

the Competitive Edge

for Credit Unions

Summer 2009

Corporate Stabilization Fund Updates and Financial Regulatory Reform

Inside This Issue

- 1 Corporate Stabilization Fund Update
- 3 Navigating Troubled Loans
- 4 Are Your Business Members Looking To Switch Institutions?
- 5 Leverage Online Banking To Generate Deposit Growth

New legislation, The Helping Families Save Their Homes Act of 2009, signed by the President on May 20, 2009, changes the playing field for credit unions coping with the National Credit Union Share Insurance Fund (“NCUSIF”) impairment assessments. The new legislation allows for a Stabilization Fund, separate from the NCUSIF, to be created that will provide immediate relief to credit unions penalized with the impairment assessment in regards to the corporate credit union stabilization plan. The original impairment assessment enforced by the NCUA earlier this year called for the entire impairment to be taken in one year. Under the new legislation, the Federal Credit Union Act was amended to create a Temporary Corporate Credit Union Stabilization Fund (“Stabilization Fund”), with the Board’s authority to assess premiums over seven years. The legislation also increased the NCUA’s borrowing authority to \$6 billion, provided the NCUSIF authority to assess premiums over 8 years to rebuild the equity ratio should the ratio fall below 1.20%, and established emergency borrowing authority of \$30 billion.

The Stabilization Fund allows the Board to improve the NCUSIF’s equity ratio to better position the NCUSIF to cover future losses and reduce the burden of natural person credit unions



in 2009. Due to this new legislation, the Board of Directors of the NCUA has determined that there will be additional actions and requirements of credit unions, which are outlined below.

- **Recapitalization of NCUSIF Deposit** - The NCUSIF capitalization deposit will be fully restored.

(Continued on page 2)

Corporate Stabilization Fund Updates and Financial Regulatory Reform- Continued from page 1)

■ **Stabilization Fund**

Implementation - The NCUA Board approved action that would legally obligate the Stabilization Fund to fulfill any liability arising from the Temporary Corporate Credit Union Share Guarantee Program and the Temporary Corporate Credit Union Liquidity Guarantee Program. NCUSIF would only provide funds if any liability exceeds the funds available from the Stabilization Fund.

■ **Adjustments to the NCUSIF Capitalization Deposit for the extension of the \$250,000 share and deposit insurance through 2013** -Credit unions with \$50 million or more in assets will receive their normal notice in the fall, based on the June 30, 2009 report of insured shares. Credit unions with less than \$50 million in assets will not receive their adjustment notice until the spring of 2010 and it will be based on insured shares reported as of December 31, 2009. An increase in cash will be needed

for assessments so credit unions need to consider the impact on liquidity.

The NCUSIF impairment and premium assessment entries made in 2008 or 2009 do not change the obligations under Prompt Corrective Action (“PCA”). However, credit unions having net worth between 6% and 6.99% are subject to an earnings retention requirement, and credit unions having net worth of less than 6 %, must timely submit a Net Worth Restoration Plan (“NWRP”) for approval. NCUA has communicated in NCUA Letter to Credit Unions 09-CU-14 that they would be receptive to approving a NWRP that consists of the single step of recording the impairment recoverability along with providing pro forma financial statements covering the next two years showing a net worth ratio remaining above 6 percent for four consecutive quarters.

For more information on the new legislation and the impact it will have on your credit union, please contact a Doeren Mayhew Financial Institutions Group professional today or review Letter to Credit Unions 09-CU-14 which can be obtained at www.ncua.gov.

Financial Regulatory Reform
On June 17, 2009, President Obama

proposed a new and powerful agency that would be charged with just one job: looking out for ordinary consumers. The agency will have the power to set standards so that companies compete by offering innovative products that consumers actually want and understand. The goal of this agency would be to provide information to consumers that are simple, transparent and accurate. Currently the proposal would have the agency supervise consumer protections at all consumer service providers. This would include regulated entities such as credit unions, as well as non-regulated, and to remove the authority from the federal financial institution supervisory agencies. Both the Federal Reserve and the NCUA have advocated that the financial institution supervisory agencies have expertise in financial markets, payment systems and supervision and that expertise provides them the ability to protect the interest of consumers in their financial transactions. NCUA Chairman Michael Fryzel has communicated that he will seek funds for a consumer protection office in the NCUA’s 2010 budget. On July 23, 2009 a vote on the House Financial Services Committee mark-up of a bill to create the Consumer Financial Protection Agency was postponed to September 2009.

Troubled Debt Restructuring Example

John is unable to make the payments on a \$300,000 loan from his credit union. The loan is secured and bears interest at 5%, which also is the current market rate. The credit union agrees to restructure the loan, with interest-only payments of 3% for two years and a final payment of \$309,000 (the principal plus 3% interest) at the end of year three.

Assuming that the loan is neither collateral-dependent nor readily marketable, impairment is measured by the present value of expected future cash flows, discounted at the loan’s original interest rate. In this case, the present value of John’s expected payments under the restructured terms, discounted at 5%, is \$283,661.

The impairment — that is, the difference between the loan’s recorded value (\$300,000) and the present value of the payments (\$283,661) — is recognized through a \$16,339 valuation allowance.

Navigating Troubled Loans

For the first time in years, credit unions face significant numbers of troubled loans, so it's important to be diligent in identifying, monitoring and, if appropriate, restructuring them.

Reworking a problem loan can be a viable alternative to foreclosure. Not only does it allow you to avoid the cost and stress of foreclosure proceedings, but in many cases it enables you to recover more of the loan principal than you would through a foreclosure sale. It also may help you retain a potentially viable credit union relationship.

As you review your loan portfolio and make decisions about how to handle troubled borrowers, it's a good idea to familiarize yourself with the accounting issues surrounding "troubled debt restructurings" (TDRs).

Develop An Early Warning System

The earlier you identify potentially troubled loans, the better your chances of minimizing your losses, whether by restructuring the loans or foreclosing. You should have systems in place to spot and monitor signs of increased credit risk in your portfolio, such as high concentrations of loans in particular geographical areas or loan types.

Other warning signs of credit risk include transactions with high loan-to-value ratios and borrowers with elevated debt-to-income ratios or large unsecured debt limits.

You also should look for signs that borrowers are experiencing financial difficulties, such as defaulting on one or more debts or lacking sufficient cash flow to service their debts.

The decision whether to restructure a loan or foreclose depends on your assessment of the borrower's ability to

repay the loan, the amount you could recover through foreclosure and the continued value of the banking relationship. A credit analysis can help you evaluate these factors and, as discussed below, can help you determine whether a modified loan would be considered a TDR for accounting purposes.

Know The Difference Between TDR's and Other Restructuring

Before you restructure a loan, it's important to understand how it will affect your financial statements. The key issue is whether a restructuring constitutes a TDR. The criteria are found in FASB's *Statement of Financial Accounting Standards (SFAS) No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

Under SFAS 15, a restructuring is a TDR if the credit union "for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider." Determining whether a restructuring is a TDR involves a two-part test:

1. Is the borrower experiencing financial difficulty?
2. Has the credit union granted a concession?

Generally, the following factors indicate that a borrower is experiencing financial difficulty:

- Default on any debts,
- Bankruptcy,
- De-listing of the borrower's securities,
- Doubt as to whether the borrower will continue as a going concern,



- Insufficient projected cash flows to service the loan, or
- Inability to obtain funds from other sources at market rates for similar loans to nontroubled borrowers.

Concessions include assets transferred or equity interests granted in full or partial satisfaction of the loan (unless their fair value is equal to the loan's book value). But the most common type of concession is a modification of loan terms.

Loan modifications might include reducing the interest rate, the principal or accrued interest; extending the maturity date at a below-market interest rate; adding contingent payment provisions (based on meeting profitability goals, for example); or substituting or adding a new borrower or guarantor.

But remember 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. A lower rate may reflect declining market rates or the borrower's increased creditworthiness, for example, rather than a troubled loan situation.

Are Your Business Members Looking To Switch Institutions?

A recent survey by research firm Greenwich Associates revealed that nearly half of small and middle-market companies in the U.S. are “actively seeking a new financial institution or would consider changing financial institutions if presented with a compelling offer.”

Greenwich surveyed 670 companies, consisting of 260 small businesses and 410 middle-market companies. As of the end of 2008, almost half of small businesses and 40% of middle-market companies were looking for a new financial institution or were open to the idea. In contrast, at the beginning of 2007, less than one-third of companies participating in the survey were looking to switch.

This trend represents a threat to credit unions. But it also presents an opportunity for credit unions to increase their market share by fixing the things that dissatisfy members.

Why Are They Unhappy?

According to Greenwich, the main reasons companies want to switch financial institutions are “lack of demonstrated commitment to the business,” “poor communication” and “uncertainty regarding financial

health.” This is a departure from previous years, when price and service issues were the primary reasons for member dissatisfaction (although they remain a factor for many of the survey respondents).

In addition, many companies are concerned about reductions in credit availability and changes in credit terms brought on by the current economic climate. Many loyal, long-term, creditworthy members felt that

an opportunity to retain existing members and attract new ones by making an effort to improve communications and provide more personalized attention.

Around 25% of survey respondents that switched financial institutions in the preceding year said that their previous institutions could have kept their business with better communication and responsiveness or simply by “appreciating our business and treating us better.”

In light of the various reasons members give for their dissatisfaction, many credit unions should be able to reverse the trend and hold onto members by improving communications, making credit decisions on a case-by-case basis, showing more appreciation for long-term members and providing greater transparency regarding their own financial condition.

Back To Basics

The lesson here seems to be that now, more than ever, credit unions need to focus on the things that historically have distinguished them from their larger competitors: pluses like personalized

service, access to senior management, and credit decisions based on members’ individual circumstances rather than application of a formula.

By refocusing on these areas, credit unions can help preserve existing member relationships and attract new ones.



they had been mistreated by financial institutions that subjected them to the same tough restrictions — reduced credit, stricter terms and higher fees — as everyone else.

What Should You Do About It?

Although member dissatisfaction is a threat to credit unions that ignore the problem, it presents credit unions with

Leverage Online Banking To Generate Deposit Growth

As a byproduct of the current financial downturn, more people are keeping their money in savings accounts and other investments they consider “safe.” This presents an opportunity for financially sound credit unions to attract new deposits. And one way to spur deposit growth is to take advantage of the Internet and other technologies that encourage people to save and make it easier for them to make deposits with your credit union.

But although online banking can be a great way to generate new business, it can also increase your credit union’s exposure to fraud, identity theft, money laundering and other risks. Before you introduce online banking or add new services to your website, it’s critical to address security issues. You must be sure that you have appropriate internal controls in place to minimize and monitor online risks.

Online Tools To Consider

There are many tools you can offer existing and new members that make it easier for them to save. Examples include:

- Online account opening and funding. Enabling members to open accounts from the comfort of their homes and offices can be a powerful tool for attracting deposits.
- Automatic transfers. Allowing members to set up automatic, recurring transfers to a savings account can be a powerful tool for growing deposits. The key is to make it as simple as possible for members to set up transfers. You can even offer automatic transfers each time a payroll check is deposited into a member’s checking account.

- Credit union alerts. E-mail or text-message alerts that warn members of low balances or NSF status can encourage them to deposit or transfer funds and avoid overdraft fees.
- Bill paying. Online bill paying provides a convenient way for members to manage their finances as well as an incentive to keep more funds in the credit union.
- Financial planning tools. Financial calculators, budgeting programs and other planning tools can help members manage spending and encourage them to save.

The key to all of these tools, of course, is convenience. The easier you make it to do business with your credit union, the more likely you are to attract new business. But remember, when you make it easier for legitimate members to do business with you, you also make it easier for fraudsters, identity thieves, money launderers and other criminals.

Risks To Guard Against

If you’re contemplating offering online banking or adding new features to your existing site, be sure to plan carefully and take steps to minimize security risks. According to a University of Michigan survey conducted last year, more than 75% of financial institution websites surveyed had at least one design flaw that made members/customers vulnerable to cyber theft.

Common flaws included:

- Placing secure login boxes on insecure pages,
- Placing contact information and security advice on insecure

pages,

- Redirecting members/customers to third-party sites without warning,
- Allowing inadequate user IDs and passwords, and
- E-mailing security-sensitive information insecurely.

Most of these problems are easily solved by using the secure socket layer (SSL) protocol on pages that ask for sensitive information and making other relatively simple changes to your credit union’s website.

If you offer online account opening, it’s critical to ensure that your member identification procedures comply with BSA/AML requirements. Many credit unions have opted not to allow online account opening because of risk of noncompliance. Others permit members to begin the process online but still require them to visit a branch or send in documents by mail to complete the transaction.

With the advent of digital signatures and other technologies for authenticating a member’s identity online, online account opening is becoming safer and more prevalent.

Handle With Care

In today’s competitive environment, credit unions need any edge they can get in the battle for members. The convenience of online banking can provide a competitive advantage, but it’s important to take your time and be sure that you have the appropriate procedures, internal controls and security measures in place. Just one incident of fraud or identity theft can do irreparable damage to your credit union’s reputation.



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The Competitive Edge for Credit Unions — Summer 2009

(Navigating Troubled Loans - Continued from page 3)

Understand The Accounting Implications

If a loan modification constitutes a TDR, it must be evaluated for impairment in accordance with *SFAS 114, Accounting by Creditors for Impairment of a Loan*. 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.

Special rules apply when the credit union receives equity or assets. But, in general, if equity or assets are accepted in full satisfaction of a loan, impairment is based on their fair value.

Perform A Credit Analysis

Whenever you restructure, renew or extend a loan under modified terms, it’s important to conduct a thorough credit analysis. As explained above, a loan modification is not considered a TDR if the new terms are consistent with market rates for new loans with similar risks.

A credit analysis evaluates the risk associated with a restructured loan and helps support the credit union’s classification of the restructuring as a TDR or a non-TDR.

Looking For Trouble

This article touches on just a few of the accounting issues involved with restructured loans. Other issues include the accrual or nonaccrual status of TDRs, treatment of TDRs on call reports and the accounting treatment of loan modifications that are not TDRs.

In today’s struggling economy, credit unions need to be proactive in looking for signs of troubled loans and taking appropriate steps to minimize their losses. If a credit union determines that restructuring a loan is the best course, it’s important to understand and apply the relevant accounting standards.