Problem Resolution by Credit Union Management

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Attempting to resolve serious operational problems in addition to running the daily operations of a credit union can be a daunting task. However, many general managers and credit union officials are asked to do just that. Some of the individuals working on the solutions may have been a part of overall management when the problems occurred while others may have entered the credit union only to find that their job is twice as difficult as anticipated. Not only do they have to direct and control daily operations but they have to resolve serious problems that if left unaddressed, could threaten the very existence of the credit union and the livelihoods of all staff members.

Discussed below are some of the most common and potentially serious problems along with suggested solutions. A manager may only have to implement a couple of the solutions to make the necessary operational changes or he/she may have to implement numerous solutions to resolve several problem areas. The problems and suggestions discussed are not mutually exclusive; a suggested solution may provide positive results in several problem areas.

Problem – High, Rising, or Uncontrolled Loan Delinquency is one of the most common problems that can quickly destroy a credit union if management does not locate the cause and remedy the problem(s). A loan is considered delinquent when one payment has been missed. When calculating delinquency the entire outstanding loan balance should always be considered delinquent not just the delinquent payments.

Identifying the Cause of Rising Delinquency – Management must analyze the delinquent loans to determine the cause of the problem. Management might want to ask the following questions to determine the cause:

- When were the delinquent loans granted?
- Were a majority of the delinquent loans granted by the credit committee or one particular loan officer?
- Have there been any employee changes that would affect the quality of loan underwriting or collection efforts?
- Are the loan officers or credit committee adequately trained to grant quality loans?
- Do the delinquent borrowers have anything in common? Are they related? Do they live in the same area? Do they work together? Do they have similar occupations?
- Have the loan underwriting standards decreased as of late in order to increase loans outstanding?
- Do the loan officers or credit committee effectively analyze the borrower's ability to repay the loan granted?
- Are the loan and collection policies and procedures adequate?
- When do collection efforts begin once a loan becomes delinquent? Is this quick enough? Are collection efforts effective? Is the collection department adequately staffed and focused to meet the challenges of high or increasing delinquency?

- Has anyone manipulated the delinquency information in the past to hide delinquency? This can be done by changing the terms in the computer or on the manual loan ledger card or by improper use of loan extensions and refinances.
- Has there been a major event that is beyond the credit union's control such as a natural disaster, a strike, employee layoff, or business closure?

Problem Resolution – Delinquency can have a major impact on the financial condition of the credit union. Because delinquency is high or increasing and borrowers are not making their loan payments, interest on loans decreases, collection expenses increase, the provision for loan loss expense will increase if the loans are considered a potential loss or deemed uncollectible, and capital will decrease due to the negative impact on net income of falling income and rising expenses.

Depending on the cause of the delinquency, management should do a number of things to resolve the problem that will probably include several of the following:

1. Management and the officials should ensure that delinquency is correctly calculated and disclosed. Management should review the delinquency list no less than weekly when delinquency is considered problematic to determine:
   - if collection efforts are effective;
   - the causes for new loans being added to the list; and
   - to ensure that any loans that are removed from the list are done so without improper data manipulations.
2. Management should ensure that the delinquency report is useful. The report should include:
   - Member name;
   - Member account number;
   - Date the loan was made;
   - Original amount of loan;
   - Current delinquent loan balances grouped by age of delinquency (1-2 months, 2-3 months, 3-6 months, 6-9 months, 9-12 months, and greater than 12 months delinquent);
   - Date of last payment;
   - Amount of last payment;
   - If the loan has been extended or refinanced;
   - Member share and savings balances; and
   - Comments.

   This report should be analyzed with the following in mind:
   - The trend in the number and total amount of delinquent loans in each delinquency category;
   - The total number and amount of delinquent loans;
   - The original date the loans were granted;
   - Determining if a majority of the loans were granted by one individual;
   - Determining if the credit union has enough collection staff working in the office and field to handle the level of delinquency; and if lawyers and collection agencies are being used appropriately.

3. Employees working with delinquent loans should perform a review of each loan to determine their collectibility. Any loans that are greater than 12 months delinquent or deemed to be uncollectible, no matter how delinquent they are, should be removed from the accounting records by charging off the loan to the allowance for loan loss account. This will provide for more transparent financial statements and allow collection personnel to concentrate on delinquent loans that are collectible.
4. All charged off loans and loans that are need of legal attention should be given to lawyers or collection agencies for legal action against the delinquent borrower. Management should receive a monthly report from any third party collecting loans to ensure that collected funds are remitted to the credit union and that there is adequate progress on collecting delinquent loans.
5. Management should ensure that interest on loans is not accrued when a loan becomes two months delinquent. Interest should only be recognized upon receipt for all loans two months or more delinquent.
6. Management should determine that the allowance for loan loss account is adequate for all potential loan losses. If it is found to be inadequate it should be increased through the appropriate expense account.
7. Loan delinquency can be fictitiously lowered through extending the maturities of delinquent loans or rewriting the loans as new loans. The use of loan extension and refinances should be strictly limited. Loan extensions are an extension of the term and should be used only when the borrower has the ability to repay the loan but is faced with an unexpected emergency such as a death in the family, hospitalization, or a family crisis. Loan refinancing should be used only when the borrower no longer has the capacity to repay the loan under the original terms but still has the intent, desire, and ability to repay the loan under new terms.
8. If delinquency is high or increasing due to the actions of one specific loan officer, that individual should either be terminated, or removed from the loan officer position and placed in another position or, adequately trained, and only allowed in the future to grant loans under close supervision. If the delinquent loans were granted by a volunteer credit committee, their duties should be delegated, if allowed by law, to a more professional group such as a technical loan committee that is staffed with competent, paid individuals who have proven lending experience.
9. If loan underwriting appears to be the source of the problem, the credit policies and procedures should be revised. Credit should only be granted to those borrowers who have demonstrated their ability to repay. Loan policies should provide guidelines for: loan authorities, loan ceilings, concentration limits, credit information requirements, credit granting, security and collateral, establishing and maintaining interest rates, and the review of files to ascertain compliance with policy and procedures. The credit policy and procedures should be part of the training program for lending staff members.
10. Loan applications should be revised so that they collect the information necessary to determine the members ability to repay such as: number of dependents, sources of all income, employment and salary history, outstanding debts and monthly payments, and credit references.
11. If loan collection practices appear to be at fault, the policies and procedures should be revised. Collection practices should focus on immediate contact with delinquent

borrowers, personal contacts instead of phone calls and letter writing, documentation of all contacts made and promises to pay by the borrowers, and consistent follow-up until the delinquent loans are current. Collection policies should clearly state: when a loan is considered delinquent, when the first contact should be made, how contacts are to be documented, what should be done if the borrower misses a promised payment, when the co-signer should be contacted, when collateral should be repossessed, how repossessed collateral will be sold, and under what circumstances loan extensions, refinances, and work-out plans can be used. The collection policy and procedures should be part of the training for collection staff members.

12. Frequently in credit unions collection activity is an afterthought and the collection work is given to an employee who has some extra time. Management should ensure that collection staff has the experience and disposition or personality necessary to be effective.

Problem – Inadequate or Falling Net Income is another fairly common problem in credit unions. Net income problems need to be addressed quickly because many of the changes that can be made do not have immediate results, they take time to effect net income. Decreases in net income also negatively impact capital. Capital growth comes from net income, if net income is inadequate or decreasing then so is capital.

Identifying the Cause of Inadequate or Falling Net Income – Management must look closely at all operational areas. To assess operations and determine the cause of the inadequate or falling net income, the following questions should be answered:

- Are loan rates competitive with local competition for similar loan products?
- Do the credit union's loan rates cover the cost of funds, operating costs, provision for loan losses, and capital formation needs?
- Has loan delinquency increased or loan demand decreased, therefore reducing the interest collected on loans?
- Is the interest on loans calculated correctly?
- Do the loan interest rates adequately compensate the credit union for the risk present in different loan types and with individual borrowers?
- Are fees for loan origination adequate to cover the associated costs?
- Is excess cash invested in interest bearing accounts?
- Is interest on investments a consideration along with safety and liquidity when making investment decisions?
- Are fees and charges adequate to cover the costs of associated services? Are there fees assessed for abuse of credit union services or to change member behavior such as late loan payment fees or excessive withdrawal fees?
- Are operating expenses reviewed periodically in an attempt to reduce or eliminate unnecessary expenses?
- Are operating expenses within the amount approved in the annual budget?
- Are all operating expenses approved by management?
- Are there large expenditures that can be postponed?
- Have loan collection and provision for loan loss expenses increased due to an increase in loan delinquency?

- Has a new product or service been added that is very costly?
- Are savings interest and share dividend rates above the rates paid by local competitors?
- Do the savings interest and share dividend calculation methods correctly calculate interest and dividends?

Problem Resolution – Like increasing delinquency, falling net income is a serious problem if left unresolved. It can directly affect the credit union's ability to survive in the future. In order to improve net income, management will probably have to take several of the following actions:

1. In order to respond quickly to changes in the marketplace management should have the ability to change loan and savings interest rates and share dividends as needed. At the monthly board meeting the directors can approve any interest rate changes made.
2. Monthly a credit union representative should compare the loan rates offered by the credit union as compared with local competition. If rates are too high, the credit union will only attract those borrowers who can go no where else to get a loan and delinquency will likely increase. If the rates are too low loan income will not be adequate to cover operating expenses, the provision for loan losses, cost of funds, and capital formation needs.
3. In addition to determining that rates are competitive, management should also ensure that the interest rates charged are adequate to cover credit union costs and compensate the credit union for risk present in different loan types and with individual borrowers.
4. An analysis should be performed of the costs associated with granting a loan. Borrowers can be required to pay associated direct costs to improve loan income.
5. To improve loan demand and the resulting loan income, management should ensure that credit union loan products offered meet the needs of the membership. This can be done through a member survey or suggestion box.
6. A cash flow analysis should be performed to:
   - isolate the sources of income funds,
   - determine if excess funds are quickly placed in interest bearing accounts, and
   - explain changes in cash accounts.

   Management should determine that cash is used in the most effective manner and any excess funds are immediately placed in interest bearing accounts.
7. How members use credit union services should be carefully analyzed. Members who abuse credit union service should be assessed fees. For example – There should be fees for late loan payments, excessive withdrawals, or for account balances that fall below an established minimum. In addition, fees should be assessed for member services such as: bill paying, money orders, wire transfers, traveler's checks, or safety deposit boxes.
8. Management and/or the supervisory committee should periodically review operating expenses to determine that all expenses are necessary and if there are ways to decrease or eliminate some expenses. Additionally, management and the supervisory committee should determine that all expenses are properly approved,

are in deed expenses of the credit union, and are within the approved budget amount.

9. Each month a credit union representative should review the savings and share rates offered by local competition. Credit unions should pay average market rates to attract funds. If rates are too high, then money that is "rate sensitive" or looking for yield only will be attracted. When the credit union can no longer pay the higher rate, these funds will likely leave in search of higher rates quite possibly causing a liquidity shortage. If rates are too low, it will be difficult to attract and retain member deposits.
10. To reduce the cost of funds, interest on savings and dividends on shares could be calculated using the low or average account balance for the interest or dividend period. Interest should only be added to accounts at the end of an accounting period or at maturity for fixed term deposits.
11. To lower the cost of funds, management can also establish minimum balance requirements to earn interest for each account type.

Problem – Accounting Records are Out of Balance and/or Seriously in Arrears. On a monthly basis, the general manager should determine that all accounting records are up-to-date and in balance. This is accomplished by reviewing the accuracy of the financial statements and ensuring that each general ledger account balances with its supporting subsidiary ledger. If the records are not verified for accuracy monthly and/or a credit union does not have an adequately trained accountant, or the accountant leaves the employment of the credit union and is not quickly replaced by a qualified individual, or the accountant is on leave and not replaced by a knowledgeable individual, the accounting records can quickly become in arrears and/or out of balance.

Identifying the Cause of the Accounting Deficiencies – Management will want to waste no time in identifying the cause of any accounting problems as the longer one waits the more serious the problem becomes and the harder it is to correct without incurring a loss. Additionally, due to the lack of effective internal controls this is an ideal environment to commit fraud as the accounting entries are not being reviewed and verified. In identifying the causes, management might want to answer the following questions:

- What is the extent of the out-of-balance condition and/or for how long have the accounting records been in arrears?
- Is only one account out of balance or in arrears or are numerous accounts?
- Do the accounts that are out of balance or in arrears have high transaction volumes or will it be fairly easy to bring the records in to balance or up-to-date because the affected accounts have low transaction volumes?
- What is the cause(s) for the out of balance condition and/or the reason(s) for the accounts being in arrears?

Problem Resolution – Once the source of the problem has been correctly identified, management will need to quickly take some or all of the following steps.

1. If the accountant is incapable of balancing the accounts or keeping them up-to-date then this individual should be quickly replaced. They should not be allowed to take

any of their records with them, they will be needed to correct the accounting problems.

2. If the accounting problem is serious, management should consider hiring someone temporarily to bring the accounts in to balance and/or up to date while the accountant ensures that all current transactions are properly accounted for. If the accountant uses their time to resolve past problems, then the current information most likely will not be up-to-date and/or could continue in an out of balance condition, this only makes the problem more serious.
3. The individual that is responsible for bringing the accounts into balance and/or up-to-date should be required to balance all general ledger account balances with subsidiary ledgers, document all of their work in writing, identify any losses due to the lack of adequate accounting, and determine and make (with the assistance of the accountant) the entries needed to correct all of the accounting errors.
4. If the losses can not be resolved, then the losses should be approved by the board of directors and written off to current earnings.
5. To ensure that accounting problems do not occur in the future, management should determine that there are adequate written procedures in place that state at a minimum:
    - All general ledger account balances involving cash and member transactions should be supported by a subsidiary ledger from a source independent of the general ledger such as a bank statement, investment statement, or member savings and loan ledger cards. General ledger accounts that are based on accounting transactions such as fixed and prepaid assets and accrued expenses should be supported by a subsidiary ledger that is based on the cost of the item evidenced by an invoice and depreciated or amortized over the life of the item.
    - Individuals, other than those responsible for making accounting entries, should ensure that the general ledger account totals balance with the subsidiary ledgers monthly.
        - If reconciliations have to be performed then the reconciling items should be reviewed no less than monthly to determine that reconciling items are being researched and cleared in a timely fashion.
    - Accounts should be closed and financial statements finalized no later than the 15th of the following month.

Problem – Credit Union Dependency on External Credit is more common in the developing world due to access to subsidized credit. Credit unions become dependent on this source of credit in bulk however, this dependency seriously changes the characteristics of a credit union from a combination of savers and borrowers to a borrower dominated institution accustomed to low interest loans. With external credit borrowers often have little incentive to repay the loan and credit unions have limited incentive to collect delinquent loans because both parties often believe the funds come from wealthy individuals who live far away. When a credit union loses the subsidized credit source, illiquidity can become a serious problem, as does reeducating membership to repay loans because the loan funds now come from local member deposits instead of foreign credit sources.

Problem Resolution – Resolving this problem is a lengthy process for credit union management that normally involves numerous steps and a complete change in thinking, attitude, and operations. External credit is problematic because the interest rate on the credit is controlled by an outside source, the funds are frequently not available when anticipated or needed, and future funding is at the whim of individuals not involved with the credit union or community. In order to reduce this dependency, credit union management must change their focus from locating and accessing external credit to mobilizing member savings.

1. When accepting member deposits, the credit union has a fiduciary responsibility to protect those deposits from loss. Therefore, prior to promoting savings mobilization any responsible official or manager must first ensure that the credit union is safe and sound. Institutional capital should be adequate to absorb losses and protect member savings. Adequate credit, collections, investment, savings, and internal control policies and procedures should be in place and officials, daily management, and staff members properly trained.
2. Management should survey the membership to determine the savings potential of the community, individual members, and what types of savings products are needed and desired. Based on the survey information a marketing campaign should be initiated that focuses on changing the image of the credit union to one of a safe and sound institution with local savings mobilization as a primary objective.
    - The marketing campaign should focus on aggressive recruitment of members with strong savings potential.
3. Members must be assured that their savings are secure, that access to their funds is convenient, and that they can withdraw their funds when they want.
    - To enhance security, the credit union may want to hire a security guard, install an electronic security system, a vault, locking teller drawers, and bars, or other devices to deter entry through doors and windows. The member's privacy should also be considered. Each member should be able to complete transactions with adequate privacy and all credit union business should be held in strict confidence.
    - Convenient service usually entails having office hours before and after work hours and on the weekend. To extend hours, credit unions also use drop boxes, night depositories, mobile collectors or cashiers, or ATMs.
    - Based on the member survey, management should develop savings products attractive to membership. Generally, the most popular savings product is the regular savings or passbook account that allows members to withdraw their funds as needed. If members are going to make a large withdrawal, they can be required to give prior notice so that liquidity is not adversely effected.
4. Many credit unions have required members to make deposits into non or low- interest bearing ownership share accounts to access credit, this should no longer be required. Members should be encouraged to open savings and deposit accounts at the credit union. Ownership share accounts should pay a fair rate of return, if all capital requirements have been met.
5. In order to attract deposits the interest rates paid on deposits and the terms must be competitive with local competition. To initially attract savings deposits the credit union may offer, for a limited time period, higher interest on certain savings types

or for account balances over a certain amount, or institute a raffle for useful household items. As stated previously, except for promotional periods or if the credit union has a specific use for higher cost funds, the interest paid on deposits should be equal to the average rate paid by the competition so the credit union does not attract "rate sensitive" money that is deposited for the sole reason of earning high interest.

6. The management of liquidity should take on added importance. When external credit is the source for loan funds and there are no loanable funds available, a waiting list is formed and the borrowers wait if no other alternatives exist for obtaining a loan. When member savings are mobilized, credit union management must ensure that there are sufficient funds available to meet, first and foremost, the member savings withdrawals and secondly, loan demand. If a member is told that their funds are withdrawable only to arrive at the credit union and be unable to access funds because of a liquidity shortage, the credit union will quickly lose the confidence of these members and others who learn of the illiquid situation. This could easily cause a run on deposits when members are finally given access, causing a more serious liquidity shortage.

Problem – Share Multiple Lending is Used instead of making lending decisions based on the member's credit history, their ability to repay the loan, the risk associated with the loan purpose, and the value, condition, and resalability of the collateral offered to secure the loan. Share multiple lending effectively restricts the size of the loans available. Only member's who can place a large amount in shares can access larger loans, however, members with a large savings potential frequently do not need loans. Therefore, regardless of a member's income and repayment capacity, the member is not able to acquire a large loan. This practice results in credit unions often being unable to meet member needs for loans to finance housing and commerce. In order to change from the archaic share multiple lending method to a more dynamic lending method management should consider the following:

1. Credit policies and procedures should be revised. Credit should only be granted to those borrowers who have demonstrated their ability to repay. Loan policies should provide guidelines for: loan authorities, loan ceilings, concentration limits, credit information requirements, credit granting, security and collateral, establishing and maintaining interest rates, and the review of files to ascertain compliance with policy and procedures. The credit policy and procedures should be part of the training program for lending staff members.
2. Loan applications should be revised so that they collect the information necessary to determine the members ability to repay such as: number of dependents, sources of all income, employment and salary history, outstanding debts and monthly payments, and credit references.
3. If a volunteer credit committee is currently being used, their duties should be delegated, if allowed by law, to a more professional group such as a technical loan committee that is staffed with competent, paid individuals who have proven experience granting loans based on a borrower's ability to repay. This method requires much more analysis and knowledge than does lending based on a multiple of the share balance.

4. A credit granting system should be established that has several different tiers of loan approval. Large, longer-term, and risky loans should be approved by all of the technical loan committee. The general manager, credit manager, and credit officers may have different levels of authority for loan approval based on their experience. All credit decisions should be subject to random review by the supervisory or credit committees and the board of directors.
5. The credit union should be adequately compensated for the risk involved in making loans. To this end, loan interest rates and terms should vary according to the risk posed by the loan type, loan purpose, and the individual borrower.
6. The credit union should develop loan products based on member needs and desires. Small, low risk loans should be offered first such as unsecured, co-signer, and share secured loans. As the technical credit committee and individuals granting loans gains experience more difficult, risky loans can be granted such as vehicle, real estate, agricultural, and business loans.
7. Borrowers should be expected to build-up a credit history with the credit union. To establish a credit history borrowers should start with simple, small loans. Members will gain access to larger loans based on their repayment history of the smaller loans and their ability to repay larger amounts. As loan size and risk posed by the loans grows, members should be required to provide collateral to secure the loan and be subject to a more in-depth analysis of their repayment capacity.

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