Chapter 103

ON-SITE PRESENCE SUPERVISION

Introduction

Corporates qualifying for Type II supervision will generally be assigned a capital markets specialist (CMS) to perform on-site supervision one to two weeks each month. However, if a Type II corporate is assigned CRIS ratings of 4 in both Financial Risk and Risk Management, the CMS will maintain a full-time on-site presence.

Corporates qualifying for Type III supervision (as defined in Chapter 102) will be assigned a CMS on a full-time basis. Additionally, the assigned examiner-in-charge will generally be on-site monthly.

Objectives of On-site Supervision Presence

The goal of the on-site supervision presence is to develop and maintain a thorough understanding of the operations and risk profiles of large complex corporates. Maintaining an on-site presence promotes interaction with the corporate's staff and allows the CMS to maintain a working knowledge of the corporate's operations, especially in the capital markets areas (investments, asset and liability management, risk monitoring, etc.). The knowledge gained through on-site supervision allows the CMS to more effectively monitor and evaluate financial changes. The EIC's monthly on-site presence promotes a higher level of understanding of operational issues and changes. Early understanding of changes in financial strategies as well as early review of new products, services, and operational changes provides OCCU and the SSA, if state chartered, the opportunity to promptly dialogue with corporate officials and management to address issues and/or concerns.

Operational understanding and changes will be the primary responsibility of the EIC. Operational risk is significant throughout the corporate system. Ongoing supervision of these activities (e.g. item processing, payment systems, network security) is crucial for the continued understanding of the evolving technology utilized in all these areas.

<u>New Investment Strategies</u>
The CMS will monitor the corporate's investment portfolio to identify changes in and/or variances from investment strategies and to assess impact of changing economic conditions. New or changing investment strategies will be analyzed and discussed with the corporate's investment and risk management staff to determine the rationale for the change and the impact on the corporate's risk

position. Economic factors affecting the investment portfolio will also be discussed.

<u>New Member Deposit Products/Services</u>
The CMS will monitor new deposit products and services offered to the corporate's members. New member deposit products will be analyzed in relation to the corporate's strategic business plan and ALM/balance sheet structure strategies. Safety and soundness issues, if any, will be addressed with management.

<u>Organizational/Infrastructure (Key Personnel Changes)</u>
Changes in key staff or reporting structures may affect the corporate's ability to adequately address risks.

The CMS will evaluate individuals filling key risk management positions in relation to the level of the corporate's expanded authorities. The benefit derived from the on-site supervision presence is the timeliness in obtaining such information. However, the CMS must not be involved in the employee selection process or any other personnel matters.

Certain expanded authorities require adequate separation of duties as well as expertise and experience to adequately control risk. Any changes to the corporate's operational structure will be evaluated to ensure the new structure meets the requirements defined in the Guidelines for Submission of Requests for Expanded Authorities and Part 704 Guidance Letter No. 2, and those approved by the NCUA Board and SSA, if applicable.

<u>ALM Modeling, Assumptions, and Results</u>
Effective asset/liability management is the cornerstone of a safe and sound financial institution. ALM modeling results are affected by the methodology applied and the assumptions used. The CMS will review any changes to:

1. model(s) used by the corporate;
2. assumptions used in the model(s);
3. management reports generated by the models; and
4. management's review process and documentation of model results.

The CMS will determine whether such changes are appropriate and consistent with the corporate's complexity and approved level of expanded authorities. In general, new models and/or assumption changes should be run parallel with the old model(s) and/or assumptions to determine the effect of these changes versus changes in the corporate's portfolio and the market environment. The analysis resulting in the changes should be maintained by the corporate for review during the annual examination period.

Corporates with expanded authorities are expected to have their ALM modeling methods validated periodically. A qualified third party should conduct such validations and the results reported to the Asset-Liability Committee.

Monitoring Strategic Plans and Initiatives

The CMS will review the corporate's strategic and marketing plans and periodic product/business line evaluations to ensure management is adequately evaluating current and potential competitors. The corporate's board and management should have plans in place to effectively address competition through either product development, improved efficiencies, and/or exit strategies, if necessary. The CMS will evaluate the effectiveness and timeliness of the corporate's response to competitive market pressures. The CMS will report any concerns to OCCU management and SSA (if state chartered) after discussing them with corporate management.

The CMS will discuss changes in strategic plans, goals, and significant budget variances with senior management to ensure the monitoring and planning process is adequate.

Cultivate Effective Communications

The CMS will foster open communications with corporate management through regular meetings with key managers and staff. Meetings may be formal or informal but in all cases, the CMS should document the topics of discussion for inclusion in the monthly management report.

The CMS will function as a liaison between the corporate, OCCU, and where applicable, the SSA. The CMS on-site presence allows them to coordinate prompt feedback to all parties and to facilitate meetings between respective staff.

As necessary, the CMS will formalize communications by submitting draft correspondence for the OCCU Director's signature. Correspondence involving state chartered corporates will be coordinated with the appropriate SSA.

Corporates applying for expanded authorities must submit detailed documentation supporting their request. Additionally, corporates sometimes require waivers from provisions of Part 704. The CMS will coordinate these efforts with the corporate and provide appropriate guidance in order to expedite the application process. However, the CMS should not construct the documentation for the corporate.

Monitor Effects of Capital Markets Trends

Corporates are affected by changes in the capital markets. Changes in interest rates, credit spreads, and liquidity all affect a corporate's risk position. The CMS will stay abreast of market trends and provide timely feedback to OCCU, and the SSA, if applicable, regarding any material effects of changes to their assigned corporate(s).

The CMS will regularly evaluate the following and discuss any significant changes or concerns with corporate credit union management:

1) The effect of changes in interest rates on:
    a. the duration and weighted average life of the corporate's investment portfolio;
    b. the corporate's NEV; and
    c. the corporate's net income.

2) The effect of changes in market sector credit spreads on:
    a. the corporate's NEV; and
    b. the corporate's liquidity.

3) The effect of changes in market liquidity levels on:
    a. the corporate's ability to fund member demands; and
    b. the corporate's ability to raise liquidity from available sources.

Corporates with Part III expanded authorities are exposed to sovereign risk. The CMS will stay informed of the countries to which the corporate has exposure. Any potential changes to a country's risk rating should be evaluated and discussed with corporate management. Where appropriate, the CMS will utilize Bloomberg to monitor investment values, as well as, market activities, which will impact the corporate's balance sheet or risk profile. Additionally, for institutions with Part III expanded authorities, the CMS will monitor the sovereign ratings and news items for countries and financial institutions the corporate has approved for investments.

Monitor Changes in Balance Sheet Structure

A corporate's role as a liquidity center may require management to restructure the balance sheet in response to changing member needs and market conditions. The CMS will evaluate trends at least monthly by reviewing the Corporate 5310 Call Reports. Key information will be verified to internal financial statements, General Ledger balances, and/or subsidiary reports. The CMS should utilize the Consolidated Balance Sheet (CBS) to evaluate monthly trends and to identify and monitor fluctuations.

Corporate management utilizes numerous internal management reports. These reports may be generated daily, weekly, monthly, or quarterly. If corporate management utilizes a daily balance sheet report, the CMS should obtain them to identify changes in the corporates balance sheet structure. Such reports are especially useful during times of low liquidity when corporates may have to liquidate assets or borrow to meet member liquidity demands.

Review Material Risk Areas for Compliance

The CMS will utilize the Corporate'*s* 5310, CBS, ALM reports, and management reports to monitor compliance with Part 704 and corporate policies. At a minimum, the CMS will verify compliance with key regulatory risk limits including, but not limited to:

1. the NEV ratio;
2. the maximum allowable change in NEV in +/- 300 basis point interest rate shock tests;
3. the change in net interest income in +/- 300 basis point shock tests;
4. the capital ratio;
5. credit concentration limits;
6. reserve transfers;
7. lending limits;
8. borrowing limits; and
9. credit ratings.

In addition to the above listed regulatory limits, the CMS should also review the corporate's investment and credit watch lists to monitor securities facing possible downgrades. The CMS will monitor all watch list securities on Bloomberg for press releases, downgrades, and any other information that may be available.

Lending and borrowing trends should be monitored as increased activity in these areas may reflect decreasing liquidity in the credit union system. This monitoring may occur through the review of the corporate's lending activities to members as well as its borrowing activity on both and overnight and term basis.

Any regulatory violations or negative trends should be promptly reported to OCCU and the SSA, if applicable.

Planning Focused Supervision Activity

Chapter 102 of this guide outlines normal examination/supervision planning. In addition to normal planning, the CMS must plan regular on-site supervision activity. This supervision activity is determined using the targeted risk approach.

Supervision of federally chartered corporate credit unions should be developed jointly with the appropriate corporate field supervisor. Supervision of state chartered corporates must also be coordinated with the appropriate SSA.

As described in Chapter 102, OCCU's supervision policies require a specific supervisory strategy for each corporate. Planning for on-site supervision presence is ongoing. Ongoing supervision activity may be daily, weekly, monthly, or quarterly. Appendix A of this chapter contains a checklist of standard on-site supervision activity. The CMS, CFS, and the SSA if the corporate is state chartered, will complete a separate checklist for each assigned corporate.

Actual supervision activities will vary between Type II and Type III corporates and between individual corporates as situations warrant. Type II corporate supervision activities may be less frequent or reduced in scope compared to those for a Type III corporate since the CMS are only on-site part-time.

The CMS will tailor the regular supervision activities to the specific corporate. In addition, the CMS will exercise judgment by recommending any additional supervision deemed necessary to the CFS.

Following the conclusion of the annual examination the CMS, CFS, and SSA if the corporate is state chartered, will develop a detailed supervision plan for the following year. The plan will outline supervision activities addressing significant risk areas or areas of concern for each quarter. The plan will be submitted to the Director of OCCU for final approval. The plan may be reviewed and revised as necessary.

Use of Other NCUA Resources
When planning on-site supervision activities, the CMS may determine a need to utilize other specialized NCUA examiners. These include but are not limited to:

1. OCCU Information Systems Specialist;
2. OCCU Subject Matter Examiners; and
3. Office of Strategic Program Support and Planning Investment Officers.

The CMS will be actively involved in the examination and supervision planning process. However, another corporate examiner may serve as the EIC and perform monthly supervision. This will allow the CMS to focus on the corporate's risk activities. The EICs will be rotated every three years or as necessary.

Recommendation For Continued On-site Presence
The CMS will work with the EIC after the conclusion of each annual examination to develop the supervision plan for the following year and contingent plans for the subsequent two years. This plan will include a recommendation regarding the continued level of on-site supervision. The planning process will include the SSA if the corporate is state chartered. The plan will be submitted to the Director of OCCU for approval.

Communication with SSA
The CMS is expected to keep the SSA or his/her designee informed of any material issues discovered during on-site supervision. To facilitate effective communications, the CMS will provide the SSA with a schedule reflecting the dates of on-site supervision activity and phone numbers where the CMS may be reached. When practicable, on-site supervision will be scheduled to allow participation by SSA staff. When SSA staff is unable to participate in the on-site supervision activities, the CMS will maintain regular contact with the SSA or his/her designee via telephone and/or e-mail to ensure information is communicated timely. The CMS will facilitate meetings between OCCU supervisors and the SSA when necessary.

Training

Maintaining an on-site supervision presence offers the CMS opportunities to gain in-depth knowledge of corporate operations. The CMS will share this knowledge with other corporate examiners by developing and instructing focused training courses. These courses will be developed to provide logical progressive training for both new and seasoned corporate examiners.

The CMS will also serve as mentors for new corporate examiners. The new examiners will spend time on-site with the CMS and receive orientation training regarding corporate credit unions and their unique role in the credit union system. Maintaining a regular on-site presence provides ready access to corporate policies and procedures as well as opportunities to observe corporate operations. This type of orientation training is intended to accelerate the development of new corporate examiners.

Periodically, the CMS may be called upon to develop and deliver presentations to NCUA staff and external groups. These presentation opportunities afford OCCU an opportunity to share in-depth knowledge of corporate credit union investment products and correspondent services with both NCUA staff and others.