

# The Auditor's Report



## 2012 AICPA NATIONAL CONFERENCE ON CREDIT UNIONS RECAP

This past October the American Institute of Certified Public Accountants (AICPA) held their annual "National Conference on Credit Unions" in San Diego, CA. The conference was a big success!!! There were over 420 attendees who gathered to attend the educational sessions and network with their peers. The objective of this conference is to enhance the technical knowledge of public practitioners, internal auditors, supervisory committee members, and credit union management, particularly CFOs. An overwhelming majority of those attending believe we met this objective.

A sample of this year's speakers included the Chairman of the National Credit Union Administration, Debbie Matz, CUNA's Chief Economist, Bill Hampel, and Lee Wetherington. Lee delivered an insightful speech on the use of technology by credit unions in the future. Other session topics include loan participations, allowance for loan losses, and an update on accounting and regulatory issues. Attendees were very pleased with the sessions and have given excellent input for next year's conference.

Next year's conference will be October 22<sup>nd</sup> - 24<sup>th</sup> at The Bellagio in Las Vegas. As the Chairman of the Conference Steering Committee, I ask that you to join us in Las Vegas for another excellent conference. See you in October.

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Partner  
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**REMINDER**...the deadline for the annual ACH compliance audit is December 31st. This deadline was extended from the previous deadline of December 1st.



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## Loan Participations

Loan participations can be a useful tool for credit unions. Loan participations can help increase loans, diversify the loan portfolio, reduce concentration risk, and increase credit availability to members. However, due diligence by the participating credit union is key to a successful loan participation. The following are just a few examples of the type of due diligence a participating credit union can perform:

**Know the participation agreement well.** A successful loan participation starts with the participation agreement. The agreement lays out the responsibilities of all parties. Knowing each party's responsibility is essential when the loan participation does not perform as planned. The agreement should detail each party's contractual rights and obligations. A well drafted participation agreement can help avoid many of the potential claims that can arise and provide the resolution between parties if conflicts do arise.

**Know the borrower.** Even if you are the participating credit union, you have to understand the loan as if you were underwriting it yourself. This will mean performing due diligence on the borrower. Run background checks. Background checks should include bankruptcy searches, judgment and litigation searches and Patriot Act searches, along with basic financial due diligence.

**Perform property level due diligence.** Each collateralized loan can have a unique type of property and therefore, property due diligence can be different for each loan. Property due diligence should include review of title and survey, property management agreements, leases and environmental reports, as well as estoppel certificates from all major tenants. Each property type has its own individual due diligence quirks.

In a construction loan one might want to pay special attention to insurance and the draw on funds requirements. For a multi-family residential loan obtain a current rent roll and rental delinquency report. For a loan related to an office building, obtain a schedule of tenant improvement obligations. Shopping center loans would include a review of the creditworthiness of the anchor tenants. These are just some of the different areas that one would focus on, but the overall due diligence would be much too lengthy to list here.

**Review loan documentation.** Prior to participating in a pool of loans, a participating credit union should perform a detail review of loan documentation. The National Credit Union Administration (NCUA) states in their proposed Rule and Regulation, that the scope of a loan documentation review should be based on the size of the participation relative to net worth of the participating credit union. A large loan participation might require a full review of loan documentation, while a review based on statistical sampling might suffice in other situations.

Loan participations can be a useful tool for a credit union to manage their portfolio, but like any loan product credit unions need to do their homework. You can find more info on loan participations and due diligence at the NCUA's web site, [www.nuca.gov](http://www.nuca.gov).

*Chris Vallez, CPA, MBA, CICA, Partner  
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## Happy Holidays

At the close of another year, our entire firm would like to wish you a warm and happy holiday season with every good wish for the new year.

In addition, please take note of our holiday hours:

Our firm will be closed Monday, December 24th - Friday, December 28th for the Christmas holiday.

Our offices will re-open on Monday, December 31st, but will be closed on Tuesday, January 1, 2013 in observance of New Year's Day.



## Background Checks On Credit Union Employees

One of the most valuable assets of a credit union is its employees. Credit union employees serve as personal representatives of the credit union, usually have first contact with members and potential members, and conduct business on behalf of the credit union. In the 2012 Global Fraud Study put out by the Association of Certified Fraud Examiners (ACFE), it was reported that in approximately 87% of the cases reported the fraudster had not been charged or convicted of a fraud-related offense prior to the scheme in question. In addition, the report stated that approximately 84% of occupational fraudsters had never been punished or terminated by an employer for a fraud-related offense before the frauds in question. Based on the data provided by the ACFE, it is very important to conduct a detail background check covering numerous areas on potential employees. Due to the far reaching implications, extreme care should be exercised in the selection and retention of credit union employees. Therefore, below are several considerations which a potential employer may want to consider during the hiring process.

**NCUA Rules and Regulation, Part 748, Appendix A** establishes provisions which a credit union must consider in its Security Program. Specifically, in order to control and manage risk, the NCUA Regulations require that a credit union assess whether the following security measures specifically related to employees are appropriate and if so, establish:

***"Dual controls procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to member information."***

Therefore, a thorough evaluation process is critical in the selection of individuals who will be employed by the credit union. Although resources may be limited in conducting all of the following recommendations, the credit union is strongly urged to consider any or all of the following suggestions while considering prospective employees.

### **BONDING**

The determination of whether potential employees are bondable is important and a good proactive tool against fraud. This is very important for sensitive areas of the credit union and could cover different areas from the tellers in the cash area to the employees who purchases investments for the credit union. The credit union should be aware the search and bondability of potential employees is only as good as the database of the organization. For example, the bondability of tellers may not cover all financial institutions, just credit unions, and only if a claim was filed.

### **CREDIT REPORTS**

Credit Bureau Reports provide a wealth of information on the potential employee and should be used in part to confirm and verify the information that the potential employee has provided to the credit union. Honesty and full disclosure is important in any working relationship and all parties should have a comfort level with each other. It is not what the potential employee has told you in many instances that is important; it is what the employee has not told you which needs to be considered, and the credit report will give Management a good idea of the candidate's financial responsibilities.

### **CRIMINAL BACKGROUND CHECKS**

Criminal background checks can provide information on convictions of criminal offenses. However, the information is only as good as the database and may only cover a particular area or State. This is why it is important to obtain employment and residential history during the application process on the potential employee to ensure the appropriate databases are searched.

### **DRIVING HISTORY**

Management should identify which employees will be operating the credit union's vehicle or employees who will be operating a vehicle while on credit union business. These employees could create a liability for the credit union that could result in expensive legal fees, a judgment, and even death to others. Depending on the areas or State, information on a candidate's driving history could reveal traffic violations, driving-related offenses, license suspensions, etc. In addition, the potential employee should be asked for any and all information related to prior traffic violations as part of the application process.

### **EDUCATION RECORDS**

Education records, degrees, or certificates granted should be verified back to the application of the candidate, when applicable. Independent verification should be made between the credit union and the institution. Transcripts received directly from the candidate could be fictitious and/or altered. Therefore, independent copies must be obtained from the institution in order to have a comfort level with the information provided.

### **PRIOR EMPLOYMENT REFERENCES**

One of the most important areas of any background check is verifying the references of the potential employee.

Contacting references will provide the credit union with the opportunity to confirm and verify the information that the potential employee has provided to the credit union and clarify any issues that may develop during the interview process.

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## Background Checks On Employees

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Our firm takes this process one step further by informing all potential candidates that we may ask that their current employer to provide us with the candidate's last two written evaluations. In addition, we have the potential candidate sign a release which states:

***"I authorize previous employers and other references to provide background information about me, and I waive any claims against them for doing so."***

#### PROFESSIONAL LICENSING BOARDS AND AGENCIES

Information from Professional Licensing Boards and Agencies provides information on the existence and current status of an individual's credentials. Important information as to current status and disciplinary actions taken against the licensee are usually revealed in this type of search. The verification is very important especially when the potential candidate's professional designation could be used in the business of the credit union, for example, CPAs, Attorneys, Appraisers, Business Lending Experts, etc. The verification of this infor-

mation could be especially critical when these individuals deal with the members who may rely on these individuals for any type of information or guidance.

#### INTERNET SEARCH

With the availability of the Internet, credit unions should consider conducting several searches of the potential employee on the Internet. In addition, the Credit Union may want to consider searching the social networking websites for the potential employee to see what the potential employee says about himself/herself and the content they post.

#### OTHER BACKGROUND CHECKS

It should be noted that there are numerous other areas which may help in the evaluation of potential employees. These other areas include but are not limited to: Military record searches; civil judgments; drug testing, bibliographies and directories, etc.

Credit union employees owe a fiduciary duty to the credit union to act in good faith in the performance of their duties. Most employees take their fiduciary duty seriously and perform their duties in accordance

with the policies and procedures of the credit union. However, not all employees share this loyalty to the credit union. While the above procedures cannot guarantee that there will not be problems in the future, the items above are **proactive measures** which could aid the credit union in its search of qualified employees. Credit unions may want to consider professional companies which provide a combination of the above services to credit unions for a fee. In addition, several of these services will add to or modify their search for a fee; the credit union should determine where the risks are and develop a plan in the evaluation of potential employees.

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*Over the past 30 years, Nearman, Maynard, Vallez CPAs has learned that not only do our clients want quality services at reasonable prices; they require a wide variety of services. To better meet our clients' ever changing needs, our firm has formed alliances with some top professionals in the industry. One of our strategic partners is the firm, Wilary Winn, LLC. Wilary Winn specializes in determining the fair value in connection with credit union mergers, including the overall value of the credit union, its financial assets and liabilities, and the value of its intangible assets, including the core deposit intangible. Wilary Winn also provides services for determination of fair value of securities and servicing rights and the validation of asset liability management (ALM) models. If you would like more information regarding their article below, please contact them at 651.224.1200 or visit their website at [www.wilwinn.com](http://www.wilwinn.com).*

## Mortgage Servicing Rights

Given record low interest rates, most credit unions are selling the residential mortgage loans they generate into the secondary market. Loans can be sold servicing released or servicing retained. We highly recommend that organizations consider retaining the servicing for the following reasons.

- First and foremost, we believe it is important for a credit union to preserve its relationship with its member and not sell the servicing to a mega-bank.
- Second, servicing provides ongoing fee income.
- Third, we have found that our clients can service loans very efficiently, and the notion that an institution must have a very large portfolio to compete is a myth.

- Fourth, when interest rates go up and we believe this is inevitable, that the servicing will remain on the books for a very long time and will increase in value.

#### Selling Servicing Released

Credit unions can retain the right to service loans they sell into the secondary market or they can sell loans servicing released. Selling the MSR seems straightforward, an institution gives up the right to service the loan in exchange for a fee which is included in the all-in sales price or specified in a Servicing Released Premium (SRP) schedule. The sales are generally to the mega-banks. Unfortunately, things are often not as straightforward as they first appear and an institution that sells servicing released should consider three things:

1. Is the price specified on the schedule the final price it will receive, or are their downward price adjustments for loans not meeting the exact sales criteria?
2. Under what circumstances will it be required to refund the SRP?
3. What is the risk that the institution to which it sold the loan will successfully cross-sell the mortgagor other banking products?

In our experience, there are often price deducts which can significantly affect the all-in price.

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## Mortgage Servicing Rights

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In addition, most contracts provide for refunds of the SRP if the loan is refinanced within a certain time period, or in the case of early loan defaults (in which case an institution is generally required to repurchase the loan and refund the SRP). *Most importantly, a significant portion of the value of the MSR from the buyer's perspective is the opportunity to cross-sell the borrower.* Indeed, studies have shown that the home mortgage loan is one of the most important relationships an institution can have with its customers.

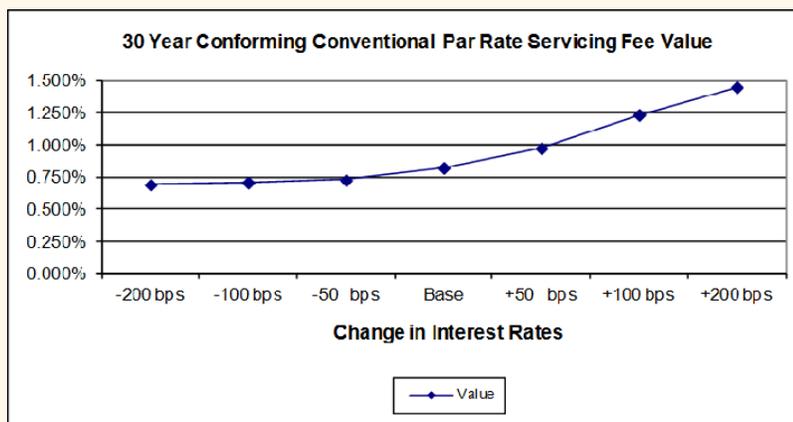
#### Valuation of Retained MSRs

The servicing fee is paid monthly based on the outstanding principal balance of the loan. The expected life of the loan is based on its expected prepayment rate and is the most important valuation variable. Other important components are: the expected ancillary income, the current and future servicing costs, the current and expected delinquency rate and related incremental servicing costs. The final key element in valuing the MSR is the interest rate used to discount the future cash flows to present value.

The following table shows the relative effect on value of changes in one variable, while holding the others constant, for a conforming conventional loan.

	Value	Change	% Change
Base	0.821		
Prepayments increase 30%	0.707	-0.113	-13.8%
Servicing costs increase 30%	0.767	-0.054	-6.5%
Delinquencies increase 30%	0.816	-0.004	-0.5%
Discount rate increases 30%	0.770	-0.051	-6.2%

The variable with the greatest effect on the analysis are expected prepayments. Expected prepayment rates have historically varied significantly and servicing values can therefore be very volatile. Given historically low interest rates, we believe that newly originated MSRs have the potential to increase in value when rates rise. The following graph shows the change in the value of an MSR given instantaneous, parallel, sustained shifts in the yield curve.



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Since its inception, Wilary Winn has grown rapidly, and we currently have more than 375 clients in 44 states and the District of Columbia, ranging in size from \$50 million to \$137 billion in total assets. Wilary Winn's clients include community banks, 28 of which are publicly traded, and credit unions, including 29 of the top 100. Wilary Winn currently values more than 125 mortgage servicing rights portfolios, at least annually, ranging in size from \$5 million to over \$1 billion. We also assist our clients with accounting and regulatory reporting related to the MSR asset including calculation of amortization and recording new assets. Please feel free to contact us at 651.224.1200 or visit our website at <http://www.wilwinn.com> for more information.



## ABOUT US

Since 1979, Nearman, Maynard, Vallez, CPAs has provided auditing and consulting services exclusively to credit unions throughout the United States. Our dedication to credit unions has given us the unique ability to provide exceptional service at a reasonable price. Our primary objective is to assist our clients in accomplishing their goals through our experience, service, & commitment. If your Supervisory/ Audit Committee or Management is interested in obtaining information on the subjects in this issue or about our many services, call or email us today.

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