

NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

YEAR 2000

**PROGRESS OF
HIGH RISK CREDIT UNIONS**

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Introduction

This is the fourth of the Office of Inspector General's (OIG) series of reports addressing the Year 2000 (Y2K) computer problem as it relates to the National Credit Union Administration (NCUA) and federally insured credit unions (FICUs). This report primarily addresses NCUA's follow-up of high risk credit unions. This report also reviews the justification for assigning low risk ratings to a small sample of credit unions.

Because of the time critical nature of the Y2K problem, and in order to provide the NCUA Board with timely information, we are not making formal recommendations or asking for a written response. Rather, we are offering certain suggested actions as matters for consideration by the NCUA Board and agency management in this management report.

Other Y2K reviews in process include: Y2K readiness status of credit union vendors; and liquidity status of natural person credit unions.

Background

Internally, NCUA Y2K risk ratings for each credit union are determined by the examiner as of the most recent on-site contact. Internal risk ratings are *high*, *medium*, and *low* based on examiner judgment of the credit union's progress. A *high* rating is assigned to credit unions not progressing towards compliance. A *low* rating is assigned to credit unions clearly demonstrating their progress towards compliance. A *medium* rating is assigned to credit unions that fall somewhere between the *high* and *low* ratings. A *medium* rating indicates a need for supervisory attention but not to the degree that necessitates NCUA's intervention. The NCUA has provided guidance to examiners to ensure that timely contacts are made at credit unions to address any readiness problems. Guidance was provided to examiners in June 1999 to clarify the criteria for assignment of *high*, *medium*, and *low* ratings and supervision follow-up.

NCUA reports credit union progress in preparing for Y2K operations to Congress using the Federal Financial Institution Examination Council (FFIEC) categories of *unsatisfactory*, *needs improvement*, and *satisfactory*. Prior to June 1999, the risk ratings reported to Congress were not consistent with the internal risk ratings assigned by the examiners. For example, the *unsatisfactory* category reported to Congress only included those credit unions under administrative "compel" actions. However, starting in June 1999, the risk ratings reported to Congress (*unsatisfactory*, *needs improvement*, and *satisfactory*) now match the internal ratings of *high*, *medium*, and *low* respectively.

In an August 28, 1998 letter to the NCUA Inspector General, the House Committee on Banking and Financial Services requested information regarding OIG Y2K review activities. The OIG discussed the possibility of reviewing several areas of NCUA Y2K activities including consistent reporting to Congress of credit union readiness with committee staff. The OIG and committee staff were interested to determine if credit unions particularly in the *unsatisfactory* and *needs*

improvement reporting categories, were receiving appropriate and timely follow-up to ensure satisfactory progress.

Objectives

Our specific review objectives were: (a) to evaluate whether credit unions rated *unsatisfactory* (credit unions under administrative actions) and those rated *needs improvement* (examiner rated *high risk* - not progressing satisfactorily) are receiving appropriate and timely follow-up; and (b) to determine if *high risk* credit unions have adequate Y2K contingency plans. In addition, we wanted to review a small sample of credit unions rated *satisfactory* (*low* and *medium* risk rated credit unions) to determine if the rating appeared justified based upon NCUA's criteria.

Scope and Methodology

We reviewed documentation for a sample of credit unions for supervision and follow up contacts from two of six NCUA regions to determine adequacy and timeliness of follow up. We also reviewed this sample of credit unions to determine the adequacy of contingency plans in accordance with agency guidance. Our March 31, 1999 review universe included 152 *high risk* credit unions (53 *unsatisfactory* and 99 *needs improvement*). The review was performed in Regions I and III and included a sample of 33 credit unions with *unsatisfactory* and *needs improvement* ratings. We began our review in April 1999 and the fieldwork was completed in August 1999. Because of the limited review scope and our desire to provide NCUA management with timely information, we followed the President's Council on Integrity and Efficiency Quality Standards for Inspections with the exception of the standards for fraud and other illegal acts and follow-up.

Our review included documentation for natural person credit unions. We reviewed documentation to determine if contact occurred in accordance with agency guidance; and that the contact occurred in a timely manner. We reviewed documentation for nine credit unions rated *satisfactory* to determine consistency of rating assignment.

Our review was designed to answer the following questions.

A. NCUA follow-up:

- Why was credit union assigned the rating and did rating meet agency criteria for rating.
- What type of contact.
- Was contact timely.
- Was contact performed in accordance with plans and agency guidance.
- If contact was not performed why not.
- What are plans for next contact and are the plans reasonable.
- How was contact documented.
- Can credit union meet current and future milestones. If not what are credit union and agency plans.
- If administrative action assigned, can credit union reasonably comply. If not what are alternative plans by the credit union and agency.
- What quality control/review performed prior to and for the contact.

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- For Federally Insured State Credit Union (FISCU): Is there evidence of timely and adequate monitoring/plans by State Supervisory Authority (SSA) and NCUA in order to ensure credit union problems are resolved in timely manner.
- Overall assessment of credit union progress.

B. Business Resumption Contingency Plans:

- Does credit union have a written contingency plan.
- Does contingency plan meet guidance provided by agency.
- What evidence of examiner assessment of plan (is plan reasonable).
- Does agency have plan to monitor the credit union to ensure that if necessary the plan will be implemented if needed in a timely manner.
- Does plan address liquidity and how was this assessed by the agency.
- For FISCU: Is there evidence of timely monitoring and action by SSA and NCUA.
- What is overall assessment of adequacy of contingency plan.

We performed the following procedures to meet our review objectives:

- Interviewed certain Central Office and regional office staff;
- Reviewed Central Office and regional guidance and procedures; and
- Reviewed sample documentation for 42 credit unions (21 federal credit unions and 21 federally insured state chartered credit unions). Our review was limited to examination and contact documentation available in the regional offices. We reviewed follow-up documentation, including information update forms and contact checklist information, prepared by staff. We also reviewed credit union Y2K contingency plans and examiner-prepared contingency plan review checklists when available.

OBSERVATIONS

NCUA has reported that 99.3 percent of the nation's federally insured credit unions have finished repairing, testing and verifying their computer systems to ensure they can process transactions smoothly after January 1, 2000. To determine credit union readiness agency examiners have visited every federal credit union twice and many will have a third visit before the end of 1999. NCUA examiners spent over 90,000 hours onsite conducting Y2K readiness examinations. We found that supervisory contacts are being made in accordance with agency guidance and staff are following supervision guidance.

Credit unions rated *unsatisfactory* and *needs improvement* have declined dramatically in 1999. As of August 31, 1999, NCUA reported that only .5 percent of the credit unions are rated *unsatisfactory* or *needs improvement*. The results of our review found that, in most instances, follow-up contacts were made as required at *high risk* credit unions in a timely manner and in accordance with agency guidance.

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In our review of a small sample of credit unions rated *low* risk, we found that credit unions are being rated in a consistent manner in accordance with agency guidance. At the time of our review, follow-up at *satisfactory* rated credit unions was under discussion.

NCUA requires that credit unions prepare Business Resumption Contingency Plans (BRCP). We found that BRCPs were prepared by the credit unions in our review sample. The examiner's review documentation indicated most BRCPs were reasonable and acceptable. However, it was difficult to determine the degree of analysis performed by the examiner in determining the acceptability of the plans. At the time of our review, not all BRCPs had been tested. In some instances, testing of the BRCPs was to be done in the third and fourth quarters of 1999. Follow-up plans regarding analysis and testing of BRCPs were in the discussion and developmental stages.

Follow up at Credit Unions Rated Unsatisfactory or Needs Improvement - High Risk

We reviewed documentation for 33 credit unions risk rated *high* risk. We found that in most instances contacts were made as required at *high* risk credit unions in a timely manner and in accordance with agency guidance. Overall we found that staff are following guidance regarding *high* risk credit unions in regards to appropriate and timely follow-up.

High risk credit unions, at the time of our review, included credit unions that were not progressing toward compliance and in the examiner's judgment, management at these institutions did not have a sufficient understanding of the problem or its consequences. *High* risk credit unions included those rated as *unsatisfactory* or *needs improvement* according to the criteria provided by the Federal Financial Institutions Examination Council.

As recently as July 28, 1999, the agency indicated there were 63 *unsatisfactory* (*high* risk) and 830 *needs improvement* (*medium* risk) rated credit unions. As of August 31, 1999 the agency reported 7 credit unions rated *unsatisfactory* and 50 credit unions rated *needs improvement*. This represents .5 percent of the 10,753 credit unions. As of August 31, 1999, less than 1 percent of the credit unions were rated *unsatisfactory* or *needs improvement* in the two regions we visited.

NCUA is a part of the Federal Financial Institution Examination Council (FFIEC). The FFIEC developed a work program for use by the regulators in evaluating the Y2K status of financial institutions. In addition to FFIEC guidance, the Central Office and regional offices provided instructions and clarifications regarding risk ratings¹. Risk rating definitions are open to some

¹ Examiners assign overall risk ratings of High, Medium, and Low to credit unions based on examiner judgment of the credit union's progress. "Use high, medium, or low risk categorization based on examiner judgment of the credit union's progress.... Credit unions rated as low risk are clearly demonstrating their progress towards compliance both in terms of systems remediation and interfaces with third parties. Those credit unions rated as high risk are not progressing towards compliance and in the examiner's judgment, management at these institutions does not have a sufficient understanding of the problem or its consequences. Credit unions rated as

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interpretation and examiner judgment in assigning the ratings to individual credit unions. Credit union examiners follow the FFIEC program including completion of a checklist and overall risk rating during the credit union examination or Y2K contact.

NCUA has provided guidance for monitoring credit union compliance progress in meeting remaining milestones of June 30, 1999 testing; July 31, 1999 substantially complete implementation; and September 30, 1999 final implementation. Field staff and regional offices periodically report to the Central Office progress being made by credit unions.

We found regional management continuously communicates with examiners and staff regarding Y2K through phone calls, written guidance, memos, and status reports. One example is the Region I monthly Y2K Watchlist report sent to appropriate field staff. In addition the agency has provided guidance and clarification regarding risk rating assessments in bulletins and memorandums. Regions received input from examiners in developing risk rating guidelines. In June 1999, new criteria and clarification regarding risk assessments was provided to examiner staff. Credit unions deemed *unsatisfactory* were *high* risk rated; credit unions rated *needs improvement* were *medium* risk rated; and credit unions rated *satisfactory* were rated *low* risk rated. Examiners were required to upload e-forms by July 31, 1999, if there were any credit unions needed to be re-rated to *unsatisfactory* or *needs improvement* based on the new criteria.

When a credit union is identified as making unsatisfactory progress (*high* risk) an on-site contact was conducted by July 31, 1999, and monthly thereafter until such time as the risk rating improves to *needs improvement* or *satisfactory*. When a credit union is identified as *needs improvement* an examiner will conduct monthly or quarterly on-site or off-site contacts as determined by policy until such time as the credit union is rated as making satisfactory progress. A *satisfactory* (*low* risk) credit union will receive normal supervision as determined by regional policy.

Examiners are required to submit a Y2K update to NCUA for the credit union via an electronic update form (e-form) at the time of each examination or contact. A part of the e-form requires the examiner to risk rate the credit union *high*, *medium*, or *low* based on the examiner's judgment of the credit union's progress in becoming Y2K ready. The e-form update information; examiner prepared FFIEC checklist (Section 6 form) information; and credit union prepared quarterly status Y2K reports are used by the regional office and Central Office in determining overall Y2K readiness for credit unions. Regional management addresses status of FICUs in periodic reports to the Central Office.

The regional division of supervision (DOS) conducts monthly reviews of reports and update information from examiners to determine credit union progress, to ensure contacts are made in a timely manner, and that examiners take needed corrective action. DOS conveys information regarding credit union status to staff through memos and reports. During the past two examiner group meetings, management reviewed ratings and status with examiners and supervisory examiners for all credit unions.

medium risk fall somewhere between the other two ratings, indicating a need for supervisory attention but not to a degree that necessitates intervention on NCUA's part." (NCUA Bulletin No. 13610.02(REV), dated July 27, 1998)

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The agency and state supervisory authorities (SSAs) utilize administrative actions and Regional Director Letters (RDLs) to ensure compliance and readiness at credit unions. As milestones are passing and approaching quicker, regions are increasingly using published Letters of Understanding and Agreement to resolve Y2K compliance issues. According to Central Office guidance, credit unions must be risk rated *unsatisfactory* or *needs improvement* (*high* risk and *medium* risk respectively) if there is outstanding Y2K-related administrative action. Generally, however, a credit union does not have to be risk rated less than *satisfactory* if the outstanding administrative action addresses non-Y2K issues. It is our understanding all *high* risk credit unions have been issued administrative “compel” actions. In addition, all *high* risk rated credit unions had an on-site contact in July and will continue to have monthly on-site contacts until the credit union resolves the problems and is rated *medium* or *low*.

Our sample included 14 credit unions under Y2K related administrative actions that were rated as *low* risk. Under guidance sent from the Central Office in June 1999, these credit unions should have been reclassified to *medium* or *high* risk by July 31, 1999 if sufficient progress had not been accomplished. As of July 31, 1999, sufficient progress had been made in 13 of the 14 cases to warrant a *low* risk rating. The remaining credit union was rated *medium* risk because of an outstanding Regional Director Letter.

NCUA regions review samples of federally insured state chartered credit unions (FISCU) quarterly reports to ensure that credit unions are becoming Y2K compliant in a timely manner. SSAs determine when on-site contacts at FISCUs are performed or needed. Regions select 3 percent of FISCU prepared quarterly status reports for review. The supervisory examiner selects the FISCU report to be reviewed. Examiners perform the review and DOS monitors action by examiner. Regional management has met and is continuing to meet on a periodic basis with SSAs to discuss common problems. In addition, DOS sends monthly reports to SSAs regarding FISCU risk ratings, review results, and progress of FISCUs.

Follow up at Credit Unions Rated Satisfactory - Low Risk

The vast majority of credit unions, 99.5 percent as of August 31, 1999, are reported by NCUA as making satisfactory progress in becoming Y2K ready. Accordingly, these credit unions are rated *low* risk and receive a limited amount of resources in monitoring. To determine if risk ratings are being applied on a consistent and reasonable basis we reviewed a small sample of nine credit unions rated *satisfactory* with assets in excess of \$50 million. Our review of sample documentation indicated that, overall, examiners addressed problems noted and identified plans to resolve the problems.

We found that there are limited plans to monitor credit unions reported as being Y2K compliant. However, both regions plan to perform some follow-up work to ensure that credit unions rated *satisfactory* are in fact compliant. At the time of our review, Region I management had prepared preliminary draft plans regarding on-site quality control reviews at credit unions. DOS analysts

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in conjunction with SSAs were planning to perform on-site contacts in September at selected credit unions. If problems were noted in September, the on-site review program would be expanded in October with additional follow-up by select Y2K group specialists.

Region III indicated that some work in *satisfactory* rated credit unions would be performed towards the end of 1999. The plans were incomplete. However, the region planned to visit or be in contact with all credit unions during the fourth quarter 1999.

Business Resumption Contingency Plans

Credit unions are required to complete a Business Resumption Contingency Plan (BRCP) that is comprehensive and unique to the credit union. The plan should be designed to mitigate risks associated with (1) the failure to successfully complete renovation or implementation of its Year 2000 readiness plan (remediation contingency plan) and (2) the failure of systems at critical dates (business resumption contingency planning). The BRCP process should include establishing organizational planning guidelines, completing a business impact analysis, developing a contingency plan that establishes timelines, and designing a method of plan validation. The BRCP was to be completed by no later than June 30, 1999. Credit union testing of the BRCP may be performed in the third and fourth quarters of 1999.

We found that credit unions are developing BRCPs as required. In addition we found that the vast majority of credit unions in our review sample had acceptable Business Resumption Contingency Plans as determined by examiner review. The chart below shows how the 42 credit unions in our sample performed in key BRCP criteria at the time of our review.

Business Resumption Contingency Plan (BRCP) Criteria:	Yes:	No:
Does the credit union have a written BRCP?	41	1
Is the BRCP reasonable and acceptable for the credit union's size and complexity?	39	3
Has the credit union developed a Core Systems Contingency Plan?	39	3
Is the Core Systems Contingency Plan reasonable and acceptable for the credit union's size and complexity?	39	3
Has the credit union performed a Business Impact Analysis?	33	9
Is the Business Impact Analysis reasonable and acceptable for the credit union's size and complexity?	33	9
Has the credit union validated (tested) the BRCP?	26	16
Is the Validation reasonable and acceptable for the credit union's size and complexity?	26	16

The examiner analysis documentation available for review included a detailed database BRCP checklist. Our review did not determine the depth of analysis performed by the examiner in determining the adequacy of the plans or testing performed by the credit union.

Examiners were to ensure automated federal credit unions had BRCPs including liquidity plans, and were to review the plans by July 31, 1999. If the plans were inadequate appropriate

administrative action was to be taken. Examiners prepare a BRCP checklist maintained in an agency database to document adequacy of BRCPs. Database information and update information is monitored and analyzed by the regional DOS. Quarterly updated information is provided to the Central Office with the first quarterly report for June 30, 1999. DOS in each region will identify as needed areas for further action.

As a part of contingency plans, credit unions are establishing lines of credit with corporate credit unions. Regional managements are meeting with corporates to discuss emergency lines of credit and cash services. Safety and soundness issues regarding corporates are exchanged between the Central Office and regional management.

Regional plans to ensure BRCP plans are implemented in a timely manner are incomplete. In Region I, bi-weekly conference calls between the regional office and the group Y2K specialists are held to determine status and areas that need additional work. Future plans for Region I are for DOS to provide analysis guidance to staff and to perform on-site and off-site reviews of BRCPs to determine reasonableness of plans and to assess examiner analysis of the plans. We were informed in Region III that DOS does not currently plan to perform on or off-site verification of the examiner's work or to validate, verify, or review credit union BRCPs due to resource limitations.

MATTERS FOR CONSIDERATION

The OIG is suggesting the following actions as matters for consideration by the NCUA Board and agency management:

- NCUA should develop plans to test actual status of a sample of credit unions making satisfactory progress (*low risk rated*).
- NCUA should develop appropriate staff guidance for follow-up by examiners at credit unions for analysis of the adequacy of credit union Business Resumption Contingency Plans and to ensure timely implementation of the plans as needed.
- NCUA should develop plans and guidance for staff for the review of testing of credit union Business Resumption Contingency Plans to ensure that the testing plans are reasonable and that the testing has been successfully performed.

