

# the Competitive Edge

for Credit Unions

## Reduce Costs Without Losing Control

Many credit unions are under enormous pressure to improve their earnings. And in a weak economy, like it or not, cost-cutting is an integral part of their strategy.

There's no one right way to cut costs, but as you review your options, consider their potential impact on internal controls. For credit unions, like many companies, salaries represent a major fixed expense and are an obvious target for cost-reduction. But eliminating jobs can heighten a credit union's risk if affected employees are integral to internal control processes.

### Why Internal Controls Matter

Internal controls form the foundation of a credit union's risk management system. Weak or ineffective controls can lead to operational losses and often contribute to credit union failures as well as create a higher risk of fraud.

The Association of Certified Fraud Examiners' 2008 Report to the Nation on Occupational Fraud & Abuse demonstrates the importance of internal controls in preventing and detecting fraud. Survey participants said that the three most important factors that allowed fraud to occur were: lack of internal controls (35.2%), lack of management review (17.4%) and override of existing controls (17.4%).

The survey also showed that median fraud losses were significantly lower in



organizations that had implemented antifraud controls, such as surprise audits and job rotation.

### How Layoffs Affect Controls

Segregation of duties, for example, is a key control, especially for credit union. Assigning different people responsibility for authorizing transactions, recording them and maintaining custody of assets makes it more unlikely that any one employee could both perpetrate a fraud or error and conceal it.

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# Navigating Troubled Loans - Part 2

## Accounting, Regulatory, and Operational Issues that Can Be Avoided

Over the past few months, there has been much conversation amongst credit union management, accounting professionals and regulators on the proper accounting and reporting of troubled debt restructurings.

Doeren Mayhew's "The Competitive Edge for Credit Unions – Summer 2009", edition outlined the accounting issues surrounding troubled debt restructurings (TDR). A recap of that article is as follows:

- Develop an early warning system with proper segregation of duties to identify potentially troubled loans. Detailed documentation should be maintained to assist in monitoring and to provide the necessary documentation for the quarterly call report. Early identification betters the chances to minimize losses.
- Know the difference between TDRs and other modifications. A restructuring is a TDR if the following questions can be answered.
  1. Is the borrower experiencing financial difficulty?
  2. Has the credit union granted a concession in the loan terms?
- Keep in mind that not every loan modification is a TDR. A credit union that renews or extends a loan at the same or a lower interest rate does not trigger TDR accounting if the rate is equal to the market rate for a new loan with similar risk.
- If a loan modification

constitutes a TDR, it must be evaluated for impairment. Generally, the amount of impairment is based on the difference between the loan balance and the present value of the loan's expected future cash flows. In some cases, however, impairment may be based on the loan's observable market price or, if the loan is "collateral-dependent," on the collateral's fair value (less selling costs). If the resulting amount is less than the loan's book value, the difference is the amount of impairment, which should be recognized as a valuation allowance or, if the impairment is determined to be uncollectible, as a loss.

Further detail of the accounting guidance on the above items is codified in FASB ASC 310-10 and 310-40.

Since the issuance of the Summer 2009 article, there has been a significant increase in the volume of troubled debt restructurings in the credit union industry. Much discussion within the industry has been around the implementation inconsistencies within accounting, regulatory and operational issues of the loan modification programs.

Modifications of loans have occurred historically, but due to low volume, the accounting and regulatory reporting for these loans has not always been scrutinized. However, in light of the economic conditions, that has changed. Over the past few months Doeren Mayhew Financial Institution Group personnel have observed the following:

### Common Accounting/Regulatory Issues Observed

- Failure to perform or document risk assessment and due diligence on the loan modification program before implementation
- Improper identification and tracking of TDRs
- Improper accounting for the present value cash flow of the modified loan in accordance with the accounting standards.
- Utilizing the new interest rate for the discount factor instead of the old rate
- Not reporting the delinquency of the TDR in the call report in accordance with the old payment terms until at least six payments under the modified terms have been made
- Not disclosing loan modifications outstanding in the call report
- Not considering an additional loss factor for default on TDRs in the allowance for loan loss methodology

See Exhibit 2 and 3 for accounting and call report guidance.

### Common Operational Issues Observed

- Lack of documented TDR policy and procedures, including underwriting analysis
- Lack of experience and training in loan modification for employees responsible for management and monitoring of the program.

- Improper segregation of duties of the TDR approval and the allowance for loan loss evaluation process
- Untimely identification of TDR situations
- Lack of underwriting scrutiny in the modified terms
- Inadequate TDR file documentation

NCUA recently issued guidance regarding loan modifications in their Letter to Credit Unions 09-CU-19 “Evaluating Residential Real Estate Mortgage Loan Modifications” (September 2009). The guidance provided information on what the examiners will be evaluating as part of their review of the loan modification programs. First and foremost, regulatory examiners will determine if a proper risk assessment and due diligence was performed in implementing the credit union’s loan modification program. Risk assessments should take into account the following:

- Amount of Loan delinquency
- Concentration of high risk loans
- Property value trends for real estate loans
- Impact of loan modifications on financial performance of the credit union
- Foreclosure prevention options

The number of employees administering the loan modification program and their experience level will also be evaluated. Keep in mind that the experience level of the personnel should commensurate with the volume and complexity of the program.

Legal consultation should be sought on the laws of the state in which the real estate is located to make sure all the loan modification documents meet state law and regulatory standards

(including state real estate, lien, consumer protection, and Federal Trade Commission laws and regulations).

A Loan Modification Policy and Procedure should be prepared and approved. The underwriting portion of this policy and procedure should detail what will be performed in order to determine the member’s capacity to repay the loan according to the modified terms. Some of the minimum requirements are outlined in the NCUA guidance letter.

Monthly reporting to the board of directors on modified real estate loans should be communicated. This may include reports that profile delinquent and charged-off loans and reports tracking:

- Number and volume of each type of modified loan;
- Delinquency and charge-offs;
- First payment defaults;
- Principal reductions;
- High LTV ratios, particularly in areas with continued market declines, and total loss exposure in relation to net worth;
- High Debt to Income Ratios;
- Credit quality; and
- Number of times a loan has been modified.

The allowance for loan and lease losses (ALLL) funding needs to separately factor losses for loan modifications as the expectation for re-default is highly probable.

Some loan modifications that involve a reduction or forgiveness of principal may result in additional tax liabilities for the member that should be considered in any assessment of the member’s ability to meet future obligations. The credit union should consult their independent accountant regarding applicable IRS reporting requirements.

Unfortunately, there will be times when a loan modification is not economically feasible or appropriate and management may need to consider other loss mitigation strategies such as short sale, deed in lieu of foreclosure to avoid foreclosure and reduce the credit union’s loss exposure. Regardless of the loss mitigation strategy employed, the credit union should continue to appropriately identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

A TDR Evaluation Documentation Checklist should be utilized when considering a member for modification. This checklist can be used to document and support the TDR. (See Exhibit 1 for an example)

If you have any questions, please contact a Doeren Mayhew Financial Institutions Group Specialist.

### Exhibit 3 - Call Report Disclosure Requirements

There are three areas of disclosure relating to loan modifications in the call report:

1. Delinquent TDR loans (number and amounts) by stage of delinquency. Include in delinquent category until six consecutive payments received. Aging during this period is based on the old payment. (Line 17, 18, and 19 of the Delinquent Loans Section of the 5300 Report)
2. Year to Date Charge-offs and Recoveries for TDR loans (Lines 35, 36 and 37 of the Delinquent Loans Section of the 5300 Report)
3. Schedule A “Specialized Lending” Line 12 (a-c) reports all real estate loan modifications not just those resulting in a TDR for number outstanding, amount outstanding and amount modified year-to-date.

## Exhibit 1 - TDR Evaluation Documentation Checklist

## Detail Information

- Original and current credit scores \_\_\_\_\_
- Original and current collateral values \_\_\_\_\_
- Calculated debt ratios, indicating the member's ability to perform under the terms of the loan modification \_\_\_\_\_
- Reasonable estimate for real estate taxes and insurance, whether or not escrowed. \_\_\_\_\_
- Reason or event that caused financial hardship for the member \_\_\_\_\_
- Reason modification was approved \_\_\_\_\_
- Whether the member can pledge additional collateral to improve the collateral position (cross collateralization) of the Credit Union \_\_\_\_\_
- Date TDR impairment communicated to personnel responsible for tracking and calculating the allowance for loan losses \_\_\_\_\_
- TDR coded separately in the loan subsidiary ledger \_\_\_\_\_

Approval \_\_\_\_\_

## Exhibit 2 - Example of TDR Accounting

- Three years into the loan, member not delinquent on Credit Union loan but is experiencing financial difficulties and requests modification.
- Home value at origination of the loan is \$550,000
- Current Loan to Value is 125%
- Going interest rate on the loan type is 5.5%
- To reduce payments, the Credit Union lowers interest rate from 6.25% to 3.25%

	<u>At Origination</u>	<u>At Modification</u>		
Balance	\$550,000.00	\$500,000.00	Principal Balance	\$500,000
Rate	6.25%	3.25%	Present Value of future Cash Flows	\$462,100
Term	360 Months	312 Months	*\$3,000 over 312 months discounted at 6.25%	
Payments	\$4,500.00	\$3,000.00	Present Value - Loan Balance Deficiency	<u><u>\$(37,900)</u></u>
			Provision for Loan Losses	\$37,900
			Allowance for Loan Losses	\$37,900
			(To recap resume for TDR)	

# Outsourcing: Another Cost-Saving Strategy

In times when cost-cutting is king, outsourcing some functions can be more appealing than ever to credit unions. First and foremost, it can be more feasible than hiring full-time staff. But that's not all.

Outsourcing also can shift the burden of keeping up with technological changes or compliance requirements to a responsible party outside of your institution.

And it can allow your credit union to offer products and services you normally might be unable to afford — with outsourcing, the costs will be incremental rather than upfront. Additionally, it can give credit unions in small communities more access to a qualified workforce. The key to success is finding the areas of your credit union's operation that are right for outsourcing and carefully selecting and monitoring the service provider.

## Should You Outsource Auditing?

A credit union should have an internal audit function appropriate for its size and scope of activities. But some credit unions may have the same firm handle internal and external auditing functions when splitting audit activities poses a significant cost or burden. It also may be appropriate when people with the appropriate specialized knowledge and skills are difficult to locate and hire, or outsourced internal audit services are limited in scope or frequency.

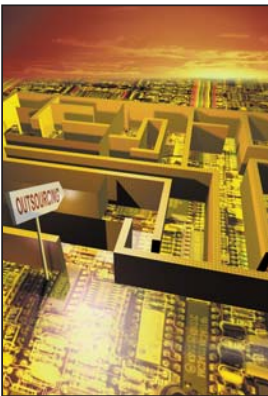
If your credit union uses the same firm for internal and external auditing, the audit committee should document its consideration of independence issues and

preapprove the outsourced services to satisfy AICPA and regulatory guidance, which requires independence.

## What About Human Resources?

It can be difficult to outsource HR because of the high interpersonal contact required, but many credit unions have determined that outsourcing specific aspects of HR will save them money and resources in the long run.

For instance, it can be costly to keep up with payroll process



software upgrades. By outsourcing payroll, you can reduce the administrative costs and benefit from an improved process.

Benefits management also is commonly outsourced. This can provide workers with quick and easy access to information about their medical plans, flexible spending accounts, 401(k)s and more. Just be sure that you can guide your staff through the self-service process and respond to questions in a timely manner — it's frustrating for employees if they

have to ask multiple people to obtain information.

Keep in mind that your HR needs will change as your credit union grows. So you'll want a provider with the capability to meet new objectives, which may include recruitment, performance management, strategic growth and employment related compliance.

## Any Other Functions?

Some credit unions are farming out basic processes that underlie consumer products such as first and second mortgages, home equity lines of credit and credit cards. This allows your employees to focus more on underwriting risk with members than on handling mortgage fulfillment.

Another outsourced service is proof of deposit, especially by credit unions that use an external data processor. This means no more proof machines and proof operators in-house. All of that work is handled by individuals who focus only on that function.

## Where To Start

Before you sign a contract for an outsourcing arrangement, make sure you lay the groundwork. First, determine your objectives for outsourcing. Then develop an implementation plan, and be sure to include details on how you'll evaluate the service provider's performance.

Also, consider launching the outsourcing as a pilot program related to one product or service and then slowly expand to other areas as your credit union's comfort level increases. With proper planning and monitoring, outsourcing can improve efficiency and save your credit union money.

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- Mergers and Consolidation Strategies
- CUSO Planning and Compliance
- Regulatory Compliance

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### *(Reduce Costs Without Losing Control - Continued from page 1)*

To the extent that job elimination reduces the segregation of duties, it can significantly weaken a credit union's internal controls. Another important concern is the internal audit function. Reducing IA staff — or cutting spending on an outsourced or co-sourced IA function — can severely diminish a credit union's ability to uncover accounting irregularities and fraud.

### **How To Protect Yourself**

Ironically, internal controls are even more important now than they were when the economy was flourishing. The same economic forces that are causing credit unions to tighten their belts also are putting pressure on

employees' personal finances, so sacrificing internal controls may be an invitation for fraud. So it's critical to protect yourself.

The first step is to review your internal control policies and procedures so you can anticipate the impact of contemplated cost-cutting measures. If a staff reduction is unavoidable, try to eliminate jobs that have little or no impact on internal controls.

If you must eliminate employees who perform internal control procedures, a risk assessment can help you identify the areas within the credit union where job elimination will present the least amount of risk. Finally, consider whether beefing up other types of controls — such as surprise audits, management or director oversight, job rotation, mandatory vacations,

employee support programs or fraud training — can help compensate for weaknesses caused by cost-cutting.

### **Think Long-Term**

In today's economy, cost-cutting may be unavoidable. But as you take out your red pen, be sure to consider the risk management implications. Don't sacrifice your credit union's long-term strength and stability for the sake of short-term gains.