Examination Process – Institutional Capital and Profitability

November 6, 2002

Institutional capital is defined as the total of the credit union's regulatory reserve accounts, undivided or retained earnings, special reserves (designated for a specific purpose), and net income that has yet to be closed to the retained earnings account. The stronger the overall capital position, the easier it is for the credit union to deal with future uncertainties such as asset losses and adverse economic cycles.
Capital accounts exist to:
- Provide a base for future growth;
- Enable the credit union to meet competitive pressures as they arise;
- Provide protection against operating losses; and
- Ensure the credit union remains an on-going concern.

Objective of Capital Review – The examiner reviews the area of capital to determine that:
- The board has established a capital accumulation strategy that states the capital goal ratios, financial plan, and time frames for achieving the goals;
- There is sufficient capital as compared to operational risk;
- The credit union has adequate capital policies, practices, and procedures in place;
- Officials and employees follow the requirements of the law, rules and regulations, bylaws, and established guidelines;
- Activity in the capital accounts is periodically reviewed; and
- Management promptly corrects deficiencies or violations.

Scope of Capital Review – The examiner should review the capital position and the official's philosophy toward building and maintaining capital when determining the scope. If the capital position falls short of established goals and needs, the examiner should expand the review to determine if the shortfall poses a threat to the financial condition and discuss corrective action with management.

When determining the adequacy of capital and the scope of the review, the examiner should consider the following factors:
- Size of the credit union;
- Complexity of products and services offered;
- Level of management expertise;
- Involvement of officials;
- Operational risks present (interest rate risk, long-term assets, high-risk investments, etc.)
- Lack of adequate internal controls;
- Presence of sufficient insurance;
- Current and anticipated earnings capacity of the credit union;
- Quality of the loan and investment portfolios;

- Contingent liabilities;
- Compliance with regulatory reserve requirements, if applicable;
- Stability and diversity of the field of membership; and
- Concentration of loans and savings to only a few members.

If the examiner determines that the level of capital is not sufficient to ensure the credit union's long-term future, then the examiner should develop goal ratios and time frames with management and present these in the Document of Resolution.

Institutional Capital Review – In the review of the capital accounts the examiner should consider the adequacy of capital, apparent trends, and any unusual account activity. Examiners should document their review on self-designed workpapers. The workpaper should include the beginning balance (date of last exam), all entries made to the account along with adequate descriptions, the ending balance (as of the exam date), and any examiner comments.

Examiners should use the following procedures to review the capital accounts:
- Obtain the activity in all the capital accounts for the exam period;
- Ensure that the ending subsidiary ledger balances of the capital accounts are equal to the respective general ledger accounts and the account balances on the financial statements as of the examination date;
- Determine that all of the entries made to the capital accounts were approved by the board for the same amount prior to the date of the entry and documented in the board minutes; and
- Verify that all entries to the capital accounts were made in accordance with the law, rules and regulations, bylaws, and applicable guidelines.

In addition to the above, examiners should calculate the following ratios (see the discussion of the PEARLS ratios for additional information) to determine the adequacy of the credit union's capital, how it compares to similar sized credit unions, and any negative trends:
- Capital (regulatory reserves, special reserves, undivided earnings, and net income) Growth versus Asset Growth
  - Are the trends of both ratios in the same direction or opposite and is the growth of each ratio similar?
- Capital to Assets;
  - Is this ratio at least 10%?
- Total Delinquent Loans and Other Classified Assets / Total Capital;
  - Is this amount of delinquent and classified assets less than total capital?
- Solvency Evaluation; and
- Balance of the Allowance for Loan Loss account / Collection Problem Loans;
  - Is the amount of collection problem loans less than the balance of the Allowance for Loan Loss account?

Signs of Warning – These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of capital, the examiner should look for the following signs of warning:

- Entries made to the capital accounts without board approval;
- Entries made to the capital accounts for amounts different than the amounts approved in the board minutes;
- Entries made to the capital accounts by unauthorized individuals;
- Negative trends or decreasing ratios;
- Asset growth that is greater than capital growth;
- An allowance for loan loss account that is not adequate for collection problem loans;
- Consecutive operating losses;
- Adverse economic conditions that effect the member's ability to repay their loans;
- High risk investments; and
- A few members with concentrations of credit and savings.

Objective of Profitability Review – The objective of the profitability review is to determine:

- Income and expense trends;
- Adequacy of policies and procedures regarding income and expenses;
- Actual operating results as compared to the budgeted amounts and institutional capital goals;
- Sufficiency of the credit union's earnings to increase institutional capital to established goals;
- Compliance with applicable laws, rules and regulations, bylaws, and guidelines; and
- Prompt correction by management of errors or problems.

Scope of Profitability Review – The scope of the review should include a review of the Income Statement, income and expense accounts with negative trends or unusual activity, and ratios that assess profitability. If problems are detected, then the scope should be expanded so that the examiner can determine the source of the problem and develop corrective action plans.

Profitability Review – The review of profitability should include a review of the credit union's general financial condition. A credit union with weak capital requires strong, stable profitability to improve the capital position. In contrast, a credit union with a solid capital position may only require enough profitability to maintain the capital position. Other factors to consider when analyzing profitability include: asset growth as compared to capital growth, loan loss history, expense trends, growth projections and goals, and economic factors.

Examiners should document their review of profitability on self-designed workpapers. The workpaper should document the purpose of the review, the individual performing the review, the account, ratio or issue reviewed, the credit union staff member that took part in the review, and any comments or findings.

Examiners should perform the following when analyzing profitability:

- Compare the previous year's income statement to the income statement as of the exam date to determine changes in income and expense accounts and negative and positive trends;
- Review a sample of income and expense accounts with numerous transactions, large dollar transactions, suspicious activity, and/or erratic trends;
    - Determine that adequate documentation exists for expenses, the expense was approved by an authorized employee, is reasonable, and is associated with credit union business;
    - Determine that income is not overaccrued to fictitiously improve profitability; and
    - Determine that above average fee income is not due to inefficient credit union operations;
- Calculate the fundamental profitability ratios (see PEARLS ratio discussion for additional ratio information) and compare the results to credit union's of a similar size for the following: Yield on Assets, Cost of Funds to Average Assets, Operating Expenses to Average Assets, Net Income to Average Assets; and
- Discuss with management strategies to increase income or decrease expenses and note these in the Document of Resolution.

Signs of Warning – These signs or indicators are ratios, numbers, trends, or suspicious activity that may indicate existing or potential problems. During the review of the profitability, the examiner should look for the following signs of warning:

- Increasing expenses, and decreasing gross and net income;
- Erratic income and expense amounts as compared to other time periods;
- Large variances between budgeted numbers and the actual results;
- Lack of adequate expense documentation;
- Personal expenses included in credit union expenses;
- Above average fee income due to inefficient credit union operations;
- Expenses paid without proper approval;
- Profitability is inadequate to maintain or increase institutional capital; and
- Profitability is inadequate to pay local market interest rates on savings and deposits.

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