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An evaluation of the examination process of state chartered credit unions in Virginia

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AN EVALUATION OF THE EXAMINATION PROCESS OF STATE CHARTERED CREDIT UNIONS IN VIRGINIA

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by

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ABSTRACT

State chartered credit unions in Virginia are by Statute incorporated and regulated by the State Corporation Commission of the Commonwealth. Part of the regulatory process is a periodic examination of the books and records of each credit union to determine compliance with applicable laws and regulations as well as the safety and soundness of depositors' funds. The quality and effectiveness of this examination process has never been measured, nor has it been empirically evaluated to determine its strengths and weaknesses. This study identifies areas of the examination report which can be improved in order to make it a more useful regulatory tool and to provide a more meaningful reference for regulated credit unions.

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INTRODUCTION

Traditionally, bank examinations emphasized credit review, asset appraisal, and some auditing or verification of accounts. In Virginia, as in most states, credit unions were examined by bank examiners because the regulation of all financial institutions was supervised by one regulatory agency; specialization in credit union examination was not deemed necessary probably because credit unions were relatively small and conducted very simple operations. Since credit unions were examined by bank examiners, the credit union examination report naturally emphasized traditional bank examination values. This examination report has survived through the years despite dramatic changes in the credit union industry.

With the idea that the credit union examination report now in use in Virginia is outmoded, this study identifies areas necessary for improvement of the examination report to provide more information (1) for regulators to better determine the financial welfare of a credit union, and (2) for management of a credit union to set policies that are conducive to sound financial operations.

The organizational structure of state financial institution regulatory agencies remains basically the same as the traditional concept: of 47 states with credit union statutes only five have an independent credit union supervisory department. However, expanding organizational autonomy is seen in the increasing number of credit union supervisors who can make decisions without securing approval from another person or agency.[1] While more than half the states do not have minimal educational requirements,[2] twenty-four state credit union supervisors have college degrees and nine others have graduate degrees.[3]

The growth of the credit union industry is well documented. While the total number of credit unions has declined somewhat in recent years due to mergers and liquidations, industry assets as of July 31, 1985, exceeded $131 billion while more than 51 million members are served by their credit unions.[4] The most recent growth can be in large part attributed to deregulation of the financial institution industry which has allowed credit unions to offer many new services to their members and consequently compete with banks and savings and loans to become the member's primary financial center.[5]

Since credit unions now have such a large impact when competing for savings dollars, it is no longer enough to examine them with traditional bank examination procedures. As the literature review indicates, proper management of these savings resources is vitally important to the continued success of credit unions.

LITERATURE REVIEW

Most of the literature dealing with critiques of the examination process is written about bank or thrift examinations. With the number of bank failures in 1984 the highest since the depression, consumers want assurances that their money is safe, and consequently examiners have come under close scrutiny. The literature investigates the causes of the failures of Penn Square Bank in 1982, Continental Illinois in 1984, and in 1985 Home State Savings Association of Cincinnati and Old Court Savings and Loan in Maryland. Findings suggest bank examiners face several problems which make effective examinations very difficult to achieve.

After the failure of Franklin National Bank in 1974, the Office of the Comptroller of the Currency (OCC)--one of three federal agencies that regulate banks--reviewed and subsequently overhauled national bank examination techniques. The revised procedures, developed by a "Big 8" accounting firm, emphasized good audit procedures and management review practices. The OCC Examiner Handbook describes the functions of the examination as "to provide an objective evaluation of a bank's soundness,...to permit the OCC to appraise the quality of management and directors,...and to identify those areas where corrective action is required to strengthen the bank, to improve the quality of its performance, and to enable it to comply with applicable laws, rulings and regulations."[6] Yet Dince, who is a former Deputy Comptroller of the Currency, points out that examinations have never proven to be an important deterrent to bank failure, while good management and good controls are the best defense.[7] This argument is supported by the statistics shown in Table I which indicate that over 61% of all business failures are attributable to poor management. The lesson to be learned and the concern of credit union regulators should be that good management is in charge of credit unions.

TABLE 1

REASONS FOR BUSINESS FAILURE

REASON	PERCENT
Management incompetence	44.4
Lack of managerial experience	16.8
Unbalanced experience in finance, sales, production	15.8
Lack of experience in production line	14.9
Neglect	1.1
Disaster	0.6
Fraud	0.6
Other	5.8
	100.0

Source: Dun & Bradstreet, The Business Failure Record (New York): 1981, p. 12

Several articles point out the problems bank examiners face. The number of federal examiners is currently less than 4,400--down from about 5,000 in 1980.[8] States also find they lack sufficient numbers of trained people to examine all their state-chartered financial institutions. The pressures on an examiner include lower pay than offered by private industry, grueling travel schedules, the necessity to complete examinations quickly, and lack of training and expertise necessary to keep up with the complex new activities in which banks are involved.[9] Examiners are also often intimidated by high-salaried bank executives and important board members. State regulators frequently lack clout to enforce prohibitions. For instance, in Ohio the state thrift superintendent is a political appointee, and not a career state employee knowledgeable in savings and loan regulation. The board chairman of Home State contributed heavily to Governor Richard Celeste's 1982 election and thus used his influence in the choice of thrift superintendent. Despite examiner predictions of failure 2½ years in advance, a series of thrift superintendents extracted from Home State's board nothing but promises that abnormally overcollateralized investments would be reduced; in fact, more of these investments were purchased. Ohio legislative investigation must resolve why the board ignored the regulator and consider making the superintendent a career person.[10]

Dince further points out that the various state and federal agencies don't share enough information with each other. While there were obvious problems with the loans generated at Penn Square, the examiners responsible for the "upstream" purchasers at Continental Illinois, Chase Manhattan, and at other money centers were apparently not notified of the looming disaster. Dince also proposes that problem banks are underexamined while average banks are overexamined. This apparent deficiency is caused by the inflexibility of the examination system that, because of time scheduling, requires that loan review be limited by pre-determined dollar cut off amounts and also requires a review of consumer protection regulations.[11] The problem of secrecy-versus--disclosure is a dilemma for CPA's who are being whipsawed by regulators on one hand who fear adverse information will create investor panic, and Congress on the other hand which clamors for full disclosure. In the fall of 1984 the Comptroller of the Currency required two of the nation's largest banks to disclose their capital inadequency. This reversal of position on disclosure by OCC is applauded by columnist Richard Reeves. He believes the market force of public opinion will induce banks to "shape up" before problems arise, and thereby restore public confidence. The embarassment of a problem bank is less expensive than the recent trend of bailing out failed banks with public money. Knapp's article is addressed to those CPA's seeking or already engaging bank and savings and loan clients. He warns of the perils of dealing with inconsistent--and thus unpredictable--regulatory agencies, the lack of cooperation and communication between agencies, and the increased risk brought about by deregulation.[12]

Edwards cites the breakdown of market segmentation as the reason for current regulatory pressures. Banks are diversifying into traditionally non-bank activities while transaction/deposit accounts have appeared in non-bank financial intermediaries (Sears, American Express, etc.). Additionally, restrictive branching laws are being circumvented by bank holding companies, or are becoming outdated with the use of electronic funds transfer and international banking. The implications of this diminished segmentation are elimination of distinctions between commercial banks and other financial institutions, increased competition (with additional pressure on bank solvency), and some loss of control over monetary aggregates by the Federal Reserve.

Additional articles on the examination process include Kristufek's discussion of the procedures the Federal Home Loan Bank uses to limit the disruptive effect on operations as well as time spent in examined institutions.

The article notes that the audit function is left to independent auditors which allows examiners to focus on operations and management. Fair and McFarlane point out that public comments on proposed regulations are valued by regulators. Regulators often are not familiar with the operational effect regulations have; their request for comments gives management of regulated institutions the opportunity to provide information on possible effects of these regulations. Since proposed regulations are frequently modified, management input is a useful tool.

While there are pertinent lessons for credit unions to learn from these documented difficulties of bank regulators, credit unions are a different type of financial institution. The need for good management is still a concern, but in credit unions the volunteer nature of management raises the question of where motivation and incentive comes from to correct problems and prevent failures. Credit unions use more than 500,000 volunteers nationwide, and with annual turnover approaching 30% managerial stability is a concern for regulators. Ideas for keeping these volunteers informed and motivated are presented in the September, 1985, edition of Virginian.[13]

The pressures on credit union examiners are similiar to those of their banking and thrift counterparts. However, when dealing with credit union management, the intimidation and expertise factor usually favor the examiner. In other words, the non-professional nature of credit union management forces it to seek the professional advice of examiners, and examiners are willing to help. This willingness is one example of the spirit of the credit union industry, which is more concerned with the welfare of its members than with profits--and is thus set apart from all other financial institutions.

The cooperation problems that the various state and federal bank and thrift regulators encounter are by and large absent in the credit union industry. The National Credit Union Administration (NCUA) regulates federally chartered credit unions, and administers the National Credit Union Share Insurance Fund (NCUSIF) which insures members deposits up to $100,000. While there are many state chartered credit unions which are insured by NCUSIF, the NCUA does not examine them but rather accepts the state regulator's examination report. NCUA and the National Association of State Credit Union Supervisors (NASCUS) executed a Memorandum of Understanding on April 21, 1982, with an intent to "effect a program of uniform enforcement of various state [credit union] laws and the integrity of the (federal share) insurance fund." NCUA and NASCUS meet together semi-annually to resolve problems in the spirit of the memorandum.

The U.S. General Accounting Office report to the Chairman of the National Credit Union Administration reviews NCUA's examination and regulatory procedures and makes recommendations in two areas: (1) better administrative procedures in resolution of "problem" credit union situations, and (2) setting standards of acceptability for state examination programs.[14] NASCUS felt that this second recommendation should be developed by NASCUS, and not NCUA. Thus, NASCUS's 1983 Regulatory Development Committee composed the minimum standards report. The report defines as its goal the development of an examination scope as well as systems and/or procedures, the communication of findings, and remedies to resolve problems. Most of the report deals with defining of examination scope as shown in Table 2. Eighteen checkpoints to cover these areas are elaborated. Since none of these checkpoints focuses on analysis of management, it must be assumed that if one wishes to rate management, the rating must be derived from management's ability to set policies and direct operations in a manner which results in satisfactory ratings in the factors given in Table 2. The NASCUS Minimum Standards report is useful and should be considered in revision of any examination report.

While there is public and regulatory concern with the record number of bank failures, credit union failures have not had, to date, significant economic

TABLE 2

NASCUS's MINIMUM STATE CREDIT UNION EXAMINATION STANDARDS

While not all inclusive, the following factors in defining the scope of the examination are considered most important:

- Historical soundness of the credit union
- Equity position (Reserves, Undivided Profits, Special Reserves)
- Delinquency percentage of the loan portfolio
- Past history of sound operations
- Stable management and satisfactory rating of the Board of Directors
- Functioning (and adequate) Supervisory Committee
- History of compliance with Regulation Z, Regulation B, etc., and applicable state statutes and rules
- Call Report and/or other annual reports of condition

or social impact. While the assets in the credit union industry have grown dramatically as previously indicated, recent statistics show over sixty percent of all credit unions have assets less than $1 million and account for less than ten percent of total industry assets. As mutual cooperatives, credit unions are not required to sell stock and capitalize at multi-million dollar minimums, while most banks and thrifts are. The fact that most failures are among small-sized credit unions[15] and newly chartered credit unions[16] explains the minimal economic impact such failures have had. In Virginia in the ten year period ending in 1983 thirty-two new credit unions were chartered. Eight of these credit unions were liquidated and one merged into another credit union. Of the twenty-three remaining, only two had assets in excess of $1 million (the larger one had $1.7 million in assets). Failures of these sizes have not put pressure on federal or private share deposit insurance funds, and credit union members have recovered their investments without much public attention. However, the failure of any of those credit unions larger in asset size than the share insurer who insures their deposits would have obvious economic and social impacts. Home State's failure and the inability of the Ohio private insurer to pay insured amounts without a governmental bailout exemplifies this fact. Deposit insurance is an issue of growing concern in the credit union industry. Public confidence in private (non-federal) deposit insurers is very low in the backlash of the Ohio and Maryland 1985 thrift failures, even though private and federal credit union deposit insurers are stronger than the Federal Deposit Insurance Corporation and Federal Savings and Loan Insurance Corporation.

An accurate model using stepwise multiple regression analysis was developed by Kharadia and Collins to forecast credit union failures.[17] The significant variables were found to be dividend rate, liquidity ratio, delinquent loan ratio, assets, and membership variation. Small credit unions were found to be more susceptible to failure (which supports findings cited above in the U.S. General Accounting Office report). It is also significant that 85% of failed credit unions had management rated in "weak" or "unsatisfactory" categories when tested against NCUA's early warning system. A basic problem with this model is that the data used comes from a period ending in 1971, well before deregulation and other major changes in the industry occurred. This deficiency was also noted by Dr. Idol. He contends in his critique of this model[18] that since deregulation has been in effect the most predictive factors would be (1) return on assets, (2) rate sensitivity gap analysis,[19] (3) capital strength, and (4) various delinquency and charged-off loan factors.

Nevertheless, a couple of the significant variables found by the Kharadia and Collins model are used today to evaluate the operational strength of credit unions. The Illinois Department of Financial Institutions developed an evaluation system "designed to help credit unions regulate themselves, and to assist the regulator in monitoring credit union performance".[20] This system was incorporated almost in toto in NCUA's Financial Performance Report, which is generated by data given on call reports received from credit unions semi-annually. Table 3 gives the basic ratios used by NCUA to give a percentile ranking to credit unions. NCUA dropped Illinois' loan to share ratio (a traditional ratio still used by credit unions which is considered worthless by Dr. Idol because it ignores rate sensitivity--see footnote #19), and added the delinquency ratio. Note from Table 3 the importance given dividends (the payout ratio measures a credit union's ability to compete for savings dollars) and the delinquency ratio--both factors found to be significant in Kharadia and Collin's model. Erratic changes in the number of members still tend to disrupt operations significantly. This is particularly true in small credit unions where strikes, layoffs, and business recessions as well as rapid expansion (on the other extreme) are difficult for inexperienced management to handle.

TABLE 3

NCUA FINANCIAL PERFORMANCE RATIOS

Expenses	Three year compounded growth rates of total income minus total expenses
Reserves	Five year compounded growth rates of reserves and undivided earnings minus assets
Market Growth	Percentage increase (decrease) in total shares from the prior year
Reserves	Percentage increase (decrease) in total reserves and undivided earnings from the prior year
Capital	Reserves and Undivided earnings divided by shares
Expenses	Total operating expenses divided by average assets
Personnel Expenses	Salaries and benefits as a percentage of gross income
Payout Ratio	Dividends as a percentage of gross income
Charge Offs	Net charge offs divided by average loans
Delinquency	Total delinquent loans as a percentage of total loans

The purpose of this study is to identify possible areas of improvement in the examination report used in Virginia state-chartered credit unions in order to enhance the Bureau of Financial Institution's ability to determine the fitness of a credit union and to provide a more useful tool for credit union self-examination. Two sources of expertise in evaluating examination reports are obvious: regulators and credit union management. Therefore, two surveys were developed to collect these group's opinions on the strengths and weaknesses of the current examination report and process.

One survey was sent to the 47 state credit union supervisors and to the Puerto Rican supervisor who are all members of NASCUS. (Delaware, South Dakota, Wyoming, and the District of Columbia do not have credit union statutes.) The survey asked the supervisors what, given several choices, they considered the most important part of the examination; what they considered to be the strong and weak points of their examination report; what additions or deletions they would make to their report; how they rated their opinions on several items concerning the examination process; and finally for their subjective thought on what incentives are available to ensure good management in credit unions. In addition to the survey, a blank copy of their credit union examination report was requested for review as well as any criteria they used for a rating system. (See Appendix A)

The second survey was to the board of directors of the 122 state-chartered credit unions currently in operation in Virginia. The board was surveyed because they receive the examination report in the normal examination process. It was recommended to them that they review their recent examination report before answering the survey. For control purposes the survey first asked for placement of their credit union in one of four asset ranges. This was done because the needs of small credit unions are felt to be different from large credit unions. Next they were asked to indicate the services they provided to their members, and their degree of involvement with computers. Since the survey was sent to the board, they were next asked who was completing the survey and who reads the examination report (a preception exists that paid treasurers or managers [or bookkeepers in small credit unions] run credit unions). Next, a rating from 1 to 4 of each report page was requested to determine which pages were considered most and least important. They were also asked to select the ratios they considered most important from a group of ten commonly used in analyzing credit unions. A series of questions followed asking for a rating of their opinions on a number of items concerning the examination process. Many of these questions appeared on the regulator's survey as well in order to compare the opinions of regulators and credit union management. To gather more input, the same subjective question asked of the regulators about incentives to ensure good management was presented. Finally, the opportunity was given to comment on anything else about the examination report and process. (See Appendix B)

It was originally conceived that a random sampling of state chartered credit unions in other states would also be surveyed. In addition, trade associations and private deposit guarantors were felt to have an interest in this study and thus the study might benefit from their input. Due to time constraints and the large number of potential members in the sample, these groups were eliminated.

The participants in the survey were given thirty days to respond.

DATA

Of the 48 regulators surveyed, 31 responded (65% response rate) and 16 sent blank copies of their examination report for review. The results of the quantitative data are given in Table 4. Even though the first question asked for the most important aspect of credit union examination, 17 of the 31 respondents checked two or more of the choices given; thus the results indicate how many times each choice was checked. In no case was management analysis or internal control analysis checked alone. A few respondents added short comments to four questions. The call report is already included in the examination report in one state while another state has its examiners submit a corrected call report with the examination report. While agreeing that standardized accounting should be required, one respondent felt there still must be some flexibility. Three respondents felt management's response to examiner's comments should be in the reply to the examination (i.e., after the final examination report is sent to the board). To the final question, one respondent indicated that a mandatory meeting with the board follows each examination.

Although the surveyor hoped to get a definitive response, respondents gave a wide variety of answers to the question of strong points in their examination reports. In retrospect, this variety is to be expected since each state's examination report is unique. A number of subjective responses included directness, clarity, flexibility, brevity, and "findings and recommendations". A number of other responses could be categorized as strong in asset quality evaluation or financial analysis.

The response to the question of weak points in the examination reports was also varied. It is noteworthy that seven respondents felt their reports had no weak points. No clear categorization of responses can be made, although five respondents did indicate internal control and data processing analysis to

TABLE 4

RESULTS OF REGULATORS SURVEY

What is the most important part of credit union examination?

Asset quality	68%
Financial analysis	48%
Management analysis	39%
Internal Control analysis	23%
Compliance	3%

Should examiners advise or present options for problem resolution?	97% agree
Should examination results be disclosed to the public?	90% disagree (55% strongly)
Should the examination report be a reference or educational source?	94% agree (no one disagrees)
Should the call report be part of the examination report?	42% agree 36% no opinion
Do communications to credit union boards or management clearly indicate their status?	94% agree (only 32% strongly)
Does the examining staff have adequate familiarity with credit union operation and management?	90% agree (only 29% strongly) (no one disagrees)
Should standardized accounting be required in credit unions?	68% agree 16% disagree
Should management's response to examiner's comments be included in the report?	71% agree (35% strongly agree) 19% disagree
Are poor management procedures properly identified and clearly indicated to the board?	90% agree (only 16% strongly)

be weak; four of the five felt asset quality was the strong point and the important point of their examinations, and the fifth felt financial analysis to be strong and important. One interesting response emerged from two respondents: the lack of proforma financial statements, projecting where a credit union will be in the future if present conditions continue, was felt to be a weakness.

What the respondent would add to his examination report again elicited varied answers, but eleven respondents indicated the need to correct the problems just cited in the previous question. A majority of the respondents indicated a need to upgrade financial analysis. Two respondents wanted to perform more audit functions, and two thought more loan review was necessary.

Only six respondents would delete anything from their reports. The surveyor surmises that there is reluctance to delete anything possibly worthwhile. The responses included deletion of an internal control questionnaire, investments, loan documentation exceptions (indicated twice), detail of reserve accounts, and listing of shares and loans (and balancing totals to the general ledger).

The final question on incentives available to ensure stable and knowledgeable management and to promote problem resolution was answered by only eleven respondents. While "management" in the question was intended to mean the volunteer board and committee members, several respondents introduced salaries as incentives; statutes prohibit anyone except the manager and staff from being paid. Five of the answers brought up participation in the state's credit union league and making usuage of the league's consultants, seminars, and schools. One respondent astutely observed that the dilemma for regulatory authorities is that they "have to rely almost entirely on criticism. Administrative action against an errant board is too costly and cumbersome to use very often." He further observes that, within his experience, the boards that do the best jobs come from the tightest common bonds. Apparently, social pressure effectively deters poor management since board members do not like to face peers once poor credit union performance is established. (This observation is certainly a significant argument against field of membership expansion which has been so prevalent in recent years - expansion aimed almost ironically at providing better services to credit union members.) Another respondent's state proposes statutory accountability of the board of directors, who are not seen as being currently responsible to anyone. "The statute [would] allow a credit union to issue an 'at risk' - 'uninsured' membership share. A certain required portion of the credit union's net income would be allocated to these shareholders. If the credit union loses money, the value of the share would depreciate." To promote problem resolution, respondents suggested administrative directives, regular monitoring of submitted financial statements, cease and desist orders, memorandums of understanding, suspension of operations, and forced mergers or liquidations. These are traditional actions which have been used despite minimal economic and social effects.

Of the 122 credit unions surveyed 59 responded (48% response rate). Table 5 shows the rating given to each page in the current examination report. There was obviously a misunderstanding of this rating question. The surveyor intended that four pages would be ranked from 1 to 4 as most important in one column and four different pages would be likewise ranked as least important in the other column, but only three respondents answered as intended. The rest either gave each page a 1 to 4 ranking in one column or the other, or checked the pages as being most important or least important. To make use of the data provided, a scoring system was devised which assigned a 4 each time a page was rated either most or least important, a 3 each time a page was rated either second most or second least important, and so on, and a 2.5 was assigned for each check given a page. Page two was used as the standard to determine most important when rating discrepancies occurred since this page was rated more

TABLE 5

RANKING OF IMPORTANCE OF REPORT PAGES

		Most Important		Least Important	
		Rank	Score	Rank	Score
Page 1-	Credit Union and examiner balance sheets	4	114	4	48.5
Page 2-	Examiner's comments	1	174.5	11	8.5
Page 3-	Breakdown of page 1 asset categories	9	57.5	2	72
Page 4-	Breakdown of page 1 asset and liability categories; classifications	11	52	3	70
Page 5-	Comparative Operating Statements	3	122.5	9	19.5
Page 5a-	Breakdown of charge-offs and recoveries	5	108.5	7	36.5
Page 6-	Listing of delinquent loans	7	99	8	35.5
Page 7-	Loan file documentation exception	8	78	5	43
Page 8-	Insurance Coverages	6	106	6	41.5
Page 9-	Members of the board, staff and committees and their share and loan balances	10	54.5	1	73.5
Page 10-	Internal Control Checklist	2	144	10	11

than any other and was obviously considered most important. Based on the total "most" and "least" scores for each page the rankings shown in Table 5 tend to verify each other (i.e., the examiner's comment page is ranked first in the most important column and last in the least important column, the page with board members, etc.. share and loan balances is ranked first in the least important column and next to last in the most important column, <u>et cetera</u>.)

A notable exception is page one, which is ranked fourth in the most important column and fourth in the least important column. Since page one tends to be important in showing the effects of classifications, and the possibility exists that those credit unions who consider it unimportant may have had limited classifications, it is felt by the surveyor that the "most important" rating is more realistic.

The survey found that nearly all board members do read the examination report. The manager reads the report nearly half the time, while the report is available to staff and the supervisory committee nearly 20% of the time. (The supervisory committee is required by law to perform an annual audit of the credit union.) The treasurer or manager filled out and responded to the survey in 48 out of the 59 samples (over 81%). This was expected: as pointed out above the perception exists that the paid individual is thought to run the credit union.

As with the regulators, response was limited on the question concerning incentives to ensure stable and knowledgeable management and to promote problem resolution. Salary again was brought up as an incentive, even though the intent of the question was to find ways to motivate volunteers. Participation in credit union schools and workshops along with continuing education were given as answers. Also, some ideals were mentioned: "dedication," "honest effort", "self-motivation", "sense of pride and accomplishment." Several respondents suggested that problem resolution could be enhanced by more and better examinations and audits as well as board evaluations and reviews.

The final open-ended question brought several additional responses. Examiners were generally viewed as helpful, but some respondents indicated that they felt examiners may too severely criticize insignificant deficiencies or practices. In a few instances, board members suggested that they would like to see examiners use their expertise to offer suggestions to resolve problems. A few respondents thought the examiners should extend more praise when it is appropriate. Finally, several respondents cautioned against examinations becoming too routine and suggested that the primary purpose should be to determine safety and soundness.

The traditional credit union statistical ratios scored highest among the choices given in the survey; loans to shares, expense to income and delinquency percentages are all used by more than two-thirds of the respondents to assess their operations. Over 40% use capital to assets, dividends to income, and percentage changes in shares and capital as monitors.

A quantitative summary of management's opinions about the examination process is presented in Table 6.

<u>TABLE 6</u>

<u>RESULTS OF CREDIT UNION SURVEY</u>

Is examination report referred to during the year?	64% yes 19% no
Should the examination report be a reference or educational source?	85% agree
Is more satisfaction gained from the examination report than from audit?	51% agree 19% disagree
Is the examination report credible (well written)?	83% agree (only 24% strongly)
Should management's response to examiner's comments be included in the report?	54% agree 11% disagree
Would a rating of the credit union be helpful?	34% agree 17% disagree
Would inclusion of a correct call report in the examination report be helpful?	44% agree 14% disagree
Should more financial analysis be included in the examination report?	66% agree 19% disagree
Are detailed notes about delinquent loans helpful?	36% agree 37% disagree
Is a listing of <u>all</u> delinquents preferred whether classified or not?	25% agree 53% disagree
Is a summary of delinquents preferred to a listing?	54% agree 31% disagree
Is loan and credit review adequate?	73% agree (only 14% strongly) 15% disagree
Is internal control analysis adequate?	69% agree 12% disagree
Are examiners adequately familiar with credit union operations?	83% agree
Should examiners present options for solving problems?	89% agree

TABLE 6

(continued)

Would a management analysis and rating by the examiners be helpful?	78% agree (only 20% strongly)
Should examination results be disclosed to the public?	15% agree 69% disagree
Are communications from the examiner or regulator clear indicators of the credit union's status?	56% agree (only 14% strongly) 25% disagree
Would standardized accounting be a burden?	29% yes 32% no

DATA INTERPETATION

A comparison of the ratings in Tables 4 and 6 indicate that regulators and credit union management are reasonably similar in their thinking. The great majority of both think examiners should offer suggestions and present options for problem resolution, given their expertise from seeing many credit union operations. Respondents in both groups believe examiners have good familarity with operating and managing a credit union. A relatively large number of both believe the examination report should be an educational and reference tool for the volunteers who serve on the board of directors and committees. Also, the survey indicates that the board reads the report.

Some of the other numbers are not as large, but still continue to reflect similar thinking by regulators and management. On the question of public disclosure of examination results, 90% of the regulators don't think examination results should be disclosed, while only 69% of management thinks the same. Interestingly, 15% of management thinks results should be disclosed. These results may indicate that credit unions think they are financially sound. They may be willing to compete with and to be judged as any other financial institution.

The use of a properly completed call report in the examination report itself did not seem to be controversal; however, over 40% of both groups believed it would be beneficial. Since the survey establishes that the examination report may be considered an educational and reference tool, inclusion of a properly completed call report is a way to make the examination report more educational. Numerous errors now found when the credit union completes the call report could be eliminated. Two states include it currently. It is the same report used semi-annually by NCUA and annually by other states to gather balance sheet, income statement, and other operational data for financial analysis and rating. Thus the potential exists for the annual call report to be the first uniform examination document among all the states.

While a majority of regulators and credit union management think that the credit union's status is clearly indicated by communications from the regulator, significant disparity exists: 94% of regulators think they communicate their findings clearly, but only 56% of management feels this way. Yet, 83% of management feels the report is well written (but only 24% feel strongly so). Regulators may be overestimating their communications skills. Examiners frequently see the same problem each year they visit a credit union. The survey results suggest that communication problems may contribute to the length of time--sometimes three or four examinations--it takes to resolve some problems. Since examiners at Penn Square knew of the problems over two years and two examinations prior to the failure, it is possible that clear and strong communications to the board could have been enough incentive to correct deficiencies.

Again, regulators and management generally agree on the issue of including management's response to examiner comments in the report. Surprisingly 17% more of the regulators felt that responses should be included in the report. It seems logical that management would welcome the opportunity to give explanations. There are good reasons to allow feedback from management. There may be cases where comment is not necessary if there is a valid explanation. When management is already working on a problem, the need for regulation is reduced.

Both groups expressed a desire to increase financial analysis in the examination report. Table 4 shows that regulators still seem to be influenced by the traditional bank examination concept of asset quality. However financial analysis is a strong second in their estimation and a number of regulators would like to add further financial analysis to their examination reports. Also, 66% of management indicated that they would like more financial analysis.

It is interesting that while 90 % of the regulators thought poor management practices were properly identified and clearly indicated to the board, 78% of management feels the need for more management analysis and a management rating. About one-half of management have no opinion on a rating. The surveyor senses that many are unfamiliar with ratings, and indeed several respondents made notations they did not understand the question. Regulators rated management analysis third on their list of important aspects of examination, and scored it slightly more than half as important as asset quality. In light of Dince's assertion (brought out in the literature review) that good management and good controls are the best defense against failure, regulators should probably reassess the importance of analyzing and rating management.

Internal control rated low in the regulator's survey, and some regulators expressed a weakness in their examination reports in this area. The importance of internal control was not overlooked by management. Seventy percent rated internal control adequate. It is also considered the second most important report page (see Table 5).

Standardized accounting is required of federally-chartered credit unions. The state regulators agree that it should also be required in state-chartered credit unions; 68% agreed and 20% disagreed. Voting by management was split fairly evenly, with 32% feeling standardized accounting would not be a burden and 29% feeling it would. Thirty-nine percent had no opinion. Standardized accounting is apparently not a significant issue, and would probably require the legislative process to implement it.

Since one of the stated reasons for this study was to provide credit union management with meaningful information in the examination report, the rest of the survey of credit unions was designed to determine their needs. Since the industry generally acknowledges that many supervisory committees do not perform their audit functions adequately, the question was asked if more satisfaction was gained from the examination than from the audit. Not surprisingly, 51% of the credit unions responded in agreement. The importance of the examination in management's eye places pressures on examiners to perform some procedures not required of them. Examiners are not auditors as they are sometimes misconceived to be. Nevertheless, the necessity of moving into the audit function may become real for examinations of the future.

Table 5 reveals some areas for revision in the current credit union examination report used in Virginia. Examiner's conclusions and recommendations are considered most important. As expected, comparative operating statements and balance sheets also rank high. Unexpectedly, the internal control checklist and insurance coverages were ranked higher than delinquency of loans. _A priori_, the surveyor and his colleagues felt that insurance and the listing of board members, etc., would be considered unimportant and that delinquency would rate highly since the delinquency percentage has been a key operating ratio in credit unions. Also unexpected was the low importance given asset and liability listings on pages three and four. These ratings do verify the other survey data. As previously indicated, the credit unions surveyed want more analysis of financial and managerial aspects of their operations. As indicated by the low rating of loan file documentation exceptions (Table 5), asset quality is rated low (as opposed to high by the regulators--see Table 4.)

The questions in Table 6 concerning delinquency were posed to determine how credit unions want the reporting of delinquent loans to be handled in the report. The responses do not provide a definitive answer. Despite the low rating given by management to delinquency (Table 5) the Kharadia and Collins failure model ranked it among the five most significant variables. Delinquency is a part of financial analysis. Since the percentage of delinquent loans to all loans is so small in some credit unions and does not threaten financial soundness, the accounting principal of materiality should be applied. Management feels that examiners are too strict on immaterial items. However, where delinquents threaten solvency, all interested parties would certainly want a listing.

Table 7 was developed to determine what services credit unions offer that require examiner knowledge and proficiency in analyzing. Obviously this list has expanded greatly from the traditional credit union of a couple decades ago which paid 6% on shares and made loans at 12%. While small credit unions are still typical, many now offer Christmas and vacation club accounts as well as automobile loans. As assets expand and the capital base can support more services, credit unions provide more member services and compete to be the member's primary financial source. Examiners and regulators must be prepared to deal with the changes and the pressures they create.

TABLE 7

MEMBERSHIP SERVICES PROVIDED BY CREDIT UNIONS

Asset size key:
Group 1: Less than $500,000
Group 2: $500,000 to less than $2,000,000
Group 3: $2,000,000 to less than $10,000,000
Group 4: more than $10,000,000

Service	Respondents Providing	Comments
Auto Loans	78%	Provided by 53% of group 1 and all of groups 3 and 4
Real estate loans	37%	Provided primarily by groups 3 (62%) and 4 (100%)
Credit Cards	10%	Provided only by groups 3 (15%) and 4 (67%)
Lines of credit	37%	By far the primary provider is group 4 (83%)
Variable rate loans	7%	Provided only by groups 3 and 4
Split rate shares	22%	None provided by group 1
Share drafts	30%	Provided primarily by groups 3 (62%) and 4 (83%)
Share certificates	42%	Provided primarily by groups 3 (85%) and 4 (100%)
IRA's	32%	Provided primarily by groups 3 (69%) and 4 (100%)
Club Accounts	69%	Provided by a majority of all
Hand Posted shares and loans	27%	Provided by 94% of group 1
Computer batching	14%	Of those providing 75% are in groups 2, none in groups 3 or 4
In-house computer	19%	Evenly spread amongst groups
General ledger on computer	10%	None in group 1, evenly spread otherwise

CONCLUSIONS AND RECOMMENDATIONS

Proceedings to revise the Virginia credit union examination report should be started promptly. More emphasis should be placed on financial and managerial analysis, and communications to credit unions must be clear and effective.

It is proposed that pages three and four, which list the assets and liabilities categorized on page one, be eliminated. In their place the annual call report should be completed using figures as of the examination date. This would show the credit union the proper usuage of the call report. The call report would be signed by a credit union official, indicating the figures are provided from the trial balance of the general ledger and also implying awareness and understanding of this report. Since page four currently also summarizes examiner classifications (adjustments) to the general ledger, these adjustments must be shown elsewhere in the report. The surveyor feels no clear explanation is provided for differences between "per book" and "per examiner" figures on page one; a third "adjustment" colunm between the other two would remedy this deficiency.

The comparative operating statements on page five should be revised to the format used by Dr. Charles R. Idol to facilitate return on asset (ROA) analysis. Each credit union's Financial Performance Report (FPR), generated by NCUA's computers using call report data, uses this format. Thus, to facilitate more financial analysis the most recent FPR should be included in the examination report with current ratios. The call report and FPR would become part of the examination report and provide financial data for analysis as well as a reference and educational source.

Delinquent loans would be listed in the report only when delinquency is determined to have a major impact on credit union operations or solvency. Loan file documentation exceptions currently listed on page seven, would continue to be reported only as examples for citation of major documentation problems; otherwise, documentation should be critiqued in the internal control section of the report.

Listing of insurance coverages should continue as presently reported.

Listing of board, staff, and committee members and their share and loan balances should be eliminated. Summary information necessary to indicate their qualification as well as to determine how well they are performing their duties and responsibilities, can be included in the internal control section of the report.

A "CAMEL" (capital-asset-management-earnings-liquidity) rating should be incorporated into the comment section of the report. Such a rating apparently is being used more and more by regulators, and management of credit unions indicate they would like to know "where they stand."

The survey did not resolve the issue of management incentives. However,it is significant that the survey finds disparity between credit union management and regulators on their respective estimation of clarity of communications. Including management response to examiner's comments in the examination report can help to narrow the communications gap. It is important that management clearly understands their problems and knows how to resolve them. Since incentives to motivate volunteer management are lacking, examiner suggestions for improvement can clearly make problem resolution easier for management. Clear communications, acknowledged as understood, can be an effective regulatory tool.

Many issues were raised by the surveys. A clear need for change in the present examination process is indicated. Hopefully, the recommendations presented in this paper can be incorporated into an improved credit union examination.

APPENDIX A

1. What do you consider the most important part of credit union examination?

_____ asset quality
_____ financial analysis
_____ management analysis
_____ internal control analysis
_____ other; please list ______________________________

____

____

2. What is the strong point of your examination report?

3. What is the weak point of your examination report?

4. What would you add to your examination report?

5. What would you delete from your examination report?

Please indicate your feeling about the following by circling the number if you:

1--strongly agree
2--agree
3--don't have an opinion
4--disagree
5--strongly disagree

6. Do you think examiners should advise or present options for problem resolution?

1 2 3 4 5

7. If it were allowable, should the results of examinations be disclosed to the public?
(and let the marketplace decide where to invest its funds)

1 2 3 4 5

8. Do you think the examination report should be (among other things) a reference or educational source for credit union boards and management?

1 2 3 4 5

9. Do you believe inclusion of your call report in the examination report - properly completed using data as of the examination date - would be beneficial to the credit union?

1 2 3 4 5

10. Do you believe that your communications to credit union boards or management are clear indicators of their status?

1 2 3 4 5

11. Do you believe your staff has adequate familiarity with credit union operations and managment?

1 2 3 4 5

12. Do you think standardized accounting should be required in credit unions?

1 2 3 4 5

13. Do you believe it is important to have management's response to the examiner's comments included in the report?

1 2 3 4 5

14. Do you believe poor management procedures are properly identified and clearly indicated to the credit union board?

1 2 3 4 5

Please share any thoughts you might have:

15. What incentives are availabe to ensure stable, knowledgeable management in credit unions and to promote problem resolution?

APPENDIX B

EXAMINATION REPORT EVALUATION QUESTIONNAIRE

1. Please indicate the asset size of your credit union:

____ less than $500,000
____ $500,000 to less than $2,000,000
____ $2,000,000 to less than $10,000,00
____ more than $10,000,000

2. Please indicate which services your credit union provides:

____ auto loans
____ real estate loans
____ VISA or MasterCard
____ line of credit loans
____ variable rate loans
(rate automatically changes with money market conditions)
____ split rate shares
(dividend rate increases as minimum share deposits are maintained)
____ share drafts
____ share certificates
____ IRA's
____ club accounts

3. Please indicate your usuage of computers:

____ no computerization--shares and loans hand-posted
____ shares and loans on batch computer system
(no terminals in credit union office)
____ shares and loans on-line computer system
____ shares and loans in-house computer system
____ general ledger on-line or in-house computer system

4. Who reads the examination report?

____ board members
____ president
____ treasurer or chief financial officer
____ manager (if different from above)
____ staff heads
____ other: please list________

5. Who is responding to this questionnaire?

____ president
____ treasurer or chief financial officer
____ manager (if different from above)
____ other

6. Please rate from 1 to 4 the pages in the examination report that you feel are:

	most important	least important
page 1--credit union and examiner balance sheets	______	______
page 2--examiner's comments	______	______
page 3--breakdown of page 1 asset categories	______	______
page 4--breakdown of page 1 asset and liability categories; classifications	______	______
page 5--comparative operating statements	______	______
page 5a--breakdown of charge-offs and recoveries	______	______
page 6--listing of delinquent loans	______	______
page 7--loan file documentation exceptions	______	______
page 8--insurance coverages	______	______
page 9--members of the board, staff, committees, and their share and loan balances	______	______
page 10--internal control checklist	______	______

7. What statistical ratios do you feel are important in assessing your credit union's operations?

_____loan to shares
_____capital to assets
_____income to expense
_____delinquent loans to total loans
_____delinquent loans to capital
_____earning assets to assets
_____return on assets (ROA)
_____dividends to income
_____percentage change in shares over the past year
_____percentage change in capital over the past year
_____other: please list______________________________
____
____

Please indicate your feelings about the following by circling the number if you:

1--strongly agree
2--agree
3--don't have an opinion
4--disagree
5--strongly disagree

8. Do you refer to the examination report during the year?

1 2 3 4 5

9. Do you think the examination report should be (among other things) a reference or educational source?

1 2 3 4 5

10. Do you feel that you gain more satisfaction from the examination report than from your audit?

1 2 3 4 5

11. Is the examination report credible? (correct, clear, consistent, complete)

1 2 3 4 5

12. Would your like to have your management's response to the examiner's comments and criticisms included in the examination report?

1 2 3 4 5

13. Would a rating (CAMEL, EWS Code, etc.) of your credit union help you?

1 2 3 4 5

14. Would inclusion of the BFI's year end "call report" in the examination report--properly completed using data as of the examination date--be helpful to you?

1 2 3 4 5

15. Should more financial analysis of your credit union be included in the examination report?

1 2 3 4 5

16. Is it helpful to have the examiner list with delinquent loans collateral, extension agreements, judgements, and principal payment dates and amounts?

1 2 3 4 5

17. Do you prefer to have <u>all</u> delinquent loans listed--classified or not?

1 2 3 4 5

18. Rather than list delinquent loans, would you prefer a summary?

1 2 3 4 5

19. Do you think loan documentation and credit analysis review by the examiners is adequate?

1 2 3 4 5

20. Do you think review of internal controls is adequate and meaningful?

1 2 3 4 5

21. Do you think the examiners have adequate familiarity with credit union operations and management?

1 2 3 4 5

22. Do you think the examiners should present options for solving problems?

1 2 3 4 5

23. Would an analysis and rating by the examiners of various management functions and practices be helpful?

1 2 3 4 5

24. If it were allowable should the results of examinations be disclosed to the public?
(and let the marketplace decide where to invest its funds)

1 2 3 4 5

25. Do you peceive that communications from the examiner or regulator are clear indicators of your credit union's status?

1 2 3 4 5

26. Would the requirement of standardized accounting be a burden to your credit union?

1 2 3 4 5

Please feel free to share your thoughts on the following two questions:

27. What incentives are available to ensure stable, knowlegeable management in credit unions and to promote problem resolution?

28. Other comments you might have on the examination process and report:
What would you like to see added, deleted?
What do you like, dislike about the process?
Are the examiners any problem?
What concerns do you have?
etc.

FOOTNOTES

1. A Profile of State Credit Union Supervisory Agencies. A study by the National Association of State Credit Union Supervisors and Credit Union National Association. June, 1984, pp. 1-2.

2. Ibid., p. 40.

3. Ibid., p. 51.

4. Interview with William F. Stark, Executive Vice President, Virginia Credit Union League, Lynchburg, Virginia, November 26, 1985. Mr. Stark quoted from statistics supplied by CUNA Economics and Research Department dated July 31, 1985.

5. This growth has come at a time when "more banks failed [in 1984] than at any time since the depression and...the strength of the Federal Savings and Loan Insurance Corporation is questioned daily." "Credit Unions' Success Puzzles Some," Virginian, 6 (April, 1985), p. 2.

6. Dince, Robert R., "Penn Square, Upstream Lending, and the Bank Examination Dilemma," The Bankers Magazine, 165 (November/December, 1982), pp. 15-16.

7. Ibid., p. 16.

8. "Federal Bank Examiners are Drawing Fire," The Wall Street Journal, July 16, 1985, p. 6.

9. "State Bank Examiners Often Lack Numbers and Skill to Do Work," The Wall Street Journal, July 16, 1985, p. 1.

10. "How Ohio's Home State Beat The Examiners," The Wall Street Journal, September 3, 1985. p. 10.

11. Dince, Robert R., "Why Bank Examiners Fail," Fortune, 106 (August 28, 1982), P. 127.

12. Knapp, Michael C., CPA, Ph. D., "The Bank Audit: More Challenge and Risk," The CPA Journal, 54 (February, 1984), p. 16 - 21.

13. "Keeping Volunteers Motivated and Informed," Virginian, 6 (September, 1985), P. 9.

14. The Conference of State Bank Supervisors (CSBS)--NASCUS's counterpart in the banking industry--recently introduced a program to accredit state bank regulatory procedures. This program intends to demonstate to Congress state competence in examination procedures. "CSBS Announces Accreditation Program," NASCUS Stateliner, XI (January, 1985),p. 3.

15. U. S. General Accounting Office Report to the Chairman of the National Credit Union Administration, "Stronger Supervision of Credit Unions Needed," October 6, 1982 (document GAO/GGD-83-12), p. 3. Of 220 involuntarily liquidated federal credit unions in 1980 only 15 had assets in excess of $1 million.

16. Ibid., p. 4. Over 50% of involuntarily liquidated federal credit unions during 1978-1980 had been chartered within ten years of their liquidation.

17. Kharadia, V.C., and Robert A. Collins, "Forecasting Credit Union Failures," Journal of Economics and Business, 33 (winter, 1981), pp. 147-151.

18. Interview with Dr. Charles R. Idol, Chief Economist for the Texas Credit Union League and Affiliates, Dallas, Texas, August 6, 1985.

19. Idol, Charles R., "Alternatives to Expense/Income and Loan/Share Ratios in Analyzing Credit Union Profitability and Rate Sensitivity," Texas Credit Union League and Affiliates, Dallas, Texas. Rate sensitive assets (RSA) are variable-rate loans with yields that change with money market conditions, and investments maturing within six months. Rate sensitive funds (RSF) are deposits and borrowing with costs that respond to short-term interest rates. The rate sensitive gap (RSGAP) equals RSA minus RSF, and the RSGAP ratio is RSGAP divided by total assets. When this ratio is large, the gross spread (asset yield less cost of money) is vulnerable to small changes in money market rates.

20. "Evaluations Help Credit Unions," Credit Union Magazine, 47 (September, 1981), p. 36.

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