


Executive intelligence on credit union exams, enforcement and risk management

Don't overlook liquidity risk

New guidance demands thorough risk mitigation strategies

Not many CUs would consider liquidity a high concern right now. Many of them are sitting on what they might consider to be too much liquidity and they're far more worried about anemic loan growth than liquidity risk. Don't underestimate the gravity of liquidity risk right now, experts say.

The industry's liquidity position could change rapidly, and CUs need to know how to manage their own liquidity needs – and ensure their access to liquidity– in the event that it does. Recent guidance on liquidity , re-released by the NCUA, ensures that examiners will be checking to make sure CUs do plan adequately for liquidity risk.

“All of the regulatory agencies are worried about a rapid, Greece-like rise in rates,” says Don Musso, a financial analyst and interest rate risk specialist with FinPro, a management consulting firm based in Liberty Corner, N.J. “Here we are coming out of a problem loan and real-estate market. And to get double-whacked [on liquidity] because of interest rate risk? That's more than the regulators want to take a chance on.”

Right now, liquidity problems are impacting banks to a greater degree than credit unions, but the CUs' liquidity risk isn't much different than the banks', considering the credit union portfolio looks more like a bank portfolio every year, argues Musso.


Participation delinquencies, charge-offs also rising

It isn't just indirect lending the NCUA has its eye on. Delinquencies and charge-offs in participations keep rising, too. Participation delinquencies, as of Dec. 2006, stood at 1.4% , with only 0.38% in charge-offs, according to NCUA data. By the end of 2009, those numbers rose to 3.45% and 1.06% respectively. As of June 30, charge-offs stayed about the same, while delinquencies climbed again to 4.09%. New guidance on participations may not be too far behind the agency's recent indirect lending guidance.

“Credit unions didn't have the same level of risk as banks historically, but credit unions have pushed into the real estate market more and more,”

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New guidance signals agency concern over indirect lending

Some of the biggest recent CU failures stemmed from poorly structured, insufficiently vetted indirect lending programs. The NCUA hasn't forgotten. The agency will want to know – and want you to know – your indirect lending program inside and out at your next exam. That's according to guidance released earlier this month .

The NCUA is seeing a rising number of repossessed autos, as well as increasing lending delinquency and loan losses with indirect lending programs, says NCUA spokesman John McKechnie. “We decided it was an opportune time to remind credit unions of the types of controls they need over these programs,” he adds.

Indirect loans account for around

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he says. “Now they’re more bank-like. To them, liquidity and interest rate risk is every bit the challenge that it is for banks.”

The NCUA recognizes that, when it comes to liquidity risk and interest rate risk, CU concerns look a lot like bank concerns. That’s why it’s appropriate for CUs to adopt the liquidity management practices banks have been using for years, says Musso. Recent FFIEC liquidity guidance, adopted by the NCUA, asks CUs to follow the same liquidity risk guidelines as banks, which makes perfect sense, Musso argues.

The NCUA first signed onto and released the FFIEC’s liquidity risk guidance several months ago. The agency re-issued the guidance earlier this month. “It became apparent to us that credit unions hadn’t seen the information,” says NCUA spokesman John McKechnie. “We decided to re-issue [the guidance] through a Letter to Credit Unions, so we could emphasize the points.”

The FFIEC guidance provides banks and credit unions with a thorough compendium of strategies and techniques they can use to manage liquidity risk. The NCUA calls out five in particular:

- Projecting cash flows;
- Diversifying funding sources;
- Stress testing;
- Cushioning liquid assets; and
- Developing a formal contingency funding plan.

Of the five, a contingency funding plan is critical, says Musso. Banks have been drafting plans for a few years and CUs should use them, too, he says.

The guidance suggests that all financial institutions, regardless of size

and complexity, should have a formal plan in place, one that sets policies to “manage a range of stress environments, establish clear lines of responsibility and articulate clear implementation and escalation procedures.”

For Musso, the point of a formal contingency funding plan is not to build liquidity, but rather to set some formal guidelines for managing liquidity.

“In the banking sector, what we’re doing is setting cash and cash equivalents at 4% of funding,” Musso says. “Cash, cash equivalents and unimpaired investments – i.e., investments that aren’t pledged and that we can out and out sell – we set at 10%. All that plus borrowing capacity ought to be 20%.”

Once you set these standards, it changes the way you manage liquidity, Musso says. “Historically, people found it easy to pledge investments against ability to borrow from, say,

“Nothing will sink an institution faster than liquidity,” FinPro’s Musso says. “It’s one of the top risks to be managed. I don’t fault the NCUA [in issuing this guidance]. It’s prudent”

the Federal Home Loan Bank because it’s so quick and easy,” he says. “With these liquidity guidelines, we need unimpaired investments. So, we start pulling investments as collateral and replacing them with loans, which we have a ton of.”

Replacing investments with loans can take some work, Musso adds. Sometimes, those loans have to be packaged up and delivered to the actual lending site. But the effort is worth it, since the financial institution can end up in a much better liquidity

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Best practices for vetting your liquidity source


It’s not enough to have two or three sources of liquidity. CUs need to know how reliable those sources are, says Crowe Horwath consultant Eileen Iles.

When it comes to those lines of credit, every CU should perform ongoing due diligence, she recommends. Here’s what you need to do:

1. Get as much financial information as you can. At least annually, try to collect Call Reports and articles on the funding source, Iles recommends. Try to monitor with whom that source is doing business.

2. Check for regulatory action. To the greatest extent possible, try to find out if any regulatory action has been taken against that source and what the action is.

If something could impact your ability to borrow from any one of your lines, you’ll want to know about it, Iles says.

“We’ve seen some financial institutions have lines of credit reduced or even eliminated,” she adds. “Credit unions will want to be proactive. They need to make sure they have funding sources available when they need them.” 

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position.

“[In making the switch,] I’ve unimpaired my investments, which I can readily sell, whereas I can’t sell loans,” he adds. “Now I can borrow against my loans and that’s a winning strategy.”

Don’t neglect to project cash flow, either, argues Eileen Iles, a partner and risk consultant in the Chicago office of Crowe Horwath.

“We’re telling clients that they should be doing cash flow projections looking at the next 30, 60 and 90 days,” she says. “This needs to be a true cash flow analysis. Credit unions need to know they can get the cash they need.”

CUs can start by looking at cash sources and cash needs and then by checking to see which loans are maturing in the next 30, 60 or 90 days, she advises. Find and list the loans that need to be funded and then list your cash needs, she advises. Then estimate payment streams from loans.

CUs absolutely need to know if they have enough cash coming in. If not, then they need to look to funding

sources.

Iles also advises CUs to keep several lines of credit open. There’s an element of potential concentration risk for CUs that don’t manage their liquidity sources, she says. Diversification is the opposite of concentration and sticking with just one line is a form of concentration. If CUs are relying on just one source for liquidity, they may find themselves with a capped line-of-credit or no line at all, precisely when they need it.


“No credit union needs five lines of credit, but the important thing is to have options,” Iles says. “If a credit union has one line of credit open, it should have one to two more in case something comes up with the primary line.”

“You’ve got to have a mechanism in place [to find other sources of liquidity],” agrees Burt Ely, a financial analyst based in Alexandria, Va. “Some credit unions haven’t done this and some sources of liquidity, like the Federal Home Loan Bank, have strict collateral requirements.”

Next week: Best Practices for Stress Testing 

What to think about when you think about liquidity risk

All financial institutions should prepare for sudden events or conditions that could leave them in a liquidity crunch, argues the recent – and twice released – FFIEC guidance. What sort of situations are they talking about? Here’s a quick list:

- A failure to fund asset growth;
- An inability to renew or replace maturing funding liabilities;
- Members unexpectedly exercising options to withdraw deposits or off-balance sheet commitments;
- Changes in market value and price volatility involving various asset types; and
- Changes in economic conditions or market perception; and
- Sudden dislocations in financial markets. 

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8% of total industry loans. Federally-insured credit unions held \$73.8 billion in indirect loans out of \$566 billion in total loans as of March 2010, according to the NCUA. Indirect lending delinquency (greater than 2 months) hit a recent high in 2008 with 1.56%. Indirect lending delinquency dropped slightly to 1.47% in 2009 and, through the first quarter of 2010, sits at 1.17%.

“The NCUA’s been hammering due diligence for three years now and you’d think that credit unions would be doing it by now, but the NCUA must be seeing examples of credit unions not doing it.”

“[The NCUA is] still chasing the ghost of Centrix,” says Rob Rutkowski, a partner in Weltman, Weinberg & Reis in Brooklyn Heights, Ohio. “The risks for indirect lending haven’t changed. If a credit union doesn’t monitor what comes in carefully, it can get stuffed with bad loans from the dealer. Moreover, indirectly lending programs traditionally bring in ‘one-off’ members that only use the credit union for the car loan. This is not the best quality member from the credit union’s perspective.”

Programs like Centrix or First America Funding helped some CUs add a large volume of loans to their books quickly. CUs signed up for programs like these without performing the proper due diligence and found themselves engaged with bad loans.

The NCUA knows that loan participation programs, improperly done, can function like a concentration risk generator. And that’s why

it goes into this level of detail in the guidance, says Anthony Demangone, director of regulatory compliance for NAFCU.

“The NCUA doesn’t issue guidance documents just to fill their time,” Demangone says. “These documents are issued for a reason. I’ve heard from a lot of credit unions that real estate loans are flat and that not many members are buying cars. They’re flush with cash and shares. Someone could come in and say, ‘Here’s a way to loan that money.’ The NCUA’s been hammering due diligence for three years now and you’d think that credit unions would be doing it by now, but the NCUA must be seeing examples of credit unions not doing it.”

The NCUA has also internalized the lessons from some of those recent failures, such as Nolarco CU or Cal State 9 CU, Demangone adds. Nolarco got heavily involved in First America Funding, a loan servicer that originated, closed, serviced and administered residential construction loans and then dropped them into Nolarco’s portfolio. At one point, the CU was sending as much as \$30 million per month to the loan servicer for residential home construction loans. Nolarco entered into the program without giving it a proper legal review or setting any limits (See “Loan participation programs under scrutiny,” *The Safety & Soundness Report*, January 25, 2010).

Cal State 9 took on a massive volume of subprime HELOCs in a very short period of time, thanks to the bad incentives of a single credit union officer (see “Cal State 9 and concentration risk: Lessons from the failure,” *The Safety & Soundness Report*, April 26, 2010). In fact, Demangone notes, one aspect of the guidance seems to point directly to Cal State 9’s example. At

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How to improve your direct lending

A lot of CUs would be better off – and could bypass indirect lending’s due diligence headaches and additional risk – if they focused instead on improving their direct auto lending, says Brett Christensen, president of CU Lending Advice. Here’s how Christensen recommends rehabilitating your direct lending program:

1. Hire true salespeople. “[CUs] aren’t going to grow loans just with what the members they have,” Christensen says. “They have to be good at stealing from competitors. Most credit unions are too far removed from good salespeople because they tend to promote from the teller lines. I promise you those tellers weren’t hired for their sales ability;”

2. And pay them. “A typical credit union loan officer, making \$30,000 per year, doesn’t care if they do one or 10 loans per day because it doesn’t affect their paycheck.” Sales force salaries at CUs boosting auto loan volume can rise to the \$50,000-to-\$70,000 range. CUs have to be willing to incentivize their salespeople, he says.

3. Give all non-sales work to other staff. If you’re going to pay good salespeople to

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make sales, the last thing you want them to do is work on other things, he says. Let other staff handle the loan processing and underwriting and let the sales people sell;

4. Move from branch to phone sales. It doesn't matter how good a salesperson is, if they're waiting on walk-in business, they'll spend a good part of the day doing nothing, he says. "You need to get them a steady stream of applications, and that will never happen in a branch," he adds. "Move your lending operation to the phones and get your salespeople busy;"

5. Embrace risk. CUs will take on risk when working with a third party vendor on indirect lending, but they tend not to take it on with their own loans, Christensen argues. That's a bad strategy. "You can have the best salespeople and keep them busy, but if all your loans get funneled through an underwriter who says, 'bad credit denied,' you won't get anywhere. Credit unions need to take on risk in all tiers. Around 25% of the population now has a FICO score under 600. If credit unions think they'll grow loans by chasing the B and C paper, they're crazy;"

6. Be flexible with loan-to-value and debt ratios; and

7. Market. "The message should be, 'We know you

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Cal State 9, one CFO had total control of the program. His bonus was tied directly to loan volume, which gave him little incentive to turn down risky loans.

The guidance states that CUs should maintain segregation of duties: "One person should not be responsible for loan approval, reporting, reconciliations, and collection. If staffing levels do not allow for proper segregation of duties, other compensating internal controls may be necessary."

The guidance also warns CUs never to delegate loan approval authority to any third party, advice that Nolarco executives neglected to follow.

If you participate in an indirect lending program, here, according to

the guidance, is what your examiner will be looking for:

- Comprehensive written policies addressing all facets of the indirect lending program including underwriting and monitoring;
- A review process to assess the vendor's financial and operational risks;
- A process to periodically assess the legal agreements and needs for each program; and
- A risk management process to control the risk associated with the vendor relationship. 

Indirect lending red flags

Having worked through debacles like Nolarco and Centrix, the NCUA has learned a thing or two about doomed indirect lending programs. To that end, the agency has instructed all examiners to look for certain red flags. Here's what those examiners will be looking for the next time they visit or dig into your Call Reports:

- A high concentration of indirect loans to total loans or net worth without adequate controls in place;
- Incentive programs tying loan officer bonuses to indirect loan volume;
- Inadequate analysis of overall indirect loan portfolio performance;
- High instances of first payment default, payment deferment, and account re-aging;
- Frequent refinancing of past due interest, repairs, and add-on expenses (GAP insurance);
- Insufficient loan documentation; or
- Poor dealer management including reliance on the dealer to obtain credit reports, accepting loan payments from dealers, dealer-created down payments through dealer incentives, inflated or fraudulent trade-in or purchase price, and continuous overdrafts in dealer reserve accounts.

Any one of these red flags, when spotted by an examiner, could trigger a snap exam, the guidance warns. 


Indirect lending and fraud

The NCUA's guidance on indirect lending largely follows from the more generalized due-diligence guidance the NCUA has been turning out by the box-full over the last few years. However, the agency does broach one new subject in this recent guidance: fraud.


CUs will need strong internal controls as well as timely information to catch fraud within an indirect lending program, according to the guidance.

Here are the kinds of fraud-busting internal controls the NCUA wants to see in all indirect lending programs:

- Staffing sufficient to allow for segregation of duties – one person should not be responsible for loan approval, reporting, reconciliations, and collection. If staffing levels do not allow for proper segregation of duties, other compensating internal controls may be necessary;
- Safeguards to restrict inappropriate access to data;
- Knowledge of credit union policies – staff should receive training at least annually and when policies change;
- Procedures to ensure limited exceptions to the established policies – exceptions should be infrequent and approved by appropriate personnel;
- Quality control processes to ensure the credit union receives perfected liens, proof of insurance, and other necessary documentation, in addition to verifying the completeness, accuracy and validity of loan deals; and

- Internal audit functions that include testing loans from each vendor through direct member communication. 

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got your loan with the dealer; bring it back to us and we'll save you some money," Christensen says. "Credit unions would be better off taking that \$400 to \$500 per loan they pay to the auto dealer and putting it towards marketing just to see how many loans they can get." 

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