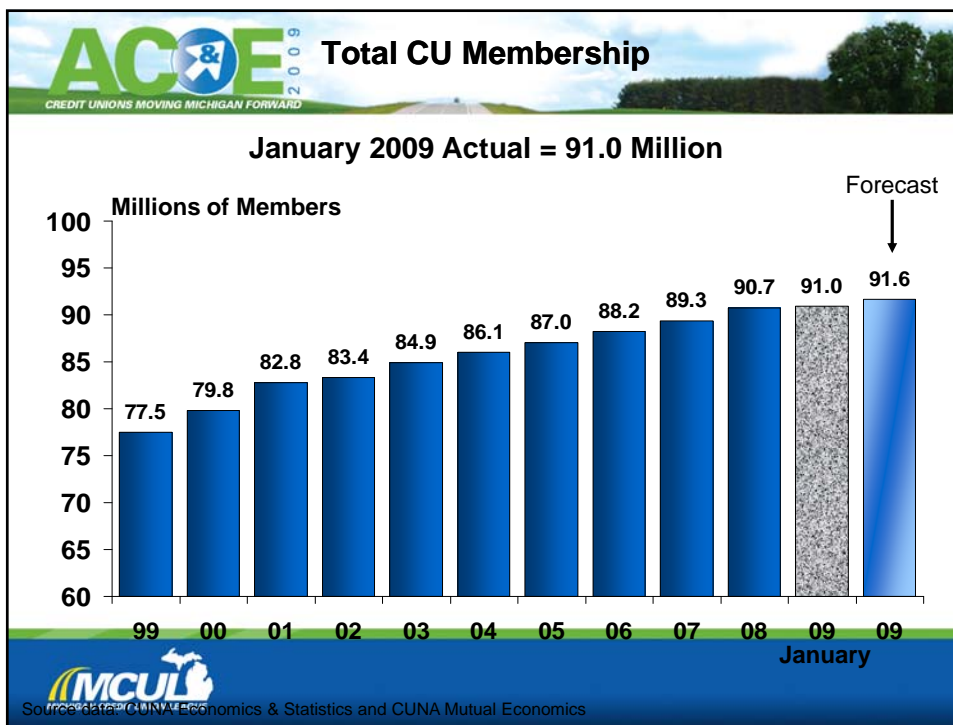
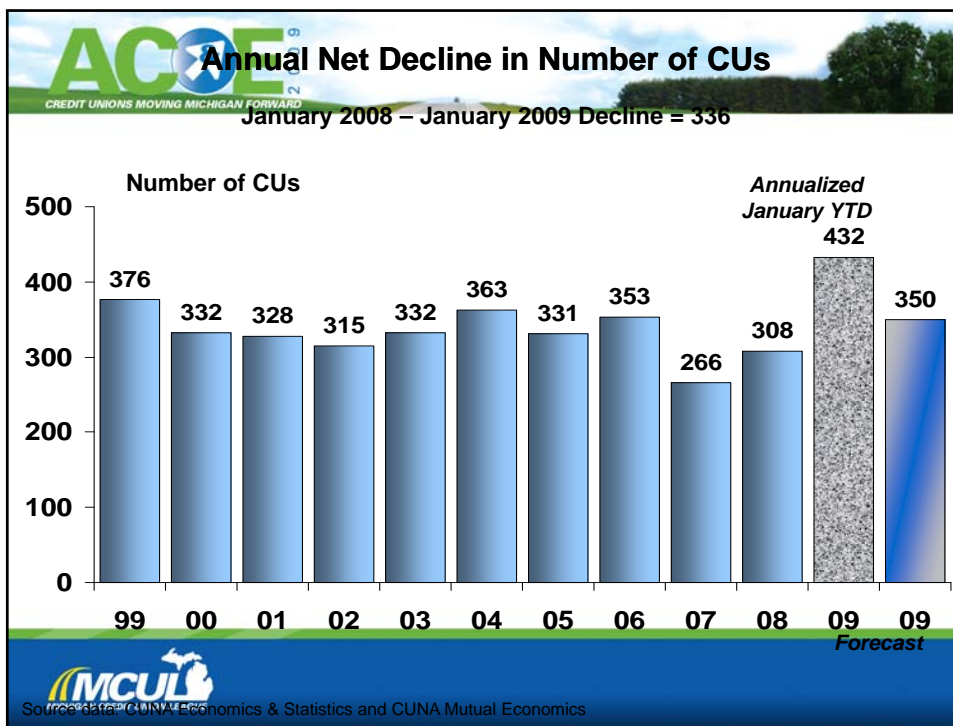


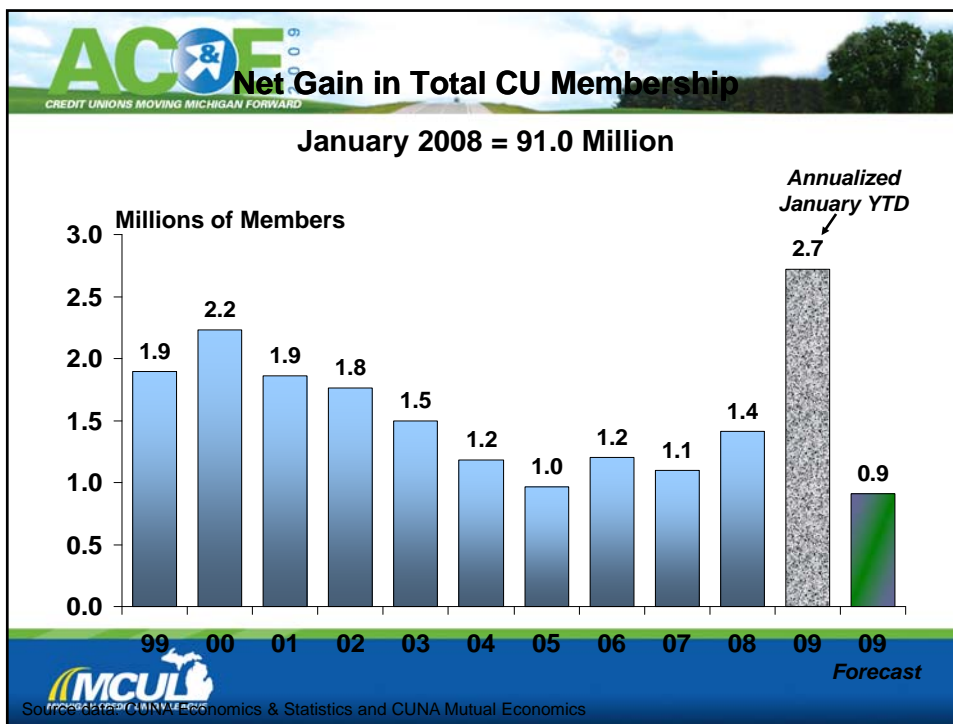
Strategic Challenges System Consolidation



Source: CUNA Economics & Statistics and CUNA Mutual 2006 Forecast

CU's and Membership Graphics





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SYSTEM CONCENTRATION

- The trend towards the **“mega-Credit Union** will continue:
 - By 2012 the U.S. CU system is projected to have 199 CUs with assets greater than \$1 billion
 - The billion dollar CUs will control:
 - 51% of total CU system assets
 - 42% of total CU members
 - An additional 800 CUs will have between \$200 million and \$1 billion in assets
 - 33% of total CU system assets
 - 35% of total CU members

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PLANNING AND BUDGETING

- **Need to get serious about Planning and Budgeting**
 - **Budgets—Rolling 12 month or more budgeting**
 - **Business Plan—1-2 years**
 - **Strategic Plan—beyond 3 years**

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Planning Model

Budget

Business Plan
1-2 years

Strategic Plan
3-5 years

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RISK

CANNOT AND SHOULD NOT BE AVOIDED BUT IT SHOULD BE ASSESSED AND EFFECTIVELY MANAGED.

A SHIP IN HARBOR IS SAFE - BUT THAT IS NOT WHAT SHIPS ARE FOR. ~JOHN A. SHEDD, *SALT FROM MY ATTIC*

