

# Operations Analysis Program

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## EXAMINATION OBJECTIVES

To evaluate the appropriateness of the association's operating environment and business strategy.

To evaluate the adequacy of policies and procedures, information systems, internal controls, and budgeting processes relating to operations.

To identify, evaluate, and explain positive and negative income and expense trends.

To evaluate the quality and sources of earnings.

To assess the prospective effect on earnings because of changes in the association's activities or strategies.

To evaluate the association's financial performance and ascertain whether it has sufficient profitability to maintain capital through retained earnings.

## EXAMINATION PROCEDURES

### LEVEL I

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1. Review prior examination reports, audit reports, monitoring reports, and any off-site analysis to ascertain strengths and weaknesses in the association's operations.
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2. Determine whether management corrected deficiencies mentioned in prior examination and audit reports.
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3. Review whether the institution provides periodic earnings and impairment reports with adequate information for management and the board of directors to assess earnings performance.
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4. Review the association's structure and determine if there are any special considerations, for instance, S Corporation structure, comprehensive income, or nontraditional business operations. For Internet operations, see Level II procedures. For securitization transactions, see Level III procedures.
  - Determine if sources of earnings are significantly reliant upon nonrecurring gains from the sale of securities, loans, or securitization transactions. If so, see Level III procedures.

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5. Review the findings in examination [Program 410, Financial Records and Reports](#), to ascertain any significant concerns, such as reporting or classification errors, unusual variances, accounting deficiencies or any material inconsistencies in the application of accounting principles that may affect the review of operations.

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6. Review the UTPR financial schedules and the association's financial statements. Identify and explain trends, material variances, and other factors affecting earnings. Note any material reporting errors or items that need further analysis. Include copies in the work papers.

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7. Compare UTPR financial schedules, the association's financial data, and recent earnings trends to the institution's historical results and to standard or customized peer group data and explain material variances.

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8. Review examination findings relating to management assessment and directors' oversight to ascertain whether the association is planning or has initiated any new activities, strategies, or major changes that could materially affect operations.

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9. Review the association's business plan. Compare it to actual operating results and explain any material differences. Determine if the association (rather than an outside consultant) developed the plan and tailored to the association's operating strategies.
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10. Review whether monetary incentives such as bonuses, stock options, or salary increases based on results exist that may create an environment for management to manipulate reported earnings.
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11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
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## LEVEL II

1. Review the findings of the asset quality review to determine the effect on earnings. For example, consider severity and level of classifications, the need for provisions to ensure the adequacy of allowances for loan and lease losses (ALLL), and loss of interest earnings due to poor quality assets. Consider the cost of carrying nonperforming assets and the effect on earnings stability over the long term. Ensure that the ALLL does not contain any allowances for other types of losses, such as allowances for retained interests. Review write-offs of nonfinancial assets for appropriateness.
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2. Obtain and review the association's current budget. Determine if it is reasonable and supported. Compare the budget to current operations; identify and explain material variances.
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3. Review the findings of the sensitivity to market risk review, particularly the interest rate risk management review. Evaluate the composition of earnings between recurring net interest margin and net noninterest income versus net interest income. Consider the effect on future earnings potential.

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4. Review and evaluate the association's sources and uses of funds since the last examination. This analysis will give insight into the savings association's business operation and the potential risks involved.

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5. Review, if applicable, TFR Schedule CSS, Subordinate Organization Schedule, to determine the extent of the parent association's dependence on a subordinate organization and the adequacy of the parent's return on the investment in the entity. See [Appendix B](#).

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6. Reconcile and determine the materiality of the parent institution and subsidiary inter-company accounts. (For further information, refer to [Appendix C](#), Reconciliation of Intercompany Accounts.)

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7. Examine whether credit losses and suspicious activities reports are high in comparison to peers. If so, discuss concern with asset quality review staff and determine if future earnings will continue to be affected.

- For subprime lending activities, determine if credit losses relate to underwriting practices, appraisal weaknesses, account management activities, or inadequate collection procedures.

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8. For Internet operations determine if the association:
- Periodically (at least quarterly) evaluates its Internet operations and marketing plan.
  - Links its strategic planning process to its Internet operations.
  - Projects the effect of its Internet operations on earnings and capital.
  - Performs cost and benefit analyses of Internet banking activities. Consider start-up, operating costs, required upgrades, customer support, and maintenance costs.
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9. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
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## LEVEL III

1. Analyze the current cost of interest-costing liabilities and the yield on interest-earning assets and compare with the previous year. Note: The yields on mortgage loans and mortgage-backed securities are dependent on prepayment rates.
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2. Review and evaluate the association's yield spread and compare with the previous year. You should check to ensure that the institution estimates noninterest income and noninterest expense based on normal levels.
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3. Review the statement of operations for nonrecurring gains and losses as well as for nonrecurring revenues and expenses.
  - Review accruals and the timing of reversals for appropriateness.
  - Ensure that the ALLL does not contain any allowances for impairment of long-term assets held for disposal, or for the discontinuation of activities.

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4. Determine if the association's earnings or payment of dividends relies on asset sales, securitizations, or any other type of nonrecurring transactions.
  - Determine if earnings are sufficient to pay dividends after considering the potential overstatements of profits using gain-on-sale accounting.
  - Determine whether earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate.
  - Note the degree of reliance on sales of whole loans for profits. If high, review the credit quality of originations.

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5. Determine whether the association significantly relies on securitization gains for earnings. Note the findings of the asset quality review of securitization transactions and ensure the review focused on the following areas:
  - The securitization documents (pooling and service agreements). Does the institution limit its post-sale credit support to that specified in the terms and conditions of the securitization contract?
  - Valuation of retained assets. Does management conservatively value its retained interests, and periodically review its valuation models for soundness?
  - Credit loss assumptions. Are management's credit loss assumptions that support retained interest valuations appropriate?
  - Management's methods for assessing impairment.

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- Are the factors management uses to estimate fair value similar to those used by the institution's peers?
  - Are impairment adjustments comparable to adjustments made for similar types of securitizations, servicing assets, or other types of transactions?
  - Calculate the percentage of retained interests to Tier 1 capital; and consider the reasonableness of the percentage.
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## EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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