ACUARP
ASSOCIATION OF CREDIT UNION AUDIT AND RISK PROFESSIONALS

Lessons Learned From Recent Exams

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PRESENTED BY

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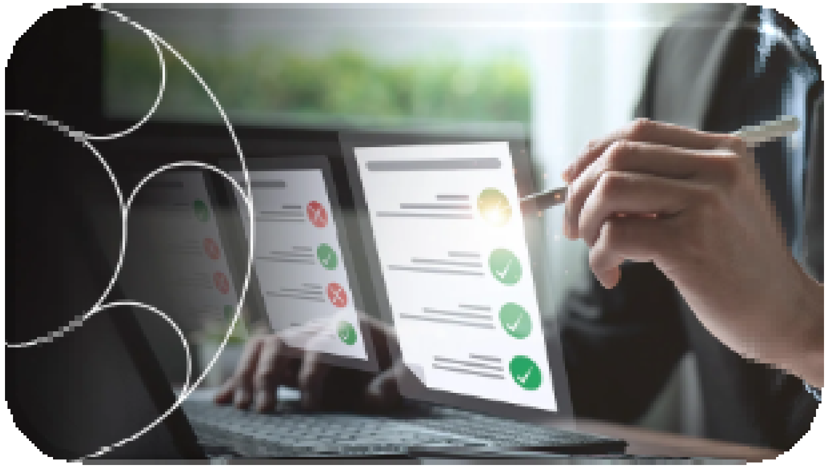
Learning Objectives

- Interest rate and liquidity risk
- Credit risk and loan portfolio quality
- Repossessed assets
- Allowance for credit losses



Interest Rate and Liquidity Risk

- Interest rate risk (IRR)
  - The potential for financial loss that an institution, such as a credit union or bank, faces due to fluctuations in interest rates. It arises when changes in market rates affect the value of the institution's assets.
- Liquidity risk
  - The potential for a financial institution, such as a credit union or bank, to be unable to meet its short-term financial obligations when they come due, without incurring unacceptable losses.

Interest Rate and Liquidity Risk

- From Letter to Credit Unions 24-CU-01
  - "Credit unions will need to maintain strong liquidity risk management in 2024, due to increased uncertainty in interest rate levels and economic conditions. Pressure in deposit pricing and the use of wholesale funding is accelerating as alternative funding options, while new lending, participations, and loan sale markets may slow. Member behaviors and risk relationships are also changing, thus requiring a greater focus on forecasting assumptions, forward-looking cash flows and risk projections. The combined effect creates liquidity challenges and increased risk to earnings and capital".

Interest Rate and Liquidity Risk

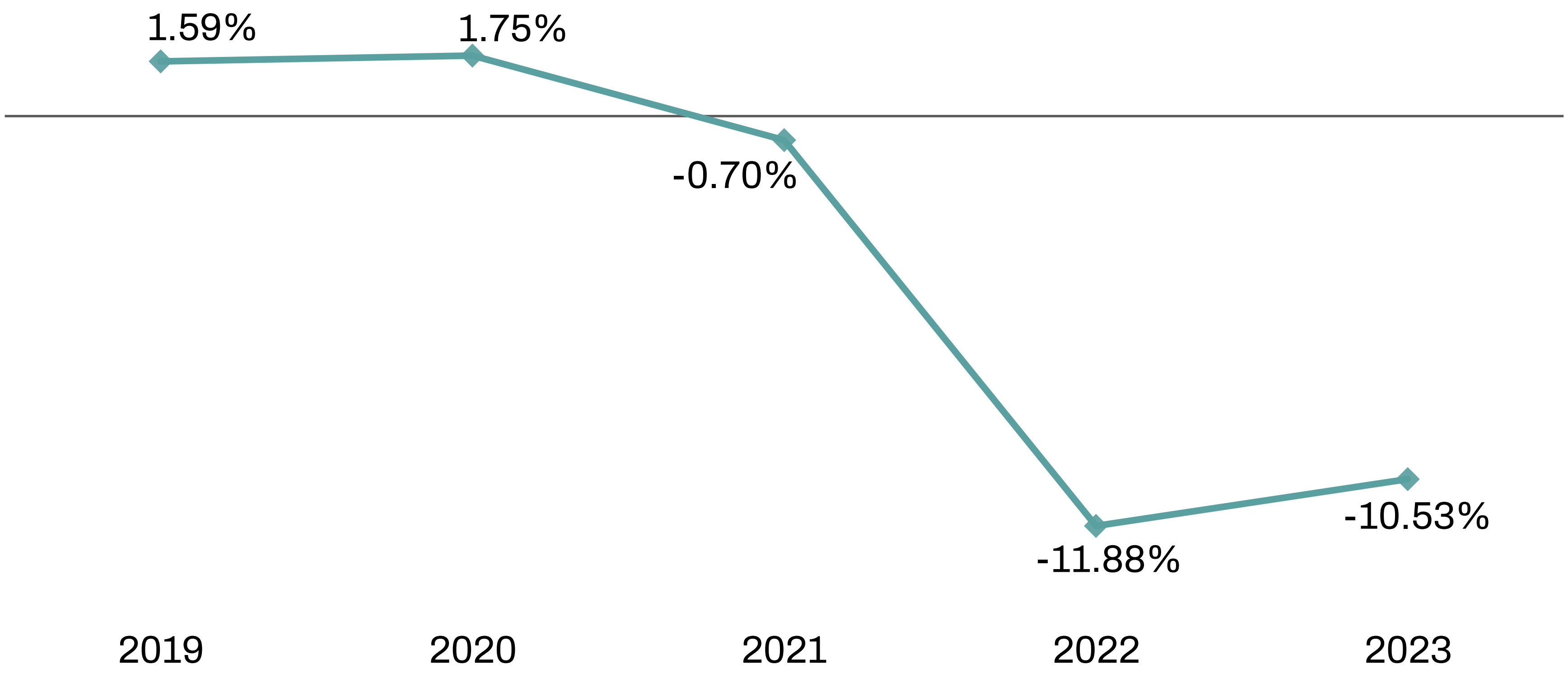
- Why are we talking about this now?
  - Most recent liquidity events
    - Silicon Valley Bank and First Republic Bank failures
- Federal Reserve interest rate changes
  - 11 interest rate changes from March 2022 to July 2023
  - 550 basis point increase in 16 months
  - 50 basis point decrease in September 2024

Interest Rate and Liquidity Risk

- How does the movement of the Fed funds rate impact the balance sheet?
  - Inverse correlation between Fed funds rate and market values of investment securities
  - Example
    - Debt security purchased yielding 5% (current interest rate)
    - If interest rates increase, the market value of the security decreases
    - If interest rates decrease, the market value of the security increases

Interest Rate and Liquidity Risk

- Unrealized gains and losses on available-for-sale debt securities to debt securities



Interest Rate and Liquidity Risk

Summary of Effects on the Balance Sheet

Federal Reserve Rate Change	Assets	Liabilities	Overall Impact
Rate Increase	- Higher income from variable-rate loans - Fixed-rate loan income remains the same - Decline in fixed-income security values - Possible decline in loan demand	- Higher cost of deposits - Increased borrowing costs - Pressure on liquidity	- Net interest margin may decrease - Margin compression - Profitability pressure
Rate Decrease	- Lower income from variable-rate loans - Fixed-rate loan income remains the same - Increase in fixed-income security values - Increased loan demand	- Lower cost of deposits - Decreased borrowing costs	- Net interest margin may increase - Profitability may rise - Higher loan demand

Interest Rate and Liquidity Risk

- NCUA Letter to Credit Unions 23-CU-06, *Importance of Contingency Funding Plans*
  - Provided additional reminders to institutions on needs to evaluate borrowing options including the FRB Discount Window and the NCUA CLF
  - Reminders to annually test access to available funding sources
  - Reminders to review and revise liquidity contingency plans as market shifts occur

Interest Rate and Liquidity Risk

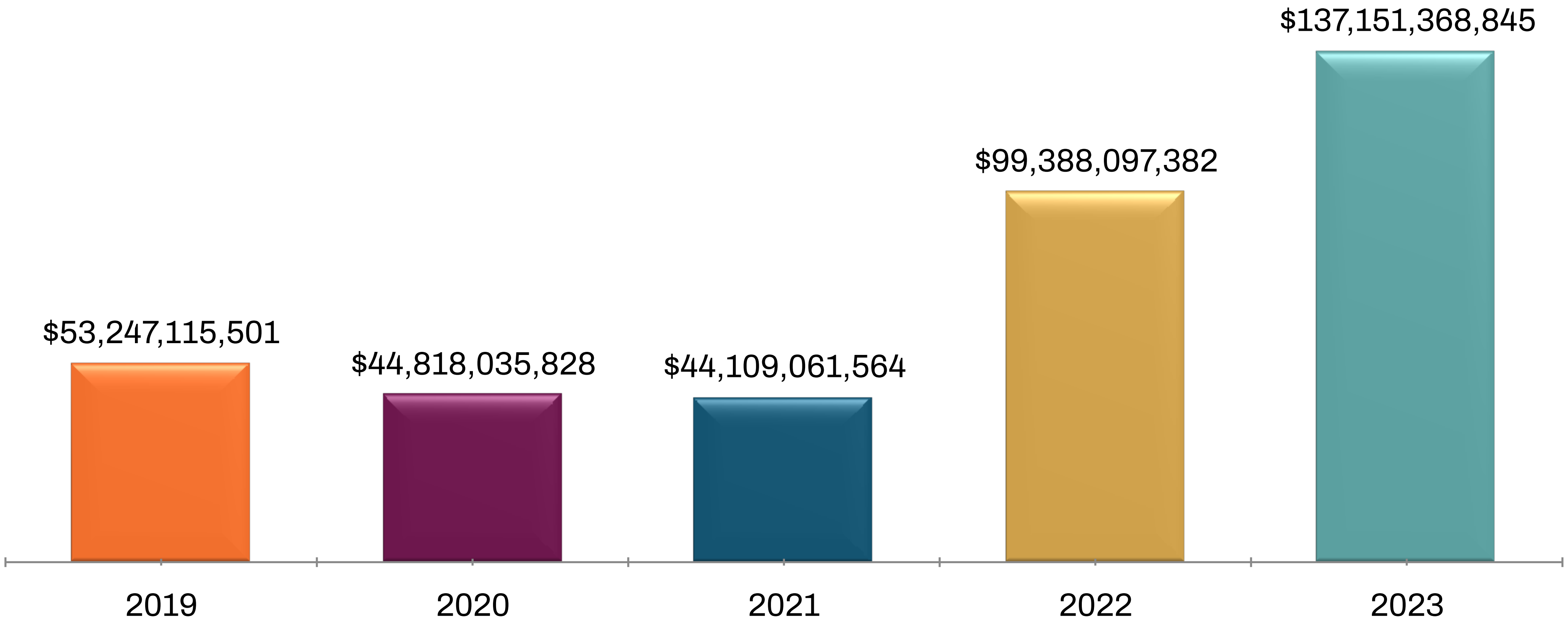
- Liquidity avenues

Regular Shares	Money Market Accounts	Variable Rate, Short-Term Borrowings	Non-Member Deposits	Uninsured Shares
Share Drafts	Member Certificates	Long-Term Borrowings	Brokered Deposits	Above-Market Rate/Promotion Certificates

More Stable Sources ← → More Volatile Sources

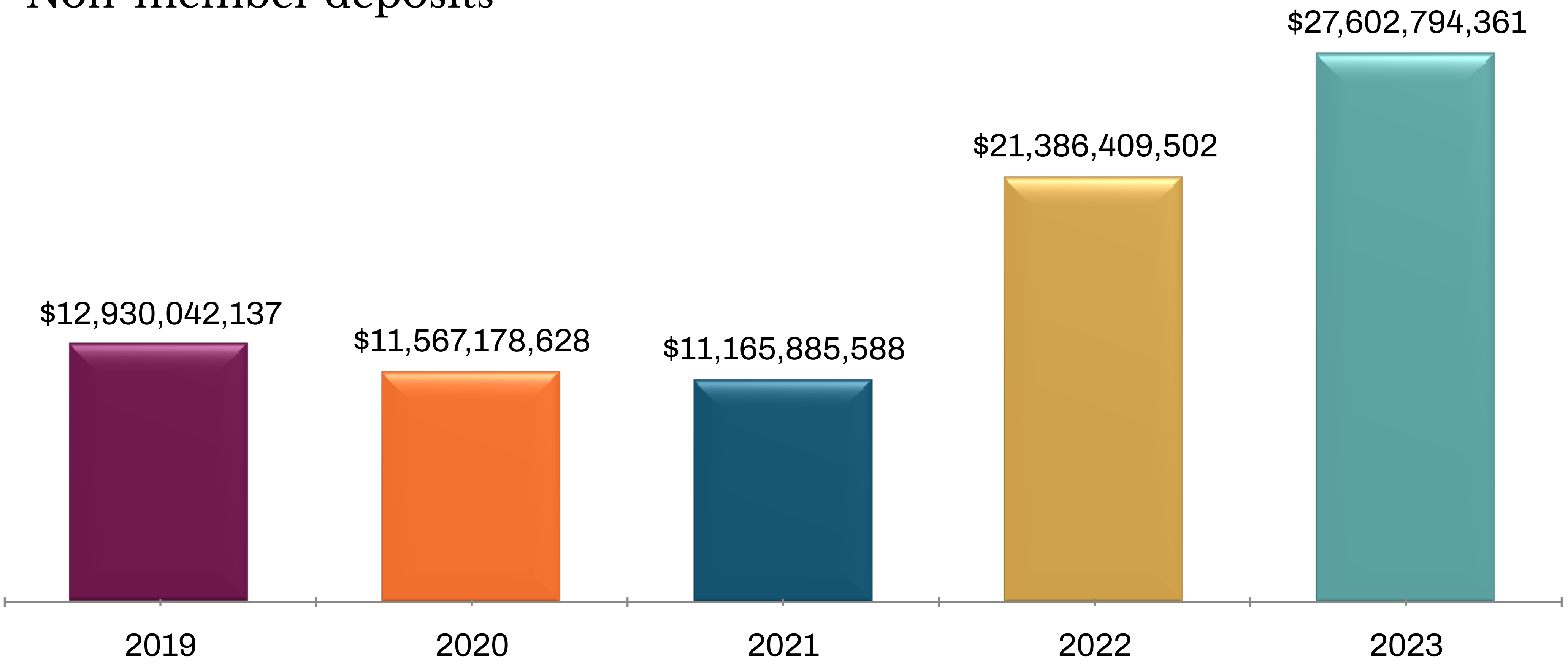
Interest Rate and Liquidity Risk

- Total borrowings outstanding



Interest Rate and Liquidity Risk

- Non-member deposits



Interest Rate and Liquidity Risk

- Liquidity takeaways
  - Monitor and review characteristics of the member deposit base
  - Review, revise and test contingency funding programs
  - Be ready to move quickly as liquidity events can happen fast

Credit Risk and Loan Portfolio Quality

- Always key areas of focus due to their potential impact on financial stability and member trust
- These risks are primarily affected by economic factors, lending practices and regulatory requirements

Credit Risk and Loan Portfolio Quality

- Credit risk management
  - Loan growth and concentrations
    - High loan growth in a particular product type typically leads to increased scrutiny from the regulators (sustainability & excessive risk)
  - Member business loans (MBLs)
    - Monitoring the portfolio is key
  - Delinquency and collection practices
    - How effective are your collection practices?

Credit Risk and Loan Portfolio Quality

- Loan portfolio quality
  - Loan quality and stress testing
  - Loan modification practices
    - How are modifications monitored/reported?
  - Portfolio diversification
    - It's imperative to appropriately diversify the loan portfolio to minimize exposure in any one particular sector
  - Interest rate risk (IRR) and asset liability management (ALM)
    - Loan portfolios are affected by interest rate risk, especially long-term fixed rate products

Credit Risk and Loan Portfolio Quality

- Loan documentation and compliance
  - Loan file documentation
    - Examiners will review whether credit unions maintain thorough documentation of loans, including borrower information, loan terms, and collateral, ensuring regulatory compliance and sound decision-making

Repossessed Assets

- Over the last year, with increases in delinquency on used auto loans, examiners are placing a heightened emphasis on reporting of repossessed assets
- Proper accounting treatment vs. real world application

Repossessed Assets

- Proper accounting treatment for repossessed assets under GAAP
  - Step 1 – reclassify loan balance to repossessed assets (other assets) on the balance sheet
  - Step 2 – at the point of reclassification, the balance should be written down to the lower of cost or fair market value of the collateral (less costs to sell)
  - Step 3 – once the repossessed asset is sold, the gain/loss is reported as gain/loss on sale of assets

Repossessed Assets

- Real world application
  - Depending on the volume of repossessed assets and the size of the credit union, materiality does come into play
  - If low volume of repossessions, consider updating policy to set a dollar threshold on what qualifies for true GAAP accounting treatment of repossessed assets

Allowance for Credit Losses

- For the most part, examiners have been silent on CECL with the exception of reserves on off-balance sheet commitments
- ASC 326, *Financial Instruments – Credit Losses*
  - Current expected credit losses (CECL) model
  - Applicable to financial assets measured at amortized cost, including loan receivables, held-to-maturity investments and **<u>off-balance sheet exposures</u>**

Allowance for Credit Losses

- How do I calculate the reserve for off-balance sheet credit exposures?
    - The liability should be estimated over the contractual period in which the entity is exposed to credit risk, **unless the obligation is unconditionally cancellable** by the issuer

Allowance for Credit Losses

- Real world example – credit cards
  - Can your credit union cancel a member's credit card at any point in time without reason?
    - If the answer is yes, no reserve is necessary
    - If the answer is no, which means the obligation is unconditionally cancellable, a liability for potential off-balance sheet credit exposures should be established

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Thank you