Chapter 1

RISK FOCUSED PROGRAM

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RISK-FOCUSED PROGRAM

Supervision Objectives

- Evaluate management's due diligence processes over the credit union's activities
- Stay abreast of local and national economic conditions that may affect the financial performance and health of credit unions
- Evaluate the credit union's current and potential risk
- Evaluate management's ability to identify, measure, monitor, and control (i.e., manage) risk
- Evaluate the adequacy and accuracy of management's risk reporting and monitoring 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
- Identify changes in the credit union's risk profile and adjust supervision plans accordingly
- Identify and address emerging risk issues before they become serious problems
- Work with management to resolve problems identified during onsite and offsite contacts
- Work with management to reach agreeable solutions to reduce levels of unwarranted risk
- Direct resources more efficiently by compiling and assimilating relevant risk information that helps prioritize examination schedules and determine need for subject matter examiners (SMEs) and specialists
- Develop a factual, documented administrative record of the credit union's problems and the attempts to resolve them

Overview

A risk-focused program is a forward-thinking approach that allocates resources to the credit unions and areas exhibiting weaknesses or adverse trends. Examiners allot time to reviewing areas containing the most risk for an individual credit union. Activities posing the highest risk receive the most scrutiny.

In the risk-focused program, distinctions between examination and supervision blur. Examination and supervision efforts may, at times, be a continuum to the extent that examiners will call a particular contact an examination, rather than supervision simply because the time frame requires an examination.

Supervision is the ongoing monitoring of a credit union's financial and operational condition. During supervision in the risk-focused program, the examiner looks forward at the direction a credit union takes and the decisions it makes. Examiners can then anticipate when those decisions could result in the credit union assuming undue risk or failing to manage the risk it has taken. Examiners may determine or adjust the timing of the examination based on conditions revealed during the supervision process.

The examiner, through other examiners, trade associations, credit union leaders, news reports, etc., should stay abreast of developments within their district credit unions and the various industries or communities that affect the credit unions. Examiners should act on potentially high-risk activities and problems by contacting credit union officials to verify information received. Depending upon their comfort level after speaking with credit union personnel, they may decide to perform an onsite contact to gain first hand knowledge of the situation, or may reschedule the examination to an earlier date. Examiners should keep their supervisory examiners informed of potentially serious conditions that could adversely affect the credit union.

Due Diligence

Credit unions should have in place a risk management program that includes a strategic plan with implementing policies, procedures, and internal controls necessary to manage the risks inherent in their operations. Successful risk management programs rely on credit union management to employ sufficient staff and have available necessary resources to identify, measure, monitor, and control existing and potential risks.

Management's due diligence involves the analysis of new products and services as well as the ongoing analysis of the credit union's current products, services, and operations to ensure their relevance, efficiency, and effectiveness. This analysis would include periodic cost-benefit studies.

If the risk to the credit union increases as a result of offering a certain product or service, the credit union should determine whether the additional risk is worth the benefit to the credit union. If not, the credit union may decide to discontinue the product or service. If management decides to continue offering the product or service, they should explore ways to mitigate the risk.

Risk-Focused Supervision

Risk, by definition, implies uncertainty. While performing risk-focused supervision, examiners should look for sources of uncertainty within the operation of the credit union. Based on their findings and using their professional judgment, examiners will prioritize these risks by the magnitude of the potentially adverse effect on the earnings and capital of the credit union.

Financial indicators, while useful, often represent lagging indicators. Indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. However, the risk-focused supervision approach emphasizes the anticipation of future problems by analyzing processes that may serve as leading indicators. These leading indicators include the following:

- Due diligence review by management for new and existing products and services;
- Development and application of strong internal controls;
- Analysis of financial outcomes; and
- Measurement of actual performance against forecasted results.

Risk is fundamental to the operation of a credit union. Examiners, therefore, should not insist that the credit union eliminate risk, but, instead, should ensure that credit unions identify and manage their risks. The desired reward for taking risk is stable profitability and increased net worth. Credit unions must balance risk and reward responsibly. The examiner's job requires assessing that the appropriate balance exists. That assessment begins with determining whether management has performed adequate due diligence with respect to the risks present and anticipated in the operation of the credit union and whether management has instituted sound internal controls to identify, manage, and mitigate undue risk.

A credit union's capital or net worth constitutes the reserve of funds available to manage or absorb the risks to the institution. The amount of capital that a credit union has accumulated is an important determinant of the amount of risk it can assume.

Generally, credit unions that have more complex operations carry more risk than do credit unions offering fewer products and services. Greater risk requires the credit union to employ able, experienced management and more sophisticated systems of control. The risk-focused supervision system largely depends upon sound controls. These controls include the following:

- Informed officials;
- Well-trained management and staff;
- Sound policies and procedures;
- Adequate due diligence by management prior to engaging in an activity, and ongoing for existing products and services;
- Sound system of internal controls;
- Prudent risk limits; and
- Identifying, measuring, controlling, monitoring and reporting of risk exposures.

Risk-Focused Examination

In the risk-focused examination, the content of the examination centers on key areas of risk. Examiners should review due diligence by management for new products and service, the credit union's risk-management systems, and the internal controls in place. Examiners may, at times, find it necessary to use transaction testing to validate their assessment of risk. They will focus on validating management's ability to identify, measure, monitor, and control risk. Some areas may receive little or no review. The examiner has discretion in determining areas requiring the most attention and allocating the time and resources accordingly. Examiners' emphasis focuses on managing future risks successfully and not expending valuable resources on minor items posing little risk to the safety and soundness of credit unions.

The risk-focused program provides examiners the flexibility to focus on areas exhibiting material current or potential risk. However, the three minimum requirements of each risk-focused examination include the following:

- Reviewing the accuracy of the 5300 Call Report data;
- Reviewing the supervisory committee audit; and
- Reviewing the credit union's compliance with the Bank Secrecy Act (BSA).

Examiners must complete these minimum procedures during each examination. However, examiners should understand that, depending on the credit union, its risk characteristics, and the examiner's familiarity with that credit union, they will perform more than the minimum procedures in most credit unions. Most credit unions will require other procedures for necessary identification and evaluation of existing and potential risks.

Although the actual evaluation of the minimum review areas may take place during supervision contacts, the examiner should document the review of these areas and any material concerns in the examination report. Examiners must also assign the CAMEL rating during the examination.

In carrying out the risk-focused examination program, examiners should allocate examination time based on areas that manifest material risk characteristics. This ensures supervisory attention remains properly focused on credit unions exhibiting existing or potential weaknesses or adverse trends.

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.

Credit Risk

Credit Risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet terms of any contract with the credit union or otherwise fail to perform as agreed. Credit risk exists in all activities where the credit union invests or loans funds with the expectation of repayment.

Interest Rate Risk

Interest Rate Risk is the risk that changes in market rates will adversely affect a credit union's capital and earnings. Interest rate risk arises from (1) differences between the timing of rate changes and the timing of cash flows (repricing risk); (2) changing rate relationships among different yield curves affecting credit union activities (basis risk); (3) changing rate relationships across the spectrum of maturities (yield curve risk); and (4) interest-related options embedded in credit union products (options risk). Not only can a move in interest rates affect the price of investments, it also has an effect on the value of the loan portfolio and on fee income, which is sensitive to changes in interest rates.

The assessment of interest rate risk should consider risk from both an accounting perspective (i.e., the effect on the credit union's accrual earnings, including held-to-maturity and available-for-sale accounts) and the economic perspective (i.e., the effect on the market value of the credit union's loans and investments.) In some credit unions, the broader category of market risk captures interest rate risk.

Liquidity Risk

Liquidity Risk is the current and prospective risk to earnings or capital arising from a credit union's inability to meet its obligations when they come due, without incurring material costs or unacceptable losses. Liquidity risk includes the inability to manage funding sources, including unplanned decreases or changes. Liquidity risk also arises from the credit union's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

Transaction Risk

Transaction Risk is the risk to earnings or capital arising from fraud or error that results 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.

Compliance Risk

Compliance Risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards. Compliance risk may also arise in situations where ambiguous or untested laws or rules govern certain credit union products or activities of the members. Compliance risk exposes the credit union to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, limited opportunities, reduced field of membership expansion potential, and lack of contract enforceability.

Compliance risk goes beyond a failure to comply with consumer protection laws. It encompasses all laws as well as prudent ethical standards, contractual obligations, and exposure to litigation. Compliance risk can blend into operational risk, transaction processing, and even legal risk, increasing the difficulty of identifying this risk.

Strategic Risk

Strategic Risk is 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. This risk is a function of the compatibility of a credit union's strategic goals, the business strategies developed to achieve those goals, the resources deployed to accomplish these goals, and the quality of implementation. The tangible and intangible resources needed to carry out business strategies include communication channels, operating systems, delivery networks, monitoring systems, and managerial capacities and capabilities.

Reputation Risk

Reputation Risk is the current and prospective risk to earnings or capital 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. This risk, which occurs in activities such as asset management decisions and transactions, can expose the credit union to litigation, financial loss, or a decline in membership base. Reputation risk exposure appears throughout the credit union organization. The officials, management, and staff must accept responsibility to exercise an abundance of caution in dealing with members and the community.

Managing Risk

The key to effective risk management is management. Effective risk management requires an informed board of directors, which guides the credit union's strategic direction including its risk tolerance. Board-approved, written policies define the board's strategic direction. Procedures intended to carry out the board's policies and well-designed monitoring systems enable the board to hold management accountable for operating within established tolerance levels.

Effective risk management also requires capable management and staff. Management must maintain the integrity of the risk management program, including evaluation of the credit union's operational and financial condition, and keep the directors informed of material existing and potential risk. Management's responsibilities include the following:

- Implementing the board's strategic direction;
- Developing formal and informal policies compatible with the strategic goals defining the credit union's risk tolerance;
- Overseeing development and maintenance of timely, accurate, and informative management information systems; and
- Ensuring effective communication of, and adherence to, strategic direction and risk tolerances throughout the organization.

Risk Management Program

Each credit union should develop its own risk management program tailored to its needs and circumstances. Differences in market conditions, fields of membership, and credit union structures preclude any single risk management program working for all credit unions. The size, complexity, and geographic diversity of each credit union determine the sophistication required of its risk management program. All sound risk management programs, however, have several common fundamentals. For example, staff responsible for implementing sound risk management programs must perform those duties independent of the credit union's risk-taking activities. Regardless of the risk management program's design, each should include:

- **Risk identification**. Proper risk identification focuses on recognizing and understanding existing risks or risks that may arise from new business initiatives. Risk identification should be a continuous process, and should occur at both the micro (transaction) and macro (overall portfolio) levels.

- **Risk measurement**. Accurate and timely measurement of risks is a critical component of effective risk management. A credit union with no risk measurement capabilities has limited ability to monitor or control risk levels. Further, the sophistication of the risk measurement tools should reflect the complexity of the operation and levels of risk assumed. The credit union should periodically verify the integrity of the measurement tools it uses. Good risk measurement systems assess both individual transactions and overall portfolios.

- **Risk control**. The credit union should establish and communicate control limits through policies, standards, and procedures that define responsibility and authority. The credit union should adjust these management tools if conditions or risk tolerances change. Further, the credit union should implement a process to authorize exceptions or changes to risk limits, if warranted.

- **Risk monitoring**. Credit unions should monitor risk levels regularly to ensure well-timed reviews of risk positions and exceptions. Prompt distribution of frequent, accurate, and informative monitoring reports to appropriate management and staff enables them to take needed actions.

Policies, Processes, Personnel, and Control Systems

When examiners assess risk management programs, they should consider the credit union's policies, processes, personnel, and control systems. A significant deficiency in one or more of these components constitutes a deficiency in risk management. The sophistication of each system will vary depending upon the complexity of the credit union's operation. Credit unions with simple structures may require and often have less formalized policies, processes, and control systems in place than do credit unions with more sophisticated structures.

Policies reflect the board's intent and commitment in pursuing desired results. Effective management requires written policies that the credit union adheres to in practice. Policies set standards and courses of action to pursue, implement, and enforce specific objectives. Good policies link with, and reflect, a credit union's underlying mission, values, and principles. They also clarify the credit union's tolerance for risk. Credit unions should have mechanisms in place to trigger a review of policies in the event activities or tolerances change.

Processes include the procedures, programs, and practices governing how a credit union will pursue its objectives and define how it will carry out its daily activities. Good processes demonstrate consistency with the underlying policies, efficiency, and adequacy of internal control checks and balances.

Personnel encompass the staff and managers executing or overseeing performance of the processes. Qualified, competent managers and staff should perform as a conscientious board expects. They must understand the mission, values, policies, and processes.

Control systems are tools and information systems managers use to measure performance, assist in decision-making, and assess the effectiveness of existing processes. Sound control systems require timely, accurate, and informative feedback devices. In turn, management must implement reporting systems by which they communicate necessary and sufficient information to the directors.

Measuring and Assessing Risk

Ensuring effective risk-focused supervision requires a common framework to document decisions about risk. The risk assessment portions of the Scope Workbook (discussed further in the Scope Development and Planning chapter) provide a method of communicating and documenting judgments regarding the quantity of risk, the quality of risk management, the level of supervisory concern, and the direction of risk. Evaluating the seven categories of risks will provide consistency to the risk assessment process. The evaluation factors for consideration in making the assessments provide an overview of issues that can assist in assessing risk.

Assessment of risk must reflect both a current and prospective view of the credit union's risk profile. Examiners should use this assessment to drive supervisory strategies and activities, facilitate discussions with management and directors, and conduct more efficient examinations.

Risk assessment will occur in all credit unions; however, small credit unions may often require more transaction examining because limited staff can impede internal control systems. Assessing risk enables the examiner to provide a common supervisory philosophy while recognizing the differing levels and complexities of risk present in each credit union.

Effectively communicating the rationale for decisions in evaluating risk assists the examiner in accomplishing the desired results from supervision. Examiners should discuss conclusions from the risk assessment with appropriate credit union officials and management. Management's input may help clarify or modify conclusions. These discussions should help management understand the quantity of each risk category (low, moderate, or high), determine the direction of each risk category (decreasing, unchanged, or increasing), focus on the strengths and weaknesses of risk management, and implement corrective actions necessary to achieve future supervisory plans.

Examiners should assess the amount and direction of risk exposure for the seven types of risk using a supervisory process that assesses the following:

- **Quantity of risk** – the level or volume of risk (low, moderate, or high);

- **Quality of risk management** – how well management identifies, measures, controls, and monitors risk;

- **Aggregate risk –** a summary of the level of supervisory concern considering both the quantity of risk and the quality of risk management, weighing the relative importance of each. Mitigating factors not necessarily considered in the quantity of risk and quality of risk management decisions (e.g., insurance) may influence the examiner's assessment of aggregate risk (i.e., low, moderate, high);

- **Direction of risk –** assessed as decreasing, unchanged, or increasing indicates the likely changes to the risk profile over the next examination cycle. Decreasing direction indicates the examiner anticipates, based on current information, the aggregate risk will decline over the next examination cycle. Unchanged direction indicates the examiner anticipates aggregate risk will neither increase nor decrease. Increasing direction indicates the examiner anticipates higher risk during the next examination cycle. For example, when the credit union has moderate but decreasing, credit risk, examiners can anticipate low or lower credit risk in the next examination cycle. The direction of risk often influences both the examiners' examination and supervision strategy.

  One of the most significant influences on the anticipated direction of risk is whether the examiner expects management to take the actions necessary to reduce unacceptable risks.

  Examiners' expectations of risk to increase or decrease do not necessarily mean the risk level at the credit union will change within the examination cycle. Examiners might expect movement **within** the risk level (e.g., decreasing risk, but not enough to change the characterization of that risk as high). Examiners should provide comments explaining why they do not expect a change in risk level.

Supervisory Risk Areas

Generally, the seven areas of risk fall within two major categories:

- Market risks, which are usually more objective, and lend themselves to measurement include:

- Credit risk
- Interest rate risk
- Liquidity risk

- Institution risks are more subjective and include:
  - Transaction risk
  - Compliance risk
  - Strategic risk
  - Reputation risk

Although the risk-focused examination and supervision process identifies the seven risks as discreet and individual, in reality, these risks are interrelated and inseparable. They often overlap, and risk in one area can cause or mitigate risk in one or more additional areas. Institution risk can result from market risk, and vice versa.

For example, compliance laws exist for protection of the consumers. Most credit unions that have significant compliance risk do not willfully set out to hurt their members; however, if the credit union does not adhere to compliance laws, its reputation could suffer causing increased reputation risk and possibly loss of members. Further, civil money penalties could diminish or even eliminate a credit union's reserves, which could result in increased liquidity risk.

Benefits of Risk-Focused Supervision

On-going risk-focused supervision provides benefits to the examiner as well as to the credit union. Risk-focused supervision enables examiners to do the following:

- Focus on areas of major risk;
- Focus on how well risk is managed over time, rather than at a single point in time;
- Identify risks more accurately;
- Identify risks proactively;
- Express risks in CAMEL ratings more meaningfully;
- Minimize loss to the insurance fund in each credit union;
- Streamline workpaper documentation to support areas of risk; and
- Improve the quality of workpaper documentation and support for conclusions.

The most obvious benefit to many credit unions for sufficiently identifying, managing, and mitigating their risks will be their eligibility for a "may be delayed" category for risk-based examination scheduling. Some additional benefits of the risk-focused supervision system to the credit unions include the following:

- Enables credit unions to focus on their major areas of risk;
- Encourages credit unions to identify the risks inherent in their current products and services and to seek ways to mitigate or manage those risks;
- Encourages credit unions to identify risks inherent in new or proposed products and services and to address management of those risks in the planning stage;
- Encourages examiners to perform preliminary analyses offsite, reducing disruption in credit union operations;
- Encourages frequent, open communication between the credit union and the examiner;
- Provides officials in CAMEL Code 1 or 2 credit unions the option to hold a joint conference with the examiner;
- Encourages credit unions to review their processes and internal controls and to correct deficiencies in those systems;
- Encourages management to proactively identify risks through a system of well-planned and carefully implemented due diligence; and
- Enables examiners to provide the officials with customized examination reports that provide only workpapers and narrative necessary to support the examiner's analysis and conclusions.

Risk-Based Examination Scheduling

Risk-based examination scheduling permits deferred scheduling of certain credit union examinations. When risk-based scheduling applies, those credit unions can receive two examinations in a three-year period. Examiners, after consulting with their supervisory examiners, may use risk-based scheduling for credit unions assigned a CAMEL 1 or 2 for the prior two examinations, and having characteristics such as the following:

- In operation for at least 10 years;
- Net worth ratio greater than 7 percent;
- Positive return on assets;
- No major or potentially adverse balance sheet changes;
- Adequate ALM program;
- Adequate internal controls;
- Accurate books and records; and
- No recent high-risk programs not yet reviewed.

Examiners perform offsite monitoring to review trends of credit unions with deferred examination schedules. If needed, examiners may schedule onsite supervision contacts when offsite monitoring indicates potential risk that requires further assessment.

NCUA Instruction 5000.15 provides additional guidance on risk-based examination scheduling.

Risk-Focused Supervision Procedures

Risk-focused supervision procedures often include both offsite and onsite work, including the following:

- Examination planning;
- Evaluating risk indicators;
- Reviewing offsite monitoring tools and risk evaluation reports;
- Developing the scope;
- Conducting a risk assessment;
- Developing and documenting conclusions and recommendations; and
- Communicating with credit union management.

Often (although not always), examination planning, evaluating risk indicators, and scope development begin with offsite work. Offsite monitoring procedures shape the examiner's focus. The examiner should involve credit union management in the discussion of subjective issues and mitigating factors; therefore, examiners will usually assess risk and draw conclusions onsite.

Supervision Tools

Examiners have a variety of tools to aid in their supervision efforts, including the following:

- Review of call reports (NCUA 5300s);
- Examination planning contacts;
- Periodic telephone contacts;
- Review of credit union risk management reports (e.g., ALM summary reports, investment shock tests);
- Review of board and committee minutes;
- Review of financial trends;
- Cycle-to-cycle comparisons;
- Review of consolidated balance sheets;
- Review of ALM program and changes to ALM program, policies and procedures;
- Review of offsite risk evaluation and monitoring reports;
- Review of publications, press releases, and news stories about conditions and events that may affect the credit union;
- Review of electronic information sources (e.g., credit union website, NCUA website, etc.);
- Review of the supervisory committee audit report and, if necessary, the audit workpapers; and
- Analysis of the Financial Performance Reports (FPRs).

5300 Call Report Review

During each examination, examiners must verify the accuracy of the 5300 Call Report. The risk-focused program places heavy reliance on the accuracy of the data in the call report. Inaccuracies in the call report may result in misleading evaluation data. Examiners should stress to the credit unions the importance of reporting accurate information on the call report.

Examiners should complete the 5300 Review questionnaire during the preliminary phase of the examination. The questionnaire's design requires answers to four basic control questions. If the answers are "Yes" then the remaining questions do not require an answer, thereby reducing the time spent reviewing a well-controlled 5300 reporting process.

Examiners should focus their review on the internal controls over the call report and the credit union's process for ensuring its accuracy, by taking the following steps:

- Determine the experience level of the personnel involved in preparing the call report. Examiners can usually place greater reliance on a call report prepared by the same person for the last several years. However, if the same person has prepared the call report and year after year each examination notes deficiencies, examiners should review the accuracy of the call report in detail.

- Determine if the credit union has a verification process. Once prepared, a second employee should verify the accuracy and document the verification by signing off on the call report. If the same person prepares the data, completes the call report, and submits it to the examiner, the examiner should take additional steps to verify the report's accuracy.

- Review the preparer's process for confirming where the numbers originated and documentation of that process. If this documentation does not exist or is not readily available (i.e., stapled to each page and filed), examiners should take additional exam steps to verify the call report's accuracy.

If the credit union lacks a reliable process to ensure call report accuracy, examiners should take the following additional examination steps, as necessary, to ensure the accuracy of the call report and document noted deficiencies in the examination report:

- Trace the statement of financial condition and income statement information to source documentation;
- Trace reported delinquency to information system-generated reports, if available, including mortgages and credit cards maintained by a third party data processor;
- Review the accuracy of uninsured shares documentation;
- Trace investments to reports received from outside parties (i.e., broker, corporate credit union, etc.), ensuring that reported

investments appear in the appropriate time periods based on the call report instructions;

- Trace loan information to the information system-generated reports, if available (manual systems may require that examiners count the loans and trace the number to reported loan information); and
- Trace share information to the information system-generated reports, if available.

To reflect call report changes in the examination report, examiners must upload any material changes to the call report and request a new corrected download.

Offsite reviews of quarterly call reports will not allow the examiner the level of detail described above. Examiners should use other tools such as the 5300 Cycle-to-Cycle Comparison Report or the Consolidated Balance Sheet report trends to identify any fluctuations or adverse trends, making and uploading corrections as necessary. Examiners should report inaccuracies in the examination report at the next examination.

Examination Planning Activities

Examination planning will assist the examiner in assessing a credit union's risk profile and developing a workable risk-focused examination scope. This scope will enable the examiner to identify and examine those areas that represent potential, material risk to the credit union's capital, earnings, or ability to continue as a going concern. These tools will enable examiners to estimate the time needed for performing the risk assessment and anticipate the need for participation by specialists and/or subject matter examiners (SMEs).

After consulting with their supervisory examiners, examiners-in-charge should request assistance from a SME, if potentially significant risk exists in an area of the SME's experience. Examiners may also choose to use a SME if they are unable to quantify the risk, or if a material risk exists in an area of proven or emerging concern to NCUA. When planning the scope of the next examination, examiners will, when necessary, request participation of a SME. They may also make such a request if supervision contacts reveal material risk that requires the skills of a SME. Obviously, SMEs cannot participate in all supervision concerns. As with all of NCUA's resources, a SME's participation and the degree of that participation should correlate with the significance of the overall risk to the NCUSIF presented by the credit union in question.

Examination planning tasks may include:

- Reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow up;

- Analyzing 5300 Call Report and Financial Performance Report (FPR) trends, using tools such as the following:

  - 5300 Cycle-to-Cycle Comparison Report – compares the prior examination quarter-end data to the current quarter-end data; and
  - Current (and possibly previous) quarter-end Consolidated Balance Sheet (CBS) report trends;

- Reviewing the Scope Workbook to identify prior risk assessment, recommended areas of review, resource needs, and supervision plans;

- Requesting an organizational chart of the credit union by division or department, along with a list of committees;

- Scheduling interviews with the credit union's management staff in key operational areas, including the CEO, Internal Auditor, staff involved in planning (strategic/business plans); and

- Requesting (and scheduling, if necessary) a meeting with the supervisory committee and/or external auditors to discuss the audit and verification processes (in some instances, telephone or email contacts may suffice).

If examiners cannot schedule a separate onsite planning contact, they should complete onsite planning at the beginning of the examination. Although examiners normally perform the following tasks onsite, circumstances (e.g., distance to the credit union, scheduling conflicts, or other considerations) may require the examiner to conduct the activities offsite, using telephone, mail, fax, or electronic mail. These onsite planning tasks include:

- Interviewing key management staff about various topics including new products and services and future plans for new products and services;

- Reviewing management's due diligence process for a new activity;

- Reviewing the annual audit workpapers and the audit plan (see the Supervisory Committee chapter), communicating audit work performed in pre-determined, high risk areas to the appropriate team members;

- Reviewing the list of internal audits completed to date and the internal audit planning matrix for the year, identifying internal audit reports needed by team members for review at the onset of their examination work;

- Reviewing the strategic/business plan;

- Reviewing the budget and assumptions;

- Reviewing the board minutes:

  - Identifying discussions about potential risk areas and discussions about website problems, products, services, and planned changes to those products and services; and

  - Identifying revisions to applicable policies and associated changes in practices;

- Reviewing recently adopted new policies and revisions to policies and procedures, providing the information to the team examiners assigned to the various risk areas; and

- Reviewing other applicable internal credit union documents, such as material contracts, engagements, pending litigation, new field of membership (FOM) groups, website changes, or other operational change documents.

After developing a preliminary risk-focused examination scope, the examiner-in-charge should communicate scope information to the appropriate team members, including expansion or contraction of applicable areas determined through the supervision process.

The risk-focused examination process should determine the adequacy of internal controls and the degree of reliance on the work efforts completed by competent, professional individuals and documented in reports and audits. Examiners should strive to avoid repeating the work of these professionals (e.g., internal audit reports, CPA audit workpapers, board meeting discussions, etc.) Examiners may identify new areas of risk throughout the contact; therefore, the examiner-in-charge should remain flexible and adjust the preliminary scope as needed.

5300 Risk Parameters

Examiners can use the 5300 Risk Parameters tool (Tab D in the Scope Workbook) to assist in the offsite monitoring. Use of this tool aids the examiner in the evaluation process; however, examiners must use their judgment. The 5300 Risk Parameters is only an indicator of risk; it does not supercede the examiner's judgment.

The 5300 Risk Parameters assists examiners in directing what areas they will focus on during their onsite work. Although the indicators may indicate a certain level and direction of risk, examiners should, nevertheless, determine the internal controls, policies, and procedures in that area. The accuracy of the 5300 Risk Parameters directly relates to the accuracy of the 5300. Examiners must review the accuracy of the 5300 as a required examination step. This step will help ensure the accuracy of the 5300 Risk Parameters reports.

The 5300 Risk Parameters is an intuitive, user-friendly tool and provides the following:

- An indication of potential risk - assessment of risk requires review and judgment; and

- Information on the direction of risk - the 5300 Risk Parameters gives an indication of how the risk changed over time.

The 5300 Risk Parameters does not:

- Assess risk - financial stability does not mean the credit union has no exposure to current or future risk;

- Predict future problems - the 5300 Risk Parameters provides an indicator of current or potential problems, but it does not predict future problems;

- Supercede examiner judgment - examiner judgment drives examination and supervision efforts;

- Specify examination procedures - using their knowledge of objective data and subjective factors, examiners must use their discretion in determining what procedures they do and why they do them; or

- Serve as a sole scope determinant - examiners must use their judgment to evaluate the various information and data, determine where to expand their analysis, and move on to another area when sufficient risk does not exist.

Cycle-to-Cycle Comparisons

The Cycle-to-Cycle Comparison Program (CCCP) enables examiners to compare current cycle 5300 financial and statistical data with data from any prior cycle within the previous five years. Examiners can scan the line item results and quickly identify significant changes. CCCP can help alert examiners to adverse or unusual trends while they review the data for accuracy.

Consolidated Balance Sheet

The Consolidated Balance Sheet (CBS) is an Excel spreadsheet that provides detailed financial information derived from 5300 Call Report data. Examiners may request a CBS for an individual credit union, a specific peer group, state, region, asset range, or group of charter numbers for comparison purposes. Other selection criteria include federal credit unions (FCU), federally insured, state chartered credit unions (FISCU), non-federally insured credit unions (NFICU), limited income credit unions, type of membership (TOM) code, and cycle date.

Examiners request a CBS using the Custom Application program called CBS Request. To request a CBS for a specific credit union, examiners must input the charter number and cycle date. Upon request, the data processing server sends the CBS to the examiner in a spreadsheet format using email. The program contains a "help menu" that explains its operation.

The CBS ratio analysis looks similar to that of the Financial Performance Report; however, the CBS provides more detailed balance sheet, income statement, and supporting schedules. In addition to the ratios and trends provided, examiners can perform additional calculations and more in-depth analyses using Excel functions.

Documenting Supervision Plans

Examiners should document supervision plans for the credit union in the Scope Workbook and follow regional procedures for consulting with their supervisory examiners. They should update the Scope Workbook after supervision contacts, if necessary. Examples of documentation for supervision plans include:

- Type and timing of supervision and examination contacts;
- Brief description of the areas of risk focus for review during the contacts; and
- Staffing recommendations for supervision and examination contacts.

Examiners will complete the Scope Workbook during each examination, documenting the severity and direction of risks found during the examination, and revise the plans when supervision efforts indicate the need for a change. This workbook will serve as the starting point for future supervision efforts. The examiner will update the workbook, as necessary, throughout the year.

The extent of the supervision plans depends largely on the severity and direction of the risks in the credit union's operation and on management's ability to manage those risks. The examiner's professional judgment is paramount in determining the degree of supervision necessary and the form the supervision efforts will take.

Documenting Changes in Risk Profile and Supervision Plans

Changes in the economy, regulatory environment, financial industry, global and local events, and numerous factors within the credit union itself can affect credit unions, thus, a credit union's risk profile may change between examinations. The supervision process encourages the examiner to identify those changes in profile through the following:

- Review of 5300s;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union (e.g., new regulations, investment broker concerns, etc.).

When examiners become aware of information that affects a credit union's profile (i.e., a change in the level of one or more of the risk categories), they should record that risk level adjustment in the Scope Workbook. The change in the risk profile will likely result in a change to supervision plans. The examiner should record the revised supervision plans in the Scope Workbook. Updating the Scope Workbook allows NCUA to have a current depiction of individual, regional, and national risk levels on any given date. It also facilitates the transfer of information when a region transfers a credit union from one examiner district to another.

Examiners can use the Scope Workbook in conjunction with either onsite or offsite contacts. They should update it as frequently as necessary to reflect a credit union's current risk assessment and their current plans for supervision. In most credit unions, examiners will complete the Scope Workbook only during examinations; however, volatile conditions in credit unions may require more frequent updates to record the changes in risk levels.

Supervision and District Management

Examiners cannot separate effective supervision from effective district management. They must know their district credit unions and provide the supervision needed, in their professional judgment, to identify and address high-risk and potentially high-risk situations.

The risk-focused program involves both of the following:

- Risk-focused examinations; and
- Risk-focused district management.

Examiners have both the authority and the responsibility to manage their own districts. This suggests that examiners establish sufficient rapport with their credit unions so that the credit unions will openly communicate with the examiners about issues and conditions that develop between onsite contacts. Initiation of this communication can reside with either the credit union officials or the examiner, when available information and data indicate the prudence of such a contact.

Successful supervision involves resolving current problems and avoiding future ones. District examiners must provide a credit union the attention it needs to identify and reduce risk and to fully resolve problems. Examiners may determine that some credit unions require frequent contacts to correct the problems, while monitoring 5300 reports may suffice for others. Credit unions with more serious problems may require in-depth monitoring of financial trends.

Additionally, effective supervision in a risk-focused environment means that examiners look beyond the risk in one credit union at a time. They should also be conscious of systemic risk to the NCUSIF. This involves informing the regional office, through their supervisory examiner, when they observe negative effects caused by similar risk (e.g., a "bubble" in the real estate market, risky lending or investment issues, concentration issues, vendors that lack appropriate "due diligence" processes) in several of the credit unions in their district.

Supervision of CAMEL 3, 4, and 5 Credit Unions

Examiners expect that successful supervision will result in better identification of risk and the direction of risk, and prompt reclassification to a less severe CAMEL code, but supervision can also result in merger, liquidation or assistance to a credit union. To ensure the prompt, effective correction of problems, the examiner who identified the problems and developed plans for corrective action should maintain supervisory responsibility, unless the region transfers the credit union to Special Actions. Whenever possible, the examiner-in-charge should take responsibility for the credit union's supervision through the next examination.

Effective supervision of credit unions coded 3, and 4 (credit unions coded 5 normally do not survive) ensures the long-term viability of the credit unions and ongoing service to members by resolving areas of concern and reducing levels of unacceptable risk. If the credit union has risks it cannot manage, or that cause the credit union to fail, effective supervision minimizes the costs to members, creditors, and the NCUSIF. The following parameters govern supervisory efforts in code 3, 4, or 5 credit unions:

- Code 3 credit unions. The examiner provides Code 3 credit unions with necessary supervision to assist them in improving their operations and condition.

- Code 4 credit unions. If appropriate, NCUA may issue Code 4 credit unions an LUA. The examiner performs supervisory contacts with the purpose of upgrading a Code 4 within 24 months, 12 months being the goal.

- Code 5 credit unions. By definition, a Code 5 credit union will not survive more than 12 months, is clearly insolvent, and the examiner has documented all efforts to save it. Once coded a 5, NCUA will merge, liquidate, or provide other assistance to the credit union expeditiously. The goal for resolution is six months from the assignment of the Code 5 and the performance standard is 12 months.

During supervision in code 3, 4, or 5 credit unions, the examiner should perform the following, as necessary:

- Review previously identified risk areas to determine whether the direction of risk has decreased or remains unchanged;

- Determine the progress made in resolving problems;

- Determine whether the Document of Resolution developed for the credit union is working, and revise the plan with the officials if changes would likely resolve the problem;

- Inform the board of directors of inadequate progress and the status of risk areas;
- Analyze emerging financial trends and risk areas that could threaten the credit union's solvency;
- Determine the credit union's economic viability and, where necessary, explore merger and liquidation alternatives;
- Recommend administrative actions, when necessary, to protect the interests of the members, the creditors, and the NCUSIF;
- Revise, as necessary, the Scope Workbook, future supervision plans, and the schedule for the next examination; and
- Review and revise, if necessary, recommendations for team participants and subject matter examiners.

Administrative Record

Although the risk-focused examination includes few required workpapers, in credit unions coded 3, 4, and 5, examiners must include sufficient workpapers and documentation to establish an administrative record, should administrative or legal actions become necessary. The administrative record is the total collection of information NCUA needs for decision-making purposes. Therefore, the record should present a complete, factual, and documented history of the credit union's problems and the attempts by NCUA and the credit union to resolve them.