

In this issue

- 1 What Will 2010 Look Like?
- 3 New Challenges Confronting Participation Loan Sales
- 4 What Are You Doing to Prevent Fraud?
- 5 Taking Stock: The Benefits of a Supervisory Committee Self-Evaluation

Credit Union

ADVANTAGE

Winter 2010

WHAT WILL 2010 LOOK LIKE?

by Scott Ewing, Partner, Financial Services Group



We can all acknowledge that 2009 was quite a year, with large provisions for loan losses, premium assessments from the National Credit Union Administration, and corporate credit union capital impairments. We can now put 2009 behind us, but the reality is that many of the same challenges exist for the year ahead—along with new regulatory impositions. Let's take a look at what might lie before us in 2010 and the areas credit unions should focus on.

Interest Rate Risk

No one seems to be able to predict interest rates. Today economists are split on when we'll see an increase in inflation and resulting increases in interest rates. The Federal Reserve has kept rates low to provide added margin to struggling financial institutions, stimulate growth in the economy, and encourage home sales. These historically low short-term rates may continue only for the near

term. And as we look ahead, there appears to be a consensus—albeit not an absolute one—that a change in federal policy and inflationary pressure will increase long-term rates as well.

It seems that all regulators of financial institutions are focused on interest rate risk. Credit unions should make sure they have in place the policies, tolerances, assumptions, multiple simulations, and ongoing monitoring they need to manage that risk effectively. With an increased concentration in real-estate loans nationally, managing interest rate risk is of critical importance.

Interest Margin

Who wants to live on interest margin only? Since 2006 the net income for credit unions nationally was not from net interest income. A decade ago one presenter at a conference declared that interest margin would continue to shrink forever. Why? He indicated it was because of the continual increases in efficiencies in capital markets and efficiencies of national platforms from nationwide financial-services entities.

The exacting science of managing loans and deposit rates will be an increasingly more important part of operations. There's increased competition for loans when at the same time credit unions are finding a strong inflow of deposits—often because they're paying the best rates. You'll need to increase loans and manage the cost of funds on new deposits in order to increase, let alone maintain, interest margin.



Profitability

Loan-loss provisions, National Credit Union Share Insurance Fund (NCUSIF) assessments, and corporate credit union capital write-downs significantly hampered net income in 2009. Concerns over a significant reduction of non-sufficient funds (NSF) fee income and a potential decrease in interchange income aren't comforting, to say nothing of remaining asset write-downs and future NCUSIF assessments.

The two largest areas of cost to a credit union are interest on member deposits and employee compensation. These will continue to require effective management to enhance 2010 income.

Loan Losses

Some are predicting delinquencies and loan losses will remain constant to some degree in 2010. Economists at the Credit Union National Association estimate the loan charge-off ratio in 2010 will be 1.20 percent, compared with 1.19 percent for 2009, with a slight increase in loan delinquency expected in 2010. Credit unions need to continually evaluate collection efforts as well as the adequacy of collection resources.

You'll need to evaluate best-case, moderate, and high scenario losses in 2010 to monitor how loan losses will affect your credit union's capital ratio going forward. Ignoring the brutal reality of loan losses will serve only to preclude management from timely implementation of measures needed to maintain capital.

Allowances and Troubled Debt Restructurings

The allowance for loan and lease losses (ALLL) is a very subjective estimate, and executing it with any precision is difficult given the significant level of delinquencies and declines in real estate values. The use of two-, three-, and five-year historical loss rates is passé. Credit unions must now rely on three-, six-, and 12-month loss rates or other detailed analysis in order to determine a viable ALLL estimate. Additionally, there is now the expectation that environmental factors surrounding the loan portfolio and loan loss experience will be considered when determining expected losses. Credit unions need to document the consideration of and underlying quantitative support for qualitative and environmental adjustments made to expected loss rates as a part of the ALLL determination.

In addition, very few credit unions are accounting for troubled debt restructurings (TDRs) correctly. They aren't calculating the impairment of modified loans in accordance with the applicable standards, which generally is the difference in the present value of the estimated future cash flows of the loan discounted by the loan's original effective interest rate. They're also not including the accumulated TDR impairments as a component of the ALLL. When you modify an impaired loan, you must follow the accounting guidance in order to account for the loss on impairment. Regulators continue to visit this area.

Capital

Projecting future expected capital ratios will be key, considering estimated future loan losses,

corporate impairments, NCUSIF assessments, return on assets, and share growth. You'll need to consider best- and worst-case scenarios as part of your planning process. The worst mistake would be to underestimate future loan losses and asset impairments; that would prevent management from making necessary changes in a timely manner.

Share Draft Accounts

Will there be a dynamic shift in share draft fees? In the past, credit unions have been able to generate a significant amount of income from NSF fees. With the prospect of diminished NSF income, there might be a shift on the part of all depository institutions to increase fees on other member share draft accounts.

The New Normal

The future will likely be different from the recent past, and as a result credit union management and boards of directors will need to continually reflect on and modify their strategic planning. Clearly, they'll need to take into account increased regulation. That's the challenge. What about the opportunity? Housing provided the engine for the last economic expansion. What sector will propel future economic growth? Each credit union will need to evaluate its local economy and monitor changes in membership dynamics to stay ahead of the curve in 2010. ■

New Challenges Confronting Participation Loan Sales

by Ryan Sturgis, Senior Manager,
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Credit unions often enter into loan participation agreements, whether for the purposes of increasing liquidity or staying within certain legal lending limits. And while this has been a common practice for many years, the rules have changed and specific issues have arisen that need to be considered prior to entering into these agreements.

In June 2009 the Financial Accounting Standards Board (FASB) issued FAS 166, Accounting for

Transfers of Financial Assets (now incorporated in Accounting Standards Codification [ASC] 860, Transfers and Servicing), amending previous guidance related to accounting for transfers of financial assets. This guidance is effective for annual and interim reporting periods beginning after November 15, 2009. Although this guidance covers many aspects of transfers, we'll focus on a few areas that drastically affect whether a transfer qualifies as a sale.

Adequate Compensation

Paragraph 8B of FAS 166 (pending content in ASC 860-10-40-6A) provides a listing of aspects to consider in order for a specific type of transfer to be considered a participating interest. One in particular, Item B, states:

From the date of the transfer, all cash flows received from the entire financial asset are divided proportionately among the participating interest holders in an amount equal to their share of ownership. Cash flows allocated as compensation for services performed, if any, shall not be included in that determination provided those cash flows are not subordinate to the proportionate cash flows of the participating interest and are not *significantly above an amount that would fairly compensate a substitute service provider, should one be required, which includes the profit that would be demanded in the marketplace.* In addition, any cash flows received by the transferor as proceeds of the transfer of the participating interest shall be excluded from the determination of proportionate cash flows provided that the transfer does not result in the transferor receiving an ownership interest in the financial asset that permits it to receive disproportionate cash flows. (Italics added)

The emphasized wording in the preceding paragraph is proving to be a challenging issue regarding participation sales. Prior to this new guidance, it was common in the industry to have benefits of servicing much greater than adequate compensation, and it posed no real problem regarding sales treatment. Now the question is, to what extent can your benefits of servicing exceed adequate compensation before it's considered a disproportionate cash-flow allocation and sales

treatment not met? There's no clear-cut definition of this, and it takes specific analysis by the credit union to justify amounts significantly in excess, such as specific risks or unique characteristics of the asset being serviced.

Interest-Only Strips

Further complicating sales treatment with transfers of participating interests is the presence of an interest-only strip receivable. Institutions have historically entered into loan participation sales in which part of the consideration was in the form of an interest-only strip receivable, and this hasn't been an issue from a sales perspective. Now, according to the guidance, if this isn't paid up front in cash but rather earned over time through cash flows of the loan, sales treatment is jeopardized due to disproportionate risk. The FASB specifically addressed the risk of disguising the strip by incorporating this excess spread into the form of a servicing fee, since that now creates further issues surrounding the concept of significantly-above-adequate compensation for servicing.

These are just a few of the issues that are affecting credit unions and other financial institutions regarding transfers of financial assets. Participation sales with the presence of an interest-only strip or excess compensation for servicing now can potentially preclude sales treatment, resulting in grossed-up loans and borrowings, with a resulting negative impact on overall capital levels. You should pay careful attention to these areas to ensure your institution doesn't jeopardize sales treatment and the overall intent of the transfer. ■

What Are You Doing to Prevent Fraud?

*by Scott Ewing, Partner,
Financial Services Group*

You've likely heard about the fraud triangle—the constellation of financial pressure, opportunity, and rationalization that drives some employees and credit union members to commit acts of theft. And sadly, nothing has the potential to draw out that kind of behavior quite like a recession.

That's why it's more important than ever for internal

auditors, controllers, supervisory committees, and management to reevaluate their processes and consider whether the right controls and practices are in place to detect and prevent fraud. Here are some questions every credit union should be asking:

- Are you including fraud detection and prevention as part of your regular management team discussions?
- Most employee fraud is detected by other employees. Have you discussed fraud with your staff, stating that you won't tolerate abuses and reminding them to be watchful for any irregular activity?
- Are you actively monitoring transactions for fraud—in a way that's visible to your employees?
- Do you review employee accounts on an ongoing basis?
- Are you conducting surprise audits and cash counts at your branches? What about surprise audits of specific transaction types or departments?
- Are the people who perform cash and investment-account reconciliations different from those reviewing those reconciliations? Are those reviews being documented?
- Are you conducting secondary reviews of new loans and member deposit accounts?
- Have you assigned the right person to review loan and deposit share file maintenance transactions? What about someone to review the reviewer?
- Is there a procedure requiring a secondary review of general ledger accounts?
- Have you reviewed system access levels to ensure that the right people have access to general ledger posting, accounts payable systems, payroll, and subsidiary posting?
- Are you reviewing closed- and dormant-account activity?
- Are loan modifications being properly approved and reviewed?
- Are expenses being properly reviewed and approved for payment? What about expense reimbursements?

- Has your credit union issued a fraud policy for each employee to sign annually? What about a conflict-of-interest policy?
- Do you have a whistle-blower policy in place as well as a fraud hotline monitored by an independent third party?

The reality is that fraud does exist, and credit unions see it all too often—even when times are good. That's why, particularly during a difficult economy, you have to constantly ask yourself whether your credit union is doing enough to detect and prevent fraud. ■

Taking Stock: The Benefits of a Supervisory Committee Self-Evaluation

by Scott Ewing, Partner,
Financial Services Group



It's the start of a new year, but to many credit unions it might still feel a lot like the old one: For one thing, we still face a challenging recessionary and regulatory environment. That's why now might be a good time for supervisory committees to consider conducting a self-evaluation of their performance and effectiveness.

The self-evaluation can take different forms, involve a number of participants, and use

diverse techniques. Regardless, it should employ a straightforward approach that will aid the supervisory committee in assessing its strengths and provide direction for future improvement. Here are some activities that might be of benefit:

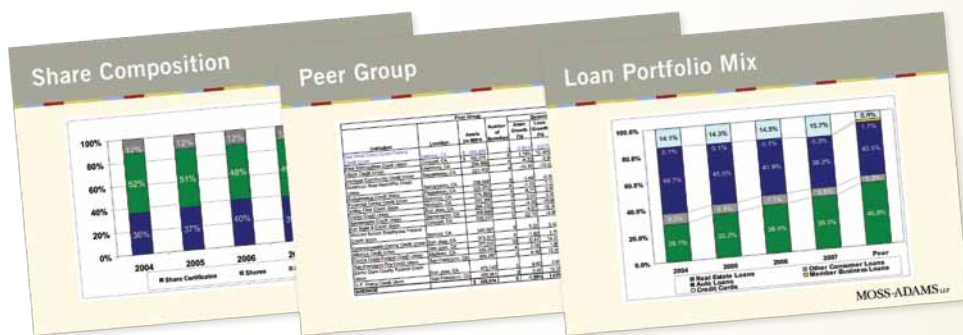
- Evaluate the audit committee's performance by asking specific questions about the impact it's had on the credit union and its financial reporting process, annual audit, and relationship with internal and independent auditors as well as management.
- Conduct evaluations of all supervisory committee members and the supervisory committee chair. The chair should consider the results of the members' evaluations of one another in the context of his or her own evaluation. The chair should also, in consultation with the board chair and upper management, consider whether any members should be rotated off the committee and determine what skills are needed to enhance the committee's effectiveness.
- Seek feedback on the supervisory committee's performance from the lead internal auditor, CFO, CEO, and independent auditor.
- Make sure your supervisory committee members are financially literate. Members should have attended recent training on enterprise risk management, accounting, auditing, and financial reporting developments as well as current business and industry practices.
- Supervisory committee members should discuss the committee chair's performance. If the members collectively agree that the chair is not performing at the proper level, the members should communicate their concerns.

The sample questions provided below are a starting point for evaluating the performance and effectiveness of the supervisory committee. The committee should determine how it can best ensure that the responses reflect a forthright exchange of ideas and opinions among committee members and how the process should be completed. For example, the questions could be completed anonymously, prior to attending an evaluation-discussion meeting, or during a committee meeting.

This list is intended to provide guidance on ways to assess the supervisory committee's general effectiveness in its roles and relationships, including understanding the credit union's business activities and risk factors and acquiring the technical and communications proficiency necessary for proper oversight of accounting, financial reporting, enterprise risk management, and internal controls. Questions can include:

- Does the supervisory committee have a positive working relationship with management, internal auditors, and independent auditors?
- Do committee members provide the chair with their own view on issues?
- Are differences of opinion resolved to the committee's satisfaction?
- Does the committee use a charter to guide its efforts and agenda?
- Does the committee engage outside experts and work with other committees, as appropriate?
- Does the committee conduct executive sessions in a manner that offers a safe haven to the individual while at the same time asking tough and necessary questions, evaluating the answers and pursuing issues to a satisfactory resolution?
- Does the committee evaluate the internal auditors' overall effectiveness?
- Does the committee evaluate the independent auditors, including their responsiveness to the committee's expectations?
- Is the size of the committee appropriate for the complexity and operations of the credit union?
- Do committee members encourage a tone at the top that conveys the basic values of ethical integrity, legal compliance, and strong financial reporting and internal control?
- Does the committee receive the internal and independent auditors' assessments of the risks for fraud and other factors that could lead to fraudulent financial reporting?
- Is the committee aware of reports or other communications received from regulators—and appropriate updates on legal matters—that may have a material effect on the credit union's financial activities and statements or that may affect related organizational compliance policies?
- Has the committee reviewed all significant risk issues and control deficiencies identified by the internal or independent auditors, as well as management's corrective action plan and timetable for addressing those recommendations?
- Are meeting agendas prepared and distributed in advance to ensure effective and efficient meetings? ■

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May 11–12, 2010
Las Vegas



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HAVE QUESTIONS ABOUT THE ARTICLES IN THIS ISSUE?

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Join us as we take an in-depth look at current challenges and opportunities in the credit union industry. Designed for CFOs, controllers, accounting personnel, internal auditors, directors, supervisory committee members, and other executives, the conference will provide up-to-date information on relevant tax, financial-reporting, compliance, and other vital issues affecting credit unions.

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