



## **Exam Fairness Guide**

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The National Credit Union Administration (NCUA) is authorized by the Federal Credit Union Act (FCU Act) to examine all federally insured credit unions. The Act says in part:

"The Board shall appoint examiners who shall have power, on its behalf, to examine any insured credit union...Each examiner shall have power to make a thorough examination of all of the affairs of the credit union and shall make a full and detailed report of the condition of the credit union to the Board."

NCUA both supervises and examines credit unions under this broad statutory authority. The line between supervision and examination is often blurred, as the on-site examination is the primary tool an examiner may use to supervise credit unions. A key goal of NCUA exams is to protect the share insurance fund while also determining whether a credit union is in compliance with applicable laws and regulations. As part of these efforts, in 2002 the agency adopted a risk-focused examination approach that "address(es) new and emerging risks in the industry and to respond to NCUA's annual supervisory focus." As a result, examiners are [supposed to use](#) "a combination of procedures" internal to NCUA as well as "their own professional judgement" in setting the scope of a credit union's exam.

## **Risk Focused Versus Defined-scope Exams**

Some credit unions will be subject to defined-scope exams as opposed to risk focused exams. NCUA's Examiner's Guide on risk-focused examinations (RFE) contains this chart outlining what type of exam a credit union can expect, which differs based on asset size and CAMEL rating:

| Asset Size             | CAMEL Rating | Type of Exam  |
|------------------------|--------------|---|
| Less than \$30 million | 1, 2, and 3  | Defined-scope examination   |
|                        | 4 and 5      | Defined-scope examination, at a minimum, plus additional reviews as necessary to appropriately supervise the risk   |
| \$30–50 million        | 1, 2, and 3  | Region has discretion to choose a defined-scope examination or an RFE (However, newer examiners will be limited to conducting only defined-scope examinations for FCUs in this asset size range.) |
|                        | 4 and 5      | RFE   |
| More than \$50 million | All          | RFE, ensuring examination scope requirements are met  |

In a defined-scope exam, the risk areas have already been identified which pre-determines the scope, so an examiner will not perform a preliminary risk assessment or develop an individualized exam. The risk focused exam aims to hone an examiner attention and resources on areas showing weaknesses and adverse trends. The examiner generally will derive these high-risk areas from previous examinations, his or her review of the credit union’s call report, and general downward trends in the industry. New products and services will likely be considered a higher risk to the credit union than those with which the credit union has vast experience.

This risk-focused process provides examiners with flexibility to focus on areas they see as exhibiting current or potential risk to the credit union and the overall system. However, there are three requirements each examination must include:

- Reviewing the accuracy of the 5300 Call Report data
- Reviewing the supervisory committee audit; and
- Reviewing the credit union’s compliance with the Bank Secrecy Act.

Once the minimum requirements have been met, examiners may turn towards areas that reveal pertinent risk characteristics.

## Frequency of Exams & Extended Exam Cycles

At the end of 2016, NCUA issued [Letter to Credit Unions](#) (16-CU-12) providing some information about its examination flexibility initiative and its efforts to move to an extended examination cycle for some credit unions. NCUA intends that the examination scheduling policy changes will permit the agency to allocate its resources to higher risk areas, be more responsive to the needs of individual credit unions, manage resources more efficiently and reduce the examination burden on credit unions.

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Federal credit unions meeting certain eligibility requirements will qualify for an extended exam cycle of 14 to 20 months from the prior examination completion date. Note, examinations for all other federal credit unions will begin between 8 and 12 months from the prior examination complete date.

Federal credit unions must meet all of the following eligibility criteria:

- Assets less than \$1 billion;
- CAMEL code 1 or 2, in both the composite rating and the management component rating;
- “Well capitalized” under prompt corrective action (PCA) regulations;
- No outstanding documents of resolution (DOR) items related to significant recordkeeping deficiencies; and
- Not operating under a formal or informal enforcement or administrative order, such as a cease and desist order (C&D), letter of understanding and agreement (LUA), preliminary warning letter (PWL) or a PCA directive.

However, small credit unions with “limited segregation of duties that are otherwise eligible for an extended exam cycle may receive more frequent examinations on a random sample basis.” NCUA aims to fully transition to the extended examination cycle within two years so not all credit unions that meet the criteria will necessarily see the benefit of this policy shift in 2017.

Federally-insured state charters that meet any one of the following three criteria will receive NCUA exams between 8 to 12 months from the prior examination completion date:

- Assets greater than \$1 billion;
- Composite NCUA CAMEL code 4 or 5 with assets greater than \$50; or
- Composite NCUA CAMEL code 3 with assets greater than \$250 million.

Note, all other federally insured state-chartered credit unions will receive an NCUA examination based on risk at least once every five years. NCUA also stated it intends to make every effort to conduct examinations of federally insured state-chartered credit unions jointly with the appropriate state supervisory authority.

The agency will continue to use the [Small Credit Union Examination Procedures](#) for credit unions with less than \$30 million in assets and risk-focused examination procedures for larger credit unions. In addition, NCUA will continue to have discretion to use the Small Credit Union Examination Procedures for credit unions with assets between \$30 million and \$50 million.

Other changes to examination procedures in 2017 include:

- Providing at least four weeks advanced notice when scheduling an exam, unless concerns at the credit union warrant shorter or no notice;

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- Improving coordination of document requests tailored to the credit union’s risk profile and products; and
- Separating and emphasizing pre-exam planning and scoping from the beginning of onsite exam work.

In general, NCUA expressed that it hopes to facilitate more effective and efficient examinations while reducing the burden on credit unions. The agency also affirmed it will emphasize the importance of timely, ongoing and open communication between examiners and credit union management and officials.

## Navigating Exam Challenges

Sometimes, NCUA’s position with regard to exams can lead to disagreements between credit unions and examiners. NCUA acknowledges that examiners are not perfect, and in spite of examiner training, disagreements and inconsistencies may occur in any given examination report. NCUA has a process in place for accommodating these situations. Navigating this process and deciding when it may be appropriate to contest examiner findings can sometimes be difficult for credit unions.

First, keep in mind that NCUA has a broad range of administrative tools at its disposal. Two good sources of information about these administrative powers are Chapters [20](#) and [30](#) of the NCUA Examiner’s Guide. The following briefly describes some of NCUA’s powers:

- **Document of Resolution.** Examiners use this administrative power, commonly referred to by its acronym of DOR, to formally document plans and agreements reached with credit union staff and officials to reduce areas of unacceptable risk. NCUA has indicated that this tool should not be used for minor issues.
- **Letter of Understanding and Agreement.** A Letter of Understanding and Agreement, commonly referred to by its acronym of LUA, is essentially a contract between NCUA and a credit union. In an LUA, the credit union agrees to take, or not take, actions outlined in the document. NCUA has indicated that it issues LUAs when credit unions have not adequately responded to less severe measures such as DORs. It is important to keep in mind that once a credit union signs an LUA, it is a final agreement and cannot be renegotiated. An LUA signed by the appropriate personnel in the credit union, typically the CEO and/or the credit union’s board, is binding and commits the credit union to take or abstain from certain actions. It is critical to seek outside counsel with appropriate expertise who can help the credit union fully assess the LUA prior to signing the document.
- **Cease and Desist Order.** Akin to an injunction, the FCU Act generally empowers NCUA to issue cease and desist orders when a credit union is or has engaged in an unsafe or unsound practice, or when the credit union has or is about to violate a law, regulation or a condition imposed in writing by NCUA’s board. Credit unions that receive a cease and desist order have a right to a formal hearing before an administrative law judge. Once effective, violating the terms of a cease and desist order can trigger additional administrative actions, including civil money penalties.

- **Other Powers.** NCUA has numerous other administrative powers, including the following:
  - Issuing civil money penalties.
  - Removing credit union officials.
  - Issuing prohibition orders, which prohibit an individual from being involved in the affairs of any insured credit union.
  - Conservatorship.

Overall, exam results can have a significant impact on a credit union and impact future exams. Even with the best circumstances, mistakes can be made by examiners and credit unions alike. NCUA, like any organization, acts through its employees and agents. No matter how much training is received, employees, including examiners, can react differently to the same situation. Some employees are more seasoned and will be better prepared than others. Meanwhile, especially in a complex regulatory environment, it is no surprise that there are occasions when a credit union and the NCUA examiner do not see eye-to-eye on a given issue.

It can be difficult to decide the best course of action when a credit union disagrees with an examiner's finding. Disagreements can vary in scope or importance when it comes to exam outcomes. Credit unions have indicated that it helps to consider whether to challenge an exam finding using a careful and measured step-by-step process and in a deliberate manner.

If the issue is minor, a credit union may wish to concede. Challenging an examination takes time, effort and occasionally money. Some credit unions are reluctant to take action with regard to an exam unless the issue is more egregious, opting to avoid potentially costly confrontations or poor relations with an examiner. If a finding is minor and can be corrected quickly with little to no operational disruptions, many credit unions will make the suggested change even if they disagree with the examiner's reasoning.

If the credit union disagrees and would like the examiner to reconsider his or her position, an initial step is an informal discussion with the examiner. NCUA has indicated that in some credit union-examiner disagreements, there was a breakdown in communications. Some credit unions take care to clearly and rationally communicate the reasons for its position. In addition, if attempts to resolve the matter with the examiner are not successful, some credit unions consider bringing supervisory examiners into the conversation before resorting to a formal dispute.

## Formal appeals

If informal conversations fail to resolve a disagreement between a credit union and an examiner, credit unions have rights through which they can formally appeal exam findings. NCUA discussed these rights in the [March 2010 issue](#) of the NCUA report. Keep in mind that a credit union's board must authorize an appeal before it is filed. In short, the steps are as follows:

1. Request a review from the appropriate regional director in writing within 30 days of receiving a final report from an examiner. The regional director is to respond within 60 days.

2. Should a credit union not agree with the regional director's response or if the regional director does not respond within 60 days of receiving the request for appeal, a credit union may submit an appeal to NCUA's Supervisory Review Committee. The Committee's structure and operation are outlined in Interpretive Ruling and Policy Statement (IRPS) [11-1](#), as amended by IRPS [12-1](#). Credit unions considering an appeal may want to closely review the IRPS, as the SRC only handles a limited number of "material issues." In addition, the following text from IRPS 11-1 is worth noting:

*The determination or denial remains in effect pending appeal. The appeal does not prevent the NCUA from taking any action, either formal or informal, that it deems appropriate during the pendency of the appeal.*

The Committee's decision is appealable to the NCUA Board within 30 days of receipt.

3. There are other procedures in place for credit unions to use when contesting examiner findings. These can be found in the following Parts of NCUA's rules and regulations:
  - [Part 709](#) (creditor claim appeals);
  - [Part 745](#) (share insurance appeals);
  - [Part 792](#) (Freedom of Information Act appeals);
  - [Part 747](#) (appeals of various administrative and enforcement actions);
  - In addition, the NCUA Board serves as the final administrative decision maker for major disputes that are not otherwise covered by IRPS 11-1 (as amended by IRPS 12-1) or the regulations noted above. These issues include disputes over chartering, insurance applications, field of membership expansion, merger, certain corporate credit union matters, charter changes and letters of understanding and agreement. NCUA has indicated that these issues should first be pursued through the appropriate Regional Office. After that, appeals concerning these matters should be addressed to the NCUA Board, but submitted through the appropriate Regional Office.

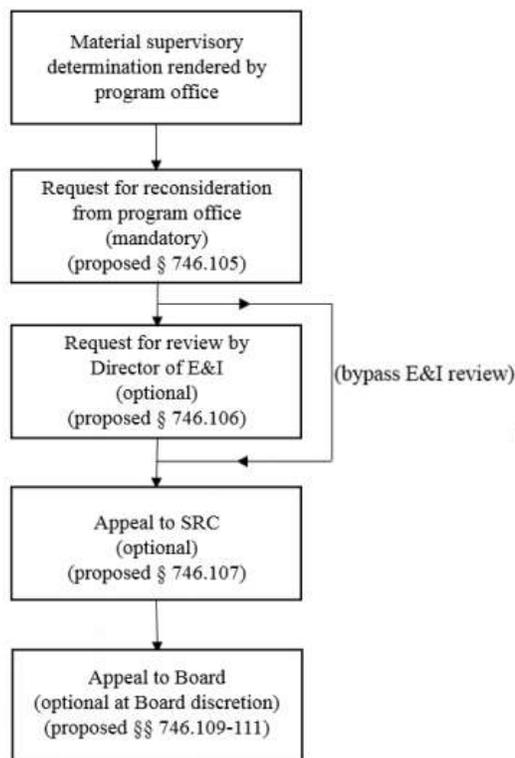
Given the various avenues that credit unions can pursue, it is important to know which avenue is the proper one given the nature of the credit union's appeal.

Also, changes in the appeals process are in progress. NCUA recently approved two proposed rules regarding the appeals process (available [here](#) and [here](#)). The NCUA Board is codifying the IRPS, items from Letters to Credit Unions, and legal opinion letters into one place. The proposals would amend the procedures for appealing material supervisory determinations to the NCUA SRC to enhance due process and to be more consistent with the practices of the federal banking agencies. The proposed rules would:

- clarify which material supervisory determinations appealable to the SRC such as:
  - a composite rating of 3, 4 or 5;
  - determinations relating to the adequacy of loan loss reserve provisions; and

- restitution orders under the *Truth in Lending Act*
- create an optional intermediate level of review before an appeal is brought to the SRC; and
- change the nature and composition of the SRC by expanding the pool of NCUA staff who may serve on an SRC panel and allowing the Committee to have a rotation of members.

If adopted, the new procedures would be as follows:



Through these proposals, NCUA seeks to promote efficiency, consistency, and transparency in the appeals process to the Board by developing a uniform set of procedures to govern all rules in which an appeal to the Board is permitted. NCUA also aims to provide parity with exam appeals improvements already adopted by other banking regulators.

## Other Tips for Managing Exams

Here are some other insights that may help in managing exams and achieving a fair outcome for a credit union:

1. **Asking for specifics.** When an examiner indicates that credit union should be taking a specific course of action, or abstaining from a particular practice, the examiner's basis for the statement may not be clear. It can help to ask what specific law, regulation or

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guidance document serves as the source of authority for the recommendation. Examiners are often forthcoming with this information and this will help the credit union understand the reasoning for the examiner's position. It can also help the credit union determine whether or not the examiner's position has proper justification.

2. **Utilizing the NCUA's examiner manual.** NCUA has an [Examiners Guide](#). Some of the Guide is [available online](#) in PDF form, and some sections are in NCUA's online platform. In fact, NCUA is in the process of updating its Examiner's Guide and migrating the entirety to a [web based platform](#). For the time being, credit unions will want to keep in mind this information is in two places. In total, the Guide is thirty-two chapters long and serves as the reference guide for credit union examiners. Chapters cover issues such as lending, asset liability management, internal controls, exam report writing and administrative actions. The guide is a good way to understand NCUA expectations on a given issue. If the examiner is not following the guide's recommendations, it would be reasonable to ask why.
3. **Documenting policies, procedures and training.** Board training, practices and the reasons behind some business decisions are often translated into records, procedures and other documents that an examiner can review. In addition, research, statistics and information as to why a credit union created a certain practice or procedure may be helpful.
4. **Developing in-house expertise.** When appealing an examiner's finding, it helps to understand NCUA's official position on a given issue. Staff with strong skills and expertise in key areas such as accounting, finance, legal, loan underwriting, compliance, and statistics can be critical to achieving positive exam outcomes. Developing expertise in these areas will not only help you during a dispute, but having can be key to running a credit union in compliance with the laws, regulations and regulatory guidance documents that govern it.
5. **Using outside experts.** Credit unions may wish to develop relationships with outside auditors and attorneys. Some credit unions even opt to have legal counsel present when the agency requests to meet with the credit union's CEO and board. In addition, credit unions may want to consider consulting with outside experts on a regular basis, rather than waiting for a formal dispute or other issue to develop. Such experts often can perform audits to identify problem areas before an examiner can locate them. Also, bringing an outside auditor or attorney up to speed is often much easier when he or she is already knowledgeable about the credit union's operations. Overall, consulting with outside experts can also help avoid problems, minimizing the odds that a formal appeal would be necessary.
6. **Being proactive.** Some credit unions have indicated that it pays to be proactive during an exam process. Examiners visit many credit unions, but credit unions are diverse in their operations, product portfolios, risk appetites, risk profiles, and other characteristics. Credit union staff members are experts on their individual credit unions and can teach examiners. Highlighting aspects like the credit union's risk management program, skilled staff, dedicated board, key operations and the rationale behind practices, policies, and procedures may help inform an examiner's review.
7. **Reviewing the exam result.** NCUA officials have indicated that credit unions who sign a Document of Resolution or Letter of Understanding and Agreement will be held to the

agreement. As a result, it is important to understand the nature of the document the credit union is signing. Being prepared to discuss the terms of these agreements with the examiner and asking clarifying questions if necessary can ensure the terms are clear. Some issues such as timing may even be open to debate.

8. **Networking.** Many credit unions have indicated to us that networking with local colleagues, trade associations, and through training and conferences is helpful. Credit union professionals are often collegial and open to discussing exam experiences to the extent permitted by NCUA given confidentiality provisions. This can be helpful in dealing with the uncertainties involved with NCUA supervision and examinations.

Given the unique nature of each credit union's operations, it is nearly impossible to generalize how a credit union should respond to NCUA. Each situation will be different, and credit unions will make business decisions on how to choose to respond, or not to respond, to particular examination findings. In the meantime, while NAFCU cannot represent a credit union in an exam, our team is here to help member credit unions with questions.