STRATEGIC INSIGHTS FOR POLICY MAKERS

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Incorporate Strategy Into Supervisory Committee's Focus

Ensure your CU properly executes its risk management game plan.

Supervisory committees and internal auditors must readjust from a purely operational focus and take a strategic view of the credit union's risk, says Tony Ferris, CEO of Rochdale Paragon Group, a CUNA strategic partner.

Committee members should ask questions such as:

- **Is** the organization accomplishing its strategic plan as it intended?
- **Do** we know enough about the details and objectives of those plans?
- **Is** the organization operating within its risk appetite?

"In the past, audit's sole responsibility has been protecting value," says Ferris, who addressed CUNA's Supervisory Committee and Internal Audit Conference. "How do we start to look at audit and supervisory as more than this backstop that signs off on financials? How do we move audit into value creation?"

Moving in this direction can push people from their comfort zone. But according to Ferris, not doing so is a lost opportunity, because the supervisory committee and internal auditors bring a valuable perspective that can form a more intelligent organization.

"It's one of the most underutilized areas we have, and also is an area that sees literally everything in the organization," Ferris says. "Auditors have opinions, but they don't always share those opinions. If you have ideas that will improve the credit union, why [wouldn't] senior management and the board ask you about that?"

'HOW DO WE MOVE AUDIT INTO VALUE CREATION?'

TONY FERRIS

This transformation does present legitimate concerns, such as:

- **Increased scrutiny** and turf protection. Supervisory committee members and auditors must come to a new understanding with credit union personnel about their heightened involvement, as they'll have to ask more questions.
- **Challenges** to objectivity and independence. Staying at arm's length from the board and senior management can become more difficult with an increasingly intertwined relationship.
- **Strain** on resources. The practical matters of staffing and time as it pertains to the scope of the audit begs the question, where does it end?

But Ferris believes the supervisory committee and auditors can surmount these obstacles so long as all sides understand those groups' marching orders.

"Your role isn't to define risk, it's to understand risk and make sure the intentions of the board are being followed through upon—that the credit union is executing risk management in an effective manner," Ferris says.

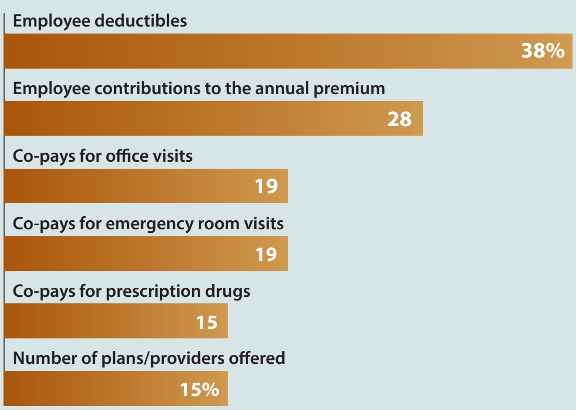
According to Ferris, new supervisory committee core duties stemming from a strategic and consultative focus include:

- **Determining** whether the credit union's risk process is effective. The credit union should have an auditable policy on risk management.
- **Confirming** the organization reports on key risks and understands those risks. Look at whether the board and management use the risk report to make decisions. Alter the report if it's not effective in its current form.
- **Evaluating** whether the credit union consistently applies its stated risk appetite across all functions. "That's the hardest one," Ferris says, "because many credit unions haven't officially decided their risk appetite,

QUICK TAKE FOR YOUR NEXT BOARD MEETING

Top Changes to CU Health-Care Plans*

About 85% of credit unions' 2016 per-employee health-care benefits costs rose over prior-year levels, at an average of 10%—double the national average for all workplaces, according to CUNA's 2016-2017 Credit Union Benefits Report. One-third of credit unions made adjustments to mitigate those rising costs, increasing:



*Among CUs with $1 million or more in assets that offer health insurance coverage to employees, and that made changes to their 2016 health care plan.
Source: *CUNA's 2016-2017 Credit Union Benefits Report* (cuna.org/compensation)

- CUNA's enterprise risk management resources: *cuna.org/erm*
- More coverage of the CUNA Supervisory Committee and Internal Audit Conference: *news.cuna.org*

let alone ascertained whether they're staying true to it."

Ferris advises credit unions to consider the appropriateness of this second tier of duties:

- **Facilitating** risk identification. Take a lead on advising the proper reporting of strategic risks.
- **Coordinating** enterprise risk management (ERM) activities. Many credit unions report ERM through the audit function, which Ferris doesn't favor except in organizations with a chief risk officer who can segment responsibilities. Absent that job role, the supervisory committee must decide whether to take on that role or defer to management. "You should understand risk and get processes in place, but don't own risk," Ferris says. "Management always owns risk. Otherwise we run into independence issues."
- **Educating** the board on the risk associated with its strategies. "That's not been your typical role. Sitting in strategy sessions is not something where you've typically been involved," Ferris says. "But that's a role you'll take on more and more, to provide an outsider's input."

Develop 4 Key Internal Audit Competencies

A highly effective internal audit function depends on identifying the right people for the job, says John Gallagher, director of internal audit at $2.9 billion State Employees Federal Credit Union in Albany, N.Y.

"Go beyond looking at a specific skill set and instead look at core competencies," Gallagher says.

Design short- and long-term development plans for staff based on four core competencies:

1. Communication. "Internal auditors tend to be introverts," he says. "You must be comfortable speaking to people at all levels of an organization, not just hiding behind a piece of paper.

"You can teach almost anybody how to audit, but to really, truly understand the controls and the associated risks, you need to interact with people."

2. Risk. Increase the emphasis on identifying, monitoring, and mitigating risk across NCUA's seven risk categories—as well as cybersecurity—and view risk through an enterprise-wide lens.

3. Alignment. Internal audit shouldn't implement policy, but can educate leadership on the fallout and limitations of controls, such as explaining that a signature on a document doesn't confirm someone followed policy generally, or addressed the details.

4. Data. Internal audit must embrace analytics. "The idea now and going forward is to get away from the traditional sampling techniques and actually look at 100% of the data," Gallagher says.

CUNA Operations, Sales & Service Council: *cunacouncils.org*

Consumers Redefine 'Convenience'

To win consumers, CUs must market their distinct advantages and offer value.

Convenience remains among the top differentiators in choosing a bank, but consumers' perception of convenience has grown increasingly complex.

No longer does "convenience" translate to whichever financial institution has the closest branch—and it's not as simple as offering the best technology, according to Novantas' 2016 Omni-Channel Shopper Survey.

Twenty-six percent of survey respondents rank online and mobile interactions as the top factor in convenience. Other factors of significance include no ATM fees (23%); branches in close proximity (18%); number of ATMs and branches (13%); nearby ATMs (9%); and longer business hours (6%).

Providers must strive to be distinctive, Novantas finds. Elements of distinction include:

- **Ease of** personal financial management;
- **Capacity** to meet all financial needs; and
- **Looking out** for people the institution serves.

Consumers view convenience as the value a financial institution offers to users, according to Accenture's 2016 North America Consumer Digital Banking Survey. Credit unions should consider:

1. Value hunting. Forty-five percent of consumers say price is the main loyalty driver;

2. Relationship switching isn't burdensome. Eleven percent of respondents reported they abandoned their financial institution the prior year;

3. Robo-advice is desirable. Forty-six percent say they will use robo-advice in the years ahead; and

4. Branch opportunity. Of the respondents, 87% intend to use a branch and prefer human contact there.

To acquire loyal consumers, credit unions should:

- **Do data right.** Have good collection strategies, protect privacy, innovate based on insights, and incorporate predictive analytics;
- **Reconsider loyalty.** Connect in meaningful ways via real-time transactions and digital opportunities;
- **Prioritize service.** Keep it consistent and superior;
- **Discover new opportunities.** Be a "go-to resource" in consumer lifestyle choices; and
- **Master "phygital" experiences.** Blend "physical" and "digital" interactions.

LORA BRAY *is a market intelligence analyst for CUNA. Contact her at* lbray@cuna.coop.

Investment Accounting Update Could Affect Strategy

Evaluate and address the potential impact on net income.

If your credit union invests in non-703 compliant securities—for example, as part of a benefits prefunding program, a charitable donation account (CDA), or a 457(f) deferred compensation plan—the board should address an accounting standards update that could affect your investment strategy.

Depending on the size of your securities investments, you might need to adjust your strategy to avoid unwanted income volatility.

The update, issued by the Financial Accounting Standards Board (FASB) in January 2016, takes effect for credit unions beginning with the 2019 fiscal year (i.e., the fiscal year beginning after Dec. 15, 2018). But it's a good idea to start looking at the potential effects of the accounting change now.

FASB's update intends to give those who need to review financial statements a more complete and clear disclosure of financial assets and liabilities. For example, the updated accounting standard now separates accounting for debt securities from equity securities.

One significant effect of the update: Most credit unions will measure and report the value of certain equity investments differently than they do now.

Impact on net income

Credit unions generally categorize one type of non-703 compliant investment targeted by the new rule—equities, such as stocks and mutual funds—as "Available for Sale." Changes in their value from one year to the next don't affect the income statement. They're considered an "unrealized gain/loss."

But to comply with FASB's update, credit unions must account for these investments as "Trading Securities," the designation that securities owners intend to sell for a short-term profit. The big difference between these two categories is that you report trading securities at fair market value—and the periodic change in this value will appear on the income statement as income or expense.

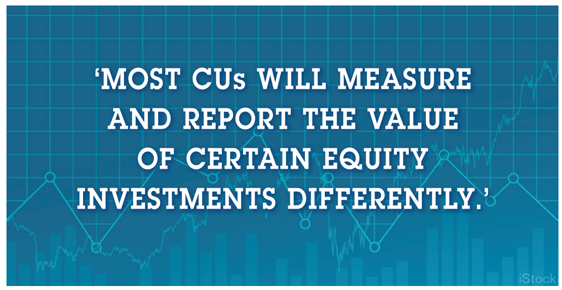
Between now and the end of 2018, credit union boards that hold the affected investments should address the potential impact on net income. Either prepare to withstand fluctuations based on these investments' fair market value, or shift to more stable investments.

Transparency shouldn't derail benefits

Many credit unions have taken advantage of non-703 compliant investments over the past decade or so. NCUA unlocked these investments, including certain equities, commercial bonds, business-owned life insurance, and other instruments, for prefunding employee benefit expenses in 2003, and for funding CDAs in 2013.

Credit union boards have signed off on employee benefits prefunding and CDAs because they give credit unions a flexible tool for improving investment performance for important priorities.

For example, since 2004, the year after the NCUA rule change about employee benefits prefunding, the average family premium for employer-sponsored health benefits has nearly doubled, from $9,950 to $18,142, according to the Kaiser Family Foundation. In addition to providing extra funding for group health costs, credit unions can apply prefunding to group life and disability income insurance, 401(k) match, and executive benefits, among other costs.



The 2013 rule change regarding CDAs not only increases potential returns on investments for charitable donations, it allows credit unions to retain up to 49% of CDA earnings. So CDAs can add to a credit union's ability to improve its area and garner goodwill while bolstering the bottom line.

Start running the numbers

If your credit union's employee benefits prefunding program or CDA has been using the investments this FASB update affects, the board will need to assess the performance of these investments over the years. The returns you've been getting might certainly warrant a potentially more volatile net earnings statement.

Another option: Find similar investments that will qualify for the "available for sale" designation. Work closely with your benefits prefunding and/or CDA provider to assess projections for your investment returns under various economic scenarios.

SCOTT ALBRACCIO *is the executive benefits sales manager for CUNA Mutual Group. Contact him at* scott.albraccio@cunamutual.com.

Key Dates

Credit unions must be in compliance with FASB's accounting standards update No. 2016-01 by fiscal years beginning after:

- **Dec. 15, 2018** for annual reporting; and
- **Dec. 15, 2019** for interim reporting.

- CUNA CU Finance for Volunteers & Staff School, May 3-5, 2017, Nashville, Tenn: *cuna.org/cuf*
- CUNA Mutual Executive Benefits and Funding Solutions: *cunamutual.com/products/executive-benefits*

More coverage of CUNA's Bank Secrecy Act Conference: *news.cuna.org*

Cyberthreats Boost BSA/AML Focus

Mobile technology's emergence opens new pathways for fraud.

While embracing the broad and increasingly complex array of payments options, credit unions also must attain and maintain Bank Secrecy Act (BSA) and anti-money laundering (AML) compliance regimens that cover technology such as mobile payments, *CUNA News* reports.

Rayleen Pirnie, founder and owner of RP Payments Risk Consulting Services, LLC, and a nationally recognized payments risk and fraud expert, reinforced that message at the CUNA Bank Secrecy Act Conference, held in partnership with the National Association of State Credit Union Supervisors.

"NCUA has a renewed vigor and focus on BSA and AML," Pirnie says. "And it's not just NCUA, it's the regulatory environment as a whole."

For instance, the Consumer Financial Protection Bureau (CFPB) also closely monitors this area, and the bureau's interpretations fluctuate: "Know these interpretations," Pirnie says.

The increased regulatory expectations take place against a backdrop of credit unions' stretched staffs and budgets, Pirnie notes, "but the cost of compliance is nothing compared to the cost of noncompliance."

Mobile payments increase compliance challenges, Pirnie says, because today "criminals are less likely to walk into your branch" and more likely to attempt to enter your system online.

Basic compliance requirements

Judy Graham, a program officer in NCUA's Office of Examination and Insurance, says that for basic BSA compliance programs, credit unions should consider Part 748 of the agency's rules and regulations to be the minimum requirement. Those rules say a program must:

- **Establish** a system of internal controls;
- **Provide** for independent testing;
- **Designate** a BSA compliance officer to monitor day-to-day compliance;
- **Establish** a customer identification program; and
- **Establish** a BSA training program for appropriate employees and volunteers.

NCUA is required by law to review BSA compliance programs during each examination of a federally insured credit union. While regulations require credit unions to conduct staff training, they don't establish frequency. The general rule of thumb is every 12 to 18 months, Graham says, but that depends on the credit union's risk profile, products, and services.

Due diligence

Graham says NCUA's minimum due diligence expectations include:

- **Having** and performing a customer identification program;
- **Confirming** registration with the Financial Crimes Enforcement Network (FinCEN), if applicable;
- **Confirming** state or local licensing, if applicable;
- **Conducting** a BSA/AML risk assessment; and
- **Conducting** enhanced due diligence, if applicable, which can include occurrences such as onsite visits.

Sharing information

Sharing information under the USA PATRIOT Act's Section 314(b) can improve credit unions' ability to identify and report potential money laundering and terror financing activities by:

- **Gathering** additional and potentially invaluable information on previously unknown accounts, activities, and/or associated entities or individuals.
- **Shedding** more comprehensive light on complex financial trails.
- **Facilitating** efficient Suspicious Activity Report (SAR) reporting decisions, including identifying transactions that appear suspicious but don't require credit unions to file a SAR.

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Publisher: Ann Hayes Peterson, vice president and editor in chief, *apeterson@cuna.coop*
Editorial staff: Adam Mertz, associate manager, *amertz@cuna.coop;* Jennifer Woldt, senior editor, *jwoldt@cuna.coop*
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Editorial: 608-231-4211 **Subscriptions:** 800-348-3646, fax 301-206-9789, or *cuna.org/directors*

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