August 12, 1997

To the Corporate Credit Union Addressed:

SUBJ: Part 704 Guidance Letter No. 2

On July 15, 1997, I issued Part 704 Guidance Letter No. 1 to each corporate credit union. In that letter, I indicated that I would use Guidance Letters to provide additional information to those corporates which will be seeking expanded authorities. This second Guidance Letter, like the first, is to supplement the Guidelines for Submission of Requests for Expanded Authority (Guidelines), which was issued by the NCUA Board.

During the Part 704 training seminars, some confusion developed regarding internal audit and compliance functions, and how they would be evaluated under the expanded authorities sections of the regulation and the Guidelines. This Guidance Letter should provide you additional information for your consideration.

Audit Vs. Compliance

One of the major objectives when drafting Part 704 was to ensure that corporate credit unions maintain an adequate and effective infrastructure conducive to a sound risk management function. The normal internal audit function is aimed at evaluating, as part of a pre-determined periodic audit scope, the adequacy of operating processes, internal controls, and adherence to approved board policies and procedures.

However, an ongoing compliance function should take a more global approach at determining the appropriateness of operating risks. As the levels of operating risk increase, the process of assessing, reporting, and controlling risk become more complex and dynamic. The regulation and Guidelines intend that systems and personnel will become more sophisticated as an institution assumes more risk

Operating under Base and Base Plus Levels of Part 704

Part 704 does not require corporates operating at base or base plus levels to implement a formal “compliance function.” However, the monitoring and reporting requirements of the regulation do inherently require that appropriate separation of duties exist to provide adequate risk detection and control. Additionally, Section 704.15(b) requires that corporates with assets over $400 million employ or contract a full- or part-time internal auditor.

A Board of Directors (Board) must continuously evaluate the adequacy of the audit and compliance functions' detection and reporting procedures, as a corporate's operations become more complex. NCUA will be evaluating not only the corporate's operations, but also the Board's evaluation of those operations.

Compliance Process Under Expanded Powers

Under the Guidelines, corporate credit unions wishing to operate under the increased risk profiles permitted by Parts I through IV Expanded Authorities must have systems and personnel to detect and report risk commensurate with the expanded powers granted. Due to the increase in day-to-day risk exposure allowed in operating under the expanded investment powers, it is even more important to distinguish between periodic audit functions and ongoing compliance procedures.

The expertise and sophistication of audit and/or compliance personnel must be appropriate to evaluate the increased financial risk associated with the expanded authorities. **In most instances, individuals assessing and reporting risk may need to possess the same level of expertise as those assuming risk for the institution.** This may lead to increased staffing and/or contract labor costs. Each corporate's board must make an assessment of the financial/operations benefit under the expanded powers as it applies to the costs of managing that risk. As part of the Self-Assessment process, the board must first determine the types of risks inherent within the institution's balance sheet and then assess the expertise and sophistication of the individuals and systems identifying and controlling that risk.

<u>Part I and III Expanded Authorities</u>

Because of the market (interest rate, credit, and liquidity) risk permitted under Parts I and III Expanded Authorities, the Guidelines necessitate that corporates seeking these expanded authorities have an internal audit function in place. This function should have the tools and personnel to monitor and evaluate all activities associated with the expanded authorities.

A "stand alone" compliance department is not necessary; however, an active and effective compliance function necessitates that a separation of duties exist between the "risk taking" (front office) and the "risk reporting" (middle office) control processes of each specific area of corporate operation. Whether or not the compliance function is in a stand alone department depends on the its ability to perform accurately and timely. It is the corporate Board's responsibility to determine that management has accurate and timely reports to evaluate and adjust the corporate's risks. If a function within a department is not able to provide those reports as necessary, the Board should consider separating those functions into a stand alone department which can meet the priorities established by the board.

Enclosure 1 depicts one possible management structure that meets the requirement of Part 704 and the Guidelines for Parts I and III Expanded Authorities. Under this scenario four departments (investments, accounting, operations, and credit) report directly to the Chief Executive Officer (CEO). There is no separate risk management department directly accountable to the CEO. In this case the risk management and compliance functions are housed through a vertical structure in the accounting department (back office) under the control of the Vice President of Accounting. The systems used by both the investment department (front office) and the accounting department (here, a combined middle and back office) may be housed in either department as long as each can independently use the systems to complete their functions. Enclosure 2 is a second alternative with the risk management and compliance function housed in the Operations Department.

Part II and IV Expanded Authorities

Part II and IV Expanded Authorities enable corporates to take greater risk in their investment portfolios and provides increased discretionary control to the Board in establishing policies in certain investment areas. However, in implementing these additional authorities, a greater obligation is imposed not only on the Board, but also on the investment, credit, and risk management functions of the corporate. Meeting these additional responsibilities can only be accomplished by instituting a separate stand alone risk management and compliance department.

Under Part II and IV Expanded Authorities, compliance personnel should be more instrumental in identifying, measuring, and monitoring the risks of investment and ALM strategies and may assist in developing policies. The independence of these actions must be clearly established. The horizontal management structure depicted in Enclosure 3 assures the appropriate segregation of duties and accountability for risk taking, control, and assessment.

As noted previously, individuals responsible for setting risk management strategies and controls should possess the necessary knowledge and expertise to challenge those involved in taking risk, thus ensuring that the overall risk profile of the institution is at all times capable of being assessed by the middle office and adjusted by the front office, if necessary.

Asset Liability Committee (ALCO)

Given the management scenarios listed above, who should be on the ALCO? The makeup of the ALCO will be determined by each corporate credit union and may vary depending on the expanded authorities authorized. By regulation at least one member must be from the corporate's Board. In most corporate credit unions the Chief Executive Officer (CEO) is also named a member. And, for logical reasons, a representative of the investment risk taking function is usually a member. Additionally, consideration should be given to a representative of the risk management and compliance function, whether that person is housed in a stand alone department or under the accounting or operations departments. Lastly, to round out the experience available to make sound decisions, a credit representative should be included on the ALCO.

Supervisory Committee Responsibilities

The compliance functions previously described generally fall under the responsibility of each corporate's CEO. However, the responsibilities of the Supervisory Committee (or Audit Committee) also increase as Expanded Authorities increase the risk to a corporate.

By regulation, the Supervisory Committee is responsible to ensure that an annual CPA audit is completed each year. Additionally, all institutions with assets in excess of $400 million must have a separate internal audit function (on staff or contracted) under the control of the Supervisory Committee. With Expanded Authorities, Supervisory Committee's now must consider the need for and timing of an external risk management review function. This function is necessary to test the reliability of models and systems employed by management to determine the level of risk that the corporate takes. Factors determining the need and timing of these reviews include:

a. The known level of risk currently being taken;

b. The currentness of the model and systems in place in comparison with standards and trends in financial risk management;

c. The knowledge and technical expertise of staff responsible for the modeling and systems; and

d. Recommendations and findings of auditors and regulators.

While no one factor will determine the need for this external review, the combination of factors should clearly point the committee to the right decision.

Recommendations for Determining Compliance/Audit Needs

As each corporate evaluates the need for expanded investment authority and proceeds with the application process, I recommend that you consider the following in developing and implementing internal audit and compliance procedures:

1. Complete all other sections of the Corporate Credit Union Self-Assessment for the level of authority being considered prior to evaluating the adequacy of the audit and compliance functions. Use the Self-Assessment as a basis for determining the corporate's overall risk assessment from which the Board can set forth an overall compliance and audit policy.

2. Develop and document detailed compliance and audit policies establishing procedures for segregating the risk taking functions from the risk management functions and the degree of external risk management review, respectively. The compliance policy should consider the staff and systems needed to adequately determine, monitor, and control all operational risks (i.e. interest rate, liquidity, market, event risk, etc.). It also should be specific as to the timeliness of receiving information on risk management issues and the process through which any adjustments to specific risk profiles would be made.

3. Based upon the compliance/audit needs in the policy and procedural statement, make an assessment of the institution's organizational structure. Determine, not only that a segregation of duties exist between the risk taking and risk management functions, but also the effectiveness with which those functions can provide accurate and timely information needed to monitor and control risk.

4. Consider any necessary changes to the corporate's infrastructure, and evaluate the associated costs in relation to the benefits of operating at an increased level of investment and balance sheet risk.

I hope this letter serves to clarify the regulation and Guidelines and that you consider our comments in finalizing your self-assessment plan. If you have already submitted your application for Expanded Authorities and your proposed infrastructure is not consistent with this letter, my staff will discuss any differences with you during the application review process.

Sincerely,

Robert F. Schafer
Director
Office of Corporate Credit Unions

Enclosures

CC: All OCCU Staff
Edward Dupcak, Director OIS