Managing Lending Risk

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- 22 offices in Arizona, California, Kansas, New Mexico, Oregon, and Washington
- Founded in 1913 and headquartered in Seattle, Washington
- We are the 4th largest firm servicing credit unions in the nation (based on assets)
- Founding member of Praxity, a global alliance of accounting firms
PRESENTERS

Carrie Kennedy, CPA, Partner

Carrie has practiced public accounting since 1997. She performs internal audit outsourcing, supervisory audits, annual opinion audits, loan reviews, and SEC reporting engagements. Carrie is a member of the Financial Services Group and provides audit and business assurance services to her 20 credit union and financial institution clients. Her experience includes financial and operational audits, with related management recommendations for cost savings and efficiency improvements; loan file review and evaluation; numerous recurring audits of financial statements; assistance, preparation, and review of SEC registration statements, including Forms S-1, S-4, and Forms 10, 10-K, 10-Q, and 8-Q; and employee benefit plan audits and qualification status reviews.

Anthony Porter, CPA, Manager

Anthony has been in public accounting and with Moss Adams for six years working with financial institutions. He manages financial and operational audits, with related management recommendations for cost savings and efficiency improvements. He has experience with SEC filings and registration statements, mutual-stock conversions, and merger and acquisition engagements. He is proficient in all phases of audits, including HUD reporting, Sarbanes-Oxley and FDICIA control testing, fieldwork, and report preparation. Anthony is also involved in the firm’s Financial Services Group. He received a BA in Business Administration with an emphasis in Accounting and a Masters of Professional Accountancy from the University of Washington.
OBJECTIVES

• Distinguish between preventative and detective controls

• Gain an understanding the types of controls that should be in place for a strong control environment

• Understand the risks associated with each type of lending: mortgage, consumer, indirect, and member business
CONTROL ENVIRONMENT

• What is the tone?
  o Ethical tenor starts at top management and trickles down
  o Code of conduct?

• Credit Union can control “opportunities” for fraud

• Active, strong controls reduce the opportunities available to those who find themselves in the circumstances referred to above.
CONTROL ENVIRONMENT

• Internal control objectives are desired goals or conditions for a specific event cycle which, if achieved, minimize the potential that waste, loss, unauthorized use or misappropriate will occur. They are conditions which we want the system of internal control to satisfy.

• For a control objective to be effective, compliance with it must be measurable and observable.
INTERNAL CONTROLS

• Internal controls can be detective, corrective, or preventative in nature.
  
  o Preventative controls are designed to keep errors or irregularities from occurring in the first place.

  o Corrective errors are designed to correct errors or irregularities that have been detected.

  o Detective controls are designed to detect errors or irregularities that may have occurred.
INTERNAL CONTROLS

• Preventative vs. Corrective vs. Detective
  
  o Preventative
    ▪ Strongest type of control
    ▪ Larger companies with lots of employees
  
  o Corrective
    ▪ Not as strong as preventative
    ▪ Difficult to implement
    ▪ More common in IT areas
  
  o Detective
    ▪ Not as strong as preventative or corrective
    ▪ Smaller companies with limited number of employees
    ▪ Better than NO controls
LOANS – INTERNAL CONTROLS

• Lending function can be broadly divided into the following categories:
  o Origination and disbursement
  o Loan review (QC and Credit Quality)
  o Credit supervision/monitoring

• Segregation of duties
  o Separate the underwriting, disbursement, and boarding processes

  o System controls
    • Preventive measures
LOANS – ORIGINATING AND DISBURSEMENT

- Originating
  - Approved loan policy covering LTV’s, loan types, DSC, and other factors
    - Has it been updated based on current times?
  - Proper approval authority
  - Approved appraisers
    - Ordered by someone other than loan officer or underwriter
  - Appraisal reviews on ALL appraisals
LOANS – ORIGINATING AND DISBURSEMENT

- Appraisal reviews - *How are you comfortable the appraisal can be relied upon?*
  - Appraisal review conducted by independent qualified 3rd party, either internal or external party
  - Usually a “desk review” and includes:
    - Description of the property and conclusion on appraisers value
    - Discussion of key assumptions used by the appraiser
    - Summary of the appraisers findings
    - Ultimate conclusion on value compared to appraisers findings
LOANS – ORIGINATING AND DISBURSEMENT

• Originating
  o Collateral liens
    ▪ UCC searches and filings
    ▪ Filing deed of trust
    ▪ Title policies
    ▪ Freezing shares
  o Quality control review to ensure all collateral liens have been perfected
  o Tickler system for outstanding documents not yet received
LOANS – ORIGINATING AND DISBURSEMENT

• Disbursement
  o Performed by individual separate from the origination/underwriting process
  
  o Ensure proceeds are used for the borrower’s stated loan purpose
  
  o Unable to segregate disbursement function???
LOANS – LOAN REVIEW

- Boarding review
  - Detects common errors such as interest rate and maturity date errors

- Quality control review
  - Determine whether loans adhere to the loan policy
  - Conducted by personnel independent of credit functions
  - Don’t rely on your external auditors!
LOANS – LOAN REVIEW

• Credit Quality Review
  
  o Increasing in frequency at Credit Unions with the increase in Member Business Lending

  o Usually performed by external 3rd party

  o Can be tied in with QC loan reviews, but ultimate purpose is to validate the credit evaluation/monitoring by the Credit Union
Common Key Credit Risk Indicators

- Delinquency (60+ days past due)
- Early stage delinquency (1 – 59 days past due)
- Charge-off history
- FICO/LTV/loan grade migration
- Concentrations
- Multiple modifications/extensions and renewals
LOANS – CREDIT SUPERVISION/MONITORING

• Questions to ask regarding monitoring:

  o Is the loan review function independent of the credit administration and loan approval processes?

  o Are any loan findings reported directly to the board of directors or board level committee?

  o Does the board receive necessary and reliable information on a regular basis to assess and potential risks within the lending portfolio?
• Questions to ask regarding monitoring:

  o Are procedures in place to ensure the prompt identification of loans with well-defined weaknesses and relevant lending patterns that may potentially be indicative of fictitious or fraudulent activity?

  o Do loan review personnel have the knowledge and confidence to challenge transactions that look suspicious?
LOANS – FRAUD CONTROLS

• Common detective controls to identify errors and/or fraud
  o Review low rate loan reports
  o Common address review
  o File maintenance reports should be reviewed for:
    ▪ Advancing payment due dates
    ▪ Changes in interest rates
    ▪ Changes of the payment amount
    ▪ Several address changes to the same address
    ▪ Changing the payment frequency
  o Overdraft reports reviewed for:
    ▪ Overdrafts created for purpose of “paying” loan
LOANS – FRAUD CONTROLS

• Other fraud and error detection

  o Large amount of interest is due, but the loan is current

  o Original loan amount and current loan amount are the same, but the loan is not delinquent

  o Review of employee and official loans
LOANS – INTERNAL CONTROLS

• Other controls to consider
  
  o Reconciling subsidiaries to the general ledger
  
  o Global rate change review
  
  o Loan exception report
LOANS – INTERNAL CONTROLS

• Member statements are the final detection controls
  o Proper controls over no-mail and print suppressed
  o Reconciling total statements processed to members
  o Timely response to member inquiries
INDIRECT LENDING

• What is it?
  o Exists in different forms
  o Most common form is an arrangement where a credit union contracts with a merchant (commonly a car dealer) to originate loans at the point of sale.

• What are the risks?
  o Rapid growth in an indirect product line can lead to a material shift in a credit union’s balance sheet composition.
  o Improperly managed indirect programs can lead to unintended risk exposure including credit risk, liquidity risk, transaction risk, and compliance risk.
INDIRECT LENDING

• Mitigating Risk
  o Process in place to perform due diligence on the third party vendors which should include:
    ▪ A planning process which assesses the risk of the vendor relationship both initially and ongoing
    ▪ Written policies addressing all facets of indirect lending program including underwriting and monitoring
    ▪ A process to periodically assess the legal agreements
    ▪ A review process to assess the vendor’s financial and operational risks
INDIRECT LENDING

• Monitoring Activities
  o Approval/decline ratios by dealer
  o First payment defaults by dealer
  o Evaluate ALLL loss ratios
    ▪ Separate from direct autos
  o Early payoffs by dealer and incentives paid
  o Loans approved by loan officer
  o Loan-to-value by dealer
INDIRECT LENDING

• Monitoring Activities
  - Delinquency rates
    • By dealer
    • By loan officer
    • By origination date
    • By credit score
    • By days – typical delinquency report
  - Track charge offs by these categories as well
  - Rates of return/profitability analysis by vendor
INDIRECT LENDING

• Quality Control Process
  o Review of the application
    ▪ Is income consistent with the stated job
    ▪ Credit Report – Comparison with application
MEMBER BUSINESS LOANS

• Increasing in frequency across credit unions

• These are commercial loans and are more complex than the typical consumer loan
  o Also includes all participated loans

• They are regulated by NCUA Part 723

• Requires increased underwriting controls and monitoring

• Increased risk
MEMBER BUSINESS LOANS

- There are restrictions on loan types and volume of loans
  - Credit Unions currently limited to lesser of 1.75x credit union net worth, or 12.25% of total assets
  - Legislation introduced to increase the limit to 27.5% of total assets

- Need to monitor and report ratios to ensure compliance to both policy and regulatory limits
MEMBER BUSINESS LOANS

• Underwriting Issues
  o Right people with adequate experience
  o Appropriate segregation and limits on approval authority
  o Understanding and documentation of cash flows (spreads), collateral, guarantees, strengths, and weaknesses
MEMBER BUSINESS LOANS

• Monitoring
  o Good secondary review process
    ▪ Strongly recommend 3rd party review
  o Concentrations
    ▪ Typically credit unions are geographically and member occupation concentrated. Is there product concentration too?
  o Monitoring LTV’s and future maturities of collateral dependent loans

  o More prone to extensions, renewals, and delinquencies
    ▪ Potential TDR’s
MEMBER BUSINESS LOANS

• Participations purchased
  - Purchaser often relies on the work performed by other institution
    • Purchases of more than 50% should be rare!
  - Monitoring is much more difficult
    • Know the participating institution
  - Substantial losses have occurred here and foreclosures get messy
    • Participation losses have grown
MEMBER BUSINESS LOANS

• Allowance for loan losses
  o Loan grading
    ▪ 3rd party credit review
  o Impairment analysis
    ▪ Policy on frequency of analysis and collateral valuation updates and types of acceptable collateral valuations?
OTHER LOAN ISSUES

- Troubled Debt Restructurings (TDR)
  - Who can approve?
  - Process to identify TDR’s
  - Report TDR’s to management and the Board
  - Disclosure and proper accounting treatment
OTHER LOAN ISSUES

○ Credit Cards – Still Risky?

- Credit card charge offs continue to decline
- Stability of the average credit card holder still unpredictable
- Competitive risks increasing
- Review underwriting approaches and portfolio management
OTHER INTERNAL CONTROL ISSUES TO CONSIDER…

- No matter how well internal controls are designed and implemented, they can only provide a reasonable assurance that objectives will be achieved. Some limitations are inherent in all internal control systems. These limitation include:
  
  - Judgment – the effectiveness of controls will be limited by decisions made with human judgment
  
  - Breakdowns – even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.
OTHER INTERNAL CONTROL ISSUES TO CONSIDER…

Control limitations also include:

- **Management Override** – high level personnel may be able to override prescribed policies or procedures for personal gains or advantages. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.

- **Collusion** – control system can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.
OTHER INTERNAL CONTROL ISSUES TO CONSIDER…

- What are some common issues faced by lending controls of Credit Unions?
  - *Not enough staff* – each different lending cycle requires separate controls and creates segregation of duties issues
  - *Too expensive* – consider the costs of a breakdown
  - *Trust of employees* – trustworthy employees are not a good reason to limit the amount of controls
QUESTIONS

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