NASCUS DIRECTOR'S COLLEGE

The "M" Stands Alone
and DFI Financial Trends

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IRC 501(c)(14) organization

- Credit unions are democratically controlled, mutual entities created for the purpose of encouraging thrift (**wise management of resources, especially money**) and providing a source of credit for its members.

- A credit union must be formed and operated under a state credit union law, without capital stock and, thus, have state defined characteristics, **operate without profit and for the mutual benefit of its members**.

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The CAMEL Rating System

- The CAMEL rating system is based upon an evaluation of five critical elements of a credit union's operations:
  - Capital Adequacy
  - Asset Quality
  - Management
  - Earnings
  - Liquidity/Asset-Liability Management
- CAMEL is designed to take into account and reflect all significant financial, operational, and management factors examiners assess in their evaluation of a credit union's performance and risk profile.

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The "M" in CAMEL– MANAGEMENT

- The capabilities of the board of directors and management, in their respective roles, to **identify, measure, monitor, and control the risks** of a credit union's activities and to ensure a credit union's **safe, sound, and efficient operation in compliance** with applicable laws and regulations is reflected in this rating.

National Credit Union Administration CAMEL Rating System

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The Traditional Emphasis

- A credit union's performance with respect to
  - asset quality
  - capital adequacy
  - earnings performance
  - liquidity and
  - funds management
- was often the result of decisions made by the credit union's directors and officers.
- <u>Consequently, findings and conclusions in regard to the other four elements of the CAMEL rating system were often major determinants of the management rating</u>.

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A Better Approach

1. Does the credit union have effective board oversight and corporate governance practices, policies and procedures?

2. Does the credit union have an effective framework for enterprise risk management consistent with its size, complexity, structure and risk profile?

3. How well do the board, management and control functions execute against this framework?

1. Evaluate Board Oversight and Corporate Governance

- Board oversight and corporate governance involves the manner in which the business and affairs of a credit union are governed by its board and management:
  - Setting strategy and objectives
  - Determining risk tolerances
  - Protecting the interests of its members
  - Operating the credit union in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.

Common Board Weaknesses

- Board lacks experienced, capable financial professionals with knowledge of regulations and guidance.
- Board is dysfunctional (e.g., factional, distrustful, dominated by an individual or small group, unengaged, unprepared, etc.)
- Board is too trusting of the CEO & management. Dominant CEO controls the credit union.
- Lack of formalized processes for management evaluations – both management structures and executive competencies. Board relies excessively on regulatory assessments of management.
- Lack of independence of the risk management functions. Weak or inactive risk committee structures at board and management levels.

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Key Elements of Effective Board Oversight & Governance

- Board members and management have the expertise and integrity to fulfill their roles.
- Information presented to the board is complete, accurate and presented in an understandable manner.
- Board has established processes to properly and timely oversee and evaluate management and control functions and assess its own effectiveness.
- Internal audit function conducts independent, risk-based and effective audits and has access to the board.
- Board has knowledge of and controls over all actual and potential conflicts of interest at board and management levels.

2. Evaluate Enterprise Risk Management Framework

- How effectively does the credit union:
  - Identify key risks
  - Measure exposures to these risks
  - Monitor risk exposures on an ongoing basis and determine corresponding capital and liquidity needs
  - Control or mitigate risk exposures through effective processes that work as intended; and
  - Report to senior management and the board on these items

Common Weaknesses in the Risk Framework

- Emphasis is on ROA without adequate consideration of risk factors. Board does not articulate risk appetite or set risk limits in a meaningful/measurable way.
- Compensation plans that incent growth or short-run returns.
- Risk management function lacks leadership or support from the Board/CEO and/or lacks independence from revenue generating officers.
- Inadequate resources. Poor MIS. Inadequate analytical capabilities for stress testing/scenario analysis.
- Failure to recognize and control interrelated risks.
- Audit functions not independent of management.

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Key Elements of Effective Enterprise Risk Management

- Independent risk management function with adequate stature, authority, board access and resources.
- MIS and analytical capabilities to perform stress tests/scenario analyses for all key exposures.
- Risk mitigation strategies and contingency plans that are informed by such analyses.
- Capability to understand and effectively adapt to changes in the economic, financial and competitive environment.
- Compensation systems that are effectively aligned with prudent risk taking.

3. Assess Board, Management and Control Functions Execution Against Risk Framework

- Are all risk factors appropriately identified, assessed and controlled?
- Are credit concentrations properly identified and mitigated?
- Are underwriting principles sound and sensitive to market conditions?
- Is there a realistic liquidity plan for dealing with a range of potential disruptions to normal liquidity sources?
- Has the board provided proper oversight of management?
- Are internal audit, compliance and control functions effective?

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Common Weaknesses in Risk Management Execution

- Failure to stay within prescribed policy limits. Exceptions to risk limits granted to meet competition.
- Inadequate communication flows.
- Ineffective oversight and controls.
- Inadequate credit underwriting standards/credit administration function.
- Excessive reliance on third parties' risk assessments (e.g., credit rating agencies, lead lender for loan participations).
- Failure to implement audit recommendations.
- Lack of accountability.

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What to Expect from Examiners

- Concentration Risks are still a concern
  - Real estate concentrations in both the loan portfolio and investment portfolio
  - Member business loan participations
    - Purchasers are not fully aware of the risks in their portfolio
    - Over reliance on third party providers
    - Lack of continued due diligence

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What to Expect from Examiners

- Concentration Risks are still a concern
  - Concentration risk affects credit, strategic, reputation, interest rate, and liquidity risks
  - Examiners will ensure credit unions consider the following when evaluating how the Board addresses concentrations risk
    - The level and nature of inherent risk on the balance sheet
    - Management expertise
    - Risk management practices
    - Market conditions
    - Adequacy of reserves

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What to Expect from Examiners

- Continued review of loan modification programs
  - Modifications should have interest rate reset provisions
  - Refinances must take IRR into consideration
  - Refinances under the Home Affordable Refinance Program need clear policies and limitations
  - NCUA Letter 09-CU-19, 19 policy items to address

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What to Expect from Examiners

- Specific loan reviews
  - New loan programs
    - Student loans
      - Buyer or originator
      - Do you have a relationship with the student or parents?
      - AP article in September 2011 notes student loan defaults up sharply, at almost 9 percent
      - Higher tuition is forcing students out of school, not graduating
      - Graduating students having difficulty obtaining jobs

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What to Expect from Examiners

- Specific loan reviews of expanding programs
  - Loan Participations
    - Remember, these are loans, not investments
    - Fully understand the terms of the participation agreement
    - Dedicated and knowledgeable staff to monitor these credits regularly
    - Out of state credits, you must understand foreclosure rules
    - Value the asset regularly
    - Due diligence, credit worthiness, cash flow, and collateral review initially and throughout term of loan

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What to Expect from Examiners

- Specific loan reviews of expanding programs
  - Member business loans – proposal to lift cap to 27.5% of assets, increase in portfolio limited to 30% a year
  - Examiners will evaluate the credit union's program in detail and expect to see limits in relationship to net worth
  - Monitor increased long term asset ratio and effects on interest rate risk
  - Expertise to evaluate the credit throughout the loan term

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What to Expect from Examiners

- Continued Concerns
  - Challenging revenue environment
  - CFPB Regulations
  - Interest rate risk
  - Reputation risk
  - What do we not know yet?

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STATE FINANCIAL TRENDS

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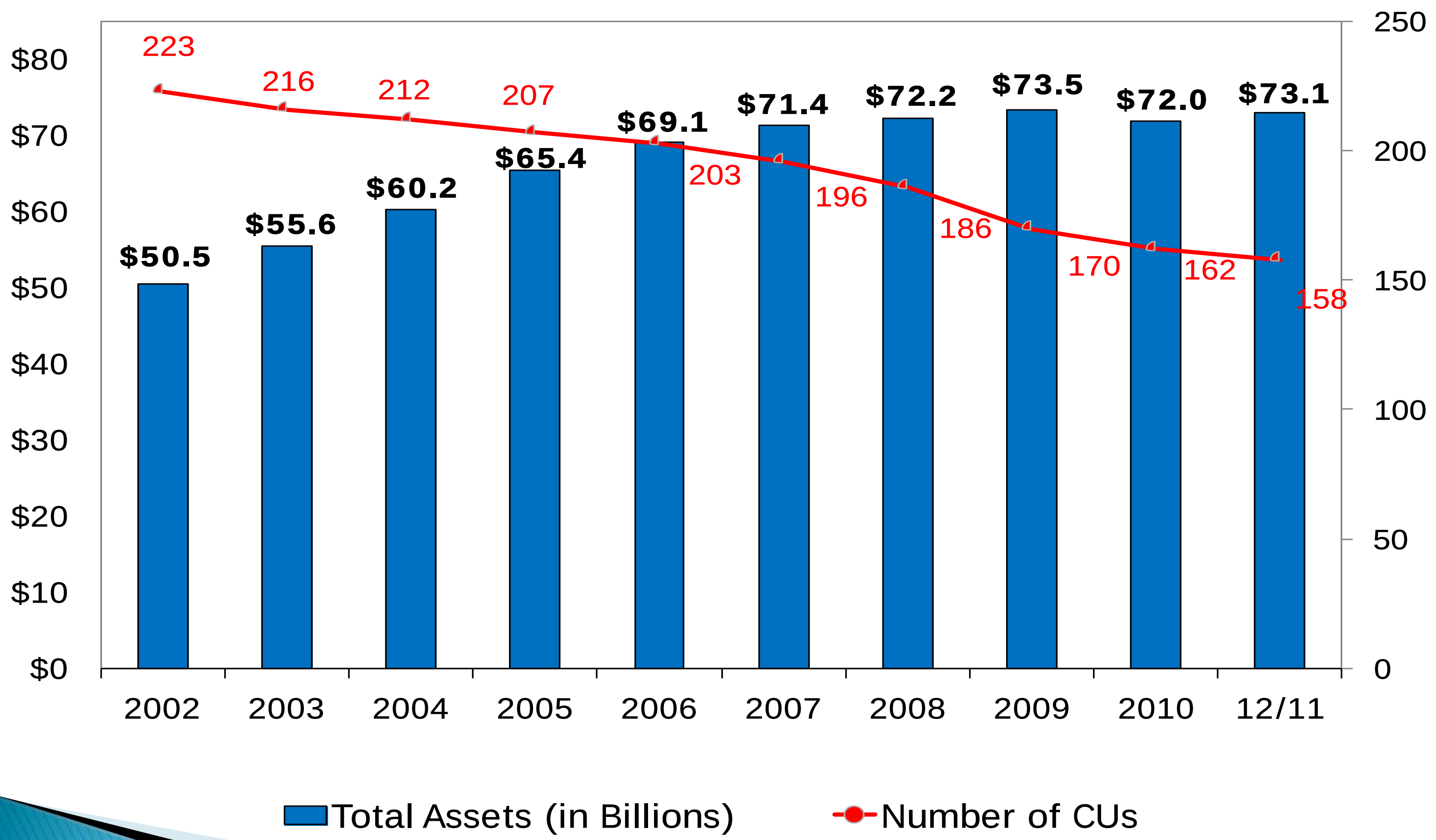
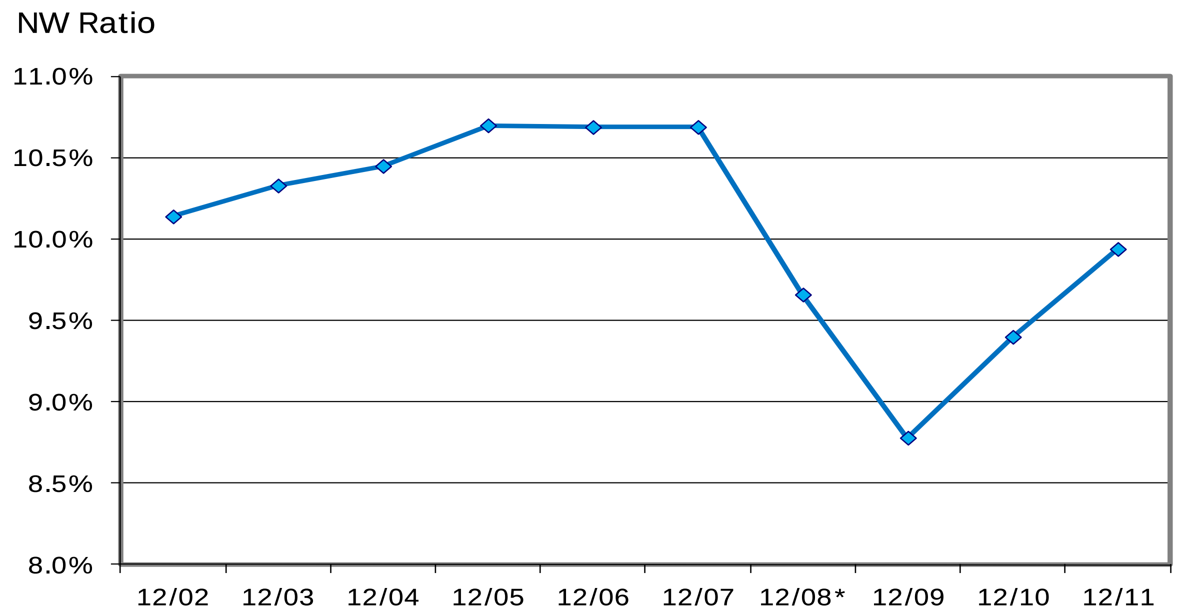
Small increase in total assets in 2011, despite continued decline in the number of credit unions



Capital Adequacy

Continued slow net worth recovery due to heavy impacts of loan losses and National Credit Union Share Insurance Fund (NCUSIF) and Corporate assessments



*Include call report adjustments after 2009 NCUSIF and Corporate stabilization expenses were announced.

NCUSIF and Corporate assessments were 0.15% of insured shares in 2009 and 0.26% for 2010.

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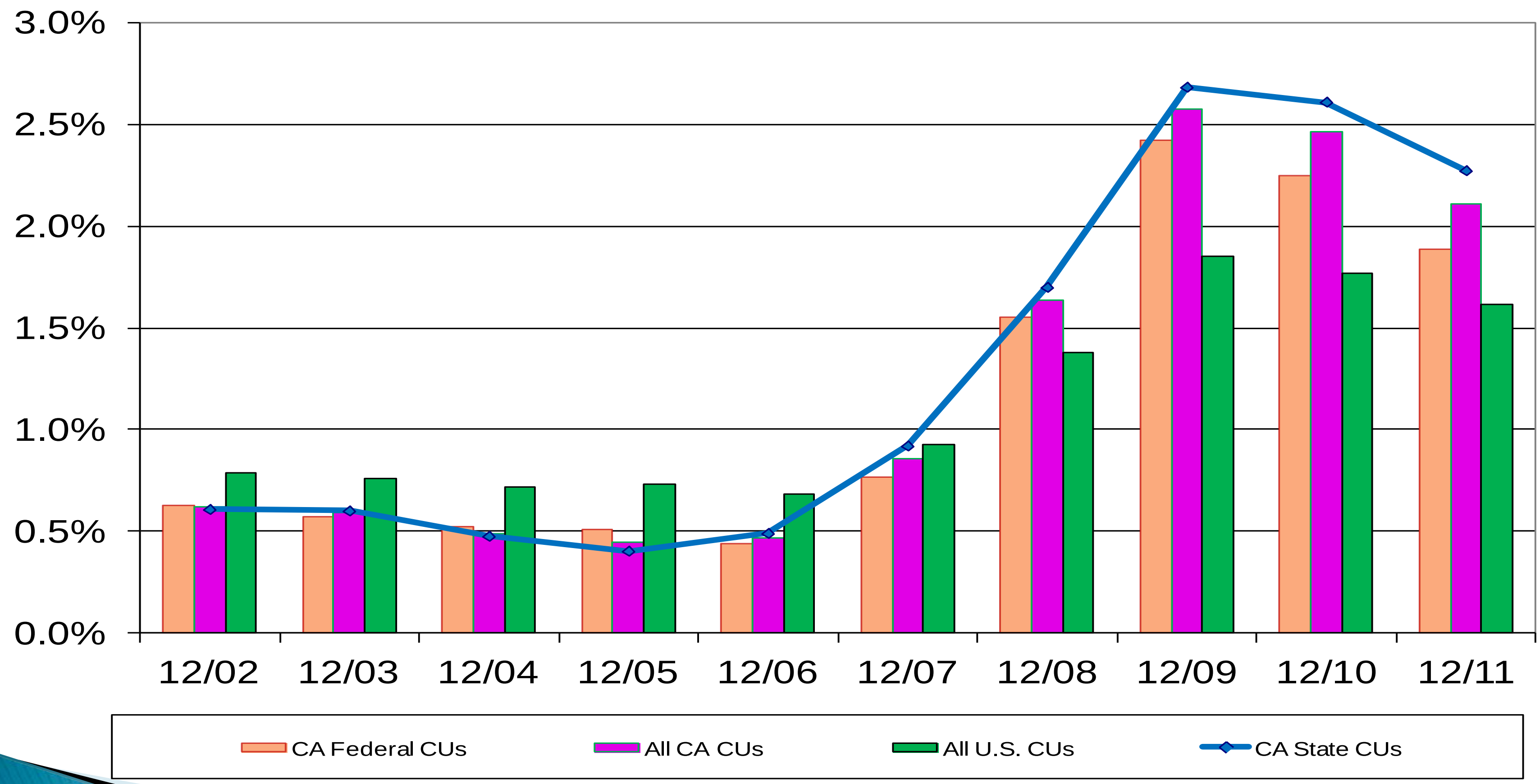
Delinquent Loans to Total Loans

Delinquency peaked in 2009, but the pace of credit deterioration is declining.



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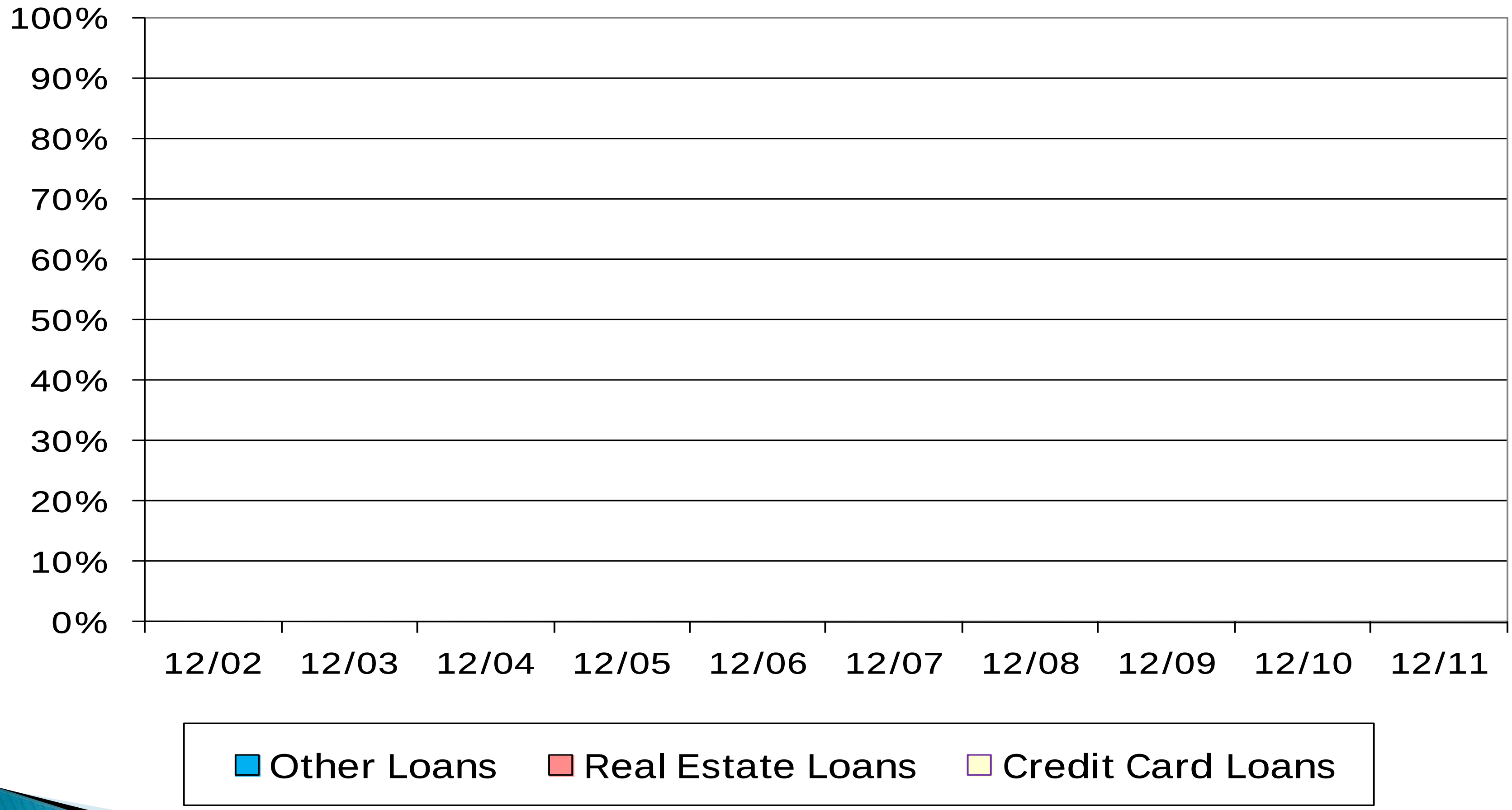
Delinquencies by Type

Real estate continues to represent the largest bucket of reportable delinquencies.



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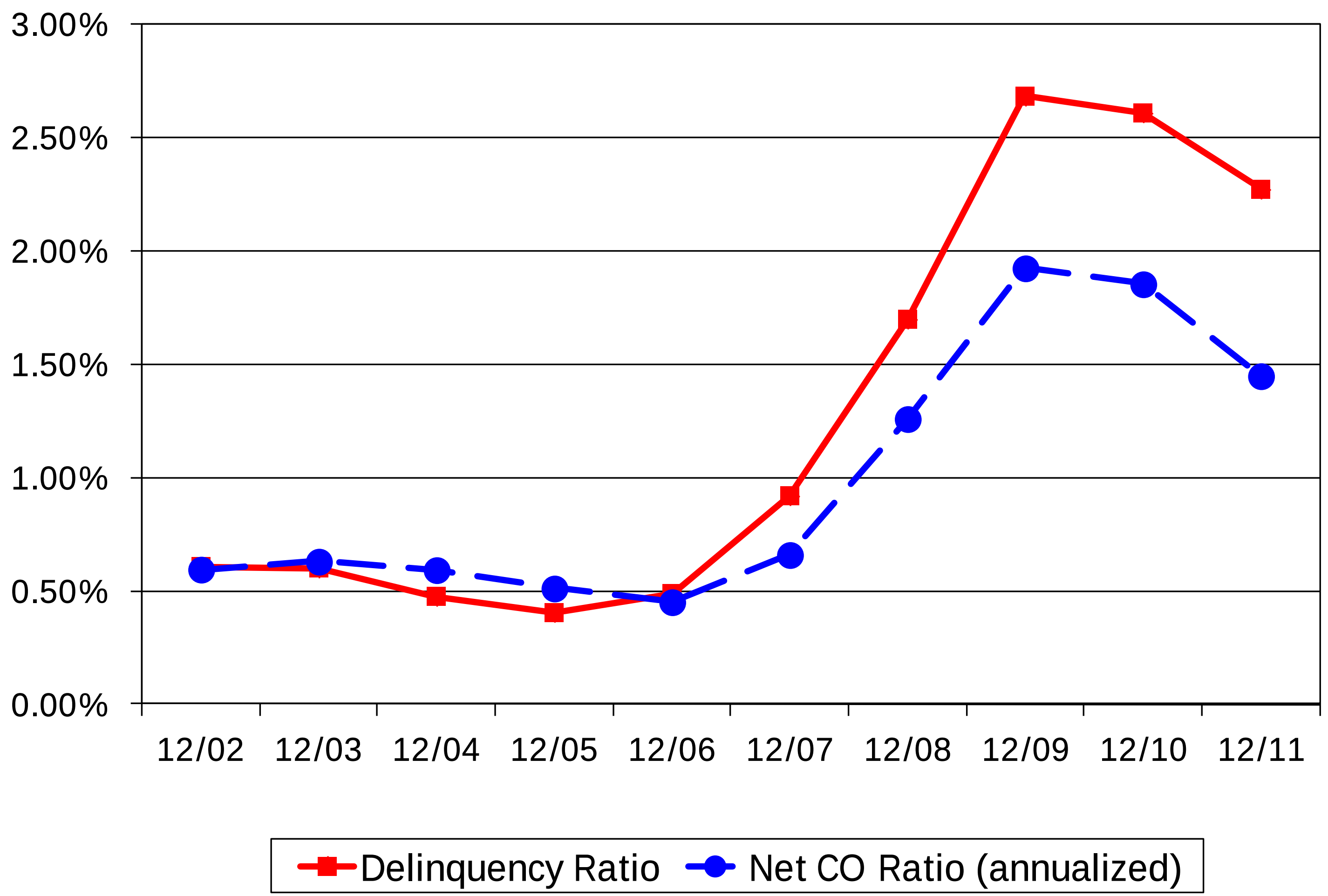
Asset Quality Trends



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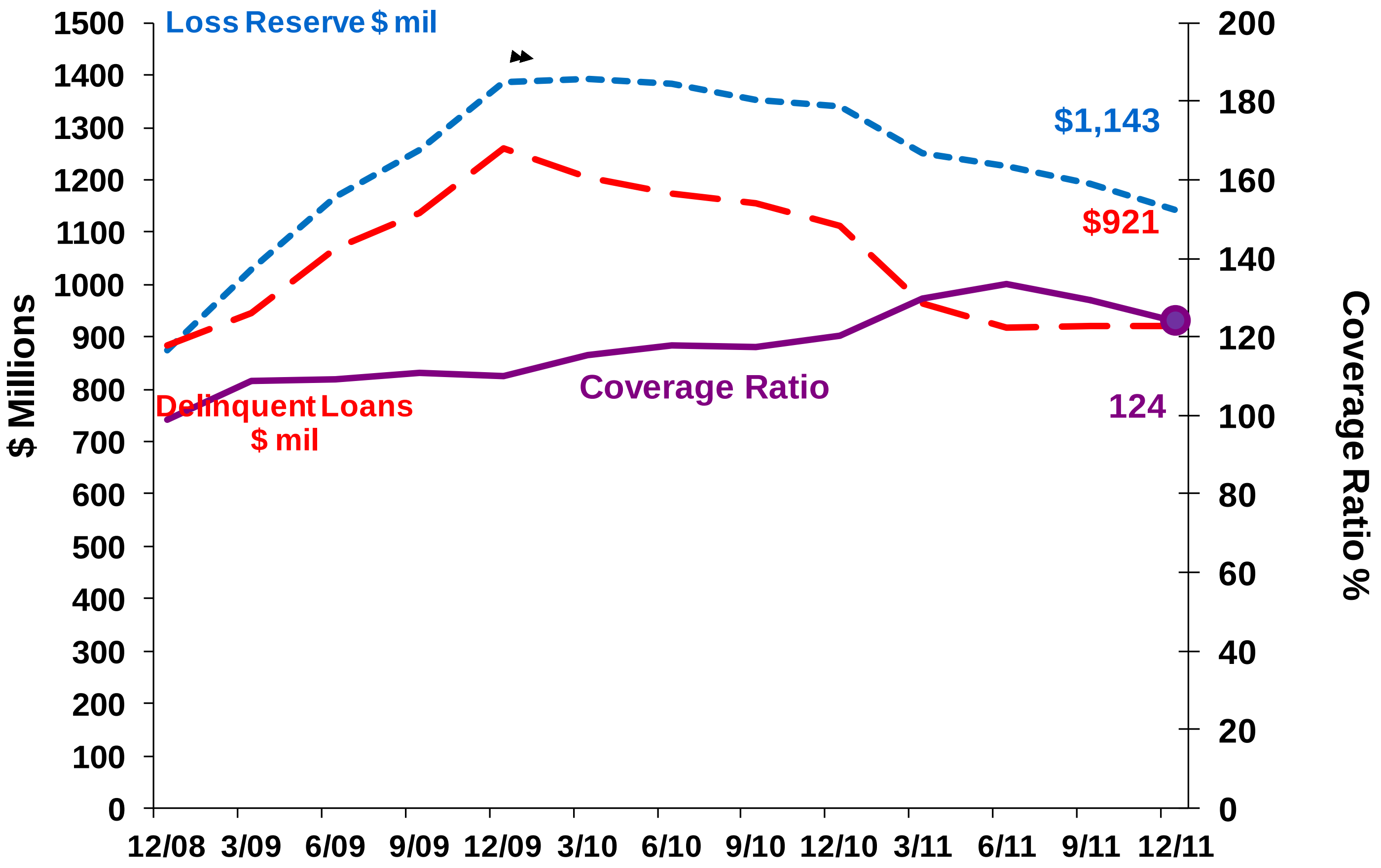
Loan Loss Reserves to Delinquent Loans



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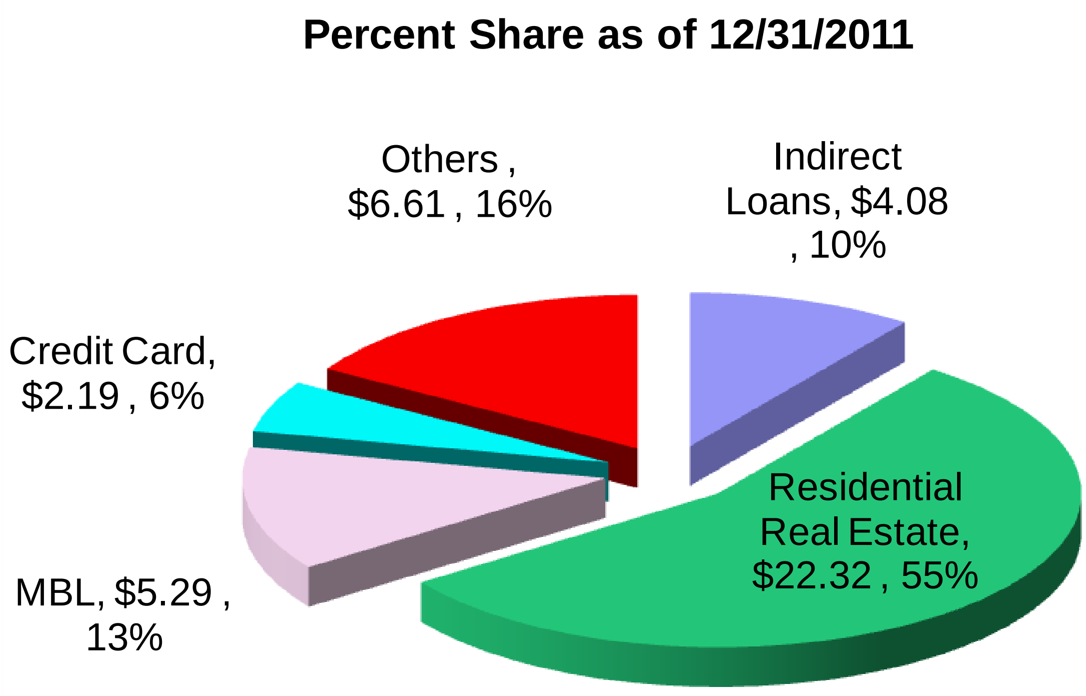
Loan Portfolios (in billions)

Loans dropped 5% in 2011, extending a downward trend that began in 4Q 09 but the pace is slowing.



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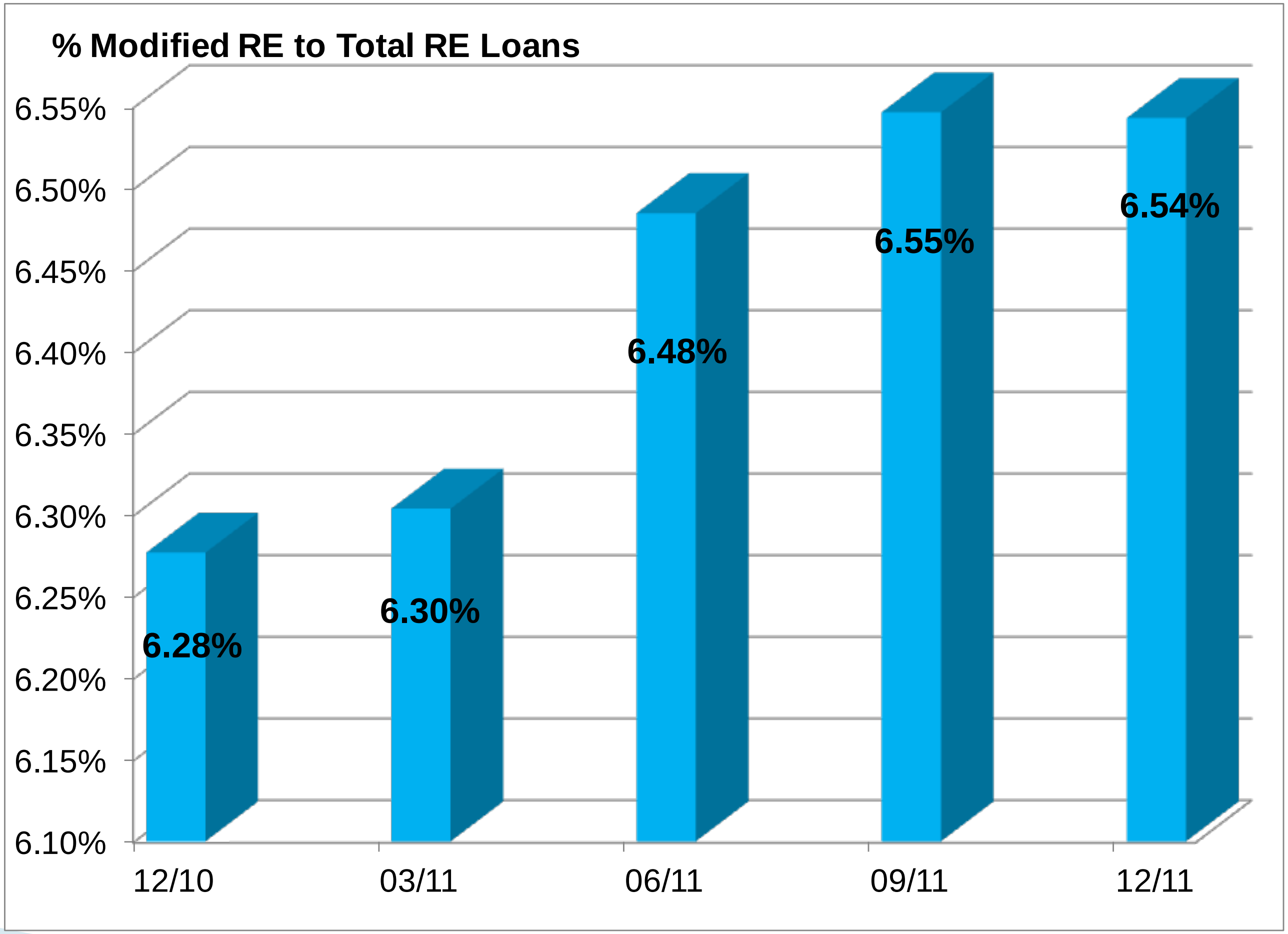
Modified Real Estate Loans

Real estate loan modifications totaled $1.79B, up slightly from YE 2010 and up 43% from YE 2009.



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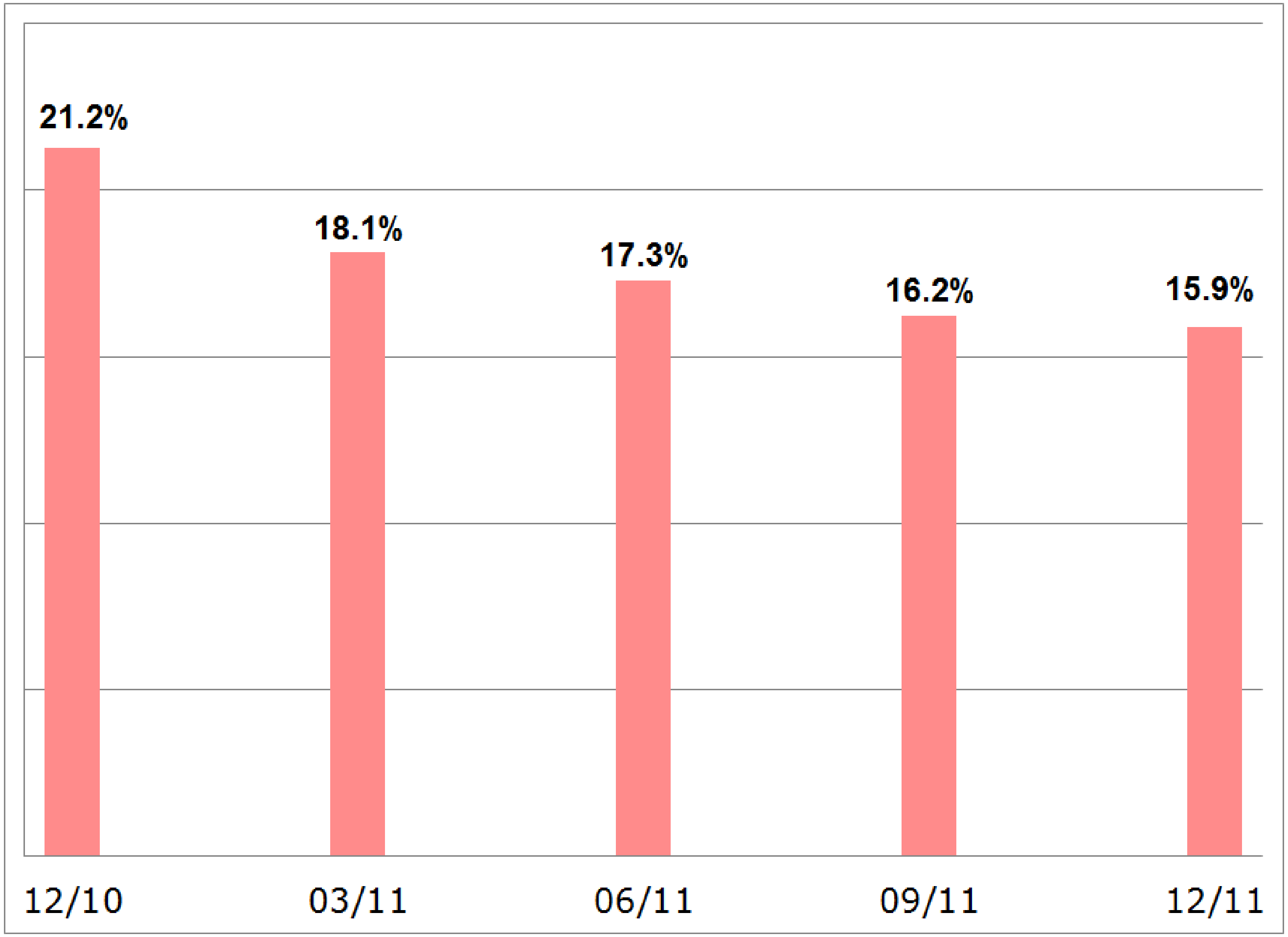
Modified real estate delinquencies, as a percentage of total modified real estate loans, are decreasing gradually



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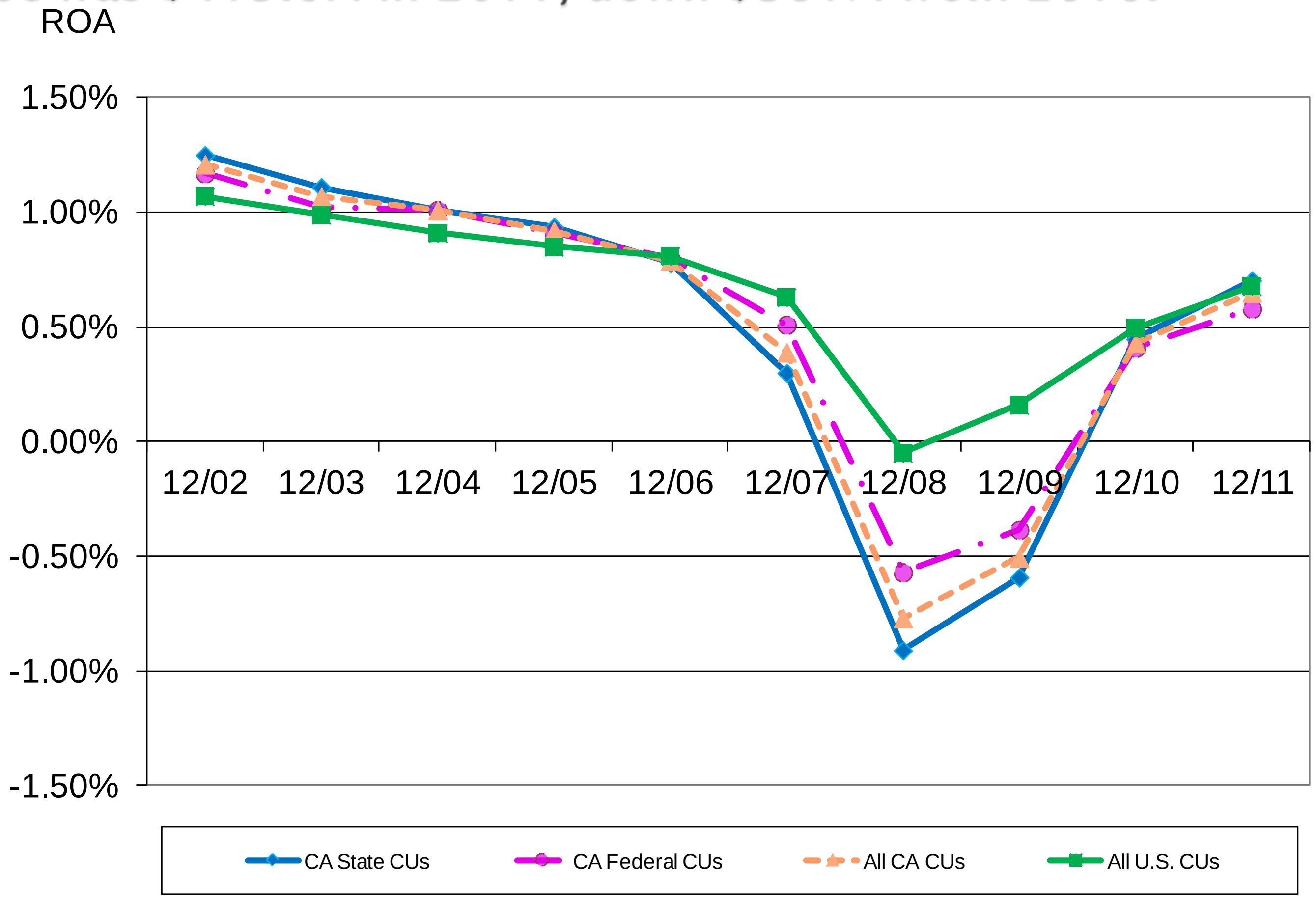
Earnings Performance

Credit unions earned $510.4M for the full year 2011, up $185M from 2010 primarily driven by lower PLL funding and cost of funds. Provision expense was $419.6M in 2011, down $361M from 2010.



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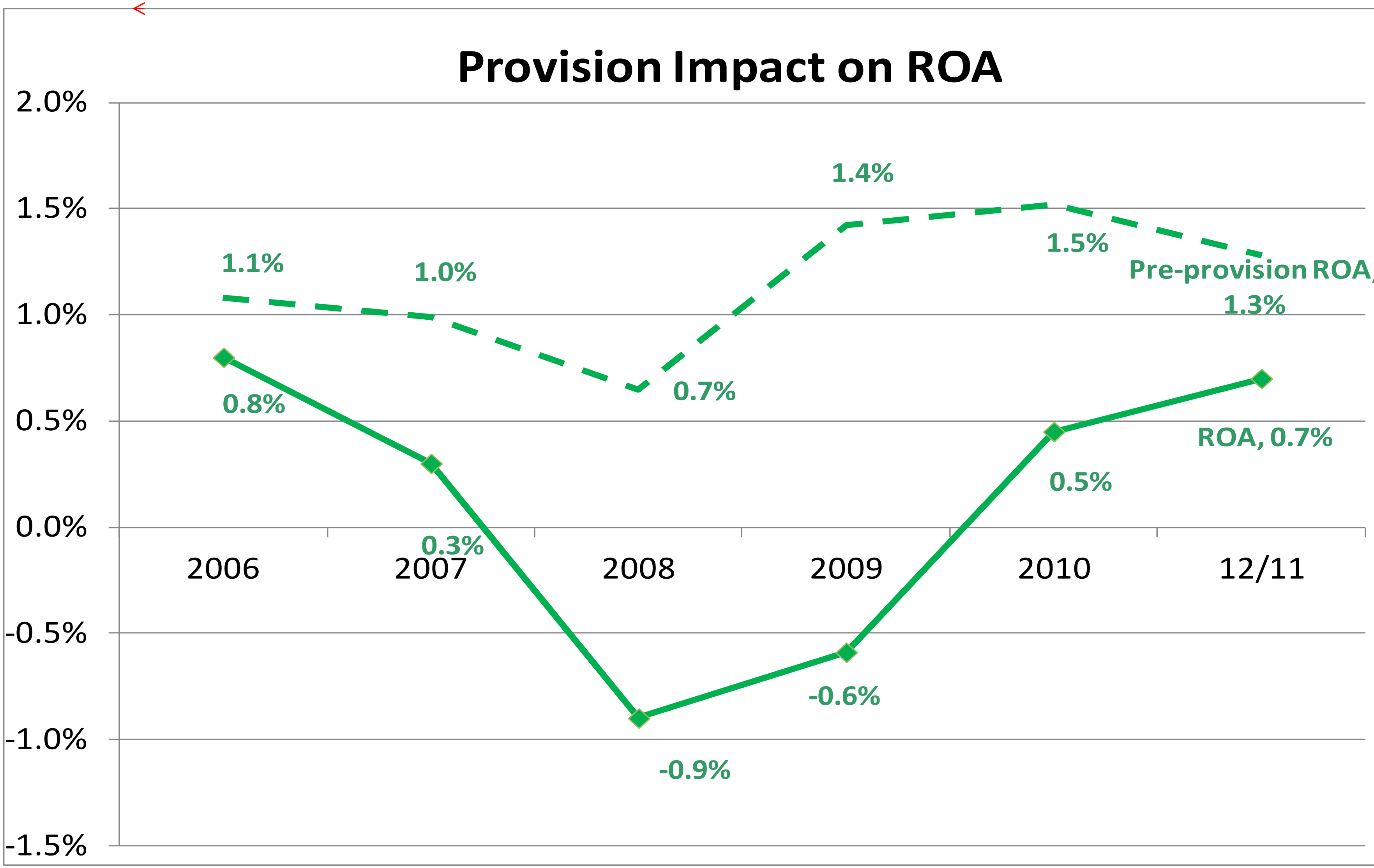
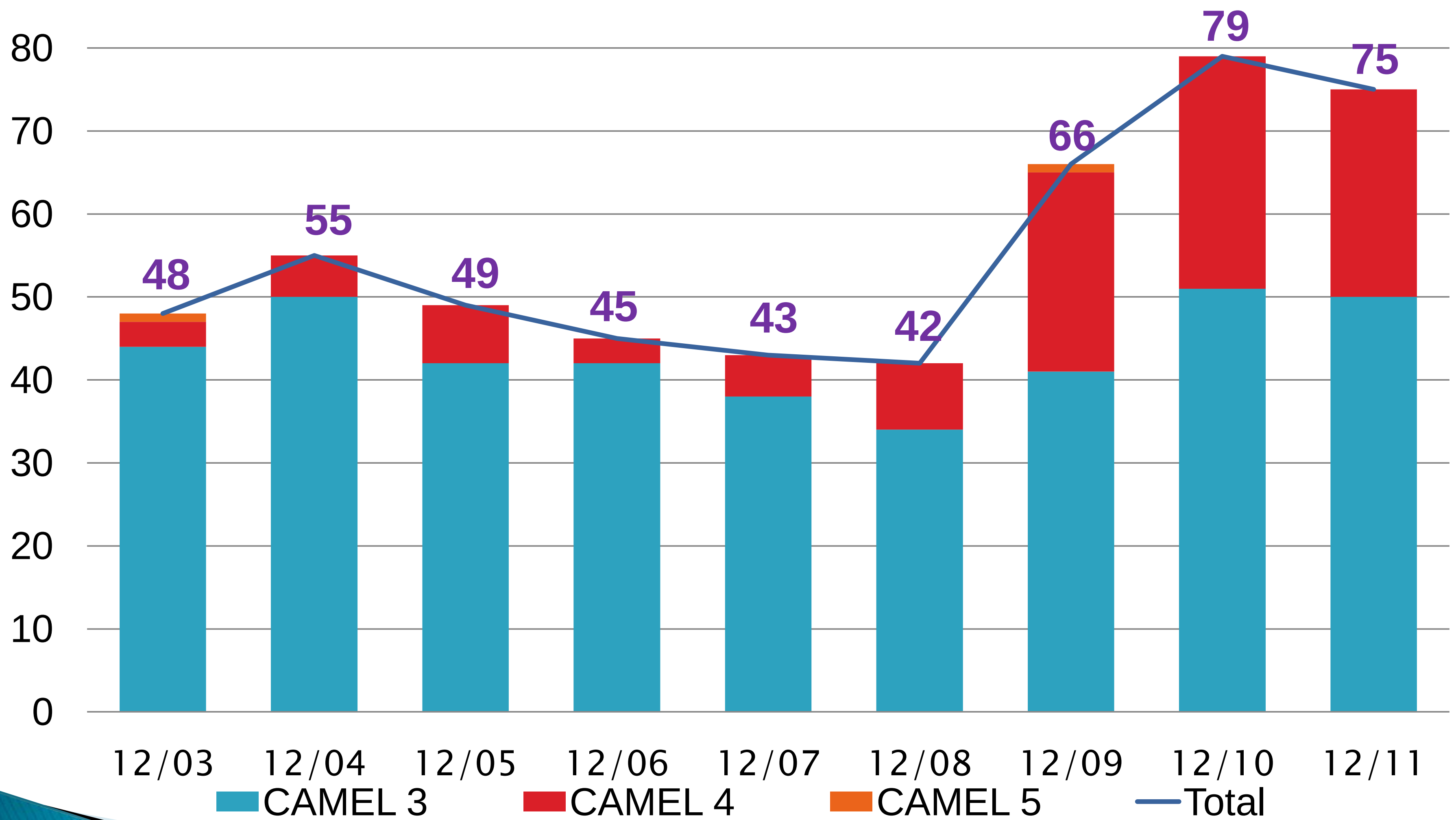


Provision Impact on ROA
2.0%
1.5%
1.0%
0.5%
0.0%
-0.5%
-1.0%
-1.5%
2006
2007
2008
2009
2010
12/11
1.1%
1.0%
0.7%
1.4%
1.5%
Pre-provision ROA, 1.3%
0.8%
0.3%
-0.9%
-0.6%
0.5%
ROA, 0.7%

Number of Problem Credit Unions



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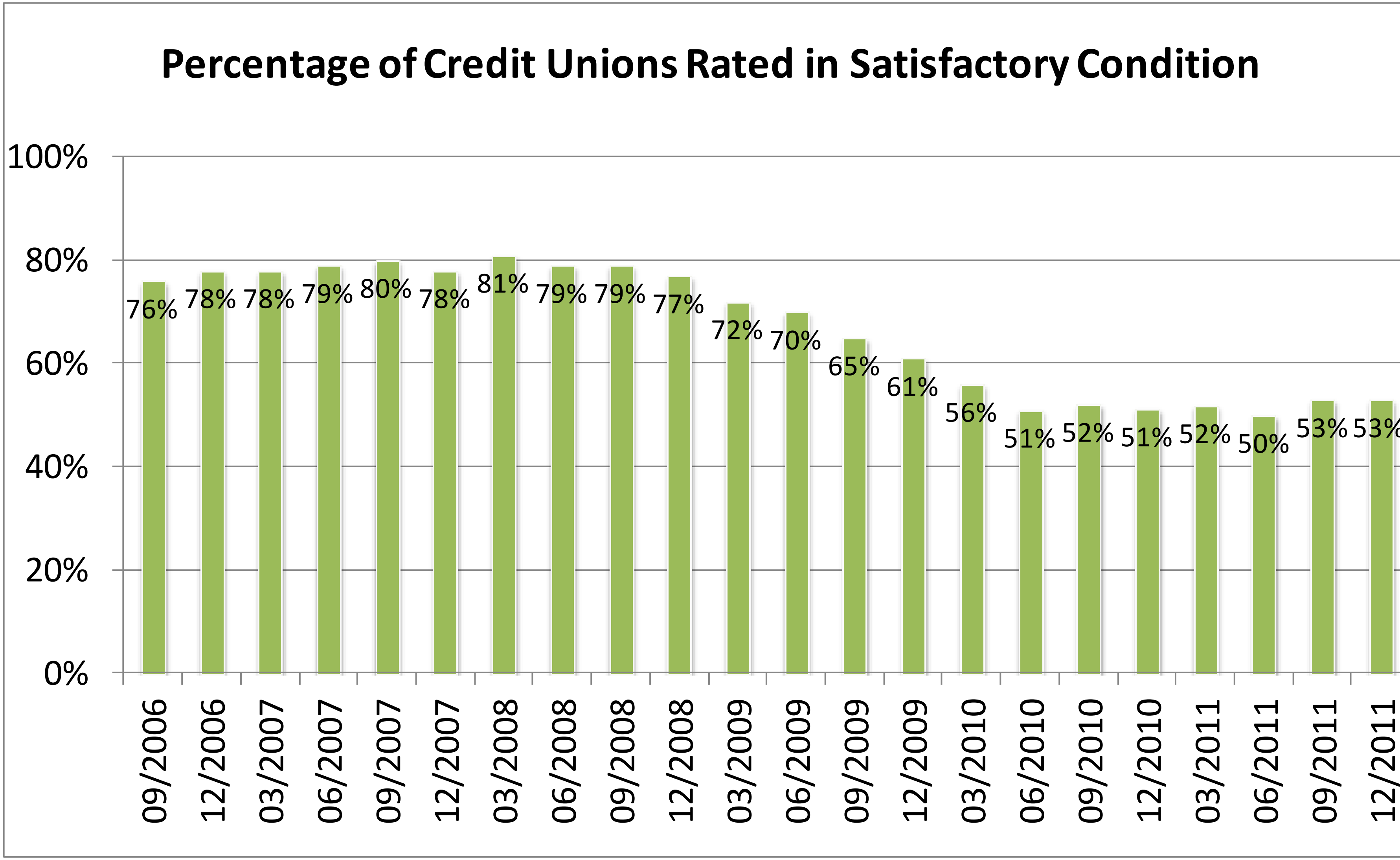

Percentage of Credit Unions Rated in Satisfactory Condition
100%
80%
60%
40%
20%
0%
76%
78%
78%
79%
80%
78%
81%
79%
79%
77%
72%
70%
65%
61%
56%
51%
52%
51%
52%
50%
53%
53%
09/2006
12/2006
03/2007
06/2007
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06/2010
09/2010
12/2010
03/2011
06/2011
09/2011
12/2011

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Outstanding Enforcement Actions as of April 10, 2012

	Effected	Pending	Proposed	Total
LUA	41	0	2	**43**
C&D	20	0	0	**20**
Total	**61**	**0**	**2**	**63**

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LUA - Letter of Understanding and Agreement
C&D - Cease and Desist

Questions?

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