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2023
Supervisory Priorities

1

Presenter Today



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30 Years of Experience
Servicing Credit Unions

Credit Union Client Asset Size Range \$40 Million to \$28 Billion

2

2

Agenda

NCUA Letter to Credit Unions 23-CU-01

- ❖ 2023 Supervisory Priorities
 - ❖ Interest Rate Risk
 - ❖ Liquidity Risk
 - ❖ Credit Risk
 - ❖ Fraud Prevention & Detection
 - ❖ Information Security
 - ❖ Consumer Financial Protection (CFPB)
 - ❖ Other Updates
 - ❖ Current Expected Credit Loss (CECL) Implementation
 - ❖ Support for Small Credit Unions & Minority Depository Institutions
 - ❖ Succession Planning
 - ❖ Post-Examination Survey

3

3

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4

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- Each year the NCUA provides a letter discussing areas they consider high risk and that credit unions can expect them to cover in a full contact examination.
- The NCUA updates their exam procedures and executes examinations using subject matter experts.
- The NCUA monitor risks and determine minimum areas that they believe need additional oversight.
- The agency's goal is to ensure a robust, safe, sound and evolving credit union system.

5

5

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While a number of risks have been outlined, the primary risks for 2023 as noted by the NCUA and other regulators are:

- Interest Rate Risk
- Liquidity Risk

Market Risk exposure has increased significantly due to the increase in interest rates. In the past 12 months, interest rates have soared 4.25%. This is a steeper increase in rates compared to the previous three economic cycles.

The risks increase because the assets and liabilities of the credit union do not reprice simultaneously. One will reprice quicker than its counterpart depending on whether we are in an upward cycle or a downward cycle.

6

6

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Interest Rate Risk (IRR)

The significant increase in interest rates has resulted in increased exposure to earnings, liquidity and capital.

In September 2022, the NCUA released Letter to Credit Unions 22-CU-09 and Supervisory Letter 22-01 which updated The NCUA's supervisory framework. The NEV supervisory tests serve as a scoping tool.

They also added "S" in CAMELS in early 2022 for "sensitivity," which separated the Interest Rate Risk from Liquidity Risk and gave it more focus.

High levels of IRR can increase the credit union's Liquidity Risk, contribute to asset quality deterioration and capital erosion, and put pressure on earnings.

7

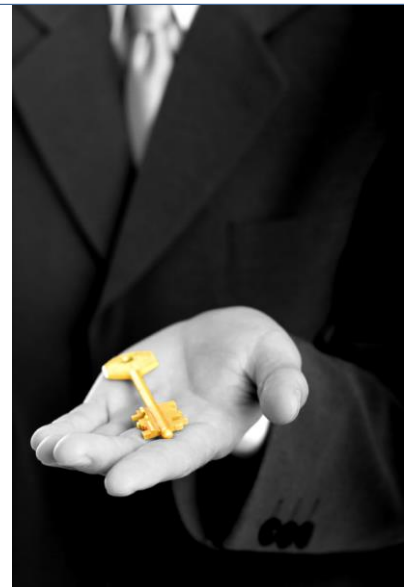
7

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Key Risk & Control Activities for IRR

Ensure:

1. Key assumptions and data sets are well documented.
2. The overall level of IRR is properly measured and controlled.
3. Results are properly communicated to decision makers and the Board of Directors.
4. Proactive measures are taken to remain within sound policies.



8

8

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Liquidity Risk

Higher interest rates have caused a slowdown in repayments of loans. This has resulted in reduced cash flows.

The increased levels of deposits from 2020 and 2021 may result in more share sensitivity and roll-off.

Examiners will look at the current sources of liquidity. They will look at the credit union's policies and procedures as they relate to liquidity and risk limits.

The larger and more complex the credit union, the more robust the expectations will be for the framework that the credit union uses.

9

9

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Key Risk & Control Activities for Liquidity Risk

Evaluate:

1. The effect of changes to the balance sheet based on rate changes.
2. The credit union's borrowing capacity.
3. Scenario analysis including share migration, shifts from core deposits to more rate sensitive accounts (Money Market and CDs).
4. Scenario analysis for cash flow projections.
5. The appropriateness of contingency funding plans to address liquidity shortfalls.



10

10

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Asset Duration or Behavior

In an upward interest rate environment, typically liabilities reprice more quickly and asset duration increases.

For example:

- During a flat rate cycle, a 30-year loan may stay on the credit union's books for 6 to 8 years, on average.
- During an upward interest cycle, that same 30-year loan may stay on the books for 12 to 14 years, on average. This is because the borrower generally will have a more favorable rate than that offered by the market.
- During a downward interest cycle, that same loan may reprice in three years. This is because the borrower can get a lower rate on their existing loan.

11

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Liability Behavior

In an upward interest rate environment, typically liabilities reprice more quickly and asset duration increases. For example:

For banks and credit unions to attract deposits, they have to pay market rates of interest. The more heavily they rely on rate-sensitive deposits for liquidity as rates start to climb, the more quickly the financial institution has to increase its rate to stay in the market.

Typically, share and checking account balances are not as rate sensitive as money market accounts and certificates of deposit. If the credit union wants to raise its liquidity, it will chase hot money, and to do that it has to pay market or just above market rates to attract deposits.

12

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Asset / Liability Mismatch (where Liquidity Risk intersects with Interest Rate Risk)

Financial institutions that rely on paying market rates on rate-sensitive deposits sometime find themselves in the position of having a portfolio of loans that may, for example, pay a steady 4% overall yield, and in years when the rates were low, this portfolio of loans was financed with deposits for which the financial institution was paying 1.5% to its members/customers.

As rates go up, members whose deposits are in money market accounts with no withdrawal or short-term withdrawal restrictions will quickly move their accounts from a lower-paying financial institution to a higher-paying one.

As a result, instead of paying 1.5% to its customers, that same financial institution may now have to pay 3%, resulting in a drop in its interest margin from 2.5% to 1.0%.

Unfortunately the financial institution does not have the luxury to reprice its assets, since they have agreements with their members and customers. The members and customers decide when they will pay or refinance their loans. Collectively, these risks are referred to as Liquidity Risk and Interest Rate Risk.

13

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Uninsured Deposits

Silicon Valley Bank (SVB) and First Republic Corporation (FRC)

Both had a strong customer base that may have needed larger banks. Banks and some credit unions often look for large clients and depositors. A depositor with more than \$250,000 in deposits in one institution is typically concerned with the health of the financial institution they do business with.

In the case of SVB, 94% of their depositors were uninsured. Most were venture capitalists or high-tech businesses that relied on the money deposited in the bank for their ongoing business. Often they would deposit large sums and then use the money for payroll and other operational expenses. Therefore, the customers would have millions at the bank, but would withdraw and deposit millions.

14

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Uninsured Deposits

First Republic Corporation (FRC)

First Republic Bank had approximately 64% of their deposits listed as uninsured. Their customer base was slightly different than that of Silicon Valley Bank. Where SVB had more venture capital and high-tech business customers such as Roblox, FRC had more high net-worth individuals and smaller clients with large balances.

Depositors at FRC were concerned with their deposits, but did not rely on them as much for the day-to-day operations of their businesses (i.e., less pressure). Even with this lower level of reliance, FRC reported that within a month of the SVB closure, it lost 40% of its deposits before deposit levels stabilized.

15

15

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Uninsured Deposits at Credit Unions

Uninsured Deposits - Navy

Rank	State	Name	\$ Total Uninsured Shares & Deposits	Uninsured Shares / Total Shares	Insured Shares / Total Shares	Additional Share Insurance
1	VA	Navy	\$12,339,346,802	9.25%	90.75%	No
2	NC	State Employees'	\$4,034,351,548	8.64%	91.36%	No
3	VA	Pentagon	\$3,622,923,689	13.07%	86.93%	No
4	WA	BECU	\$2,158,164,845	8.35%	91.65%	No
5	UT	Mountain America	\$2,016,100,973	14.61%	85.39%	No
6	CA	Star One	\$1,935,332,374	22.39%	77.61%	No
7	TX	Randolph-Brooks	\$1,790,240,616	13.54%	86.46%	No
8	CA	SchoolsFirst	\$1,779,876,059	7.33%	92.67%	No
9	MI	Lake Michigan	\$1,759,816,394	17.08%	82.92%	No
10	IL	Alliant	\$1,667,155,746	12.41%	87.59%	No
11	DC	Bank-Fund Staff	\$1,540,605,861	26.47%	73.53%	No
12	CA	First Tech	\$1,373,820,033	12.40%	87.60%	No
13	ID	Idaho Central	\$1,325,632,956	16.54%	83.46%	No
14	CA	Technology	\$1,256,195,953	33.73%	66.27%	No
15	CA	Logix	\$1,228,010,725	16.36%	83.64%	No
16	UT	America First	\$1,193,596,720	7.80%	92.20%	No
17	IN	Teachers	\$1,151,876,927	27.59%	72.41%	No
18	TX	American Airlines	\$1,100,472,537	13.75%	86.25%	No
19	CA	Golden 1	\$1,083,213,271	6.49%	93.51%	No
20	TX	Security Service	\$1,046,574,407	10.66%	89.34%	No
21	IA	GreenState	\$1,043,873,694	11.50%	88.50%	No
22	NY	Bethpage	\$1,014,399,429	9.59%	90.41%	No
23	NY	United Nations	\$956,263,959	13.04%	86.96%	No
24	IA	Veridian	\$893,496,030	16.32%	83.68%	No
25	AK	Alaska USA	\$887,077,717	8.63%	91.37%	No
26	NY	Hudson Valley	\$861,587,438	14.75%	85.25%	No
27	CA	Chevron	\$826,754,349	20.61%	79.39%	No
28	FL	WVStar	\$813,900,278	7.70%	92.30%	No

16

16

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Credit Risk

Throughout the COVID pandemic, the government maintained a loose monetary policy and pumped billions of dollars into the economy in the form of subsidies to help ensure citizens were not left out in the cold.

Financial institutions experienced high loan growth and made loans readily available to members and customers, including loan modifications. Some of these programs were in conjunction with government programs and others were not.

Now, as the government seeks to withdraw that money out of the economy and these government subsidized programs are winding down, credit risk increases. The reduction in liquidity due to tighter money policy and higher interest rates has increased credit risk. This left banks and credit unions in a position where making loans is not attractive and there is concern about the ability of borrowers to repay existing loans as the economy dances with an impending recession.

17

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Credit Risk – NCUA Expectations

The current economic environment is characterized by high inflation and interest costs. This makes it difficult for borrowers to repay outstanding debt.

The NCUA expects that credit unions will identify loans with credit weaknesses and take prompt collection actions to mitigate potential losses.

Moreover, it is expected that credit unions will adjust their underwriting standards, portfolio monitoring practices, and loan loss reserves in response to the current environment.



18

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Fraud Prevention and Detection

Insider fraud within credit unions has increased. While more prevalent and easier to accomplish in a smaller credit union, there have been a number of insider fraud cases in larger organizations.

- ❖ Kam Wong (\$10 Million) Municipal Credit Union (\$4.2 Billion)
- ❖ Jeffrey Moats (\$4 Million) Edinburg Teachers Credit Union (\$100 Million)

To combat these frauds by detecting them earlier, the NCUA is implementing a new checklist and questionnaire to use during its examinations.



19

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Fraud Prevention and Detection

- ❖ The NCUA questionnaire has two main sections:
 - ❖ **Anti-Fraud Program section** - Designed for the credit union to evaluate its own anti-fraud program and policies
 - ❖ **Board of Directors, Management, and Business Associates section** - Designed to obtain insight into insider fraud risks, red flags, and other material that may be of interest to the NCUA.
- ❖ There are two versions of the questionnaire, one for large credit unions and one for smaller credit unions.

20

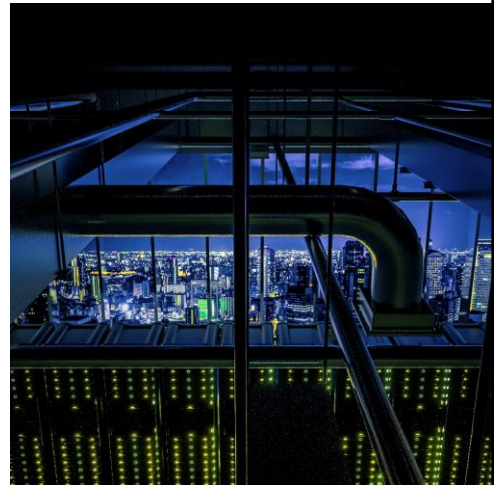
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Information Technology (Cybersecurity)

Cyber threats continue to be a problem. The NCUA will be implementing the new Information Security Examination (ISE), which revises the scope of NCUA reviews in this area. The revised methods are believed to improve the efficiency and effectiveness of their IT reviews.

The regulator will begin using ISE in 2023 to identify and address regulatory and cybersecurity risks.

The automated cybersecurity evaluation toolbox provides credit unions the capability to conduct assessments with the FFIEC tools to allow them to measure their preparedness. This is something that has been used over the past few years.



21

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Regulatory Changes & The CFPB

The Consumer Financial Protection Bureau (CFPB) was established on July 21, 2011 under the guidance of President Barack Obama.

It was created to provide a single point of accountability for enforcing federal consumer financial laws and protecting consumers in the financial marketplace. Previously, that responsibility was divided among several agencies, including the FDIC and NCUA.

The CFPB delegated supervision of consumer financial laws for banks and credit unions under \$10 billion to FDIC and NCUA, but reserved the right to push them aside if it felt these agencies were not doing an adequate job of supervision.



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Consumer Financial Protection

The NCUA makes it a point to touch on compliance matters at every exam. The NCUA bases what it looks at on:

- Recent rules
- Findings that the credit union may have
- Items from Safety Soundness and Fair Lending exams
- Consumer complaints
- Areas of common interest discussed by other FFIEC Members



23

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Consumer Financial Protection – 2023 Areas of Interest

- Overdraft Programs - for FCUs with assets greater than \$500M
 - Website advertising
 - Balance calculation methods
 - Settlement processes
 - Disclosures
- Fair Lending - including appraisal bias
 - Loan pricing discrimination
 - Steering discrimination risk
 - Appraisal bias



24

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Consumer Financial Protection – 2023 Areas of Interest (continued)

- Truth in Lending/Regulation Z - auto lending only
 - This will be limited scope for FCUs with auto loan portfolios that increased more than 30% for the 12 months ending September 30, 2022.
 - They will review for compliance with Reg. Z and auto loan disclosure requirements and terms of credit.

- Fair Credit Reporting Act/Regulation V
 - Adverse action notices
 - Risk-based pricing disclosures
 - Consumer rights disclosures

25

Other Updates

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- Current Expected Credit Losses (CECL)
- Small Credit Union and Minority Depository Institution Support
- Succession Planning
- Post-Examination Survey



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Current Expected Credit Losses (CECL)

Implementation:

- Most credit unions adopted CECL January 1, 2023.
 - The NCUA has added FAQs on its CECL Resources website.
 - Simplified CECL Tool.
 - Carve-out exception for credit unions under \$10 million.
 - Benefit of the three-year transition phase-in.
-
- Examiners will evaluate the adequacy of credit union's Allowance for Credit Losses (ACL) on loans and leases accounts by reviewing:
 - ACL policies and procedures.
 - Documentation of an ACL reserve methodology, including logic for model selection, data assumptions and qualitative adjustments.
 - Adherence to GAAP. (Losses are estimated, the concept of probable is gone.) Reasonable supported forecast.



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Current Expected Credit Losses (CECL)

Adherence to GAAP:

- There should be an independent review
 - It does not need to be a third-party review, but it should have someone look at the data integrity to ensure numbers used in the model are correct.
- Day One adjustment
 - Required by CECL
 - The change in the old allowance to the new allowance should be recorded in the undivided earnings, regardless of whether it's an increase or decrease. The change in the allowance includes the change due to:
 - Losses on loans and leases over the life of all loans
 - Losses on investments
 - Losses on off-balance-sheet credit exposures
 - This adjustment is expected to reduce the undivided earnings, and the NCUA is allowing for this decrease to be calculated in the net worth ratio over three years to give credit unions time to adjust. The amortization of this amount will be done by the NCUA on the call report outside of the credit union's General Ledger system.

29

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Small Credit Union & MDI Support Programs

Small Credit Union and Minority Depository Institutions (MDI) Support Program implemented in 2022

- MDI Credit Unions under \$100 million in assets are eligible for this program
- The NCUA makes allocated hours available to help credit unions in this program with items such as:
 - Compliance assistance
 - Succession planning
 - Strategic plans
 - Tailored approach to examining such credit unions
- The NCUA plans on continuing the support of small credit unions through programs such as ACCESS (Advancing Communities through Credit, Education, Stability, and Support) for underserved and unbanked communities.
 - Identifying additional ways to help small, low-income designated, and MDI credit unions grow and prosper
 - Providing resources such as:
 - Training
 - Community Development Revolving Loan Fund Grants
 - Mentoring Grants

30

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Succession Planning

The NCUA has identified continued consolidation in the credit union system. One primary reason is a lack of adequate succession planning, especially in small credit unions.

The NCUA has found that according to the Society for Human Resource Management:

- 4.3 million workers quit their jobs in December 2021 based on the US Bureau of Labor Statistics.
- In the 11 months ended November 30, 2021, 1,231 CEOs left their posts; an increase of 1.1% over the same period in 2020.



31

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Succession Planning

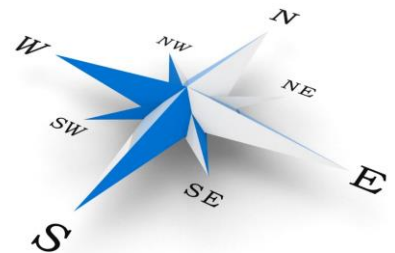
Succession Planning is a process of finding potential candidates for key roles.

A **Succession Plan** is a document that outlines key steps to be taken to fill vacant positions for a credit union. It should be board approved and evaluated every time there is a major change at the credit union. This could be a change in charter, fields of membership, changes in executive team members.

The plan should indicate whether you go outside the credit union or have internal candidates trained to take over when the time comes. For smaller credit unions, generally the credit union has to go outside; while larger credit unions may have sufficient talent to meet these needs internally.

The plan should be tailored to the credit union. The NCUA has resources to help develop a plan. Letters to Credit Unions 22-CU-05 is a letter that discusses factors to be considered in Succession Plans.

Examiners will be asking about succession plans to determine if the credit union has a plan, although it will not be issuing a finding for inadequate planning.



32

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Post-Examination Survey

Transparency is one of the values at the NCUA - This post-examination survey is one way to promote this value.

- In September 2021, the NCUA began this pilot program which was voluntary and monitored independently.
- What questions should the NCUA ask in the survey? They plan to improve the survey with input from examiners and credit unions.
- The examiner in-charge will send the survey to the credit union within two weeks after the conclusion of the examination.

33

33



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About TWHC

Turner, Warren, Hwang & Conrad AC (TWHC), based in Los Angeles, California, is a full-service CPA firm built on principles that ensure its clients receive value. TWHC was established in 1987, and its charter partners all worked together at a previous firm that was driven by similar principles.

TWHC has a diversified clientele. In addition to traditional individual and small business tax services, the firm has three specialty practices: Financial Institutions, Retirement Plans and Not-For-Profit. TWHC employs over 50 employees who provide our clients with best-in-class service. This, in turn, helps our clients to meet their objectives.

For three decades, TWHC has developed numerous services to help its clients improve their operations and take advantage of efficiencies that they may not otherwise be aware of.

The firm continues to celebrate its heritage by adding to its long list of distinguished clients who have tried large firms but were not able to receive the level of service they were looking for. Today, TWHC is recognized in various markets as being the largest provider serving that market.



Questions?

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34