Supervision of Problem Credit Unions

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One of the most important job functions of a regulatory examiner is the supervision of problem credit unions. Examiners must provide a credit union the attention it needs to fully resolve problems before they:

- threaten the credit union's safety and soundness;
- cause a financial loss to the members; or
- adversely effect member confidence in the credit union and the system as a whole.

Off-site Problem Identification – The objective of off-site supervision is to quickly identify negative trends and emerging problems and to resolve the issues before they become so serious that they could negatively affect the credit union's financial condition. Problems are best identified through a trend analysis of the credit union's balance sheet, income statement, and delinquency report figures. From these figures a ratio analysis should also be performed, using ratios that best determine a credit union's financial condition. An examiner should perform a trend analysis of both the actual results and the ratios no less than semi-annually. More frequent analysis is indicated if any serious problems have been identified, the credit union is newly chartered, or if the credit union offers higher risk products such as business and agricultural loans. In addition to a trend analysis for a particular credit union, all credit unions should be part of a peer group so that credit union results and ratios may be compared for a similar group of credit unions. Peer groups are usually based on credit union asset sizes.

The examiner that is responsible for performing the on-site supervision can perform off-site supervision or the supervision duties can be divided between on and off-site supervision departments.

On-site Problem Identification – If the regulatory agency has a sufficient budget and an adequate number of employees, there is no better way to identify and resolve a problem, whether it is emerging or evident for some time, than with an on-site contact. The examiner can:

- request and review any necessary reports to determine the extent and severity of the problem;
- interview and observe employees to determine the source of the problem;
- determine if the employees and officials are adequately trained and capable of fulfilling their job duties;
- discuss and develop agreeable solutions with daily management and the officials;
- determine on a first hand basis if fraud or a misappropriation of funds is involved; and
- observe the working relations between the employees and the quality of the overall work environment.

Supervisory Tools to Be Used for Problem Resolution – All of the most commonly used supervisory tools that may be used by an examiner are explained in-depth in the summary entitled "Administrative Actions". These supervisory tools encompass those actions that the regulatory authority can take or enforce against a problematic credit union in order to reverse negative trends or operational results, remove officials, or take over management of a credit union. Often problems can be resolved and the necessary changes affected through a well-written Document of Resolution (DOR) that is a part of every full-scope examination. If the DOR, along with on and off-site supervision provided by the assigned examiner, can not resolve the problems then the following are other tools that may be used, listed in their order of severity:

- Letter of Understanding and Agreement;
- Cease and Desist Order;
- Monetary Penalties;
- Establishment of Special Reserves;
- Removal of Officials;
- Prohibitions;
- Conservatorship;
- Merger;
- Liquidation; and
- Revocation of Deposit Insurance, License, or Charter.

Additional supervisory tools may exist if credit unions are part of a deposit insurance scheme or a stabilization fund. Generally deposit insurance or the stabilization fund is administered by the regulatory authority charged with credit union supervision. In general there are two categories of assistance that may be offered to selected credit unions:

- **Non-Financial Assistance** – The credit union's undivided earnings and other reserves first absorb losses, followed by regular reserves or revocable reserves in excess of regulatory reserve requirements. In most non-financial assistance cases, a representative of the regulatory authority (the examiner and their supervisor) will issue an LUA containing a repayment schedule to replenish regular reserves for approved reserve changes or reserve transfer reductions.
- **Financial Assistance** – If a credit union that is covered by deposit insurance or the stabilization fund has inadequate available reserves and a deficit in undivided earnings, the administrator of the deposit insurance or stabilization fund may consider granting financial assistance to continue operations, in lieu of liquidation or merger. Financial assistance may be temporary or permanent in nature. Generally temporary assistance is limited to 6 months and permanent assistance does not exceed 24 months.

The previously mentioned supervisory tools can be used to resolve any credit union problem. Examples of prevalent problems are discussed below along with suggestions for their resolutions.

1. Problem – Increasing ratio of loans delinquent more than 30 days as compared to total loans.

Identify Source of Problem – Several factors or changes can cause an increase in delinquent loans. The examiner during off or on-site supervision should determine what is the source of the increase. The source of this problem can usually be identified by:

- reviewing a sample of delinquent loans and current loans noting changes in loan underwriting and borrower creditworthiness;
- comparing the underwriting of loans granted during a period when delinquency was not an issue to the existing delinquent loans;
- reviewing the efforts of the collections department; and
- interviewing the general manager, heads of lending and collections, lending and collection staff, credit committee officials, or any other officials who may have good insight.

An increase in delinquency is often caused by:

- a decrease in loan underwriting standards in order to increase loans outstanding;
- inadequate or non-existent written loan and collection policies and procedures;
- excessive turnover in the loan department, therefore, individuals with limited experience are reviewing and approving loans;
- a credit committee with very little experience in granting loans;
- changes in the collection department staff or techniques used; or
- employment problems such as layoffs, strikes, or business closures with the credit union sponsor or in the credit union's operational area.

Supervision Techniques Used to Solve the Problem – Increasing loan delinquency can impact the financial health of a credit union quickly if left unresolved. Because borrowers are not making their loan payments:

- interest on loans will decrease,
- collection expenses will most likely increase because there are more delinquent loans,
- net income will decrease due to a reduction in gross income and an increase in expenses, and
- capital contributions will be negatively affected due to the decrease in net income.

Examiners must work with credit union management to quickly identify the source of the increase in delinquency and draft action steps to be taken in a DOR. This document is part of a full-scope examination, but can be used at any time to identify problems, establish action steps or resolutions to problems, and monitor progress made towards the resolutions of the problem or the lack thereof. The DOR could be used to outline the steps that need to be taken to improve loan underwriting or collection procedures or to assist credit union management in resolving loan delinquency due to local economic problems.

When drafting action steps to reduce delinquency, the examiner will want the assistance of the credit union's general manager, heads of collection and lending, and the credit committee, if applicable. Upon completing these agreed upon action steps, the examiner should discuss the action plans with their supervisor and have the credit union officials approve the DOR.

To closely monitor the future trend of delinquent loans the examiner should receive a balance sheet, income statement, and delinquency report monthly. The examiner should carefully analyze the status of each delinquent loan on the delinquency report. If loans are removed from the report from month to month, the examiner should determine how these loans were removed to ensure that there was no manipulation of data to reduce loan delinquency.

If the action steps in the DOR do not resolve the problem and the credit union is solvent, the examiner should consider using a more severe administrative action. Depending on the reason(s) the DOR was ineffective, what the source of the delinquency problem is, and how threatening the delinquency problem is to the on-going concern of the credit union determines alternative courses of action. Alternatives include:

- A Letter of Understanding and Agreement (LUA) requesting that the officials have the general manager or any individuals responsible for the on-going delinquency problem terminated;
- A Cease and Desist Order which requires that the credit union cease and desist all of the actions that are causing loan delinquency to increase;
- Removal of Officials, if the credit committee or any of the board members are the source of the problem;
- Establishment of Special Reserves to cover the potential loan losses;
- Conservatorship; or
- Merger.

2. Problem – The allowances for asset losses (this includes loans, investments, and any other assets) accounts are not adequately funded for potential losses.

Identify Source of Problem – Inadequate allowances can be identified quickly:

- by an individual review of all potential losses with the purpose of determining the amount that needs to be in the allowance (usually performed with an on-site contact); or
- if the allowances are not sufficient to met the required formula amount as prescribed by the regulatory authority based on the age of the asset or loan delinquency (this can be identified during off or on-site supervision).

Examiners should quickly determine the reason(s) for the inadequate allowance accounts and address the problem with the general manager. If the allowance accounts are not adequately funded it could dramatically skew financial results and any trend analyses and peer comparisons performed. Inadequate allowances are usually due to:

- no employee responsible for determining how much should be in the accounts;
- an overly optimistic or inadequately trained individual determining the amount that should be in the allowance accounts; or
- daily management's unwillingness to show a net loss for the accounting period.

When the allowances are funded, it is done through an expense account. Any increase to this expense account will therefore increase overall expenses and negatively impact the net income account. This will directly effect the credit union's ability to increase the capital accounts.

Supervision Techniques Used to Solve the Problem - If the allowances are not adequately funded then assets, net income, and institutional capital will be overstated. In the worst case scenario, a credit union could appear to be solvent, when in reality it is insolvent because the credit union's unrecognized losses exceed it's institutional capital. The DOR should initially be used to address the inadequacies of the allowance accounts and require that the allowance accounts be adequately funded immediately. If for some reason due to local law this is not possible, then the credit union should be required to adequately fund the account over an established time period. Additionally the financial statements should be footnoted as to the amount that should be in the allowances and the effect on net income and capital if the allowance accounts were adequately funded.

When drafting the action steps to adequately fund the allowance accounts, the examiner should work with the credit union's general manager. Upon completing these agreed upon action steps, the examiner should discuss the action plans with their supervisor and have the credit union officials approve the DOR.

The examiner should follow up on a monthly basis to ensure that management and officials have complied with the DOR. If the action steps in the DOR do not resolve the problem and the credit union is solvent, the examiner should consider using a more severe administrative action, depending on the reason(s) the DOR was ineffective, why the allowance accounts are inadequate, and if the improper funding of the allowance accounts is threatening to the on-going concern of the credit union. Alternatives include:

- An LUA that requires the officials to adequately fund all allowances and specifically details the more severe actions that may be taken should the officials not comply with the LUA;
- Monetary Penalties;
- Removal of Officials, if officials are the cause or they will not take the necessary actions such as terminating the general manager if he/she is the source of non-compliance with the DOR or the LUA;
- Establishment of Special Reserves to cover the amount that is not provided for in the allowance accounts;
- Conservatorship;
- Merger; or
- Revocation of Deposit Insurance, License, or Charter.

3. Problem – The operating expenses rise dramatically and net income falls.

Identify Source of Problem – It is clearly the direct responsibility of daily management to control credit union expenses. Expenses may increase quickly if:

- adequate budgeting and an expense approval process are not in place;
- the credit union lacks an adequate review process of monthly expenses to ensure that the expenses are within the budget and properly approved;

- loan losses are increasing, and the provision for loan loss expense has to be increased to adequately fund the allowance for loan loss account;
- employee salaries and benefits are increased dramatically;
- expensive fixed assets are purchased thereby increasing the monthly depreciation taken;
- collection expenses increase in an attempt to reduce the amount of delinquent loans; or
- a new service is added such as checking accounts and there are no offsetting fees or the fees established are inadequate.

Examiners can easily identify increasing expenses through on and off-site supervision using trend analyses of financial results accompanied by income statement ratio analysis and peer group comparisons. An examiner may have to make an on-site visit to identify the exact expense items that have increased or they may contact credit union management to have them send all monthly expenses broken out by expense account number or income statement line item. The examiner, with this information, may be able to determine the source of the increase.

Increasing expenses can become a very serious problem if left unchecked. They will negatively impact both the credit union's net income and its ability to build institutional capital and, if left unresolved, they could directly effect the credit union's ability to survive in the future.

Supervision Tools Used to Solve the Problem - As with the other problems discussed above, the examiner should contact management to discuss the increasing expenses, determine what the cause(s) of the increase is and establish effective solutions to the problem(s). Once the problem(s) has been identified the action steps needed to resolve increasing expenses should be outlined in the DOR with the assistance of management. In addition to the action steps, the DOR should also clearly state the time frame for completion of each action step and who is responsible for the completion of each step. The proposed DOR should then be reviewed by the examiner's supervisor and approved by the board of directors.

The examiner should follow up on a monthly basis to ensure that management and officials have complied with the DOR; the amount of total operating expenses is decreasing as is the operating expenses to average assets ratio. If the action steps in the DOR do not resolve the problem and the credit union is solvent, the examiner should consider using a more severe administrative action, depending on the reason(s) the DOR was ineffective, why the expenses are increasing, and if the increasing expenses are threatening the credit union's financial future. Alternative actions include:

- An LUA that requests the officials to review, reduce, and eliminate all unnecessary expenses and specifically details the more severe actions that may be taken should the officials not comply with the LUA;
- A Cease and Desist Order that states the actions that the officials and management must cease and/or desist in order to reduce expenses;

- Removal of Officials, if officials are the cause or they will not take the necessary action such as terminating the general manager, if he/she is the source of non-compliance with the DOR or LUA;
- Conservatorship; or
- Merger.

4. Problem – Credit union liquidity is inadequate to meet loan demand, savings withdrawal requests, and the payment of operating expenses.

Identify Source of Problem – Illiquidity can easily be identified using on or off-site supervision through the monthly monitoring of the balances of:

- cash;
- investments with a maturity of less than 1 month;
- loans with a maturity of less than 1 month;
- savings accounts with no maturity;
- savings deposits with fixed maturities that will mature in the next month; and
- liquidity ratios such as liquid assets to total assets and liquid assets-short term payables as compared to member deposits.

An illiquid credit union can experience grave and irreversible damage if members are unable to access their funds when they want. Members will immediately lose confidence in the credit union as a sound financial institution, they will quickly tell others that they could not access their funds, and they could cause a "run" on deposits once members are allowed access to their deposited funds. Illiquidity can result from:

- an increase in loan maturity therefore slowing the rate at which the loan portfolio turns over;
- an increase in loan demand and approval;
- an increase in savings withdrawals;
- important holidays, festivals, and seasonality needs of members,
- a change in investment strategy to longer term investments; or
- large investment in fixed assets and/or non-earning assets.

Supervision Tools Used to Solve the Problem – The examiner will want to contact the general manager immediately to devise solutions to the liquidity problem. Initially the action steps to be taken to resolve the problem may be addressed in the DOR. The examiner will want to outline the action steps to be taken along with the applicable time frames and responsible individuals for completing each action step. The examiner will want to review the proposed action steps with their supervisor and present the DOR to the credit union's board of director for approval. To improve liquidity, management should consider:

- improving the day-to-day management of cash;
- controlling unpredictable outflows of cash;
- adhering to targets established for liquidity ratios; or
- establishing access to a line of credit or liquidity pool for short-term liquidity needs.

The examiner should follow up on a monthly basis to ensure that management and officials have complied with the DOR and that liquidity is improving. If the action steps in the DOR do not resolve the problem and the credit union is solvent, the examiner should consider using a more severe administrative action, depending on the reason(s) the DOR was ineffective, why the credit union continues to be illiquid, and if the illiquidity is threatening the credit union's financial future. Alternative actions include:

- An LUA that requires the officials to improve liquidity through specific outlined steps, within established time frames, and specifically details the more severe actions that may be taken should the officials not comply with the LUA;
- A Cease and Desist Order that states the actions officials and management must cease and/or desist immediately to improve liquidity;
- Removal of Officials, if officials are the cause or they will not take the necessary actions such as terminating the general manager, if he/she is the source of non-compliance with the DOR or the LUA;
- Conservatorship; or
- Merger.

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