Off-Site Supervision

November 13, 2002

Supervision is the ongoing monitoring of a credit union's financial and operational condition. Examiners monitor their assigned credit unions as needed through on-site examination, supervisory contacts, and off-site through submitted regulatory reports and financial statements, and periodic trend analysis of selected ratios. In credit unions with more serious financial problems, supervision may also include follow-up examinations and monthly monitoring of financial trends and ratios.

The objective of off-site supervision is to quickly identify negative trends and emerging problems and to resolve the issues before they become so serious that they could negatively effect the credit union's financial condition. Examiners should contact a credit union immediately upon the detection of a problem to ensure that management is aware of the problem. To correct the problem(s) the examiner should not only report the problem, but work with management in determining the best workable solutions to the problem.

Data Collection - Credit unions are generally required to submit financial information and/or statements to the regulatory agency on a periodic basis. The periodicity will vary depending on the credit union's problems. Newly chartered credit unions and those with severe operational problems are generally required to submit financial information monthly. The examiner that is responsible for performing the on-site supervision can perform off-site supervision or the supervision duties can be divided between on and off-site supervision departments.

Data can be collected through the use of a required regulatory form that is to be completed no less than semi-annually (data as of June 30 and December 31). This report collects the following information:

- Balance Sheet account balances for - all the outstanding loan types, Allowance for Loan Loss, Cash, Investments, Fixed Assets, Prepaid and Deferred Expenses, Other Assets, Total Assets, Accounts Payable, External Credit, Accrued Dividends, Taxes Payable, Accrued Expenses, all the savings and share types, Regular Reserve, Special Reserves, Undivided Earnings, Net Income, and Total Liabilities and Equity.
- Income Statement account balances for – Interest on Loans, Income from Investments, Fee Income, Other Operating Income, Total Gross Income, Employee Compensation, Employee Benefits, Travel and Conference Expense, Office Occupancy Costs, Office Operations Expense, Educational and Promotional Costs, Loan Servicing Expense, Provision for Loan Loss, Member Insurance Costs, Miscellaneous Operating Expenses, Total Operating Expenses, Gain on Sale of Fixed Assets, Other Non-operating Income (Expense), Interest on External Credit, Interest on Deposits, Dividends on Shares, Net Income.
- Breakout of Delinquent Loans – the number of delinquent loans and delinquent loan balances between 1-2 months delinquent, 2-3 months delinquent, 3-6 months delinquent, 6-9 months delinquent, 9-12 months delinquent, greater than 12 months.

- Miscellaneous Loan Information – loans outstanding to credit union officials and management, loans granted year-to-date, total amount of loans charged off year-to-date, and total amount of recoveries on charged-off loans year-to-date.
- Investment Information – types of investments and a maturity distribution of investments – 0-1 month, 1-2 months, 2-3 months, 3-6 months, 6-9 months, 9-12 months, 1-2 years, 2-3 years, and greater than 3 years.
- External Credit Information – types of external credit and maturity distribution.
- Savings Information – types of savings and share accounts, a maturity distribution, and the interest rates and dividends paid on the accounts.
- Off-balance Commitments and Contingent Liabilities – such as unused lines of credit (both member lines of credit and external credit union lines of credit), potential and pending lawsuits, etc.
- Miscellaneous Information – who performed the last annual audit, the effective date of the last annual audit and member account verification, the type of system used to maintain the loan and savings records of the member, the name of the software or processor used (if the EDP system is computerized), number of current members, number of potential members, number of male and female members, number of members who have declared bankruptcy year-to-date and the number of full and part time members.

This data is collected using a standardized format. Standardization is imperative to make the data useful and comparable and to eliminate individual interpretation and incorrect information. All interested parties must use the same information for the calculation and review of ratios otherwise any comparison is useless. Along with a standardized format for reporting, there should be a line by line explanation of how the report is to be completed. The individuals completing the report should be adequately trained so that they provide reliable data.

Financial data can also be collected periodically, in addition to, the regulatory report. This can be done on a case by case basis. Examiners should contact credit unions that need additional supervision (more than is provided during the annual examination and in the review of the regulatory report information described above) and advise them of the information that needs to be collected, how often it is to be submitted, where it is to be submitted, and the deadline for receiving the requested information. The information requested by examiners usually includes:

- Balance Sheet;
- Income Statement;
- Delinquency List;
- Loan Classification performed to determine the adequacy of the Allowance for Loan Loss account; and
- Breakdown of the outstanding balance for all loan and savings types.

Examiners will then use this information to perform ratio, financial statement, and peer group analysis.

Financial Statement Analysis - The financial reports, including the balance sheet, income statement and the loan delinquency report allow the regulatory agency to measure and analyze the performance of the credit union over a period of time and compare it to similar size credit unions or a peer group. This information should be entered on a spreadsheet to analyze the numbers over a given time period (monthly or quarterly). The spreadsheet should contain at least 12 months of data so that the information can be analyzed between periods and compared to similar size credit unions. Data should be maintained on the spreadsheet long enough to identify positive and negative trends, seasonal fluctuations, and any inconsistencies.

When performing financial statement analysis the spreadsheet should include the following information and all trends, fluctuations, and inconsistencies should be noted in a comments section provided at the end of the spreadsheet:

- Number of Members;
- Total Loans balance;
  - Balances for each loan type offered;
- Allowance for Loan Loss balance;
- Cash;
- Investments;
- Fixed Assets;
- Other Assets;
- External Credit;
- Other Liabilities;
- Total Share, Savings, and Deposit account balances;
  - Balance of each type of share, savings and deposit accounts offered;
- Regulatory Reserve balance,
- Special and Other Reserve account balances;
- Undivided Earnings balance;
- Year-to-date Net Income balance;
- Income from Loans;
- Income from Investments;
- Fee Income;
- Total Gross Income;
- Total Operating Expenses;
- Total Provisions for Potential Losses;
- Non-Operating Income (Expense);
- Total Interest and Dividends paid on shares, savings, and deposits;
- Interest paid on external credit;
- Net Income;
- Delinquent loan balance from 1-2 months delinquent;
- Delinquent loan balance from 2-3 months delinquent;
- Delinquent loan balance from 3-6 months delinquent;
- Delinquent loan balance from 6-9 months delinquent;
- Delinquent loan balance from 9-12 months delinquent;
- Delinquent loan balance greater than 12 months delinquent;
- Total loans charged off for the period; and

➢ Total loan recoveries for the period.

Ratio Analysis - The most widely used and effective form of off-site supervision is ratio analysis. The financial statement information is used to calculate the ratios. Financial ratios give the numbers an added dimension. Ratios allow the examiner to objectively relate two individual numbers to measure specific areas of credit union operations. Ratios can be used effectively in a trend analysis to monitor credit union performance and determine the presence of negative and positive trends and changes.

No ratio is isolated from operational changes or problems. Changes will effect various ratios, so the ratios must be analyzed with their interdependence in mind. For instance, if delinquency increases, the delinquent loan to total loan ratio will increase as long as total loans have not grown faster than delinquent loans. Interest income will decrease because interest in not being collected on time. Fees may increase if penalties are charged for late payments and are collected. Collection expenses may rise due to the costs associated with collecting loans. Net income and, therefore, institutional capital will also be adversely effected.

The ratio analysis should be performed on a spreadsheet and it may be the same spreadsheet in which the financial statement analysis is performed. The following ratios from the PEARLS monitoring system are key ratios needed to determine a credit union's financial condition:

- Allowance for Loan Losses / Delinquent Loans > 12 months – This ratio measures the adequacy of the credit union's allowance for loan loss account for all loans that are delinquent more than 12 months. One hundred percent of the delinquent loans more than 12 months past due should be provided for in this account. If the account is not adequate, a loan charge off will reduce institutional capital and the financial strength of the credit union.
- Allowance for Loan Losses / Delinquent Loans from 1-12 months – This ratio measures the adequacy of the credit union's allowance for loan loss account for loans that are between 1-12 months. The allowance account balance should be adequate for 100% of the loans greater than 12 months delinquent and at least 35% of the outstanding loan balances between 1-12 months delinquent. If the account is not adequate, a loan charge off will reduce institutional capital and the financial strength of the credit union.
- Loan Charge-Offs / Total Loan Portfolio – This ratio measures the amount of loans charged-off from the loan portfolio in the period. This ratio should be analyzed with the result of the Total Delinquency > 1 month / Total Loans ratio. The credit union could have a low delinquency ratio because loans are charged-off quickly or a high delinquency ratio because loans are rarely charged off. There are only 4 ways in which a loan can be removed from the delinquency list:
  - Paying the loan current;
  - Charging it off to the Allowance for Loan Loss account;
  - Manipulating the terms; or
  - Refinancing or extending the loan.

- Total Loans / Total Assets – This ratio measures the percentage of assets that are invested in member loans. If the majority of assets are invested in loans, generally gross and net income are higher if delinquency, cost of funds, and operating expenses are under control.
- Savings and Deposits / Total Assets – This ratio measures the percentage of total assets that are financed by member's savings and deposits. A large percentage indicates an effective marketing program and is a good indicator that the members are saving for reasons beyond access to loans.
- External Credit / Total Assets – This ratio measures the percentage of assets that are financed by external credit. The use of external credit should be well thought out and part of the business plan. External credit should be used as an initial source of funds or short-term funding. Management should not be reliant on external credit for a medium or long-term source of funds. The receipt of external funding is often unreliable and the cost of these funds varies tremendously. These two factors could seriously effect the credit union's liquidity and profitability. Instead, management should concentrate on developing and promoting attractive savings products for its membership.
- Institutional Capital / Total Assets – This is one of the most important ratios because it measures the overall financial soundness of a credit union provided that the allowance for loan loss account is adequately funded. If the allowance for loan loss account is inadequate for potential loan losses then institutional capital will be reduced when loans are charged-off. The larger the institutional capital ratio the more capital the credit union has to absorb losses. Capital is the difference between a solvent and insolvent institution. Capital is defined as those funds within a credit union over which no person or institution has any legal claim. More specifically, capital is retained or undivided earnings, regulatory reserves, charity and donations, and net income or loss after all operating expenses, interest costs, provisions, taxes and dividends have been paid.
- Total Delinquency > 1 month / Total Loans – This ratio measures the total percentage of loans that are delinquent more than 30 days. This ratio is a very good indicator of not only the quality of the credit union's loan portfolio, but also the collection efforts. The age of the delinquent loans should also be analyzed. If there are numerous loans that are delinquent 1-2 months this could indicate:
  - The collection department is not starting collection efforts in a timely fashion;
  - An economic downturn; or
  - An adverse change in loan underwriting.
- Non-earning Assets / Total Assets – This ratio measures the percentage of the total assets not producing income. This ratio should be minimized, as these assets do not contribute to net income or institutional capital.
- Operating Expenses / Average Total Assets – This ratio measures the cost associated with the management of all credit union assets. This cost is measured as a percentage of total assets and indicates the degree of operational efficiency.
- Net Income / Average Total Assets – This ratio measures the adequacy of the credit union's earnings and its capacity to build capital. This ratio should be analyzed with the result of the Institutional Capital to Total Assets ratio in mind. If net income is

insufficient to sustain or increase capital, the credit union's survival in the future may be questionable.

- Liquid Short-term Assets – Short-term Payables / Savings Deposits – This ratio measures the adequacy of the liquid cash reserves to satisfy deposit withdrawal requests after paying all immediate obligations < 30 days. The goal of successful liquidity management is to have enough liquid funds to meet all member requests and operating expenses with any excess funds invested in interest bearing accounts and/or investments.
- Growth in Total Assets – This ratio measures the growth of total assets from one period to the next. In order to have real growth the ratio must be at least the inflation rate.
- Growth in Institutional Capital – This ratio measures the growth of the credit union's capital from one period to the next. Institutional capital growth that is the same or greater than the growth in assets insures the credit union's financial future. The more capital a credit union has the more able it is to withstand loan losses, economic downturns, costs associated with offering new member services, and financing of fixed assets. Capital can also make a credit union more profitable if operating expenses and the cost of funds are under control. There is no interest cost to attract these funds to the credit union as there is with member deposits.

(For more information on the ratios discussed above please see the information provided on the PEARLS Monitoring System.)

Peer Group Analysis – A peer group is group of similar sized credit unions. For instance all credit unions with assets less than $2 million would be a peer group. From the peer group data received peer averages can be calculated for all of the above data. Peer averages are a very helpful tool to both supervisors and credit union managers as they can take ratio analysis one step further. They can compare their financial operations and results to similar credit unions, in addition to, reviewing the trends in their operations. When using peer comparisons, examiners have to keep in mind that not all credit unions are alike even though they are in the same peer group. So there might be credit unions that have ratios that vary from that of the peer average but their operations and financial condition are sound.

Peer group ratios are normally produced by the regulatory agency. They are an end product of the required standardized data collection discussed above.

Signs of Warning - These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. While conducting off-site supervision, the examiner should look for the following signs of warning:

- Financial reports or standardized reports that are not received or received late;
- Financial reports or standardized report that are completed incorrectly;
- Management avoids examiner contacts, can not answer the questions and address concerns, and/or is evasive when questioned;
- The Allowance for Loan Loss is not adequate to cover potential loan losses;
- Management and officials do not want to increase the allowance for loan loss account as instructed;

- Loans are not charged off when they are considered a loss and/or when they are greater than 12 months delinquent;
- Accounts Receivables balance increases over the time period;
- Accrued Interest on Member Deposits continually increases;
- Fixed assets are depreciated over a time period greater than recommended in accounting standards;
- The loans to assets ratio is greater than 85% or less than 60%;
- Savings deposits are a small percentage of total assets;
- External credit as compared to total assets is greater than 10% and is used to fund medium to long-term liquidity needs;
- Institutional capital to total assets ratio decreases or is following a negative trend;
- Delinquent loans as compared to total loans is increasing and/or the ratio is erratic over a period of time;
- Delinquency between 1-2 months increases rapidly;
- Total delinquency decreases over a short time period;
- Non-earning assets increases as a percentage of total assets above 5%;
- Operating expenses as compared to average assets is increasing and/or the ratio is greater than 10%;
- Gross Income, operating expenses, and/or net income are erratic from one month to the next;
- Fee income is greater than 25% of gross income;
- The short-term liquid assets – short-term payables / savings deposits is less than 10%; and
- Asset growth is greater than institutional capital growth.

Follow-up on Off-Site Supervision – Upon identifying a potential problem or a negative or erratic trend the examiner should contact credit union management and the on-site supervision department if the supervision aspects are separate. Contact should be made by phone first to alert management of the problem or trend. Solutions should be developed jointly with management. If the problem is serious and it persists then an on-site supervision contact should be scheduled. On-site supervision contacts differ from the annual examination as they are focused on the problem or negative trend identified. Any kind of supervision contact that is made, whether it is by phone or an on-site visit, should be documented in writing and retained in the credit union's field file. At a minimum, the following information should be placed in writing:

- Identify what prompted the contact;
- Who performed the contact and who at the credit union was contacted;
- Identify the problem;
- Determine the cause of the problem;
- Report on the present financial condition of the credit union;
- Discuss corrective action completed, initiated, or planned; and
- Outline future plans for supervision.

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