2024 AICPA & CIMA Conference on Credit Unions

Highlights

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A Note From Forvis Mazars' National Industry Credit Union Leader

The credit union industry has continued to experience significant change and disruption, from regulatory updates and industry consolidation to cyberattacks and digital innovation, making it crucial for credit union leaders to stay up to pace.

Leaders from the Financial Services team at Forvis Mazars recently attended the AICPA & CIMA Conference on Credit Unions and heard several key themes that we've noted within this document. We're committed to staying at the forefront of industry issues, so our team can be a thought partner as we focus on providing an **Unmatched Client Experience**®.

Forvis Mazars, LLP is an independent member of Forvis Mazars Global, a leading global professional services network. Ranked among the largest public accounting firms in the U.S., our dedicated team members provide assurance, tax, and consulting services for clients in all 50 states and internationally through the global network. Our team has more than 40 years of experience serving credit unions. According to the 2024 Supplier Market Share Guide: Credit Union Auditors, published by Callahan & Associates, Forvis Mazars ranks sixth in auditing credit unions with more than $100 million in assets. Forvis Mazars also ranks in the top 10 of total credit unions audited.

For more information regarding any topics highlighted in this document, or if you'd like to learn more about our firm and how we can help your credit union, please contact a local team member today.

Chad Garber
Partner, Forvis Mazars

Introduction

The American Institute of CPAs (AICPA) and The Chartered Institute of Management Accountants (CIMA) held the annual Conference on Credit Unions in person and virtually on September 9–11, 2024. Forvis Mazars was honored to be an event sponsor again this year. Top officials from the National Credit Union Association (NCUA) and FASB discussed today's most pressing issues and key focus areas for credit unions.

The following are selected comments from various speakers at the conference. The summary does not capture all discussions presented during the three-day period; rather, it is intended to highlight trending topics and recurring themes. The selections below are our interpretation of the speakers' comments and do not necessarily represent the opinions of Forvis Mazars. For a deeper dive into these topics, links to our **FORsights**™ are included.

Credit Union Landscape

Credit unions have weathered the rapid increase in interest rates fairly well and are entering a period of a new normal. Key metrics are rebounding but, in many cases, not to pre-pandemic levels. As interest rates are expected to fall, credit unions must be nimble in rebalancing portfolios, managing liquidity risks, developing products and services to help retain and grow membership, and leveraging technology to help improve earnings. A lower interest rate environment is likely to spur more mergers and acquisitions (M&A) as unrealized losses on investment portfolios begin to turn around. Having a clearly defined mission and strategic plan is more important than ever. An attendee survey revealed that 74% of participants felt that credit unions are doing "as expected" in the current economic environment.

Challenges

Slow Growth Environment

- Loan and member growth slowed in 2024.
- Share growth trended up after a record low in 2023. Smaller credit unions are now growing at close to the rate of larger credit unions, a shift from 2021 and 2022 when larger credit unions grew at twice the rate of smaller credit unions.
- Certificate growth has slowed, and core deposits continue to decline.
- Both large and small credit unions are posting slower loan growth across all categories. The steepest drop-off is auto loans.

Liquidity Pressures

- The loan-to-share ratio rose in 2Q 2024 but is still below the peak in 4Q 2023.
- Unrealized investment portfolio losses, particularly for larger credit unions, continue to limit liquidity.
- Borrowing levels declined in the first half of 2024. Borrowings as a percentage of assets are well above pre-pandemic levels as credit unions look for alternate liquidity sources.
- Cash balances remain above 8% of assets.

Lower Earnings

- As the cost of funds flattens, investment yield continues to increase at about the same pace.
- Net interest margin (NIM) has expanded to 3% but is still below pre-pandemic levels. The current NIM level is narrowly covering the operating expense ratio. Investment in people and technology will likely increase the operating expense ratio going forward.
- Non-interest income is moving slightly higher post-pandemic but below pre-pandemic levels. Growth is coming from interchange fees and mortgage sales. The 20-year slide in fee income continues.
- As asset quality declines, there has been an uptick in provision expense.
- The return on assets (ROA) for both large and small credit unions is up primarily due to higher NIM. ROA will remain at historically low levels until the Federal Reserve lowers interest rates.

Delinquencies

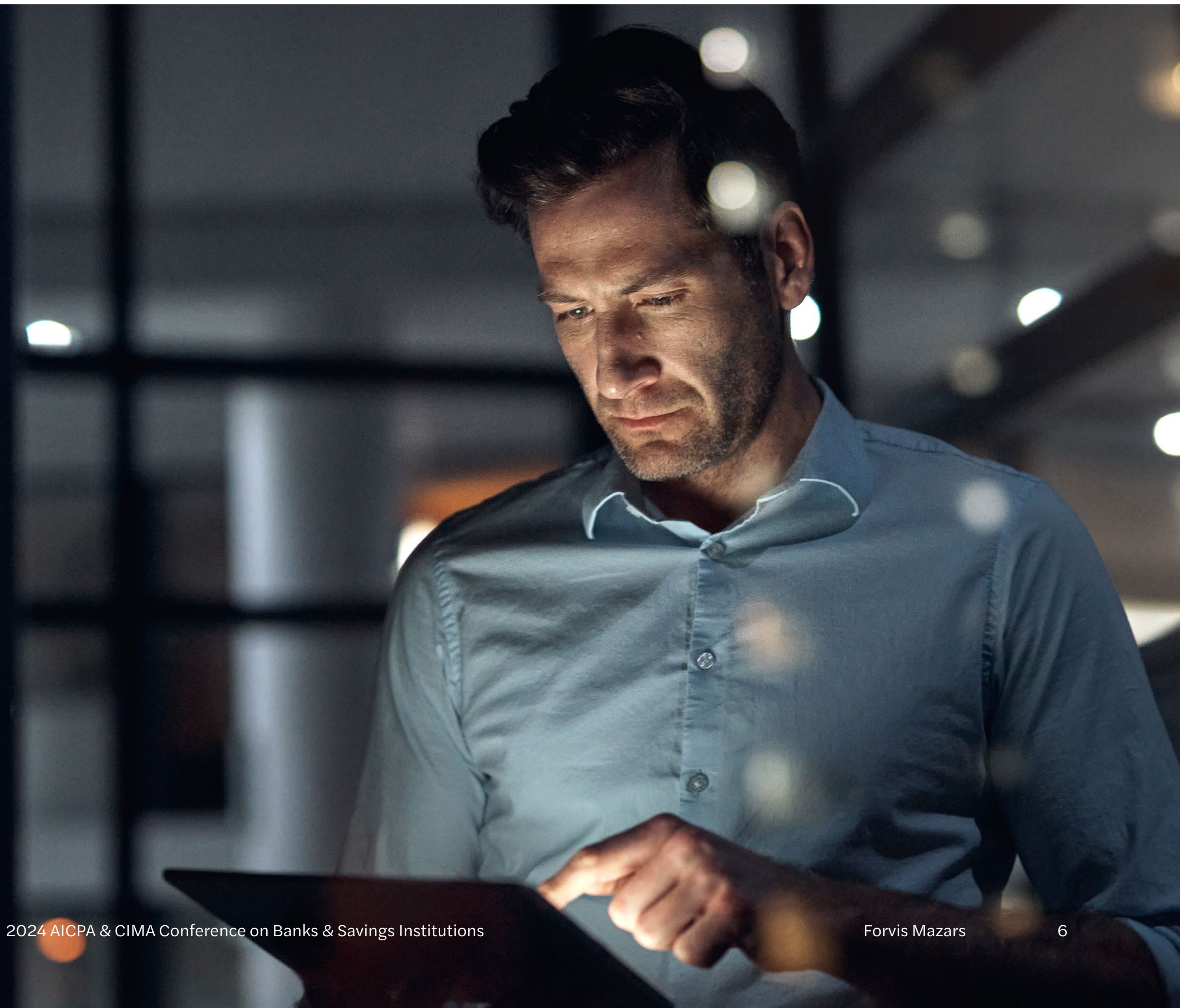
- Charge offs have improved but delinquencies are rising above pre-pandemic levels. It is unusual for both to move in the same direction, and this is a worrisome trend because write-offs generally reduce delinquencies.
- Delinquency increases are concentrated in used car and credit card loans (although at levels well below those of banks). For auto loans, 2022 originations are seeing the biggest challenges. Cars bought at peak prices are now underwater while insurance costs are rising, making it more likely for borrowers to default. Current credit card delinquencies are peaking at the level seen during the 2007 recession.
- Data from NCUA call reports indicated that federally insured credit unions held $81 billion in consumer credit card loans and $321 billion in used vehicle loans.

Opportunities

- Digital banks and fintechs are opening 47% of new checking accounts in 2023 but primarily at the expense of regional banks. Credit union account openings have held steady at 6%. Connecting with Gen Z and Millennial demographics will be key to future growth, which will require new marketing channels like TikTok and YouTube.
- A strategic growth framework starts with clearly defining a credit union's purpose or mission. Jay Johnson, chief collaboration officer with Callahan & Associates, highlighted several success stories that took quite different innovation approaches but share a common trait:

"They see themselves as economic engines for their community, they go as the community goes. The best way to ensure relevance is to ensure that the community is thriving as well. Are we really making a difference in our communities?"

– Jay Johnson



NCUA Observations & Priorities

Larry Fazio, NCUA executive director, and Chris McGrath, NCUA chief accountant, shared the following observations and exam priorities and also fielded multiple audience questions.

CECL

While the allowance for credit losses on loans almost doubled post-CECL implementation, the dollar amount has been relatively consistent as a percentage of the loan portfolio size. The impact on the net worth ratio was relatively modest, on average 20 bps. Credit unions should see an increased focus on CECL in this year's exams.

Conference attendees noted that NCUA examiners have inconsistent positions on model validation. Fazio responded by referring to auditor expectations, noting that credit unions should be focused on the data used, loan portfolio segregation, modeling approach and techniques, and judgments around qualitative factors. McGrath reiterated points from the interagency statement on model validation, noting it can be an internal or external party and, if it's internal, they have to be independent of the process.

> "I think our general expectation for credit unions is the more sophisticated, complex, problematic, challenging your portfolio is and your practices are, the more sophistication we would expect to see going into the modeling."
>
> **– Larry Fazio**

Other Priority Areas

Internal Controls & Record-Keeping

This traditionally has primarily been a small credit union problem, but some sizable credit unions are now having issues.

> "If you haven't kicked the tires lately on your bookkeeping, maybe you want to do that."
>
> **– Larry Fazio**

Consumer Financial Protection

The three primary areas of focus this year will be overdrafts, fair lending (particularly auto lending as it relates to truth in lending (TILA) disclosures and gap insurance), and member complaints.

Asset Liability Management & Interest Rate Risk

This has been the longest inverted yield curve in U.S. history. Because there is so much uncertainty on where we go from here, credit unions should focus on a range of scenarios for the key assumptions input to risk models. What is the cone around the expected path for interest rates? Reconsider interest rate shocks—300 bp was the norm in the 1990s, and, in 2022, we experienced a 500 bp increase in 12 months.

> "How wrong do we have to be before it becomes a problem?"
>
> **– Larry Fazio**

Liquidity

Liquidity models worked well during the long term of financial stability, but a lot of credit unions were caught by surprise by the pandemic volatility and

steep interest rate increases. Credit unions should be prepared for an increase in interest rate volatility and should review contingency plans for off-balance-sheet liquidity, including:

- Central liquidity facility (CLF). Regular membership is voluntary and open to all federal credit unions, federally insured state-chartered credit unions, and privately insured credit unions.
- Corporate credit unions
- Federal home loan banks
- Federal Reserve discount window

> "Keep a sharp eye on governance and risk management capabilities. When liquidity is a problem, it is a big problem."
>
> **– Larry Fazio**

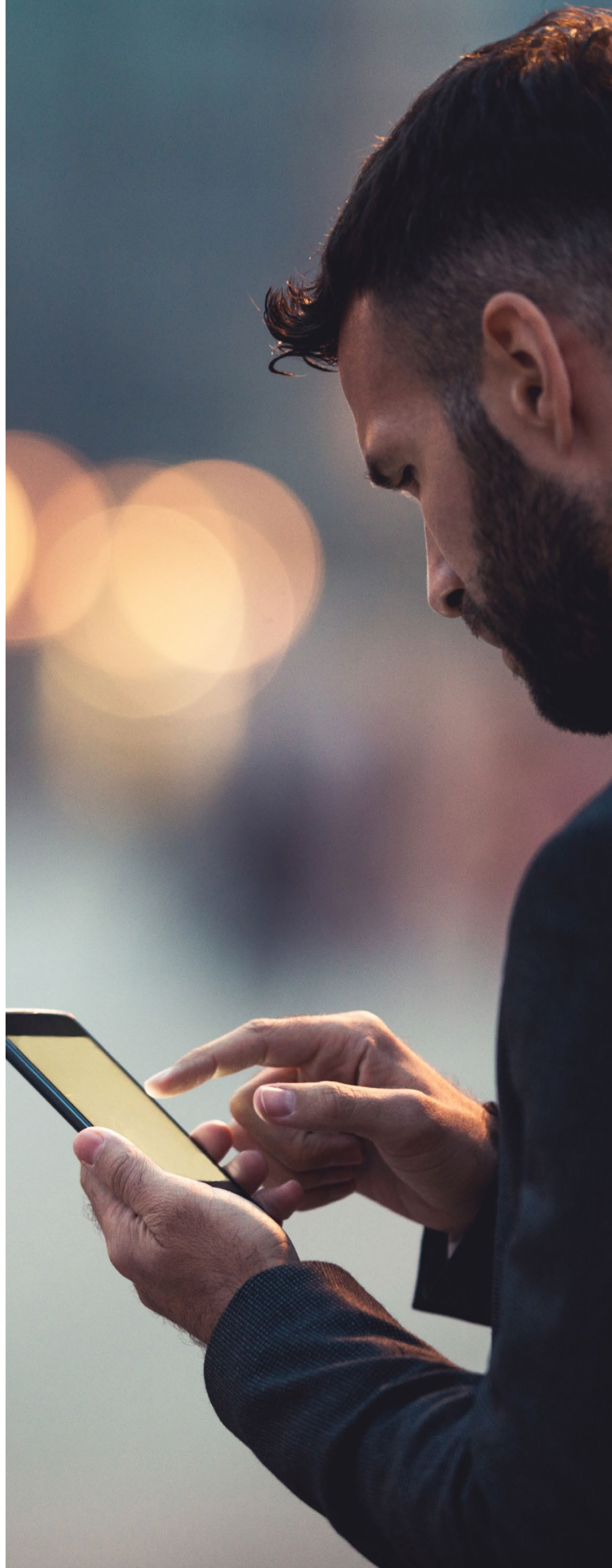
Commercial Real Estate (CRE)

Non-owner-occupied CRE is an area of concern, but for all federally insured credit unions (FICUs), the total exposure is $70 billion of the CRE holdings of $148 billion as of March 31, 2024. The NCUA is keeping a close watch on a handful of credit unions that have material positions for them.

Cybersecurity & Fraud

This needs to be one of the top risk management priorities. Credit unions need to keep the bad actors out and be prepared in advance if they do get in. How are you going to respond, and how fast can you react? This is not just a technology issue; it also is a people issue, and credit unions will have to invest in training to prevent fraud. Fazio noted that the Cyber Incident Notification Requirements (CUCIRS) became effective September 1, 2023 and highlighted the FBI's Internet Crime Complaint Center (IC3) Recovery Asset Team (RAT) for help in recovering funds for credit unions or its members if reported within 24 hours.

Part of the core exam process going forward will include an information security exam (ICE) for all credit unions.



Regulatory Update

Recent Final Rules/Guidance

Regulation	Description	Issued
12 CFR Parts 772,741	Quality Control Standards for Automated Valuation Models	August 7, 2024
Guidance	Interagency Reconsideration of Value Guidance Final	July 19, 2024
Interpretive Ruling & Policy Statement (IRPS)	IPRS 13-1, Minority Deposit Institution Preservation Program	February 26, 2024
Guidance	Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans	July 2023
Guidance	Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts	June 2023

Proposed Rules

Regulation	Description	Issued	Comments Due
12 CFR Part 753	Section 5811 of National Defense Authorization Act (NDAA) –Financial Data Transparency Act, Interagency Proposed Rule	August 22, 2024	October 21, 2024
12 CFR Part 753	Anti-Money Laundering and Countering the Financing of Terrorism Program Requirements	August 9, 2024	October 8, 2024
12 CFR Part 741 & 751	Incentive-Based Compensation Arrangements	July 18, 2024	Closed
12 CFR Part 701 & 741	Succession Planning	July 24, 2024	Closed
12 CFR Part 749	Records Preservation Program and Appendices: Record Retention Guidelines; Catastrophic Act Preparedness Guidelines (ANPR)	April 24, 2024	Closed
12 CFR Parts 701, 741, 746, 748, & 752	Fair Hiring in Banking	November 7, 2023	Closed
12 CFR Part 745	Simplification of Share Insurance Rules (Trusts, MSAs, Record-Keeping)	October 25, 2023	Closed
12 CFR Part 701, App. B	Chartering and Field of Membership	February 28, 2023	Closed

Resource

SEC's Joint Proposal Sets FDTA Data Standards

FASB Accounting Updates

The FASB panel covered its agenda prioritization process and project updates on soon-to-be-released exposure drafts. FASB regularly solicits feedback from stakeholders on its agenda prioritization. The last outreach was in 2021, and most of the top priority items have been wrapped up or will be finalized shortly. Upcoming exposure drafts include software costs, environmental credits, and government grants likely to impact community development financial institutions (CDFIs). The items of most interest to credit unions include the accounting for purchased financial assets (PFAs), hedging improvements, and updating the statement of cash flows for financial institutions to be more meaningful for users.

> Forvis Mazars encourages your institution to respond to the forthcoming agenda consultation to help shape future standard setting.

Purchased Financial Assets (PFAs)

Accounting Standards Update (ASU) 2016-13 updated the definition and accounting treatment for purchased credit impaired assets and rechristened them as purchased credit deteriorated (PCD) assets. The difference between PCD and non-PCD accounting is the recognition of the day-one provision expense for non-PCD assets versus the "gross-up" and no provision expense day-one for PCD financial assets. ASU 2016-13 also updated sections of Accounting Standards Codification (ASC) 805, Business Combinations, to require the recognition of an allowance for credit losses in the period of acquisition for both PCD and non-PCD assets. For PCD assets, the allowance for credit losses is added to the purchase price, *i.e.*, fair value, in determining the amortized cost basis rather than as an earnings charge. However, for non-PCD assets, the corresponding charge is recorded through a provision expense on the acquirer's books. In addition, the acquisition fair value includes an expectation of credit losses as part of the purchase discount. This results in the perceived double counting of expected credit losses on non-PCD assets.

FASB's original decisions on PCD accounting were one of the most debated deliberations of the CECL standard-setting process. FASB received feedback that in determining if acquired financial assets qualify or do not qualify for PCD accounting, treatment remains complex and the credit discount on certain loans is double counted upon acquisition. To address these concerns, FASB issued an exposure draft in June 2023 that had the following impacts:

- Expanded the population of acquired financial assets subject to ASC 326's "gross-up" approach currently applied to PCD assets.
- Eliminated the day-one credit loss expense.
- Eliminated the use of "gross-up" method for available-for-sale (AFS) debt securities.
- Feedback was mixed on the changes. Investors and some auditors were supportive, but preparers and auditors raised concerns in the following areas:
- Expanded scope was operationally challenging for certain financial assets like credit cards.
- Recognition and measurement challenges for some items covered by the expanded scope.
- Seasoning criteria; use of qualitative guidance rather than the 90-day rule.
- Retrospective application; prospective application with early adoption permitted is preferred.

FASB is redeliberating this comment letter feedback, but no timeline has been released for an updated exposure draft. Nothing is currently expected in 2024.

Hedging

In May 2021, the NCUA modernized its derivatives rules to make it easier for federal credit unions to manage interest rate risk. FASB also has updated its hedging rules to better align accounting with an entity's risk management strategies and has a few more areas of simplification and clarifications in the pipeline.

Scope

FASB has heard from stakeholders that applying guidance in ASC 815, Derivatives and Hedging, can be complicated, especially for new products and

arrangements not contemplated when guidance was first issued, including research and development (R&D) or litigation funding arrangements and bonds in which interest payments may vary based on environmental, social, and governance (ESG)-linked metrics. FASB issued an exposure draft on July 23, 2024 that would add a new principles-based derivative scope exception for contracts with underlying features that are based on the operations or activities of one of the contract's parties and changes the predominant characteristics assessment applicable to certain contracts that are not traded on an exchange from a correlation assessment to a fair value assessment. Comments are due by October 21, 2024.

Resource

Proposal to Clarify Derivative Scope Exception & Share-Based Payments

Hedge Accounting Improvements

FASB acknowledged that its 2019 exposure draft for narrow-scope hedging improvements fell short. FASB is expected to issue an exposure draft by the end of the third quarter, which would include the following targeted improvements to hedging guidance:

- Hedging forecasted interest payments on choose-your-rate debt instruments
- Similar risk assessments in cash flow hedges
- New written options as hedging instruments
- Cash flow hedges of nonfinancial forecasted transactions
- Foreign-currency-denominated debt instrument as a hedging instrument and hedged item (dual hedging relationships)

An exposure draft is expected before the end of 2024.

Resource

Updates on Hedge Accounting for Private Companies

Cash Flow Statement – Targeted Improvements for Financial Institutions

FASB is currently performing research and outreach on reorganizing and disaggregating the statement of cash flows to be more useful for financial statement users. FASB is considering the following:

- Reclassification of activities, such as accepting deposits and making loans to operate, as these are central to financial institution operations
- Enhancement of disclosures related to cash interest received and a reconciliation of cash net interest income received to net income on the income statement.

No expected issued date has been released.

Forvis Mazars prepares a quarterly update on all FASB standard-setting activity, including upcoming effective dates, outstanding exposure drafts, and ongoing projects that may impact your accounting and financial statement reporting.

CECL

CECL was adopted in a different economic environment than future forecasts. Management is developing a deeper knowledge of how the portfolio behaves. Have you seen unexpected results? Now is the time to fine-tune the model. Consider which inputs can be fine-tuned to mitigate volatility in model outputs. What model attributes are extremely sensitive and have an outsized impact on the allowance? Do weightings need to be rebalanced to arrive at more intuitive estimates?

Vendor Overreliance

Management must fully own the allowance for credit losses (ACL) and their CECL model, whether developed in-house or from a third-party vendor. Management must completely understand what drives their ACL estimate, the use of various inputs and methodology, the volatility of the various inputs, and the overall reasonableness of the outputs. Management's understanding of the overall ACL estimate and their tolerance thresholds should be well documented and concluded upon each time the ACL estimate is updated.

Backtesting

How good is the estimate? Management should be performing backtesting procedures to significant assumptions and inputs that drive the overall estimate (prepayment, curtailments, and loss assumptions) as these inputs can significantly cause volatility in the CECL model and drive the overall reserve. This may be a challenge since credit unions may only have 18 months of data (since the January 2023 adoption and any pre-adoption parallel runs). Credit unions can try backtesting individual items or using call report data. A coverage ratio backtest may be appropriate to ensure the calculation is properly estimating future and not historical losses.

Model Validations

As noted above, there is no NCUA requirement for external model validation. Make sure you document governance requirements for model validation, including timing, frequency, and the review process. Make sure model validation includes a full look of processes and controls. This can uncover any documentation deficiencies, particularly around adjustments being made.

Internal Controls

A good key control is to give CECL model oversight to the pricing/credit risk committee and require that any assumption or configuration changes be reviewed at least annually and the calculation be presented to that committee quarterly. Have a control in place to document the thought process on Q-factor adjustments.

Q Factors/Data Quality

Credit union members may have a different experience than national, economic, or perhaps historical correlations that have not proven consistent through the most recent economic cycle. Consider using more appropriate local data, readjusting weightings, or adding or adjusting a Q factor. Document the review and decision process and conclusions.

Individual Loan Review

Have a well-documented policy and procedures when something goes to individual loan review status.

Key Reminders

- Is your current loan segment-level reporting still appropriate?
- Are historical prepayment speeds still appropriate based on our current environment? How will this change when interest rates fall?
- Is the loss look-back period still appropriate based on our current environment?
- Does the data applied in the development of Q factors remain relevant and reliable in our current environment?
- Is our forecast period still reasonable and supportable?

- Does the economic data relied upon in supporting our forecast period remain applicable to our institution in our current environment?

Credit Union M&A

2023 was an active year for both bank and credit union acquisitions, and this trend is expected to continue and likely to accelerate as the Fed cuts interest rates. Most acquired credit unions are under $100 million in assets, although there are a handful of large and midsize credit union deals. There have been five bank acquisitions so far this year and another 14 announced. The time to complete a bank acquisition varies widely by state and regulator and is growing longer due to increased scrutiny. Certain states, like Colorado and Iowa, explicitly forbid credit union/bank mergers under state law.

Technically, a credit union cannot buy a bank. Under the Federal Credit Union Act, credit unions can acquire certain assets and assume liabilities of banks, but they cannot own the charter. The FDIC must be involved, as well as state banking regulators, for a state charter. In most cases, banks are initiating discussions with credit unions primarily due to succession issues but may not be an attractive target by another bank. A bank deal can be attractive for credit unions for various reasons, including strategic growth initiatives (new location, geographic area), acquiring additional talent, or entry into commercial lending. Credit union mergers can be challenging, and a bank acquisition can be a viable alternative since they are easier to close, albeit at higher premiums.

M&A Best Practices

As interest rates come down and the upcoming election removes tax policy uncertainty, M&A deals are expected to increase over the next 18 months. Whether it is a credit union to credit union or bank transaction, consider the following insights for a successful deal.

Merger Strategy

Most credit unions do not have a formal merger strategy or have not had board-level discussions, even though many would be open to merger opportunities. Having a plan in place when an opportunity arises will guide the decision-making process and lead to better outcomes. Layout clear strategies and objectives for growth to evaluate opportunities as they arise. This also would apply to credit union service organizations (CUSOs) and fintech investment opportunities.

Cultural Fit

For some unconsummated deals, cultural fit can be an excuse for a poor business model or personality differences. Signing the letter of intent (LOI) is the first step to evaluating culture. If talent is a key strategy for growth, thinking through how to keep talent should be addressed upfront in planning and integration plans.

Key Financial/Accounting Issues

One reason for the slowdown in merger activity has been the level of unrealized losses in investment portfolios that would be fair valued on acquisition. Understanding the loan portfolio and how a merger will affect the financial statements and changes in the economy will impact the CECL allowance is critical before finalizing a deal. Have a clear understanding of day one fair value adjustments (this includes defined benefit pension plans). Some credit unions have sold off a portion of the investment portfolio after taking the day one fair value adjustment and rebalancing the portfolio. A merger also resets the classification (HTM, AFS) on day one.

If it has been a while since an acquisition or if it is a first-time merger, review the accounting rules in ASC 805, Business Combinations. If a credit union's merger strategy includes strong deposits and liquidity (intangible assets), a merger could result in a premium that would need to be recognized on the balance sheet. Review the accounting for recording/accruing merger costs. Review terms in LOIs, benefit plans, and bonus arrangements for changes in control provisions and understand the trigger for payment and timing of an accrual.

Consider the double taxation issue when pricing a deal. A credit union's purchase of a bank's assets creates a taxable event for the bank, and the bank's shareholders are taxed again on the capital distribution. This double taxation issue needs to be adjusted to compare credit union deal pricing properly.

FASB is considering changes to the accounting for purchased financial assets (see details above). This may impact deal structuring when the ASU is finalized.

Board Control

This is the number one reason credit union mergers fail. Boards should be realistic about the number of board seats post-merger. Credit unions should consider less restrictive merger strategies for best

outcomes (board control, CEO retained, or charter obtained). Flexibility on CEO should be addressed in the change of control provisions, not as part of the acquisition strategy. The bigger credit union may not always be the charter that is retained; in certain situations, it may make sense to use the smaller entity's charter.

Economies of Scale

In general, economies of scale (staffing attrition, contract renegotiation, or data processing) are not generally seen until after three years.

Integration

Go as fast as possible to avoid running two operations for an extended time. Have a formal plan and prepare for bumps. Do not include only executive team members on the integration team—have people who know how things actually work. Have a retention or earn-out agreement in place to keep key relationship managers successful in retaining customers. Evaluate significant contracts on both sides during due diligence and any cancellation payments required. Get a clause in the LOI that the acquired entity cannot enter into any long-term contracts.

Public Announcements

Wait until you have a definitive merger agreement; a premature announcement can blow up a deal. Consider using a third-party PR/communications firm to have a go-to-market strategy to limit member turnover.

Internal Controls

Policies Versus Procedures

Keep policies more general, which will provide flexibility when regulations change, *e.g.*, avoid referencing the specific regulation number. Consider moving procedures out of the policy to allow more management flexibility, which can reduce low-level audit findings. One credit union created a policy on policies that outlines the types and formats of documents for management governance. Each policy must have a purpose statement and accountability section (ownership and review frequency, which can be different committees).

SOC Reports

The use of third-party vendors continues to increase. Always review SOC reports for any significant weaknesses and the end-user controls required. The SOC report is only valid if a credit union's controls work as intended.

Credit Union Size

Regulator and auditor expectations on internal controls depend on the credit union's size. As credit unions grow organically or through acquisition, they should be prepared as certain thresholds are approached. The nature of the financial statement audit changes, as well as the focus on internal controls that help reduce the risk of material misstatement. Corporate credit unions must have an opinion on internal controls, which results in much more sophisticated risk management process and key controls being documented. At the $10 billion threshold, the Consumer Financial Protection Bureau (CFPB) becomes an additional regulator.

Most $10 billion credit unions use the three lines of defense, which include:

1. Management
2. Risk Management & Compliance
3. Internal Auditors

Transitioning to this model can take several years to fully build out. For smaller credit unions, internal audit covers all three lines. Moving to a more formal structure meant understanding how things are done, what are the procedures, how things should be documented, and then moving those functions. To build out the second line, many credit unions create a chief risk officer (CRO) role to focus on compliance. Building out the first line of defense and creating a management-level risk committee can be a big cultural shift for an organization.

At the $1 billion threshold, there is an expectation for enhanced policies and procedures. At this junction, some credit unions outsource the internal audit functions and increase the review frequency to be quarterly or even continuous. Management is spending more time reviewing the work done.

Technology

AI

There was universal agreement that artificial intelligence (AI) is here to stay. However, there is a wide range of opinions on the potential benefits and risks of AI. Credit unions are starting to put AI policies in place to establish guardrails for employees

and developing use cases balancing risk concerns with value creation/cost savings. AI adoption varies widely. One credit union has two dedicated full-time employees working on AI applications (call center, video banking, loan originations, underwriting, and translation to reduce the need for bilingual employees). Another credit union uses robotic process automation (RPA), which is software to automate repetitive manual tasks, primarily for low-risk regimented compliance tasks. Machine learning is being used for lending approvals on small-dollar loans.

FinTech/Credit Union Support Organization (CUSO)

Fintechs are widely used by credit unions, primarily in person-to-person payments, auto lending, mortgage lending, secured and unsecured personal loans, communications, and lead generation. These arrangements can take many forms:

- Wholly owned to provide a traditional service to members.
- Acquire a percentage ownership of established CUSO.
- Acquisition of a for-profit-company in whole or partial.
- Direct investment in a startup or fintech.
- Invest in venture capital (VC) funds that invest in startups serving the credit union industry.

Challenges

- Lack of initial due diligence (What is the history of the organization (startup or established)? Who are the other owners? What are our expectations/goals (service or ROI)?)
- Lack of subsequent monitoring/evaluation
- Accounting/Financial. How is the initial investment recorded—cost, equity, or consolidation? What is the timing and frequency for review for potential future impairment?

Best Practices

- Find the right use case.
- Document expectations to help ensure what is implemented actually meets your members' needs (cost savings, access, service, or flexibility, derisk).
- Treat a fintech partner just like any other vendor.
- Centralize the decision process on potential partners/vendors to prevent duplication of effort or dueling projects.
- Include a pilot phase before a rollout to the entire membership base.

Contract Considerations

- Define access to data. Where does the data live? Who can access it? How do you get it back?
- Build pilots into the front end of a contract to have an out before moving to full implementation.
- Document any co-development expectations and restrictions.

Resource

The Critical Role of Third-Party Risk Mitigation in Financial Services

Fraud

The number of frauds and the dollar amount of losses are on the rise from both old-fashioned and high-tech schemes for a variety of reasons. New digital tools make it easier for account takeovers. The internet provides easy access to phishing kits and instructions on using social engineering to steal someone's identity or alter a check. TikTok provided a road map to take advantage of a glitch in a bank's ATM system and amplified an old-school check-skimming fraud. While fraud attempts have increased, effective credit union controls have reduced the success rate. This has led to a rise in "Authorized Push Payment Fraud," where a member is convinced to make a payment to a bad actor.

Various high-tech tools are available for fraud detection for digital transactions, phone calls, application and check deposits, bot detection, device intelligence, behavioral analytics, two-factor authentication, voice biometrics, machine learning rules, and check float automation and manual review.

Best Practices:

- Include contractual safeguards in vendor contracts specific to fraud risks, data, and data protection.
- Develop a robust incident response plan, including crisis management protocols and risk tolerances.
- Leverage the social media team to monitor for customer complaints and to remove fraudulent

data from the web (impersonated email addresses, stolen credit information).

- Continuously learn from successful fraud attempts to improve staff education and update processes, controls, and technology as needed.
- The total cost of fraud is not just the direct monetary hit. Also consider the indirect costs like reputational damage (member trust, acquisition, retention) or employee morale (burnout, increased turnover rates).
- Develop a risk dashboard specific to fraud losses, including dollars, volume, and member impact. Leverage the dashboard to update the fraud ecosystem.
- Find the right balance between the member experience and controls to help prevent and detect fraud.

Resources

Insights on Nationwide Fraud Losses

Frequently Asked Questions: Internal Controls for Fraud Prevention

How to Think About Fraud Risks & What to Do About Them

Accounting Issues

Tainting

A credit union may need to sell investments if there are no other readily available liquidity sources or in some cases, an examiner may require selling. Selling a security classified as hold to maturity (HTM) may require the remaining securities to be reclassified as AFS and marked to market. Auditors will want support of the intent and ability to hold the security, so be sure to document the decision-making process and rationale for any sales from the investment portfolio. If the transactions are part of a portfolio rebalance, consider asset-liability committee (ALCO) or board meeting minutes for support.

Split-Dollar Life Insurance (BOLI) Plans

Under these arrangements, a credit union provides a loan to an executive to buy a life insurance policy. The policy is then pledged as collateral for the loan. The accounting for these plans depends on the recourse provisions. A recourse loan is carried at the loan amount plus any interest receivable, while a non-recourse loan is recorded at lower of cash surrender value (CSV) or loan amount plus any interest receivable. Typically, the CSV in the first few years is below the loan amount and results in a day-one loss. Some new products have "limited" recourse provision (executive only responsible for difference in CSV versus loan balance) to avoid day-one losses.

However, U.S. GAAP does not recognize limited recourse (it is either full or not). A second insurance policy for the "gap" or "deficiency" is not sufficient to change the accounting outcomes as these would be separate transactions under GAAP.

Some long-term contracts coming to the payout stage may not be fully funded and require additional payments from the credit union. It may be cheaper to unwind the structure than provide additional funding. In addition, some insurance carriers are exiting the split-dollar life market and transfer to another carrier could require additional fees.

Repossessed Vehicles

The accounting for foreclosed assets has not changed. However, per-vehicle losses have increased due to used car value declines (values were overinflated for a few years) and repossessions and sale turnaround times have lengthened in some cases as long as six months. A credit union may want to re-evaluate periodically for further write-down/valuation allowance. Consider modifying devaluation and cost-to-sell assumptions if additional significant losses are recognized when sold.

Other Real Estate Owned (OREO)

It may have been a while since credit unions have had to foreclose and take ownership of houses. As a refresher, if a loan balance is more than fair value less cost to sell, the difference is charged off as a loan loss. The balance is moved to OREO and monitored for any further impairment, which would be recorded to the income statement. Ongoing costs (maintenance and taxes) should be expensed and not added to the OREO balance. Fair value should be based on current information—original appraisals may be irrelevant. Have procedures documented on how valuation will be determined.

Loan Modifications

In ASU 2022-02, FASB eliminated troubled debt restructuring (TDR) guidance once an entity adopts CECL since the model captures the effect of most concessions but added new disclosure requirements for borrowers experiencing financial difficulty. A credit union should now apply the loan refinancing and restructuring guidance in ASC 310-20 to determine whether a modification results in a new loan or a continuation of an existing loan.

Many credit union policies have not been updated and still reference TDRs; updates to the new guidance are likely to be minor (evaluation method, checklists). Double-check call reports to help ensure that only modifications made in the last 12 months (not lifetime of the loan) are included.

Debt modification disclosure requirements:

- By class of financing receivable, qualitative and quantitative information about:
  - The types of modifications an entity used
  - The financial effect of the modification-by-modification type
  - Receivable performance in the 12 months after a modification
- By portfolio segment, qualitative information about how the modifications and the debtors' subsequent performance are reflected in determining the allowance for credit losses

Talent/People

The increase in the unemployment rate is easing the pressures on finding talent. One credit union doubled down on remote work and another focused on expanding its intern and entry-level programs to attract and retain talent. The third credit union highlighted its intern program with heavy rotation throughout the organization. All acknowledged the specific challenges in recruiting accountants given the declining number of college students pursuing this career path. Credit unions took different paths on remote work; one has a hybrid model with managers coming in three days a week, while another has been back to the office since April 2021 to focus on culture and stronger connections.

Mission/Community Giveback

Each credit union had different focus areas—affordable housing, financial literacy, and institution support for staff volunteering. This guided their strategic plans.

Margin Compression/Interest Rates

One credit union was well positioned when rates rose and had strong liquidity, and it is evaluating ways to deploy liquidity to benefit members (participations, arbitrage trades). Other credit unions are looking to expense management to offset the fall in non-interest income. Management might want to consider how and when to use derivatives to manage interest rate risk in a volatile rate environment.

Call reports

Panelists cited the challenges of pulling required information from various systems and were frustrated by the frequency of call report changes from regulators and the lack of sufficient lead time to implement with proper controls.

Growth

Panelists had different growth strategies. One credit union focused on organic growth by concentrating on member service—community bricks and mortar presence and using technology sensible to advance growth. Another was using acquisition to grow while focusing on expense management to be able to grow with scale and using technology to create a frictionless member experience.

Economic Outlook

Marci Rossell, former chief economist at CNBC, and Douglas Duncan, chief economist at Fannie Mae, separately presented engaging sessions on the current macroeconomic environment and real estate market updates. Both speakers provided multiple indicators that the economy is recovering, and a recession is not likely. Rossell noted that recessions are generally caused by unexpected events and that future losses in CRE are unlikely to trigger a recession. Some sectors within the CRE market continue to perform well, such as warehouses and senior housing.

Duncan's comments were consistent with Rossell, noting an unlikely recession with economic indicators that do not reveal a weak economy. He further analyzed the CRE space, highlighting the broad nature of the asset class, with the troubled indicators seen mainly in traditional office vacancy rates. Elevated vacancy rates are noted as geocentric. Overall, he indicated a fallout of CRE lending would not impact the economy nearly as much as a residential fallout.

Market expectations and comments from Fed Chair Jerome Powell ("higher for longer" and "easing less rapid") indicated a rate cut in September.

Elections

Tariffs, exemptions of tip income, and affordable housing may gain votes, but these are not likely to pass in the House and Senate. The housing ideas put forth will likely increase demand and not address the underlying supply issues, which will likely continue. While the affordability levels of housing are high, they are not unprecedented. Current levels are comparable to the 1980s.

Federal Deficit

The deficit as a percentage of GDP is at the same level as during World War II. Given the rise in interest rates, the cost to fund the deficit will shortly exceed the defense budget. The interest rate premiums demanded in the global market will be a leading indicator that the federal deficit gets too large. Rossell noted that if the interest rate remains below 5%, then productivity gains can offset debt funding increases—but this becomes problematic if at a rate over 5%.

Global Demographics

In the near future, there will not be enough working-age people to maintain current living standards.

Slowdown in Chinese Economy

China is the world's second-largest economy, and it is facing multiple challenges – elevated debt levels, deflation, and a demographic cliff in the working-age population (by 2050, China is expected to lose 216 million working-aged people). Consumer spending represents 25% of GDP (versus 15–18% in the U.S.).

Conclusion

Our team has more than 40 years of experience serving credit unions. According to the 2024 Supplier Market Share Guide: Credit Union Auditors, published by Callahan & Associates, Forvis Mazars ranks sixth in auditing credit unions with more than $100 million in assets. Forvis Mazars also ranks in the top 10 of total credit unions audited.

With all of that in mind, our professionals are uniquely positioned to help serve your complex needs and take on the challenges your institution faces. Contact us for more information.

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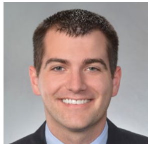

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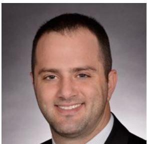

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