Risk-Focused Exam Success Stories

NCUA's Risk-Focused Exam (RFE) program has been met with mixed reaction. Naturally, those credit unions that have received a negative report are usually less than eager to repeat the process when their turn comes up again. Recently, however, some clients have called to tell us about the positive experiences and results of their RFEs. Going into the exam these credit unions were somewhat concerned because each had what they considered to be a mediocre ROA. Also, as a result of continued growth, some were experiencing a decline in their net worth ratio.

Why did their exams go well?

We concluded that the common denominator between these credit unions was the fact that both management and the board, at their appropriate levels, could readily demonstrate that they were monitoring and controlling their credit union's risk to earnings and net worth. And here are some ways they did it...

They understood that quantifying risk is not enough

We found that the managements and boards of the credit unions experiencing a successful RFE had first agreed on their appetite for risk and evaluated decisions in light of their established risk limits. Through "what-if" simulations, a couple of these credit unions with big risk appetites understood the sources of risk in their financial structures and the trade-offs of acting today to mitigate their risks versus continuing to hold the risk in their financial structure.

Another credit union, outside of its established risk limits, was able to show the examiner documentation demonstrating that management had been actively testing various options for reducing risk, weighing the impact to current earnings if rates were to stay low versus risk reduction in a rising rate environment. The board was aware that they were outside of their risk limits and that management was on top of the situation.

Their risk management process was look-ahead, with a lot of "what-if" simulations

These managements could explain their credit union's existing risks to both earnings and net worth, not only in a 300 basis point rate change, but well beyond. Just as important, they proactively tested the short- and long-term financial consequences of decisions under consideration--before implementing them.

Even if they decided not to implement a specific strategy they kept the results of the "what-if" simulations on file, reinforcing the fact that major decisions--implemented or not--were tested ahead of time.

8222 s. 48th street | suite 275 | phoenix, arizona 85044 | 800.238.7475 | fax 602.840.7909

They were taking action to manage risk

These credit union managements and boards made the tough decision to accept lower earnings in order to help reduce interest rate risk in a rising rate environment, but not before they thoroughly discussed the subject and performed "what-if" simulations to understand, ahead of time, the trade-offs. The process was well documented to prevent misunderstandings down the road.

Steps were taken to slow growth by aggressively managing share rates, even though this wasn't always popular with some members. As one CEO put it, "I know I've made a few of our savers unhappy, but our focus has to be on what's best for the entire membership long term--not just some members short term."

The financial consequences of things not going as planned--such as budgeted loan and deposit growth--were quantified and understood. If the risk of experiencing a deviation from plan was too severe, such as not achieving desired loan growth, the management and board were proactively exploring options in other areas of their financial structure to help mitigate the potential loss of income.

One credit union, determining that the risk of "outbound share flight" was too severe should the financial markets continue to heat up, proactively evaluated longer-term borrowings and alternative sources of liquidity they had not previously considered.

They knew their assumptions

These clients were able to quickly show the examiners how, under various rate environments:

- Prepayments on loans, which vary by category, were automatically changing
- Optionality in complex investments and loans was simulated
- Deposit rate sensitivity was automatically adjusting
- Management's unique deposit pricing strategy was reflected

By the way... none of these clients use NEV in their decision making

Regarding NEV, keep in mind two very important points: First, NEV is not required. Second, even though we conduct NEV simulations for clients who request it, we do not recommend that it be used in decision making because it misrepresents risks to earnings and net worth.

Summary

As these credit union managements and boards proved, successful RFE results come from focused preparation. Implementing regular steps to monitor and control risks will do wonders for streamlining the process and increasing a credit union's odds for a positive outcome.

If you have questions on how to prepare for a successful Risk-Focused Exam, please feel free to call us. We're happy to speak with you as well about NCUA Letters 03-CU-11 and 03-CU-15.

Sally Myers, CEO

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