NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW
OF
HURON RIVER AREA CREDIT UNION

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CONTENTS

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review of Huron River Area Credit Union (Huron). We reviewed Huron to: (1) determine the cause(s) of Huron's failure and the resulting loss to the NCUSIF; and (2) assess NCUA's supervision of the credit union. To achieve these objectives, we analyzed NCUA and Michigan State Supervisory Authority (SSA) examination and supervision reports and related correspondence; interviewed management and staff from NCUA Region I and the Michigan SSA; and reviewed NCUA and SSA guides, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPRs).

We determined that credit risk and strategic risk were major factors in Huron's failure. Huron management did not adequately manage and monitor the credit risk within its loan program. In addition, Huron management made strategic decisions that put Huron's continued financial viability at significant risk. Specifically, Michigan SSA and NCUA examiners determined, and the OIG agrees, that Huron management:

- Did not exercise due diligence by evaluating the third party relationship held with its lender, the Construction Loan Company (CLC);
- Allowed CLC to concentrate a majority of the credit union's loan portfolio in a speculative Florida real estate construction project;
- Allowed CLC to make construction loans to applicants outside the credit union's approved field of membership;
- Misclassified construction loans and violated NCUA's Member Business Loan (MBL) limits;
- Did not have adequate liquidity controls in its ALM Policy; and
- Failed to develop or follow adequate plans to guide the direction of the credit union and the Florida construction loan program.

We determined the following management actions also contributed to Huron's failure:

- Huron management was not forthcoming with the Michigan SSA and NCUA examiners about the Florida construction loan program.
- Huron management may have ignored warnings regarding the expected decline of housing values, in particular those in the Florida real estate market.

In addition, we determined NCUA and Michigan SSA examiners may not have adequately monitored or reacted prudently or timely to trends indicating the safe and sound operation of Huron may have been in jeopardy. Consequently, NCUA did not adequately and timely address the credit and strategic risks Huron management caused by entering Huron into an inherently risky and uncontrolled construction lending program, which ultimately led to Huron's worsening liquidity issues. Specifically, we determined:

- Although the Michigan SSA and NCUA examiners expressed concerns regarding Huron's liquidity, we believe they may not have adequately monitored or responded appropriately or timely to their concerns regarding this risk.
- We believe financial ratios and trends revealed Huron's worsening liquidity position well before NCUA and the Michigan SSA officially identified the severity of the issue during the January 2007 joint examination.
- Huron's liquidity position deteriorated rapidly after March 2005.

We made two suggestions and one recommendation to NCUA. We suggested NCUA aggressively investigate and protect against perceived risks Federally Insured State Credit Unions (FISCUs) may pose to the insurance fund. In addition, we suggested (1) Region I officials continue a new procedure they established where analysts provide a secondary review of national risk reports to better monitor FISCUs, and (2) NCUA determine whether all Regional Offices should incorporate these procedures to provide increased supervision of FISCUs. We also recommended NCUA management issue a Supervisory Letter to all Federal and State examiners to alert them of the need to (1) analyze and understand financial ratios and trends individually and as a group and (2) thoroughly analyze pertinent qualitative data in order to adequately assess the safety and soundness of credit union operations.

Management concurred with the first suggestion and the recommendation. Management stated NCUA recently reinforced the need for aggressive investigation and protection against perceived risks in Letter to Credit Unions No.: 08-CU-20 Evaluating Current Risks to Credit Unions. Management stated the letter included supervisory guidance given to NCUA examiners about diligent examination and supervision when potential risk to a credit union is identified. In addition, management concurred in principle with the second suggestion. Management stated if the suggestion is adopted on a national level, the specific procedures should be left to each regional director to determine the proper flow of information through their chain of command. A complete copy of management's formal written response is attached at Appendix E.

We appreciate the courtesies and cooperation NCUA and Michigan SSA management and staff provided to us during this review.

Background

Huron River Area Credit Union

Huron River Area Credit Union (Huron), located in Ann Arbor, Michigan, was chartered in 1937. Huron was a full service, federally insured state credit union (FISCU), which served over 1,000 employer groups in southeastern Michigan. Huron was located in NCUA's Region I.

On February 16, 2007, the State of Michigan's Office of Financial and Insurance Regulation (a State Supervisory Authority (SSA)[1] placed Huron into conservatorship. The SSA state conservatorship was converted to a Federal Conservatorship on March 23, 2007. The NCUA determined Huron to be insolvent as of June 30, 2007. At that time, Huron's assets exceeded $268 million and served nearly 38,000 members. The NCUA Board involuntarily liquidated Huron on November 17, 2007, and Detroit Edison Credit Union (DECU) purchased the credit union's assets and liabilities for a premium of $41 million. The Purchase and Assumption by DECU resulted in a loss to the National Credit Union Share Insurance Fund (NCUSIF) of approximately $38.7 million as of January 30, 2008. However, the final loss to the NCUSIF will not be known until the final disposition of the assets held by the Asset Management and Assistance Center.

NCUA Examination Process

Total Analysis Process

NCUA uses a total analysis process that includes: collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL[2] components, and reviewing qualitative and quantitative measures.

NCUA uses a CAMEL Rating System to provide an accurate and consistent assessment of a credit union's financial condition and operations. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. Examiners must assign the CAMEL rating during an examination. Assigning the CAMEL rating completes the examination process.

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[1] Prior to February 1, 2008, the Michigan SSA was known as the Office of Financial and Insurance Services (OFIS).
[2] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and Asset/[L]iability Management

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis[3], trend analysis[4], reasonableness analysis[5], variable data analysis[6], and qualitative data analysis.[7] Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends. Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, NCUA requires examiners to determine whether material negative trends exist; ascertain the action needed to reverse unfavorable trends; and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

Risk-Focused Examination Program

In May 2002, NCUA announced its new Risk-Focused Examination (RFE) Program, to be implemented in the fall of 2002. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic,* and *Reputation.* Examination planning tasks may include (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Report and Financial Performance Report (FPR) trends. The extent of the plans depends largely on the severity and direction of the risks detected in the credit union's operation and on management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

- Review of Call Reports;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union.

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[3] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[4] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[5] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[6] Examiners can often analyze an examination area in many different ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to more accurately assess the financial condition, quality of service, and risk potential.
[7] Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the credit union's current condition, and which will affect its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.

Supervision of FISCUs

NCUA's statutory authority and its guidelines indicate the agency has the legal and fiduciary responsibility to ensure the safety of the NCUSIF. FISCUs receive the same account insurance coverage under the NCUSIF as federally chartered credit unions. Therefore, FISCUs are subject to the same review of risks as other credit unions. The two most common types of on-site FISCU reviews are an independent insurance review and a joint examination/insurance review. During both reviews, NCUA limits its scope to risk issues negatively affecting the NCUSIF. However, during an independent insurance review, NCUA examiners limit their role to the review and analysis of risks to the NCUSIF only, rather than to complete an examination of the FISCU. In joint examinations/insurance reviews, both NCUA and the SSA examiners focus on risk issues, while the state examiner also focuses on regulatory concerns.

NCUA examiners primarily monitor the financial condition and progress of FISCUs by reviewing SSA examination reports, Call Reports, and FPRs. In reviewing SSA reports, NCUA's concerns include whether:

- The SSA examiners adequately addressed material risks within the FISCUs;
- The credit union understands the seriousness of the risks; and
- An agreement or plan exists for resolving unacceptable risks in a timely manner.

The Federal Credit Union Act (FCU Act) requires that, because SSAs are primarily responsible for the supervision of insured state credit unions, NCUA should use the SSA examination reports *to the maximum extent feasible*.[8] However, NCUA reserves the right to conduct an insurance review of any FISCU as it deems necessary to determine its condition for insurance purposes.[9]

Objectives, Scope and Methodology

The FCU Act requires the NCUA Office of Inspector General (OIG) to conduct a material loss review if the loss to the NCUSIF exceeds $10 million.[10] Consequently, in accordance with the FCU Act and Chapter 3 of the NCUA Special Assistance Manual, the OIG conducted a material loss review of Huron.

The objectives of our review were to: (1) determine the cause(s) of Huron's failure and the resulting loss to the NCUSIF; and (2) assess NCUA's supervision

[8]The FCU Act, 12 U.S.C. § 1781(b)(1).
[9] The FCU Act, 12 U.S.C. § 1784(a).
[10] Specifically, the FCU Act, 12 U.S.C. § 1790d(j) requires that the IG conduct a review when the Fund has incurred a material loss with respect to a credit union. A material loss is defined as (1) exceeding the sum of $10 million and (2) an amount equal to 10 percent of the total assets of the CU at the time at which the Board initiated assistance or was appointed liquidating agent.

of the credit union. The scope of our review included Huron's operations and NCUA supervision from August 1998 through January 2007.[11] To accomplish our objectives, we:

- Analyzed NCUA and Michigan SSA examination and supervision reports and related correspondence.
- Interviewed management and staff from NCUA Region I and the Michigan SSA.
- Reviewed NCUA and Michigan SSA guides, policies and procedures; NCUA Call Reports; and NCUA Financial Performance Reports (FPRs).

[11] NCUA conducted an on-site Interest Rate Risk Review and an on-site joint contact of Huron during the period covered in the scope of this Material Loss Review. All other references made to examinations throughout this report refer to on-site examinations by the Michigan SSA. NCUA completed reviews of the SSA examination reports as required.

RESULTS IN DETAIL

We determined Huron management's actions contributed significantly to Huron River Area Credit Union's failure. In addition, we determined NCUA and Michigan SSA examiners may not have adequately monitored or reacted prudently or timely to indicators that Huron was at risk.

A. Why Huron River Area Credit Union Failed

We determined that credit risk[12] and strategic risk[13] were major factors in Huron's failure. Huron management's actions contributed to the failure of the credit union by committing the majority of its assets to an inherently risky construction lending program without adequate controls in place.

Huron Management Actions Contributed to Huron's Failure

A contributing factor in Huron's failure was management's inability to adequately manage and monitor the credit risk within its loan program. In addition, management made strategic decisions that put Huron's continued financial viability at significant risk. Specifically, Michigan SSA and NCUA examiners determined, and the OIG agrees, that Huron management:

- Did not exercise due diligence by evaluating the third party relationship held with its lender, the Construction Loan Company (CLC[14]);
- Allowed CLC to concentrate a majority of the credit union's loan portfolio in a speculative Florida real estate construction project;
- Allowed CLC to make construction loans to applicants outside the credit union's approved field of membership;
- Misclassified construction loans and violated NCUA's Member Business Loan (MBL) limits;
- Did not have adequate liquidity controls in its ALM Policy; and
- Failed to develop or follow adequate plans to guide the direc*t*ion of the credit union and the Florida construction loan program.

[12] Credit Risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet terms of any contract with the credit union or otherwise fail to perform as agreed. Credit risk exists in all activities where the credit union invests or loans funds with the expectation of repayment.

[13] Strategic Risk is the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.

[14] CLC is a privately held, full service for mortgage lender located in Michigan. CLC finances all types of mortgages, construction loans, home improvement loans, vacant land loans and bridge loans. CLC can finance both the interim construction loan and the permanent mortgage. (See Confidential Section and http://www.loantobuild.com/construction-loan-faq.asp)

In addition, we determined other management actions contributed to Huron's failure including:

- Huron management was not forthcoming with the Michigan SSA and NCUA examiners about the Florida construction loan program.
- Huron management may have ignored warnings regarding the expected decline of housing values, in particular those in the Florida real estate market.

Huron was a financially sound credit union for at least nine years prior to NCUA's determination, in June 2007, that it was insolvent. The Michigan SSA rated Huron a CAMEL 1 from September 30 1998, through June 30, 2003, and rated the credit union a CAMEL 2 as of March 31, 2005. Huron management's actions surrounding its risky construction loan program fueled rapid and uncontrolled growth in total real estate loans of 206 percent between March 31, 2005 and September 30, 2006 (an 18 month period).[15] Examiners downgraded Huron to a CAMEL 5 during the final examination completed in April 2007[16].

Ultimately, NCUA concluded that as a result of Huron's participation in the Florida construction loan program, Huron was insolvent.[17] NCUA determined Huron's Allowance for Loan and Lease Loss (ALLL) account[18] was underfunded by $71 million as of June 30, 2007. In addition, NCUA determined that as of June 30, 2007, Huron's net worth was negative $29.5 million, its net worth ratio was negative 10.99 percent, and its Probable Asset/Share ratio[19] was 87.35 percent, declining from 118.78 percent as of March 31, 2005. Appendix A provides a history of the SSA examinations of Huron and the assigned CAMEL ratings from August 31, 1999 through January 2007, NCUAs reviews of the SSA examinations, and Huron management's responses to the examinations.

The following sections summarize Huron management's actions contributing to the Huron's failure:

[15] NCUA determined Huron began funding the Florida construction loans on or about June 1, 2005.
[16] Examiners used Call Report data effective September 30, 2006.
[17] A credit union is determined to be insolvent when the total amount of its shares exceeds the present cash value of its assets after providing for liabilities unless: (a) it is determined by the NCUA Board that the facts that caused the deficient share-asset ratio no longer exist; (b) the likelihood of further depreciation of the share-asset ratio is not probable; (c) the return of the share-asset ratio to its normal limits within a reasonable time for the credit union concerned is probable; and (d) the probability of a further potential loss to the insurance fund is negligible.
[18] ALLL is a credit union's best estimate of the probable amount of loans it will be unable to collect based on current information and events.
[19] The Probable Asset/Share ratio is a solvency ratio that indicates the relative worth of each one dollar in shares of an ongoing credit union.

Huron management failed to perform due diligence over CLC and the construction loan program

Huron management established a third party relationship with CLC in 1997. During the September 30, 2000 examination[20], Michigan SSA examiners determined Huron management allowed the vendor much of the responsibility for making and overseeing Huron's construction loans; they determined CLC did most of the underwriting for the construction loans. In addition, according to Michigan SSA and NCUA examiners, the Huron Board of Directors delegated authority to CLC to originate, underwrite, approve, and perform all servicing and collection functions for the Florida construction and lending program. NCUA examiners determined Huron management performed minimal up front due diligence of CLC while providing virtually no over-sight of the program.

Dating back to 1999, Michigan SSA examiners identified various deficiencies regarding Huron's mortgage and construction loan program resulting from management's lack of due diligence and oversight. During the January 2007 joint examination,[21] examiners identified significant deficiencies with the Florida loan program which were similar to deficiencies the SSA examiners had identified in prior examinations. The deficiencies included lack of [management] oversight, poor loan quality/inadequate loan documentation, concentration risk, and misclassified loans. Examiners identified specific problems with loans for both Michigan[22] and Florida properties. Table 1 below provides an overview of these January 2007 deficiencies as well as when examiners identified similar deficiencies in prior exams. Appendix B provides details of examiner findings and recommendations as they relate to the specific deficiencies noted above.

[20] This period was almost five years before Huron began funding construction loans in Florida on or about June 1, 2005.

[21] The January 2007 examination used September 30, 2006 Call Report data. Within days of NCUA arriving on site, the decision was made to place Huron under Region I Special Actions. The examination ended with the Michigan OFIR's conservatorship of Huron.

[22] NCUA examiners identified existing issues with loans related to properties in Michigan dating back to May 1999, six years before the Florida loan program.

		Table 1: ***Huron's January 2007 Deficiencies***			
Effective Exam Date ***(Dates Exam Conducted)***	**CAMEL/ Examiner**	**Lack of Mgt Oversight of CLC**	**Inadequate Loan Documentation**	**Concentration of Risk**	**Misclassified loans**
Aug 31, 1999 (Completed 9/21/99)	**CAMEL 1** ***(Examiner A)***	✓	✓		
Sep 30, 2000 (10/25/00 - 12/01/00)	**CAMEL 1** ***(Examiner A)***	✓	✓		
Sep 30, 2001 (11/14/01 - 12/03/01)	**CAMEL 1** ***(Examiner A)***			✓	✓
Sep 30, 2002 (11/18/02 - 11/27/02)	**CAMEL 1** ***(Examiner B)***				✓
Jun 30, 2003 (10/27/03 - 11/24/03)	**CAMEL 1** ***(Examiner C)***		✓		✓
Mar 31, 2005[23] (6/13/05 - 6/17/05)	**CAMEL 2** ***(Examiner C)***				
Jan 2007 [24] (Joint examination Completed 4/04/07)	**CAMEL 5**	✓	✓	✓	✓

[23] CAMEL downgraded due to high delinquency and high long term assets.
[24] Examiners used data from the September 30, 2006 Call Report.

Huron management concentrated an excessive amount of the credit union's assets in the construction loan program in the Florida real estate market.

As of December 31, 2006, Huron had assets totaling approximately $363 million. NCUA determined that as of February 8, 2007, Huron's Florida construction loan portfolio totaled $202 million, well over half its total assets and 67 percent of its total $302 million loan portfolio. Furthermore, NCUA determined Huron management had committed the credit union to approximately $65 million in future loans in the Florida construction loan program.

Huron funded loans to applicants outside its approved field of membership (FOM)

Florida construction loan applicants were not legal members of Huron.[25] NCUA and the Michigan SSA indicated two steps were required to admit an employer or other organized group into Huron's FOM. The first step required Huron's Credit Union Service Organization (CUSO), Learn and Earn Credit, LLC, to submit a written request for services to Huron. Learn and Earn Credit, LLC met this requirement. The second step required Huron to request, from the SSA, a bylaw amendment to add Learn and Earn Credit, LLC, as an "other organized group". Huron did not request the amendment; therefore, the Michigan SSA determined Learn and Earn, LLC, was not a legal member of Huron. Consequently, the applicants[26] for Florida loans who were members of Learn and Earn, LLC, were not eligible for membership with Huron. We believe this relatively unrestricted FOM contributed significantly to the rapid and uncontrolled loan growth.

Huron management misclassified construction loans and violated NCUA's MBL limits

Huron management violated NCUA's MBL rules, failing to limit its aggregate net MBL balance to the lesser of 1.75 times its net worth or 12.25 percent of its total assets. Based on Huron's December 2006 net worth and total assets of approximately $41 million and $363 million, respectively, Huron's MBL balance should not have exceeded approximately $44 million. As of February 2007, NCUA determined Huron had approximately $187 million worth of MBLs in its Florida construction loan portfolio, an amount over four times the statutory limit. However, Huron management only reported $8.6 million of its total real estate loans as MBLs in the December 2006 Call Report. As a result, NCUA and Michigan SSA examiners did not have accurate information to recognize and properly supervise and correct Huron management's MBL activities. We found

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[25] Huron funded the Florida loans to borrowers throughout the United States, including Puerto Rico.
[26] The applicants purportedly "joined" the credit union, under the aegis of Learn and Earn, LLC, as a credit union member, through the purchase of one fully paid share.

no evidence that Huron management purposely misclassified the construction loans. However, it was management's responsibility to properly classify its loans.

Huron management did not have adequate liquidity controls in its ALM policy

During the January 2007 joint examination[27], Michigan SSA and NCUA examiners performed a review of Huron's ALM practices as well as its risk positions. The review determined Huron's risk management processes were not adequate for identifying, measuring, monitoring, controlling and reporting its current and short-term liquidity risks. Specifically, the review revealed:

- The ALM policy did not:
  - Include liquidity risk measuring and monitoring functions. Huron management did not assign key responsibilities for measuring, monitoring and reporting liquidity risks.
  - Include formal procedures for reviewing short-term and long-term cash flows.
  - Require management to estimate current and future liquidity needs.
  - Include formal reporting requirements to provide information regarding short-term and long-term liquidity positions to the Huron Asset Liability Committee (ALCO) or Board of Directors.
- The liquidity risk measurement policy target did not indicate potential cash shortfalls and liquidity pressures.
- Huron management did not use the ALM model regarding liquidity gap reports that considered changing interest rate environments and stressed liquidity positions.

Overall, examiners rated Huron's liquidity risk as "high" due to the lack of adequate ALM policies, procedures, and measurement abilities necessary to protect the credit union.

Huron management failed to develop or follow adequate plans to guide the direction of the credit union and the Florida loan program

NCUA and Michigan SSA examiners determined Huron management's goal, as stated in its 2006 Operational Objectives, was to grow the Florida construction loan program to a maximum of $100 million by the end of 2006. However, the construction loan balance was $191 million at year-end, which could have significantly impacted Huron's funding requirements. In addition, Huron's 2006 annual budget planned for 12 percent asset and loan growth--all in the indirect construction loan program. However, actual growth was 156 percent between year-end 2005 and year-end 2006. Furthermore, Huron management indicated

[27] This examination was completed on April 4, 2007.

in its budget narrative that it would shift the main funding of the program from its external lines of credit (LOC) to Huron's members. Although budget projections showed reduced borrowings of $6 million, Huron management's reliance on external borrowings and non-member deposits actually grew.

Huron management was not forthcoming with the Michigan SSA and NCUA examiners about the Florida construction loan program

Based on the timing of Huron management's actions, we believe Huron management withheld from the Michigan SSA and NCUA specific information regarding its Florida construction loan program.

On January 31, 2003 Huron management *ratified* an agreement with CLC to *fund* $30 million (plus) in Florida construction loans. Huron management had numerous opportunities to inform the Michigan SSA and NCUA of this funding agreement and the extent of the construction loan program. However, Michigan SSA and NCUA examiners did not learn of this program until the March 2005 examination.[28] Furthermore, the Michigan SSA and NCUA did not learn, until the January 2007 joint examination, that the program involved investment properties in Florida.

The following presents a chronology of events subsequent to Huron entering into the funding agreement with CLC in January 2003 (See Appendix C for a graphic depiction of the chronology):

- June 2003 – Michigan SSA examination. The examination addressed CLC and construction loans; however, the examination made no mention of the funding agreement.

- February 3, 2004 – Huron management and CLC *prepared* (but did not ratify) a second agreement to *service* Huron's real estate loan portfolio, including construction loans.

- September 16, 2004 - NCUA completed an Interest Rate Risk (IRR) review.[29] The review noted a moderately high volume of real estate loans, but also noted Huron management did not intend to increase real estate loans. There was no mention in the review of the *funding* agreement.

- September 17, 2004 – Huron management *ratified* the February 2004 *servicing* agreement with CLC *one day after* NCUA completed its IRR review. The agreement referenced a potential loan portfolio volume of over $50 million.

[28] This examination was conducted from June 13 thru June 17, 2005.
[29] A large increase in Huron's long-term investments prompted this review.

- June 1, 2005 (on or about) – Huron began funding Florida construction loans.

- June 13, 2005 – the Michigan SSA initiated the March 2005 examination. In its reply to this examination, Huron management noted (a) “an expected downturn in Michigan’s economic environment;” (b) its construction loan program; and (c) the $30 million line of credit. Once again, however, Huron management failed to mention that its construction loan program involved investment properties in Florida.

- April 2006 – an NCUA examiner asked Huron management about the rapid growth of Huron construction loans. In response, Huron management emailed the examiner a detailed overview of the construction loan program, but never revealed the construction loans were for investment properties in Florida.

Huron management may have ignored warnings regarding the expected decline of housing values

Huron began offering construction loans in Florida on or about June 1, 2005. On August 31, 2005, the *Credit Union Times*[30] published an article[31] regarding overvalued home prices. The article indicated 53 cities were “at high risk of price declines,” including Cape Coral, FL where the author indicated home prices may have been overvalued by 35 percent. In addition, in October 2005, the Vice President of Huron sent an article[32] to the President/CEO of Huron discussing the “unavoidable…housing bust” followed by a weakening US economy.

These articles indicated that by mid to late 2005, Huron management was aware of the potential decline in the housing market, and that credit union publications were already reporting the declining values of the real estate market specifically in the Florida communities of Cape Coral and Lehigh Acres where Huron was concentrating its construction loan program. Nevertheless, Huron’s Florida real estate loan portfolio grew by more than 763 percent[33] between March 31, 2005, and September 30 2006. This, we believe, indicates that although Huron management was or should have been on notice of the declining values in the Florida real estate market, it nonetheless failed to give due deference to the risks presented.

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[30] The *Credit Union Times* (the *Times*) website indicates the *Times* is the leading weekly publication covering the credit union industry. It also indicates that top credit union executives read the *Times* for critical news and developments affecting the industry.

[31] The article was entitled: *Economist says Home Prices Have Risen to “Extremely Overvalued” Levels in 53 Cities.*

[32] The article was entitled: *The Almost Inevitable 99% Unavoidable, Slam-Dunk.*

[33] The percentage represents the ‘hybrid/balloon loans of *five years or less’* category on the Call Report. An NCUA official informed us Huron management presented the Florida loans as hybrid loans on the Call Report.

In addition to information credit union and other news publications were reporting, NCUA issued the following *Letters to Credit Unions* and *Risk Alerts* to FISCUs between 1991 and 2005. These Letters and Alerts provided guidance on due diligence over real estate lending and outsourced lending:

Year	Reference	Title
1991	Letter No. 124	Real Estate Secured by Credit Union Members
1995	Letter No. 174	Risk-Based Loans
1999	Letter No. 99-CU-05	Risk-Based Lending
2001	Letter No. 01-CU-20	Due Diligence Over Third Party Service Providers
2003	Letter No. 03-CU-11	Non-Maturity Shares and Balance Sheet Risk
	Letter No. 03-CU-15	Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios
	Letter No. 03-CU-17	Independent Appraisal Evaluation Functions for Real-Estate Transactions
2004	Letter No. 04-CU-13	Specialized Lending Activities
2005	Risk Alert No. 05-Risk-01	Specialized Lending Activities – Third Party Subprime Indirect Lending and Participations
	Letter No. 05-CU-07	Managing Risks Associated with Home Equity Lending

Furthermore, NCUA issued a series of *Letters to Credit Unions* between 1999 and 2008, providing guidance on balance sheet risk management or asset-liability management:

Year	Reference	Title
1999	Letter No. 99-CU-12	Real Estate and Balance Sheet Risk Management
2000	Letter No. 00-CU-10	Asset Liability Management Examination Procedures
2000	Letter No. 00-CU-13	Liquidity and Balance Sheet Risk Management
2001	Letter No. 01-CU-08	Liability Management – Highly Rate-Sensitive & Volatile Funding Sources
2008	Letter No. 08-CU-20	Supervisory Letter – Evaluating Current Risks to Credit Unions

We believe NCUA provided credit unions with sufficient guidance on (1) due diligence over third parties providing lending activities; and (2) balance sheet risk management, asset liability management, and liquidity management. Therefore, we do not have any recommendations to NCUA regarding this issue.

B. Michigan State Supervisory Authority and NCUA Supervision of Huron River Area Credit Union

We determined Michigan SSA and NCUA examiners may not have adequately monitored or reacted prudently or timely to trends that indicated the safe and sound operation of the credit union may have been in jeopardy. As a result, NCUA did not adequately and timely address the credit and strategic risks Huron management caused by entering Huron into an inherently risky and uncontrolled construction lending program, which ultimately led to Huron's worsening liquidity issues.

Supervision procedures include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The primary means by which NCUA monitors the financial condition and the progress of FISCUs is through the NCUA examiner's review of SSA examination reports, Call Reports, and FPRs. In addition, NCUA's supervision process encourages examiners to review Call Reports between examinations to identify possible changes in a credit union's risk profile.

Financial Trends Foreshadowed Huron's Failure

Liquidity risk is one of seven risk areas NCUA reviews. It is the risk that a credit union will be unable to continue meeting member demands for share withdrawals or new loans. We observed the following concerns during our review regarding Huron's liquidity risk:

- Although the Michigan SSA and NCUA examiners expressed concerns regarding Huron's liquidity, we believe they may not have adequately monitored or responded appropriately or timely to their concerns regarding this risk.
- We believe financial ratios and trends revealed Huron's worsening liquidity position well before NCUA and the Michigan SSA officially identified the severity of the issue during the January 2007 joint examination.
- Huron's liquidity position deteriorated rapidly after March 2005.

Examiners' Liquidity Risk Concerns

Michigan SSA examiners conducted an examination of Huron as of March 30, 2005,[34] and indicated in the report that:

- Liquidity was diminishing as Huron used funds for construction loans.

[34] This examination was conducted from June 13 thru June 17, 2005.

- Loan growth was 23 percent in 2004 and 20 percent during the first quarter of 2005.
- Real estate loans, including construction loans, continued to increase and represented approximately 84 percent of total loan growth.

- The ALM area and liquidity risk exposure required continuous monitoring to ensure performance remained acceptable.

In its response to the March 2005 exam report, Huron management stated it had identified a need to bring funds into the credit union to address liquidity.[35] Management said they expected to borrow to initially fund daily liquidity needs until its construction lending became fully functioning.

In addition, NCUA noted in its review of the SSA's March 2005 examination that:[36]

- Management had allocated $30 million for a construction loan program with CLC underwriting the loans.
- The activity in construction lending was a fairly new program that could have exposed the credit union to considerable risk if sufficient internal controls were not in place.
- Strong loan growth was consuming liquidity at a rapid pace.
- Loan growth trends indicated liquidity would tighten.
- Refinements were needed in the ALM program in terms of policies and the structure of Asset/Liability Committee (ALCO) meetings.

We learned the Michigan SSA monitors credit unions for liquidity-related issues through its "red flag" reports. The "red-flag" reports help identify potential issues regarding mortgage-related loan growth. One red-flag report addresses "off-balance sheet" funding (i.e., borrowing money to lend) and another report addresses loan growth. The Michigan SSA told us Huron was on the "red-flag" report for off-balance sheet funding in December 2005. However, in June 2006, Huron did not meet the "red-flag" criteria regarding loan growth (total loans to total assets).

We also learned an NCUA examiner "investigated a noted change in the balance sheet when Huron's real estate loan volume first started to increase" in December 2005.[37] In April 2006, based on a review of March 2006 Call Report data, the NCUA examiner raised concerns with Huron management regarding Huron's rapid construction loan growth. In our discussions with this examiner, he informed us that he immediately provided this information to the NCUA supervisory examiner, who in turn discussed the issue with the Michigan SSA.

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[35] Huron management's response is dated September 19, 2005.
[36] NCUA officials indicated they received the SSA examination on August 30, 2005 and completed its review on October 4, 2005.
[37] This was the same NCUA examiner who performed the review of the March 2005 state examination.

Michigan SSA officials told us that due to the holidays and scheduling conflicts, the SSA and NCUA were unable to arrange a joint examination until January 2007.[38] Furthermore, we learned an NCUA analyst observed liquidity and loan issues on an October 2006 risk analysis report. This report was based on June 2006 Call Report data.

During the January 2007 joint examination, NCUA and Michigan SSA examiners pointed out that Huron's worsening liquidity position, due to high loan growth and low share growth, had been a trend since 2005. We believe that collectively reviewing financial trends and trends in certain ratios, especially considering Huron's liquidity concerns identified in June 2005,[39] should have alerted the Michigan SSA and NCUA of Huron's severe liquidity situation prior to the January 2007 examination.

Financial Ratios and Trends

Numerous ratios measuring a variety of credit union functions provide the basis for analysis of trends and reasonableness. NCUA guidelines indicate examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends. Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems.

We reviewed the following ratios and indicators in the quarterly Call Reports and FPRs[40] for trends covering the period March 31, 2005, through September 30, 2006[41]:

- Real Estate Loan Growth
- Total Loans to Total Shares
- Total Loans to Total Assets
- Net Worth Growth versus Share Growth
- Asset Growth versus Net Worth Growth
- Investment Growth versus Loan Growth and Share Growth
- Borrowings versus Loan Growth and Share Growth

Following are discussions and charts pertaining to each of the above ratios, indicators, and trends:

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[38] The NCUA examiner told us he did not believe he had enough evidence other than loan growth to justify and insist that NCUA conduct an on-site contact sooner. However, in hindsight, he said he wished he would have stressed the urgency more.
[39] During the March 31, 2005 examination.
[40] NCUA officials informed us that it could be more than 45 days before Call Report and FPR data is available to examiners for analysis.
[41] September 30, 2006, is the effective date of the Call Report data examiners used in the January 2007 joint examination that led to the conservatorship of Huron.

Real Estate Loan Growth

Rapid growth in loans can indicate increased volatility in the balance sheet. Loan growth also reflects a credit union's risk management practices. During the January 2007 joint examination, NCUA and the Michigan SSA described Huron's 2005 and 2006 Florida loan growth as "exorbitant". While NCUA's June 2004 IRR review indicated Huron management did not intend to increase real estate lending, Huron's total real estate loan growth was 206 percent between March 31, 2005, and September 30, 2006. This included a 763 percent growth in Balloon/Hybrid real estate loans[42] over the same period. Charts 1 and 2 below highlight the rapid growth of Huron's total real estate and balloon/hybrid real estate loan *values ($) and volumes* from March 2005 through September 2006:

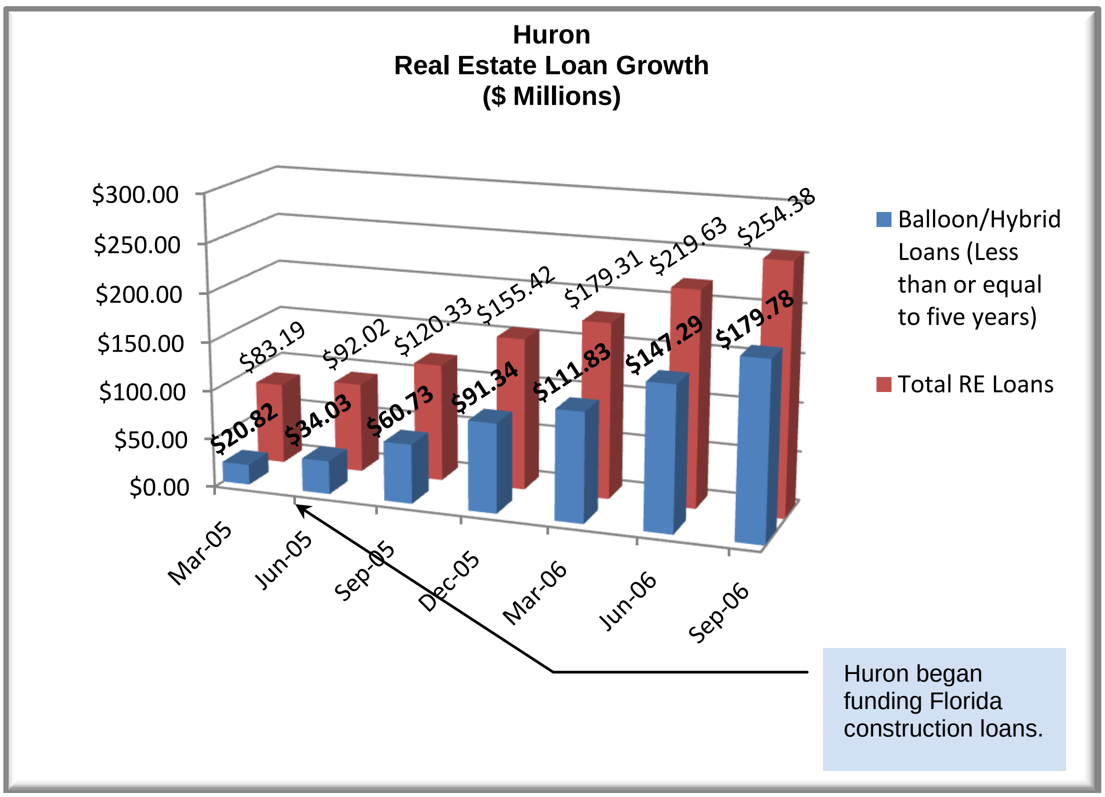

Chart 1 - Total Real Estate and Balloon/Hybrid Real Estate Loan Values ($)

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[42] Hybrid/Balloon loans consist of loans that are fixed for an initial period and then convert to a variable rate using the fully indexed rate, which can result in a significant payment shock to borrowers. This particular group of loans for Huron re-priced in five years or less. A Region I manager told us Huron management was classifying the Florida construction loans as Hybrid loans.

Growth in total real estate and balloon/hybrid loan volumes over the same period was 138 percent and 979 percent, respectively (as shown below):

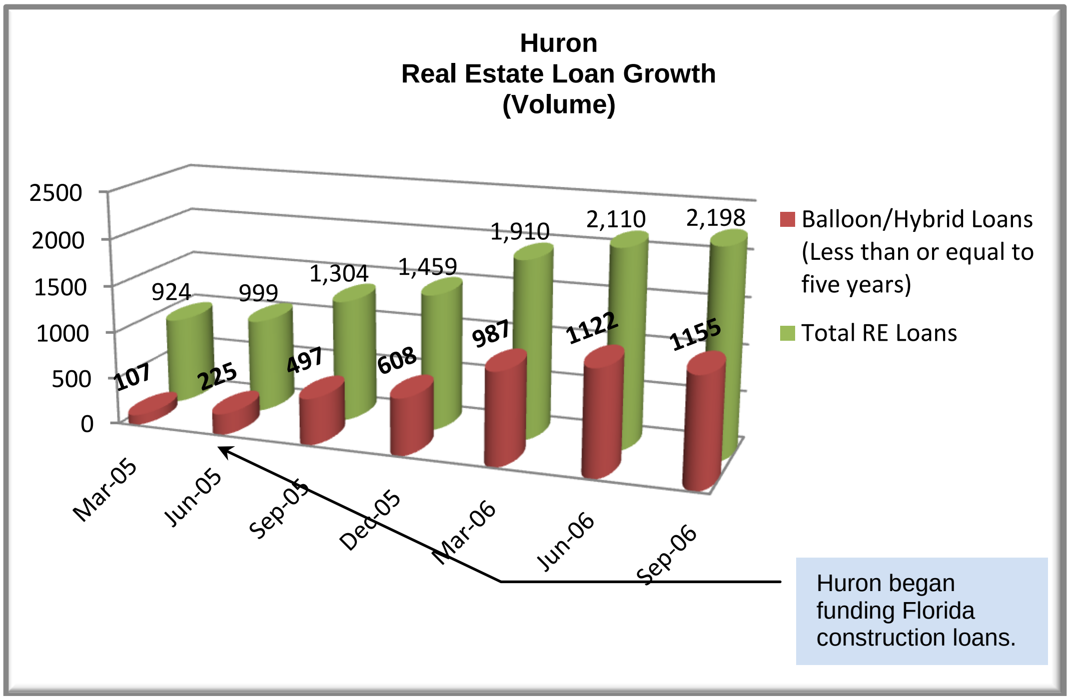

Chart 2 – Total Real Estate and Balloon Hybrid/Real Estate Loan Volumes

In addition to its increasing loan balance, Huron had a significantly increasing balance of other unfunded commitments as illustrated in Chart 3 below. Huron's other unfunded commitments increased over 1,400 percent between March 31, 2005 and September 30, 2006:

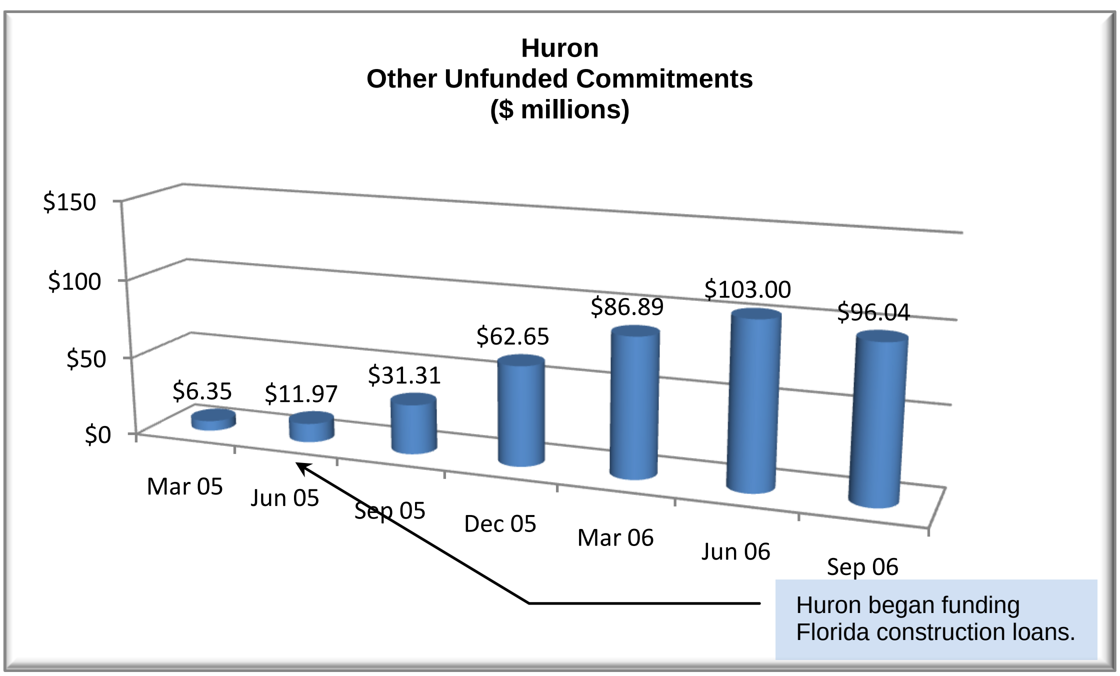

Chart 3 – Other Unfunded Commitments

Total Loans to Total Shares

NCUA guidelines indicate that a high loan to share ratio is a key indicator of tightening liquidity. NCUA guidelines also indicate when loan demand exceeds normal share growth, management must rely on access to borrowed money or the sale of securities to raise needed cash. During the January 2007 joint examination, NCUA and the Michigan SSA determined Huron was experiencing significant liquidity pressures from the uncontrolled loan versus share growth. Chart 4 below highlights a rapidly worsening trend for this ratio between March 2005 (64 percent) and September 2005 (87 percent). This ratio swelled to a critical point over the next quarter when it exceeded 106 percent as of December 2005.

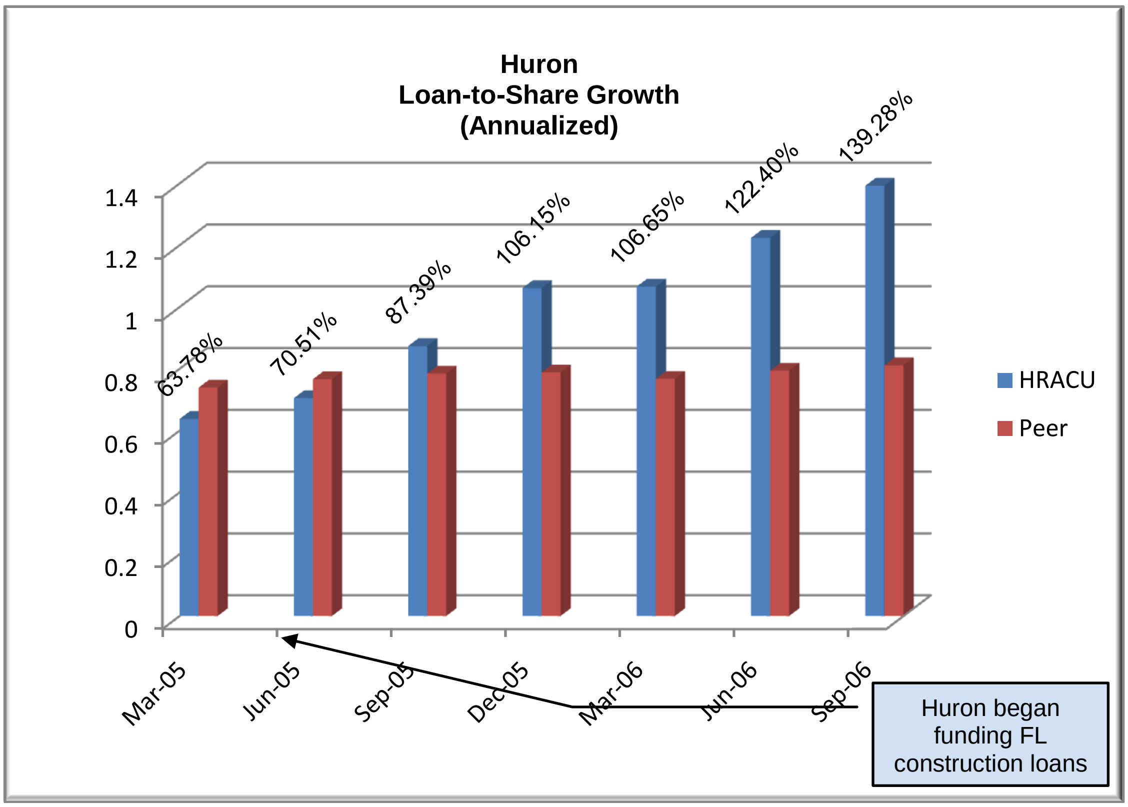

Chart 4 – Total Loans to Total Shares

Total Loans to Total Assets

A high loan to asset ratio may indicate that a credit union cannot meet its member loan demands and other liquidity needs. This is especially true if (1) the credit union has limited other funding sources; (2) existing funding depends on volatile sources; or (3) the credit union has minimal short-term investments. Chart 5 below highlights Huron's trend of increasing total loans to total assets from 53 percent in March 2005 to 85 percent in September 2006.

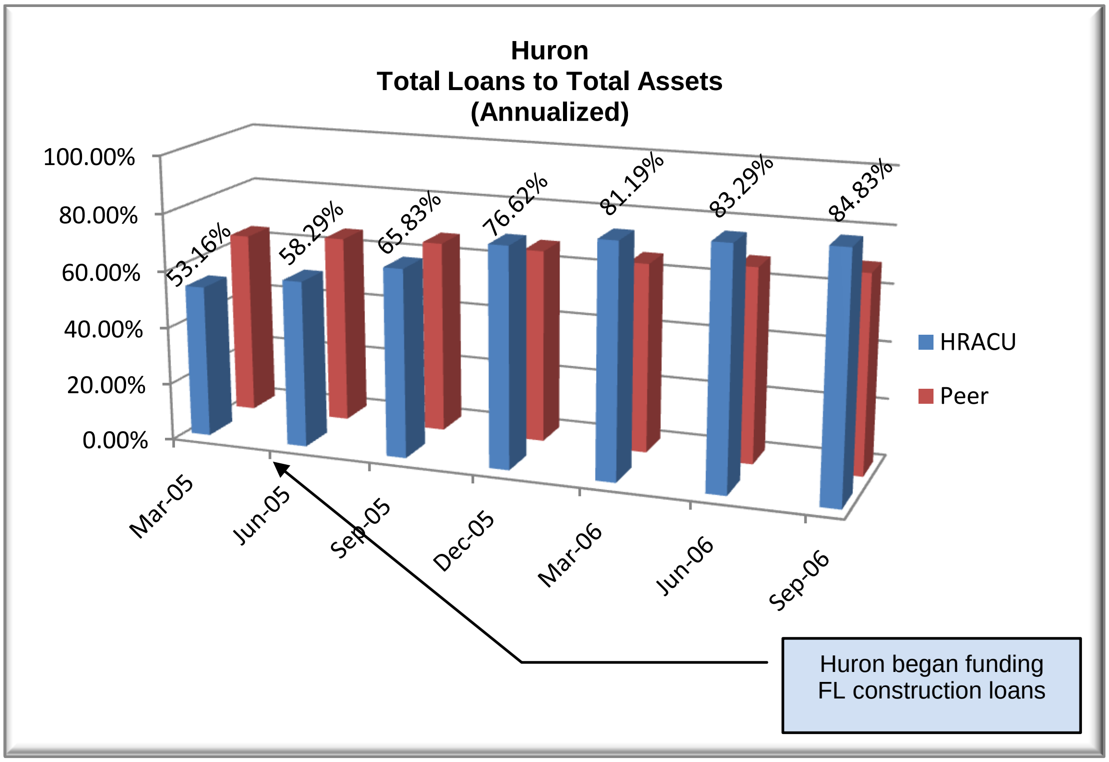

Chart 5 – Total Loans to Total Assets

Net Worth[43] Growth versus Share Growth

Although Huron remained well capitalized,[44] NCUA guidance indicates examiners should remain aware of a level of net worth that does not keep pace with share growth. NCUA guidelines state this scenario undermines a credit union's ability to absorb losses and react to changes. Chart 6 below illustrates that Huron's share growth[45] spiked significantly above its net worth growth between December 2005 and March 2006.

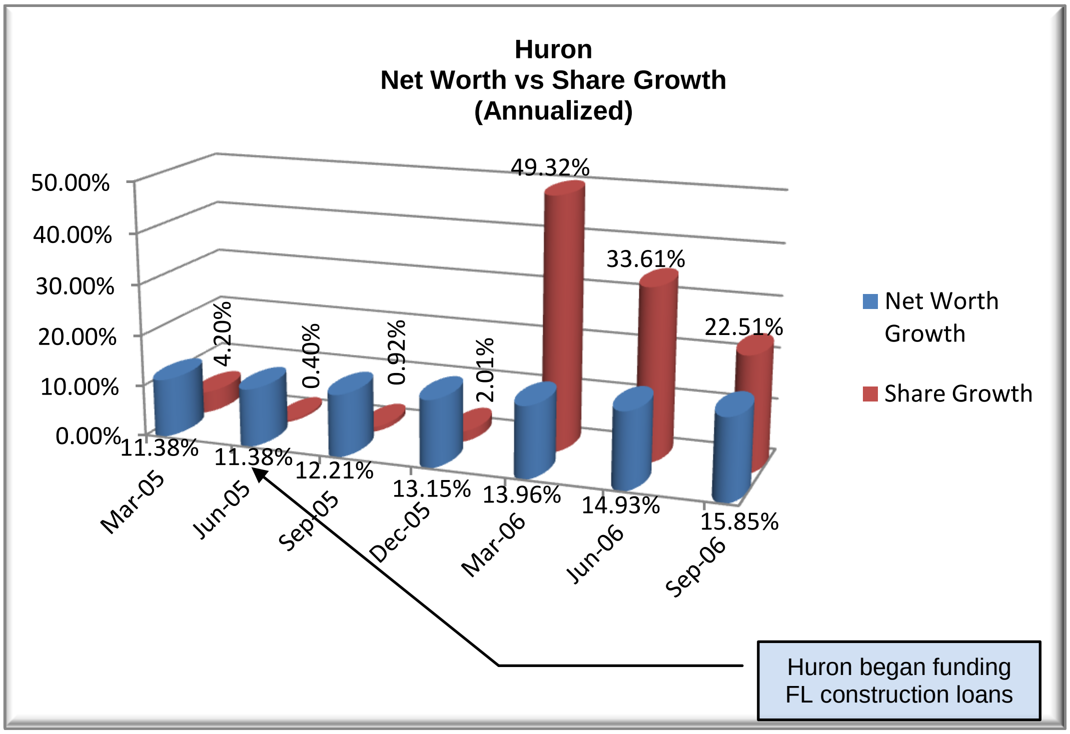

Chart 6 – Net Worth Growth vs. Share Growth

NCUA and the Michigan SSA indicated during the January 2007 joint examination that Huron management had, in an effort to stimulate share growth, aggressively marketed all types of deposits in 2006 to help increase funding sources. For instance, Huron management offered share certificate specials throughout 2006 earning six percent for four months. As a result, Huron's balance of total "Share Certificates" increased 56 percent from $27 million to $42 million between December 2005 and March 2006. Total share certificates grew to $63 million by September 30, 2006, a 133 percent increase from December 2005.

[43] Net worth cushions fluctuations in earnings, supports growth, and provides protection against insolvency. The rate of net worth growth should be commensurate with the levels of risk and asset growth.
[44] A credit union is considered well-capitalized when its net worth ratio is greater than seven percent.
[45] Rapid growth in shares can indicate increased volatility in the balance sheet. Share growth also reflects a credit union's risk management practices. Share growth that outpaces the ability to generate sufficient net income reduces the overall strength of the credit union's net worth.

Asset Growth versus Net Worth Growth

One way for a credit union to achieve rapid asset growth is to compromise its credit standards, which could result in an increase in illiquid assets[46] as well as cause a credit union to become undercapitalized. During the June 2003 state examination, a Michigan SSA examiner indicated that Huron's "exceptionally high" annualized asset growth of 21.47 percent exceeded net worth growth.[47] The examiner noted that this area should be continuously monitored to ensure asset growth is contained within an acceptable level and net worth is not further compromised. Chart 7 below illustrates that in September 2005, annualized asset growth (16 percent) began to exceed net worth growth (12 percent), and, by September 2006, asset growth significantly exceeded net worth growth (51 percent versus 16 percent).

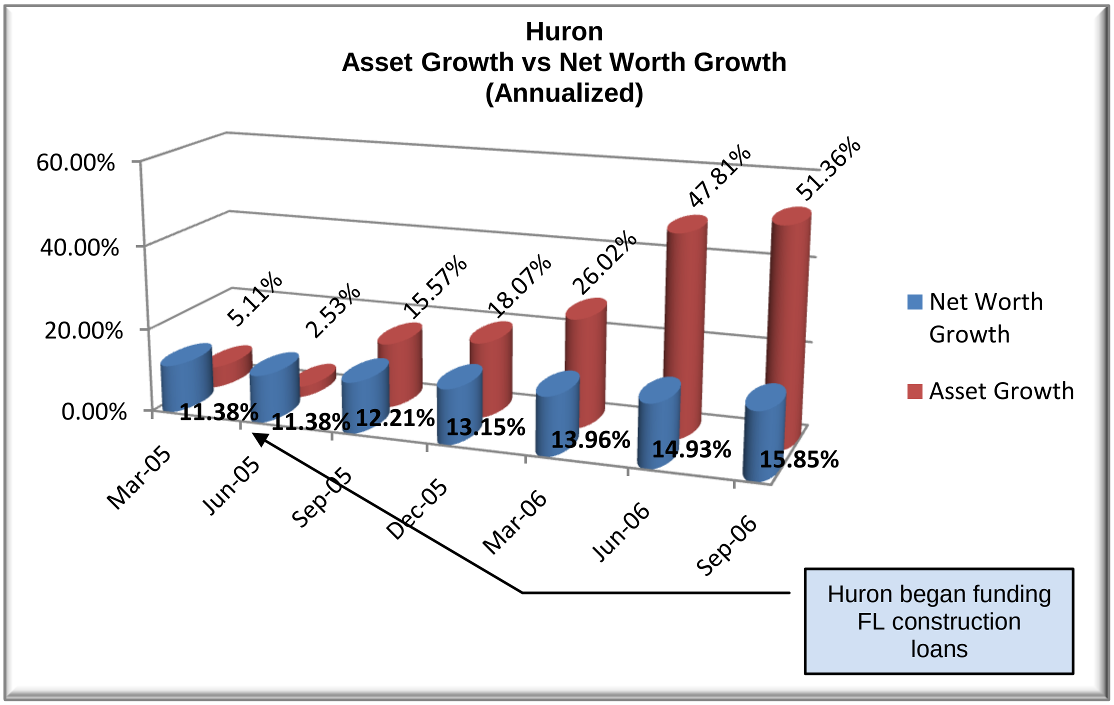

Chart 7 – Asset Growth vs. Net Worth Growth

[46] Illiquid assets cannot be quickly and easily converted into money.
[47] The examiner surmised that the annualized asset growth would decline to a lower level by year-end. The annualized asset growth did decline to 9.68 percent by the end of the year.

Investment Growth versus Loan Growth and Share Growth

NCUA guidance indicates when loan demand exceeds normal share growth, management must rely on the sale of securities[48] or access to borrowed money to raise needed cash. NCUA guidelines further state that declining investments are a key indicator of tightening liquidity. Chart 8 below illustrates Huron's declining investment position, most likely to fund Huron's significant growth of loans and unfunded commitments that outpaced share growth.

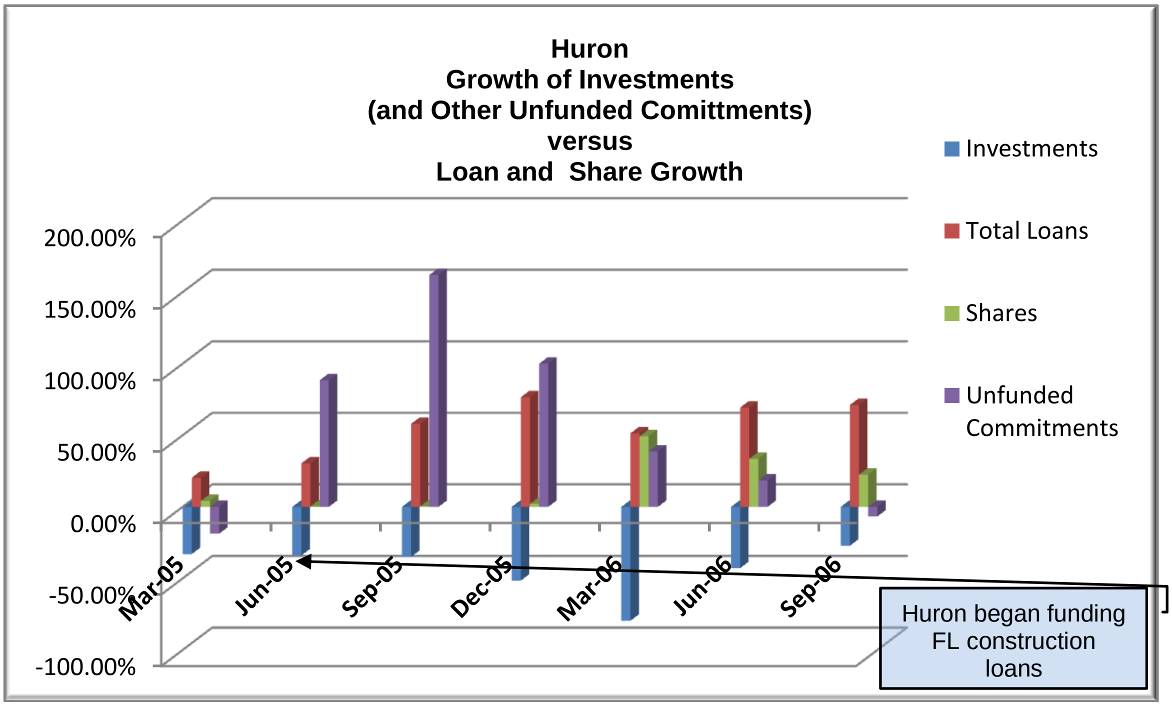

Chart 8 – Growth of Investments (and Other Unfunded Commitments) vs. Loan and Share Growth

[48] Investments that can be readily sold are one of the main sources for credit unions to raise needed cash.

In addition, NCUA guidelines indicate if a credit union sells or transfers its hold to maturity (HTM[49]) investments, it may be doing so to meet liquidity needs. Chart 9 below illustrates the decline of Huron's HTM investments and the increase of its available for sale (AFS[50]) investments. Huron's total HTM investment portfolio declined from $73 million in March 2005 to $0 in September 2006, while its portfolio of AFS investments increased from $486,000 to $23 million during the same period. Based on Huron's increased loan demand and lagging share growth, we believe that Huron management may have sold its longer term HTM investments, or transferred them to shorter term AFS investments, to help meet the growing loan demand.[51]

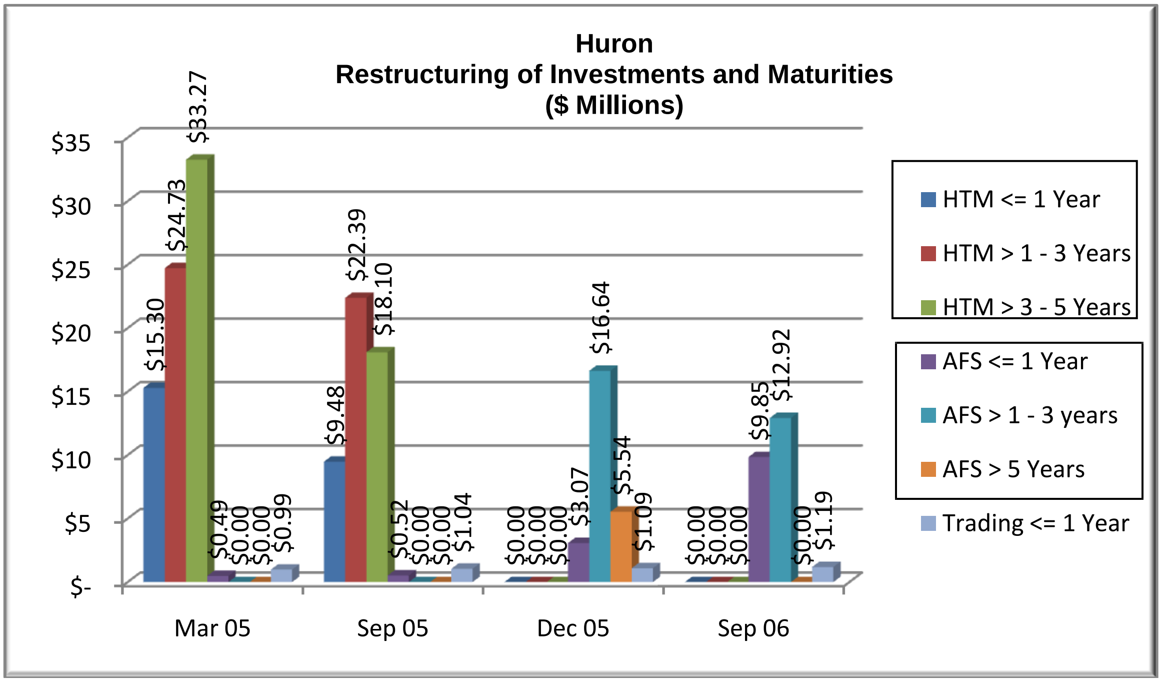

Chart 9 – Restructured Investments and Maturities

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[49] The HTM classification signifies that management intends to hold the investment until it matures.
[50] The AFS classification signifies that management will sell the investment if they need the funds for other purposes.
[51] NCUA determined that Huron pledged the AFS investments as of September 30, 2006 to the Federal Home Loan Bank (FHLB). Therefore, the investments were not available for liquidity purposes.

Borrowings versus Loan Growth and Share Growth

NCUA guidelines indicate that when loan demand exceeds share growth, management must rely on access to borrowed money or the sale of securities to raise needed cash. Although borrowing is a source of liquidity, it does not provide a continuous basis for funding loan demand or share withdrawals. Considering Huron's significant and rapid loan growth, slow growing share balance, and its unfavorable and declining investment portfolio, we reviewed Huron's lines of credit (LOC) and borrowings to determine whether Huron management increased its borrowing. Chart 10 below illustrates that Huron management increased its LOC between September and December 2005 - the same period its loan balance exceeded its share balance. The chart also highlights that Huron management significantly increased its borrowings against its LOC between March and June 2006 as loan growth continued to outpace share growth.

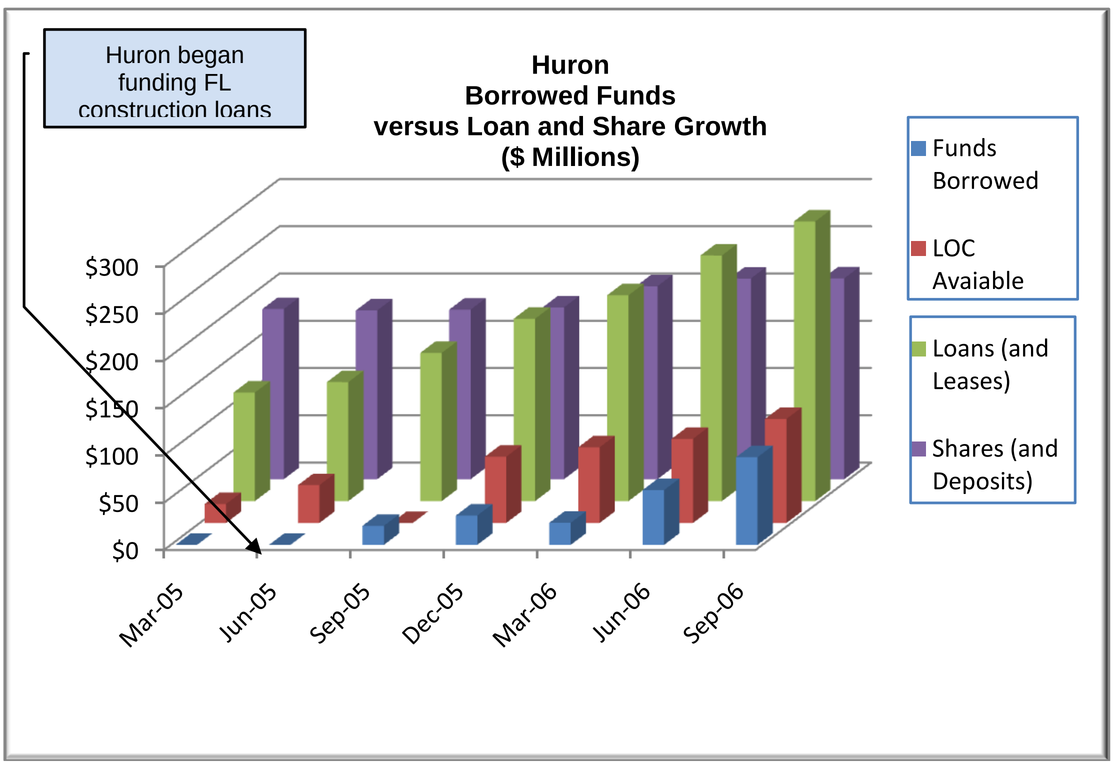

Chart 10 – Funds Borrowed versus Loan and Share Growth

In summary, our analysis of the above ratios leads us to believe continuous monitoring and analysis of several related financial ratios over a period of time can identify trends. Monitoring trends can provide a different and clearer perspective on credit union operations and changing risks than separately reviewing individual indicators at distinct points in time. In addition, it can indicate the need for examiners to conduct more qualitative data analysis to understand a credit union's operations.

Huron's Liquidity Position Deteriorated Rapidly

Huron's liquidity position deteriorated rapidly before NCUA could arrange an on-site contact to investigate Huron's construction loan growth. In December 2005, an NCUA examiner identified a trend regarding rapid construction loan growth at Huron. The examiner followed up by reviewing the March 2006 Call Report and contacted Huron management in April 2006 about the rapid loan growth. The examiner informed us that he provided this information to the supervisory examiner. The examiner also told us the supervisory examiner discussed the issue with the Michigan SSA. Michigan SSA officials told us that in November 2006, they and NCUA attempted to schedule a joint examination for December 2006. However, Michigan SSA officials stated they were not able to schedule a joint examination until January 2007 due to the holidays and scheduling conflicts. During the nine-month period, from April 2006 through December 2006, real estate loans continued to grow rapidly and significantly worsened. Total real estate and balloon/hybrid loan[52] values grew 49 percent and 73 percent respectively, and loan to share growth increased from 107 percent to 126 percent[53] between March 31, 2006 and December 31, 2006.

NCUA guidelines indicate each regional office and the respective SSA create their own working relationships and agreements to accommodate the unique circumstances of each state. Region I's agreement with the Michigan SSA addresses procedures for conducting joint contacts. In addition, the agreement provides that the Michigan SSA or the NCUA may execute an enforcement action[54] independently of the other if the agencies cannot reach agreement on the action. However, the agreement does not address procedures for or conditions under which NCUA may conduct a contact independent of the Michigan SSA. An NCUA examiner told us that he did not believe there were additional concerns, other than the rapid loan growth, to present to his supervisory examiner. However, he wished he would have stressed the urgency of the loan growth issue more.

Suggestion: We understand NCUA may face challenges when working with SSAs to schedule joint examinations. However, NCUA's primary responsibility is to protect the NCUSIF. We believe one key to limiting an institution's risk is early and timely corrective action by NCUA in response to supervisions that identify potential problems with a credit union's condition and potential impacts on the NCUSIF. Therefore, we suggest that NCUA aggressively investigate and protect against perceived risks to the insurance fund - including on site contacts when NCUA deems it is appropriate - even if state officials may not be available.

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[52] Balloons/Hybrids of less than five years.
[53] The loan to share ratio reached a high of 139 percent in September 2006.
[54] Enforcement actions typically include Memorandum of Agreement (MOA) or Letters of Understanding (LUA) both of which may be used to resolve supervisory concerns where appropriate.

Recommendation: We recommend NCUA management issue a Supervisory Letter to all Federal and State examiners to alert them of the need to (1) analyze and understand financial ratios and trends individually and as a group and (2) thoroughly analyze pertinent qualitative data in order to adequately assess the safety and soundness of credit union operations.

Agency Response: Concur. NCUA recently reinforced the need for aggressive investigation and protection against perceived risks in Letter to Credit Unions No.: 08-CU-20 Evaluating Current Risks to Credit Unions, dated August 2008. This letter includes supervisory guidance given to NCUA examiners about diligent examination and supervision when potential risk to a credit union is identified.

OIG Response: The OIG concurs with the agency's response.

OBSERVATIONS AND LESSONS LEARNED

This section addresses observations and lessons learned regarding:

- Credit Union Operations and Management Actions, and
- New Region I Procedures

Credit Union Operations and Management Actions

We reviewed industry[55] observations regarding the failures of financial institutions. We also reviewed recent NCUA observations regarding credit union failures. We believe the industry's and NCUA's observations apply to issues we observed during our review of Huron's failure.

The following table lists the industry observations regarding failed financial institutions and how they compare to our observations about Huron's failure:

Industry Observations - Failed Financial Institutions	NCUA OIG Observations of Huron's Failure
Failed institutions often exhibit warning signs when they appear financially strong.	Huron's net worth ratio was 15.04 percent as of March 2005 when examiners indicated Huron's liquidity was tightening. It was still adequate--at 8.15 percent as of December 2006--shortly before NCUA declared Huron insolvent.
The financial condition of the institution is no guarantee of future performance.	NCUA coded Huron a CAMEL 1 between 1998 and 2003. NCUA coded Huron a CAMEL 2 as of March 2005. Huron's CAMEL dropped to a CAMEL 5 based on September 2006 data.
Managers of failed institutions frequently assume more risk than they are able to handle.	Huron management's decision to enter into the Florida loan program resulted in uncontrollable loan growth and led to Huron's illiquidity.
An inattentive or passive board of directors is a precursor to problems.	The Huron Board of Directors delegated authority to CLC to originate, underwrite, approve and perform all servicing and collection functions for the Florida construction and lending program.
The Institution may reach a point at which problems become intractable and supervisory actions are of limited value.	NCUA declared Huron insolvent at the conclusion of its January 2007 examination, which identified Huron's severe liquidity issues.

Industry officials observed other issues regarding failed financial institutions similar to those we observed during our review of the Huron failure. They observed:

[55] We reviewed a 2004 report issued by the FDIC OIG - *Observations from FDIC OIG Material Loss Reviews Conducted 1993 through 2004 (Report No. 04-004, January 22, 2004)* - that summarized observations from material loss reviews of 10 failed FDIC-supervised institutions.

- The institutions' management[56] took risks that were not mitigated by systems to adequately identify, measure, monitor, and control the risks.
- Economic conditions contributed to, but were not the sole cause of, the failure and the resulting material loss.

As reported earlier, we determined the economic decline of the Florida real estate market contributed to Huron's failure. However, management's risk taking and decision to involve the credit union in the Florida construction loan program without adequate controls in place were among the main causes of Huron's failure.

We also reviewed recent observations by NCUA regarding credit union failures. NCUA indicated that overly aggressive management activity is a reason credit unions fail. This observation is consistent with the industry's observation of other failed financial institutions, that management often assumes more risk than it can handle. The following table compares the overly aggressive management activities NCUA identified at Huron with our observations in the course of this review:

<table>
<tr><th>NCUA Observations</th><th>NCUA OIG Observations at Huron</th></tr>
<tr><td>Liberal lending policies.</td><td>Huron's loan growth was fueled by (1) Huron management's limited or non-existent oversight of CLC's loan origination, underwriting, and approval practices and (2) loans to an illegal field of membership, which made Huron's lending virtually unrestricted.</td></tr>
<tr><td>Excessive loan growth compared with abilities or funding sources.</td><td rowspan="2">Huron management had to borrow externally, offer attractive share certificate rates, and divest and restructure its investments to try to fund the excessive loan growth in the Florida construction loan program.</td></tr>
<tr><td>Inadequate liquid assets/secondary source of liquidity.</td></tr>
<tr><td>Undue reliance on volatile liabilities.[57]</td><td>Huron borrowed funds from a Federal Home Loan Bank and a corporate credit union to attempt to fund its Florida loan program.</td></tr>
<tr><td>Collateral based lending/loan concentration.[58]</td><td>Huron had a high concentration of loans secured by real estate in Florida.</td></tr>
</table>

[56] Management includes the Boards of Directors and executive officers.
[57] Volatile liabilities generally include funding from institutions/brokers. These tend to be interest rate sensitive and are funds that are likely to be withdrawn at a moment's notice.
[58] A collateral loan is a loan obtained from a financial institution where, in exchange for the loan, the creditor may sell the collateral if the loan is unpaid. A collateral loan is often offered at a lower interest rate than an unsecured loan, because there is a guarantee of repayment should the borrower default on the loan.

Furthermore, the financial industry and NCUA identified four stages of an institution's failure:

- I – Strategy
- II – Growth
- III – Deterioration
- IV - Failing

Appendix D provides a summary of the first three stages leading up to the "Failing" stage. It lists elements the financial industry and NCUA identified as components of these stages. It also identifies our assessment of which elements we believe contributed to Huron's failure.

Finally, we believe a significant industry observation is that one of the more difficult challenges facing regulators is limiting risk assumed by institutions even though their capital ratios make them appear financially strong. A critical component in limiting an institution's risk is early corrective action by regulators in response to examinations that identify potential problems and effects on the institution's condition.

New Region I Procedures

We learned Region I implemented procedures, subsequent to Huron's failure,, as a "second line of defense" to help address supervisory concerns that may go undetected. These procedures use NCUA national risk reports and should help examiners better monitor FISCUs. Specifics of Region I's efforts to improve their supervision of FISCUs include:

- Supervisory Examiners (SE) are assigned an analyst who works on only those credit unions under the purview of their assigned SE.

- Analysts perform a quarterly review of the associated risk reports for the credit unions within their assigned SE's district. Analysts conduct this review to identify any potential issues, trends, or regulatory violations that might be supervisory concerns.

- Analysts prepare a detailed spreadsheet if potential issues, trends, or violations are identified. The spreadsheet is forwarded to the SE for review and comment.

- Following a review of the spreadsheet by the SE, the SE must respond in writing to all potential supervisory issues identified by the analyst. The SE must explain to the analyst whether the potential issues are supervisory concerns.

- Analysts are required to continually monitor all spreadsheet activity and provide follow-up, as necessary, in order to ensure that all potential supervisory issues raised to the SE are acted upon.

Suggestion: In order to provide additional oversight of FISCUs, Region I should continue their procedure of using analysts to provide a secondary review of national risk reports to better monitor FISCUs. Furthermore, we suggest NCUA determine whether all Regional Offices should incorporate these procedures to provide increased supervision of FISCUs.

Agency Response: We concur in principal. However, if adopted on a national level, the specific procedures should be left to each regional director to determine the proper flow of information through their chain of command.

OIG Response: The OIG concurs with the agency's response.

Appendix A: Examination History

Huron was rated a CAMEL 1 between 1996 and 2003. For the March 2005 examination, the Michigan SSA rated Huron a CAMEL 2. However, during the January 2007 examination, NCUA and the SSA downgraded Huron to a CAMEL 5 and considered the safe and sound operation of the credit union in jeopardy. This examination led to the conservatorship of Huron in February 2007. Table 3, located at the end of this Appendix, provides a summary of Huron's CAMEL ratings and comments as of the effective dates of the examinations from the August 31, 1999 through September 30, 2006.

Several of the examinations of Huron specifically cited favorable ratios and positive trends that indicated the financial strength of Huron. Table 2 below provides a summary of Huron's key ratios as of the effective dates of the examinations from 1999 through 2006.[59]

Table 2: Key Ratios

	Aug 31 1999	Sep 30 2000	Sep 30 2001	Sep 30 2002	Jun 30 2003	Mar 31 2005	Sep 30 2006[60]
	CAMEL 1	*CAMEL 1*	*CAMEL 1*	*CAMEL 1*	*CAMEL 1*	*CAMEL 2*	*CAMEL 5*
Capital/ Assets	13.04%	13.95%					
Net Capital/ Assets	12.63%	13.54%					
Net Worth			13.58%	13.51%	12.76%	15.04%	11.46%
Delin-quency	.65%	.31%	1.06%[61]	1.23%	1.17%	1.93%	1.20%
Net Charge-Offs	.59%	.37%	.39%	.57%[62]	.65%	.19%	.13%
ROAA[63]	1.56%	2.05%	2.09%	1.23%	1.15%	1.69%	1.87%

[59] Except for the joint NCUA/Michigan SSA examination effective September 30, 2006, the referenced examinations were Michigan SSA examinations.

[60] NCUA and the Michigan SSA determined the safe and sound operation of Huron was in jeopardy.

[61] Delinquency and loss ratios remain low. We noted an increase in the delinquency ratio and we will continue to monitor it. The cause of the spike in delinquency is two real estate loans. Only one remains delinquent. The credit union has had a tradition of low delinquency and loan losses. Management is capable to monitor and control delinquency. We changed the composite rating to 1 because of the low delinquency history.

[62] Delinquency and net charge offs remain above the industry average, however, collections are strong.

[63] Return On Average Assets.

Following are summaries of the Michigan SSA examinations of Huron since 1999, available Huron management responses to the state examinations, and available NCUA reviews of the SSA examinations:[64]

August 31, 1999

***Michigan SSA Examination* (Code 11)**

The Michigan SSA completed an examination of Huron on September 21, 1999 using credit union data effective August 31, 1999. While the examiner rated the component CAMEL for Asset Quality 2, the overall composite rating was 1. The examiner noted that the maintenance of favorable ratios was an indication of the strength of Huron. However, the examiner noted the following areas of concern:

- No Business Loan Policy.
- Incomplete internal control over the construction loan program.
- Loan practices in violation of bylaws.

Business Loans

Huron granted a business loan without a Business Loan Policy in place as required by Part 723 of the NCUA Rules and Regulations. The examination directed that before Huron made any more business loans that it must develop a Business Loan Policy and include a copy of the new policy with the reply to this Report of Examination.

Construction Loans

Huron granted a "significant number of construction loans"[65] between examinations. The examiner noted his concern over the reliance placed on the outside vendor for underwriting the construction loans. He indicated relying on a third party to provide loan information is a risk due to the lack of sufficient information and documentation to minimize any risk involved. Specifically, the following were some of the concerns with the program:

- No review of vendor financial statements on a regular basis.
- No determination of the financial stability of the vendor.
- No determination that plans and construction costs were accurate and authentic.
- No indication of zoning and building permits on file.
- No indication that member's equity was sufficient.

[64] We chose to start with the August 31, 1999 examination because it provides the first mention of a third party vendor underwriting Huron's construction loans.
[65] The examiner did not indicate these were member business loans.

- No documentation that a builder's risk policy was in place and sufficient.
- No documentation on file indicating a bond for the builder.
- No checks that the inspections, contractor warranty and waivers were authentic and accurate.
- No check that appraisals completed for other financial institutions were accurate.
- No review of the underwriting.
- No check to see if the vendor had the proper license.

The examiner directed Huron management to expand the Construction Loan Policy to address all the concerns listed and improve the controls over this program. In addition, the examiner required Huron include an updated Construction Loan Policy in the reply.

Loan Exceptions

The examiner indicated there was no loan documentation for a number of loans reviewed. The examiner directed Huron to:

- Research the loans to be certain they were authentic.
- Locate missing documentation.
- Review current loan documentation storage procedures to see what could be done to prevent files from being misplaced.
- Report the action taken in the reply to the examination.
- Take action to prevent these types of exceptions from recurring in the future.

Huron Management Response to the State Examination

The Michigan SSA stated it did not have the Huron response because its records retention policy is to maintain records for only five years.

NCUA Review of Michigan SSA Examination (Code 26)

Not Available

September 30, 2000

Michigan SSA Examination **(Code 11)**

The Michigan SSA conducted an examination of Huron from October 25 through December 1, 2000 using credit union data effective September 30, 2000. The examination rated Huron a CAMEL composite of 1 because of its high levels of capital and earnings. The examination rated the Asset Quality component a CAMEL 2 because of documentation problems with construction loans and the level of control over the construction loan vendor.

Construction Loan Vendor Oversight

The examination indicated management allowed the vendor and the title company much of the responsibility for making and overseeing construction loans, relying on photocopies and facsimiles from the vendor. The examination cited the lack of satisfactory internal control and oversight by management as a safety and soundness concern. The examiner directed management to review its procedures and improve oversight to ensure the authenticity of the loans and to detail their review in the credit union's response to the Report of Examination.

During the exit conference, the examiners noted that during the past examination, management did not fully agree with the amount of oversight necessary to control the construction loans. However, the examiners indicated they believed they convinced management this time that they had to rethink their controls over the construction loan vendor and be more cautious.

Incomplete Loan Files

The examination identified loan exceptions[66] that indicated the Huron loan files were incomplete. The examiner directed Huron management to detail its actions taken in its response to the examination. The examiner also advised Huron management to review the loan exceptions, make corrections where possible and to take action to prevent these types of exceptions from recurring in the future.

Huron Management Response to the State Examination

Huron management indicated it was meeting with the vendor to review all of the components of the documentation process in order to improve its overall procedures and to increase the awareness of the vendor to examination needs.

Management also indicated it had begun a program of unannounced audits of construction loan files at the vendor's location in its efforts to provide oversight of the authenticity of the loan origination process.

[66] The examination file did not include the list of loan exceptions. The examination included a note to not include the loan exceptions in the Report of Examination, and that the examiners completed loan exceptions outside of AIRES because of unresolved problems in transferring loans from one examiner to another.

NCUA Review of Michigan SSA Examination (Code 26)

Not Available

<u>September 30, 2001</u>

***Michigan SSA Examination* (Code 11)**

The Michigan SSA conducted an examination of Huron from November 14 through December 3, 2001 using credit union data effective September 30, 2001.[67] The examination rated the Huron a CAMEL composite 1 and raised the Asset Quality component to a 1 from the prior examination. However, the examination noted concerns with:

- Concentration of risk with the Construction Loan Company (CLC).
- Misclassification of loans to CLC and Multiple Services CUSO, Inc[68] (MSCUSO).
- Violation of Credit Union Rule 15a aggregate limits.
- Violation of Business Loan Policy limits for construction loans and concentrations.

<u>Concentration of Risk with CLC and Violation of Credit Union Rule 15a aggregate limits</u>

The examination addressed the large concentration of credit granted to CLC and the construction loans held and serviced by CLC:

	Loans/Lines of Credit (LOC)[69]	**Value**
1	<u>Line of Credit to CLC</u> *This was a line of credit to CLC directly from Huron. CLC used the proceeds of this loan to fund construction loans. The examiners found that nearly $445,000 of the $3,000,000 line of credit to CLC was outstanding as of September 30, 2001 and was used for a business purpose.*	$3,000,000

[67] The examiner who conducted the previous examination contact conducted this contact.
[68] (see Confidential Section.doc) Multiple Services CUSO was 33% owned by Huron along with Lansing Community Credit Union and Kalsee Credit Union who are also each 33% owners of MSCUSO.
[69] While the examination indicated the additional lines of credit granted since the last examination increased the concentration of risk in one company, the examination indicated the continued high levels of capital and earnings were the main factors that contributed to the CAMEL composite of one.

<table>
<tr><td colspan="3">Huron Management Response

Huron management indicated it would reclassify this LOC as a business loan.</td></tr>
<tr><td>2</td><td><u>Loan to CLC through Multiple Services CUSO, Inc</u>

This was a loan Huron made to Multiple Services CUSO (MSCUSO). Multiple Services CUSO then made the loan to CLC.</td><td>$1,000,000</td></tr>
<tr><td colspan="3">Huron Management Response

Huron management indicated CLC used this line of credit to fund mortgages for nonmembers. The mortgages were closed in CLC’s name and assigned to the MSCUSO as mortgages. Management indicated the loans should be classified as real estate loans rather than business loans.</td></tr>
<tr><td>3</td><td><u>Construction loans held by CLC and assigned to Huron</u>

Loans purchased from CLC and placed in the loan portfolio of Huron.</td><td>$18,025,934</td></tr>
<tr><td colspan="3">Huron Management Response

Huron management indicated the construction loan mortgages were recorded in the name of CLC and assigned to Huron. At the completion of the construction loan, Huron decided whether to fund the end mortgage</td></tr>
<tr><td colspan="2">Total Loans

The credit and loans represented a potential concentration associated with one company. The loans were written in the name of CLC. CLC executed an assignment of the mortgages to Huron.

The examination indicated Huron exceeded the 15% limit set in Credit Union Rule 15a(6)(a) which requires the aggregate limit for business loans used in financing the construction of residential property to be no more than 15% of equity. The examination indicated Huron equity totaled $22,582,672, while loans and commitments to CLC was $4,000,000, which represented almost 18% of Huron’s equity.</td><td>$22,025,934</td></tr>
</table>

The examination directed Huron management to detail in its response to the examination the steps taken to mitigate and justify the risk involved with the concentration.

Misclassification of Loans to the Construction Loan Company (CLC) and Multiple Services CUSO, Inc.

The examination indicated Huron should have classified the two loans to CLC mentioned above ($1 million and $3 million) as business loans. The examination directed management to revise the call report for September 30, 2001 to reflect the correct classification of business loans and to detail the action taken to correct the classification of business loans in its response to the examination.

Violation of Business Loan Policy limits for construction loans and concentrations

The examination noted the following violations of Huron's Business Loan Policy:

- The limitation of business loans to finance construction loans to 15% of Huron River Area Credit Union's net worth.

- The limitation of business loans to any one member or group to 15% of net worth or $100,000, whichever is higher.

- The limitation of business loans to 125% of reserves. Huron's reserve total was $3,617,803. Its business loans, including commitments, totaled $4,928,931. This represented 136% of Huron's reserves.

The examination directed Huron management to detail in its reply to the examination, its actions to reduce business loans to a level below policy limits. In addition, the examination directed Huron management to revise the call report for September 30, 2001 to reflect the correct classification of business loans. The examination also indicated the board of directors was to continue the close oversight of CLC.

Huron Management Response to the State Examination

Huron management indicated it was reviewing its Business Loan Policy and would forward a copy of its actions to the SSA. Huron management indicated in its February 18, 2002 response that it would address the call report issue.

NCUA Review of Michigan SSA Examination (Code 26)

NCUA conducted a Code 26 review of the Michigan SSA examination report. The NCUA reviewer noted member business loan and construction loan problems. While NCUA agreed with the CAMEL composite rating of 1, NCUA noted two differences:

- Asset Quality Component –The state coded this element a 1. However, NCUA coded it a 2 based on the moderate charge off levels and the following concerns identified in the business loan area:

  - Concentration of risk with CLC
  - Misclassification of loans to CLC ($3 million) and the Multiple Services CUSO ($1 million). Huron should have classified them as business loans.
  - Violation of Credit Union rule 15a – the $4 million in loans and commitments exceeded the 15% of equity limit of $3.4 million for construction loans.
  - Violation of Huron's own Business Loan Policy limits.

  The NCUA reviewer indicated the loans profiled during the examination could not be reviewed since no loans were included in the "Lists and Queries" tab within AIRES.

- Management Component – Due to the numerous violations of regulations and policies and safety and soundness principles in the business lending area [and website and home banking product control issues], NCUA rated this area a 2, while the state rated it a 1.

The NCUA reviewer indicated the joint SSA agreement provided that if the SSA identified a credit union that had exceeded the aggregate MBL limit, the SSA would notify the appropriate NCUA SE. The NCUA reviewer noted that the SSA did not notify the SE.

The NCUA reviewer also indicated that the overview appropriately addressed the problem areas and that the SSA indicated that it would monitor Huron through call reports, FPRs and the annual CPA audit. In addition, the NCUA reviewer indicated they would review Huron's reply to the examination to determine the actions taken to address the business loan violations and safety and soundness issues with the CLC concentration. Furthermore, the NCUA reviewer indicated they provided the SSA examiner with additional questions about the CLC situation and that supervision would depend on the official's reply to the examination and answers received from the SSA examiner.[70]

<u>September 30, 2002</u>

***Michigan SSA Examination* (Code 11)**

The Michigan SSA conducted an examination of Huron from November 18 through November 27, 2002 using credit union data effective September 30, 2002. The examination rated Huron an overall composite of 1. The examination determined the credit union's financial performance remained strong between examinations. Net Worth increased between examinations and compared favorably to the industry average. Net income, as a percentage of assets, decreased since year-end 2001, which the

[70] We contacted the NCUA Reviewer during this review. The reviewer indicated she did not recall the issues from the examination and did not have the email of questions she provided to the state EIC.

examiner indicated could have been attributable to declining gross income due to a reduction in investment and loan yields. The examination also indicated management had reduced operating expenses and cost of funds, as a percentage of assets, to minimize the negative impact of a reduction in gross income.

Furthermore, the examination indicated the examiner reviewed a sample of consumer, real estate, insider, and business loans. Overall, loan quality appeared to be strong and loan files contained evidence of sound credit analysis, current credit reports, and proof of lien and insurance.

The examination still considered Huron's $3 million line of credit to the CLC to fund the credit union's members' construction loans as a business loans. In addition, the examination indicated Huron also funded members' construction loans directly. The examination included a review of a sample of these loans, but did not note any concerns or exceptions.

Huron Management Response to the State Examination

Not Available

NCUA Review of Michigan SSA Examination (Code 26)

The NCUA reviewer assessed the seven risk areas – compliance, credit, interest rate, liquidity, reputation, strategic and transaction. The NCUA reviewer made the following observations:

- Compliance Risk – Moderate
    - Heavy Reliance on state's rating – no reasons given for rating. The last examination noted several violations and breach of business loan limits.

- Credit Risk – Moderate
    - The state examiner noted the construction loan, business loan and LOC situation, but indicated there were no concerns or exceptions.
    - The state examiner's response to the NCUA reviewer's questions from the prior examination indicated that the state examiner's:
        - Conclusions about the mortgage assignments were wrong.
        - Statements on the $22 million concentration of credit to CLC and assigned to Huron was also incorrect – if CLC declared bankruptcy, no loss would result because all loans are in the credit union's name.
    - No evidence of poor lending.

    - State examiner indicated loan quality appears to be strong. Loan files contained evidence of sound credit analysis, current credit reports and proof of lien and insurance.

- Interest Rate Risk – Moderate
    - Heavy reliance on state examiner's judgment.
    - Based on a review of the call report, this area rates "High". However, the SSA reduced the rating to moderate "based on the ALM data reports and discussions with the assistant manager." No other ALM comments could be found in the Overview, Confidential Section, or other areas of AIRES.
- Liquidity Risk – Low
    - Based on the slight decline in the loan-to-asset ratio, the high amount of regular shares and share drafts and loan rollover of 14 months.

- Reputation Risk – Moderate
    - No material concerns noted.

- Strategic Risk – Moderate
    - Based on the state examiner's comments, management had a strategic plan and satisfactory goals for the future. The state examiner did not elaborate.

June 30, 2003

***Michigan SSA Examination* (Code 11)**

The Michigan SSA conducted an examination of Huron from October 27 through November 24, 2003 using credit union data effective June 30, 2003. The examination rated the Asset Quality CAMEL component a 2 and rated the overall CAMEL a 1. The examination indicated Huron was performing well in most areas - earnings, net worth, and delinquency ratios were at levels that were satisfactory and met or exceeded average performance. The examination also indicated the loan charge-offs continued to increase as in the prior year; however, the percentage of past due loans decreased as loans were charged off. The examination indicated the ratio had increased each period since the year 2000.[71]

In addition, the examination indicated that despite declining asset yields and net margins, the return on assets continued to perform better than average, after reductions. With lower interest rates, the yield on loans and assets were less

[71] Increases in bankrupt accounts have been a major contributor to the rise in loan losses and delinquency. In order to control and minimize loan losses, the collection staff was utilizing more aggressive collection practices. The examination indicated continuous review of this area was needed to reduce loan losses to a satisfactory level.

than previous years, which was primarily contributed to the declining net interest income. Performance in the other related earnings ratios had not changed enough to severely impact net income and the return on assets.

Furthermore, the examination noted that net income and the return on assets were favorable even though income on loans and investments was reduced because of the lower interest rates and declining loan demand. Also, operating expenses declined each period and continued to do so, being less than the industry averages. Asset growth had been very strong for the year and was performing well in excess of earlier periods. The growth in assets had well surpassed any increase in net worth, and the result was a reduced but still respectable net worth ratio.

The examination included a review of loans for violations of credit union bylaws, policies, and consumer lending regulations, or containing technical exceptions. The review did not disclose any critical concerns or issues in the underwriting. .

Huron Management Response to the State Examination

Not Available.[72]

NCUA Review of Michigan SSA Examination (Code 26)

The NCUA reviewer assessed the seven risk areas as follows:

- Compliance Risk – Low
    - No compliance concerns noted

- Credit Risk – Moderate
    - The examination report stated there were no critical lending concerns, but there were numerous Loan Exceptions
    - Huron made business and construction loans, but no major problems noted
    - Delinquencies and Charge-Offs were slightly above average
    - The NCUA reviewer recommended an investment review and a construction and business lending review.

- Interest Rate Risk – Moderate
    - The SSA report was silent concerning Interest Rate Risk.
    - Large increase in 3- 10 year investments from $11 mil to $41 mil

[72] The Michigan SSA indicated it did not have Huron management's response; it would have destroyed the response in accordance with its records retention policy.

- December 2003 Call Report indicated continued long term investment growth to $63 mil – long term investment volume continued to grow rapidly.
- The NCUA reviewer recommended an Interest Rate Risk review.

- Liquidity Risk – Moderate
  - No liquidity concerns reported – cash and short term investments had declined slightly.
  - Liquidity expected to decline further with continued lengthening of investments but not to a critical point.

- Liquidity Risk – Huron has maintained strong net worth and return on average assets and acceptable levels of risk for several years.

- Reputation Risk – Low
  - No known or reported reputation risks.

- Strategic Risk – Moderate
  - Strategic planning and risk not specifically discussed.

June 2004

NCUA Interest Rate Risk (IRR) Review

NCUA completed an IRR review of Huron on September 16, 2004 in lieu of a scheduled state examination. While Huron had a moderately high volume of real estate loans (32.7 percent of assets), Huron's large increase in long term investments in 2003 prompted the review. The review determined Huron did not intend to increase real estate loans. More specifically, the review found that Huron's strategy for the next year was to not increase fixed first rate mortgages, promote consumer loans and variable rate HELOC loans. The review did not include an assessment of real estate loans.

The review determined Huron's Asset/Liability Management (ALM) program was not a management priority in prior years because of Huron's strong net worth and earnings combined with its relatively low volume of long term assets. The review noted Huron improved its ALM program the last two years and that Huron was using the Brick ALM program[73]. However, the ALM policy was old and did not contain adequate risk limits, procedures, etc. The review indicated Huron would adopt a new policy within 60 days.

The review did include a limited review of Huron's commercial loan program due to a material increase in commercial loans outstanding on the quarterly call

[73] The Brick & Associates ALM system is an analytical tool used to monitor and control interest rate risk and to test strategies prior to implementation.

reports.[74] The review determined Huron did not have an active member business loan program. As of June 30, 2004, Huron had three commercial loans, one was a $5 million LOC to CLC to fund short term interim funding of mortgage loans. The review surmised that the LOC may not have been permissible since the proceeds could have been used to fund non member loans. The review recommended the SSA determine whether the LOC was permissible in a state charter credit union. The review determined the LOC involved credit risk but did not pose a high IRR risk.

The review noted Huron had a $10 million LOC at the Federal Home Loan Bank (FHLB) and a $10 million LOC at the corporate credit union.

March 31, 2005

***Michigan SSA Examination* (Code 11)**

The Michigan SSA conducted an examination of Huron from June 13 through June 17, 2005 using credit union data effective March 31, 2005. The examination rated the Asset Quality CAMEL component a 2 and rated the overall CAMEL a 2. The examination noted Huron continued to realize above average earnings. The annualized return on average assets increased the first quarter of 2005 when compared with 2004 return on average assets. The credit union continued to experience above average net income and return on assets. In addition, the net worth position was strong and had increased each period. The examination noted asset growth had declined since 2003.

The examination assessed loan growth, indicating it was 23 percent in 2004 and 20 percent during the first quarter of 2005. The examination noted real estate loans, including construction loans, continued to increase as a part of outstanding loans. Real estate loans increased $18.4 million in 2004 and $4.68 million the first quarter 2005, representing approximately 84 percent of total loan growth. The examination indicated loan income had declined since 2003; however, the examination also indicated that performance suggested loan income would increase above the 2004 level.

The delinquency ratio increased in 2004 and continued to increase the first quarter 2005. The credit union’s delinquency ratio was 172 percent higher than the peer ratio, which was a large difference. However, the net charge-offs ratio decreased in 2004 and year-to-date 2005 to a level lower than peer. The review of the collection problem loans disclosed no critical concerns, but did note an increase in the number of real estate loans reported delinquent and possible foreclosure procedures. The examiner indicated it was anticipated the delinquency ratio should improve once the delinquent real estate accounts were resolved. The review of loans did not disclose any concerns.

[74] Member Business Loans increased from $1.1 million to $4.2 million between March and June 2004

The growing mortgage portfolio increased the interest rate risk exposure with only 38 percent of the mortgage portfolio re-pricing in three (3) years. The liquidity position was strained due to the increased volume in mortgage construction loan financing. Cash and short-term investments decreased since year-end 2004. The net long-term assets position continued to decline each period, but remained significantly above average performance for peer credit unions.

The Asset Liability Management (ALM) program reports suggested interest rate risk was minimal to moderate and was being adequately managed. The ALM reports showed the net interest income and net income had adequate performance after the portfolio's market values were shocked. The credit union's March 31, 2005 shocked Net Economic Value (NEV) ratio was 8.85 percent representing a satisfactory change in the ratio. However, the examination indicated the ALM area, liquidity and interest rate risk exposure, required continuous monitoring to ensure performance remained acceptable.

The examination noted Huron was offering construction loans to the membership and indicated some would be long-term financing once the home was completed. Management had approved a $30 million line of credit for the construction loan program. In addition, the Huron Board of Directors authorized management to increase the LOC to MSC CUSO from $1 million to $2 million. The LOC was secured by Individual construction loans. Liquidity was diminishing as funds were used for the construction loans and more federal agency notes were purchased.

The review of loans did not disclose any critical concerns, but indicated the need for continuous follow through to ensure all loan documentation was received as required.

Huron Management Response to the State Examination

Huron management indicated it was properly managing its risk and preparing Huron for an expected downturn in the Michigan economy. In addition, Huron management indicated regarding its liquidity needs, it had established the need to bring funds into the credit union. Huron management stated it expected to borrow to initially fund daily liquidity needs until its construction lending became fully functioning in July. Furthermore, management indicated it was replacing its long term (30 year) mortgages with shorter term (less than one year) construction loans.

NCUA Review of Michigan SSA Examination (Code 26)

The NCUA reviewer assessed the seven risk areas as follows:

- Compliance Risk – Moderate.
    - No exceptions noted.

- Compliance Risk – Moderate
    - No exceptions noted.

- Credit Risk – Moderate.
    - Delinquency had increased to 1.93 percent or 6.81 percent of net worth.
    - Management had allocated $30 million for a construction loan program with CLC underwriting the loans.
    - One of the loans may have been impermissible. The proceeds of a $5 million LOC to CLC for short interim funding of mortgage loans may be used to fund non-member loans
    - The activity in construction lending was a fairly new program that could expose the credit union to considerable risk if sufficient internal controls were not in place.
    - The NCUA reviewer recommended reviewing investments and construction and business lending.

- Interest Rate – Moderate.
    - Net Long Term Assets were high. However, a strong mitigating factor was Huron's high net worth growth.
    - Huron continued to have strong growth in real estate loans. While this may have increased interest rate risk (IRR), the credit union's ROAA was a very strong 1.69 percent.
    - Refinements were needed in the Asset/Liability Management (ALM) program in terms of policies and the structure of Asset/Liability Committee (ALCO) meetings.

- Liquidity – Moderate.
    - Strong loan growth was consuming liquidity at a rapid pace, but the loan/share ratio remained below the industry average of 64 percent.
    - Year-To-Date loan growth in 2004 and 2005 had exceeded 20 percent while the rate of share growth had lagged in the 4 – 6 percent range.

- Reputation Risk – Moderate.
    - No apparent risks noted.

- Strategic Risk – Moderate.
    - Strategic planning is not specifically discussed in the examination report.
    - With Huron's high net worth and strong earnings, presumably strategic planning is functional.

- Transaction – Moderate.
    - Huron still did not have an internal audit program which was surprising for the size of the credit union.

September 30, 2006

The Michigan SSA and NCUA conducted a joint examination of Huron between January and April 2007 using credit union data effective September 30, 2006. The joint examination included a brief review of Huron's asset/liability management (ALM) practices, and existing and prospective risk positions. The examination resulted in a downgrade of Huron's composite CAMEL from 1 to a CAMEL 5.

Joint Michigan SSA and NCUA Examination

The examiners determined the Huron Board of Directors and management had committed the majority of Huron's assets to a high risk construction loan program in Florida. As of February 8, 2007, the Florida construction loan portfolio comprised 66 percent ($202 million) of the total $302 million loan portfolio. In addition, Huron had future funding commitments in the Florida loan program of approximately $65 million.

The examination indicated the impact of the concentration in the Florida construction loan program directly impaired the future viability of the credit union putting the safe and sound operation of the credit union in jeopardy. The examiners detailed significant deficiencies with the Florida loan program, which included:

- Poor loan quality;
- Inadequate underwriting and documentation;
- Excessive unreported member business loans (MBLs);
- Exorbitant and uncontrolled loan growth of 77 percent in 2005 and 61 percent in 2006; in an outsourced construction loan program secured by properties in Florida.
- Excessive concentration risk in a Florida real estate market;
- Excessive levels of borrowed funds;
- Inadequate oversight of the third party vendor responsible for the Florida program.

- Significant liquidity risk existed due to a lack of liquidity sources and potential loan losses in excess of available net worth.

Following is a discussion of some of the issues examiners identified with the Florida construction loan program:

Insufficient Oversight of CLC

The examination found that the Huron Board and management failed to implement a formalized system of oversight for construction and development lending performed by CLC in accordance with regulatory requirements and failed to appropriately recognize a majority of loans (approximately 70 percent) as investor loans or MBLs.

Illegal Field of Membership (FOM)

The Florida construction loan applicants became eligible in the Huron FOM by joining Huron's credit union service organization (CUSO), Learn and Earn Credit, LLC. However, because Huron management did not complete the process to admit the CUSO into its FOM, those members who established FOM eligibility through the CUSO were illegal members. This violation of NCUA bylaws also violated the Michigan Credit Union Act, Section 352 (1) (a), that indicates each person belong to a group that is within the credit union's field of membership.

Excessive Loan Growth

Total Huron loans increased $83.7 million between 2004 and 2005. In addition, loans increased an additional $109 million between December 31, 2005 and December 31, 2006. Management projected total investment in the Florida loan program of $100 million. However, by February 14, 2007, Florida loans totaled $267 million including unfunded commitments. The Board exceeded its approved commitment to the program by $167 million without documented analysis of the significant variance or the impact of that variance on the safety and soundness of the credit union.

Misclassification of Member Business Loans (MBL)

Section 723.16 (a) of the NCUA Rules and Regulations set the aggregate limit on a credit union's net MBL balances as the lesser of 1.75 times the credit union's net worth or 12.25% of the credit union's total assets. Under this regulation based on its net worth position, Huron should have only had $42 million in aggregate MBLs. However, the examination revealed that nearly $187 million of the Florida construction loans were commercial. The Board and management failed to limit MBL concentration in the Florida loan program.

ALM and Liquidity Review

NCUA performed this review in January 2007 as part of the joint examination with the Michigan SSA, using data effective September 30, 2006. NCUA rated Huron's liquidity risk high due to the lack of adequate policies, procedures and measurement abilities in place to adequately protect the credit union. The review presented results regarding Huron's:

- Liquidity Risk Management
- Borrowings
- ALM and Interest Rate Risk
- Strategic Risks

Liquidity Risk Management

The review determined Huron's risk management processes were not adequate for identifying, measuring, monitoring, controlling and reporting its current and short-term liquidity risks. Specifically, the review revealed:

- Huron's liquidity risk measuring and monitoring functions were not documented. Huron management did not assign key responsibilities for measuring, monitoring and reporting liquidity risks.
- There were no formal procedures in place for reviewing short-term and long-term cash flows.
- The policy did not require management to estimate current and future liquidity needs.
- There were no formal reporting requirements to provide information regarding short-term and long-term liquidity positions to the ALCO or the Board.
- The liquidity risk measurement policy target did not indicate potential cash shortfalls and liquidity pressures.
- Huron management did not use the ALM model regarding liquidity gap reports that considered changing interest rate environments and stressed liquidity positions.

Borrowings

Examiners indicated unplanned borrowings can cause concern as to whether management truly understands the liquidity risk implications of operations. The review determined Huron had a line of credit (LOC) at Central Corporate Credit Union (CenCorp) for $65 million. Huron management had regularly borrowed from this account, maxing out at almost $64 million in October 2006. In November 2006 Huron management borrowed and subsequently paid off a $55 million 60-day loan. However, at the time of the review, Huron's LOC returned to over $25 million. In addition, Huron had a borrowing capacity with Federal Home Loan Bank (FHLB) of Indianapolis for $45 million. At the time, Huron had the following short-term borrowings with FHLB with the final maturity date of May 2007:

Amount	Date taken	Maturity
$10,000,000	4/28/06	1/30/07
$6,000,000	11/20/06	4/19/07
$10,000,000	1/3/07	4/3/07
$10,000,000	1/3/07	5/3/07

Furthermore, Huron management did not report a master listing of outstanding borrowings versus available lines of credit to the Board or the ALCO.

ALM and Interest Rate Risk

The review determined:

- Huron management conducted monthly modeling and discussed the modeling formally with the ALCO on a quarterly basis. However, the ALCO did not meet consistently and did not document informal meetings in the recent past. Operational and liquidity controls were critical; therefore,, the ALCO should have met more frequently, documenting actions and discussions regarding overall balance sheet risk management practices, strategies, and actions being considered.

- Huron management ran “what-if” scenarios using Brick ALM software and frequently provided the results to Brick and Associates for their review and consideration. However, management did not retain them or document discussions regarding future plans and possible results. It did not appear that management used these reports as part of their decision making.

- Huron’s net worth ratio and its shocked NEV (with shares at par) declined from 14.14 percent to 11.34 percent and from 9.49 percent to 6.76 percent respectively between January 31, 2006 and October 31, 2006. Huron’s excessive asset growth which diluted its capital position caused this substantial decline. At a minimum, Huron management should have been comparing results from period to period and noting significant changes.

Strategic Risks

The review determined:

- Officials failed to develop reasonable working budgets, business plans, and operational strategies for the successful direction and control of Huron.

- The strategic plan covered the period 2006 through 2008. The Board was supposed to review and update the plan at least semi-annually. However, the review did not note any updates in the minutes. In addition, the Board was supposed to receive periodic (monthly/quarterly) reports on goals. The review did not find evidence of this either.

- The Huron 2006 Operational Objectives stated that Huron was to grow the Florida construction loans to a maximum level of $100 million by year end 2006. However, this balance was $191 million at year end.

- The credit union adopted an annual budget for 2006. However, its usefulness was questionable based on current practice. The 2006 budget appeared to be based on conservative, but reasonable growth trends (12 percent asset and loan growth – all coming in the indirect construction loan program). However, actual growth was not controlled; therefore it grew 156 percent from $67 million at year-end 2005 to $172 million at year-end 2006. If management had used the 2006 budget, Huron management would have had to shut down the Florida construction loan program.

  - The budget narrative stated that it "is designed to give us the liquidity to continue moving forward with this profitable program. We will shift the main funding of this program from the FHLB and CenCorp to our members." Projections showed reduced borrowings of $6 million. However, Huron management's reliance on external borrowings grew through those sources as well as non-member deposits.

- The Board did not demonstrate that they incorporated balance sheet risk management techniques into their planning process.

Table 3: Summary of Examinations and CAMEL Ratings with Comments						
Effective Date/ Examiner	**Capital**	**Asset Quality**	**Manage-ment**	**Earnings**	**Asset / Liability Mgt**	**Composite**
8/31/1999/ Examiner B	1	2	2	1	1	1
	A - The reliance placed on the outside vendor for underwriting the construction loans is a concern. There was no loan documentation for a number of loans reviewed. The loans the vendor presents to you must contain sufficient information and documentation to minimize any risk involved.					
	M - No Business Loan Policy. Incomplete internal control over construction loan program. Loan practices in violation of bylaws.					
9/30/2000 Examiner B	1	2	1	1	1	1
	A – Loan documentation Huron oversight of CLC					
9/30/2001 Examiner B	1	1	1	1	1	1
	Concentration of risk with CLC. Misclassification of loans to CLC and Multiple Services CUSO, Inc. Violation of Credit Union Rule 15a aggregate limits. Violation of Huron Business Loan Policy limits for construction loans and concentrations.					
9/30/2002 Examiner C	1	2	1	1	1	1
	A – Loan losses have increased 13 basis points since year-end 2001 and are slightly above the industry average. The Delinquent Loans to Loans Ratio increased to 1.23% as of September 30, 2002. Delinquency has increased 20 basis points since year-end 2001 and was above the industry average. Overall, loan quality appears to be strong. Loan files contained evidence of sound credit analysis, current credit reports, and proof of lien and insurance.					

6/30/2003 Examiner D	1	2	1	1	2	**1**
	A - The net charge-off ratio has increased each period since the year 2000. Increases in bankrupt accounts have been a major contributor to rise in loan losses and delinquency.					
	L - The level of asset growth is exceptionally high and exceeded net worth growth. It should subside or decline to a lower level by year-end. Continuous monitoring should be given to this area to ensure asset growth is contained within an acceptable level and net worth is not further compromised.					
3/31/2005 Examiner D	1	2	2	1	2	**2**
	A - The credit union's delinquency ratio is 172 percent higher than the peer ratio; The review of loan exceptions disclosed no critical concerns, but disclosed the need for continuous follow through to ensure all loan documentation is received as required.					
	M - There were no written procedures and policies developed for handling mortgage foreclosures.					
	L - The growing mortgage portfolio increases the interest rate risk exposure with only 38 percent of the mortgage portfolio re-pricing in three (3) years. The liquidity position remains strained because of the increased volume in mortgage construction loan financing. The ALM reports show the net interest income and net income has adequate performance after the portfolio's market values are shocked. The credit union's March 31, 2005 shocked NEV ratio was 8.85 percent representing a satisfactory change in the ratio. The ALM area, liquidity and interest rate risk exposure, requires continuous monitoring to ensure performance remains acceptable.					
9/30/2006	5	5	5	2	5	**5**
	Given the expected losses in liquidating the Florida loan portfolio, the credit union may not survive.					
	C – Liquidation of MBLs will eliminate net worth					
	A – Reclassification of FL construction loans is egregious violation of NCUA 723.16(a)					
	M – Decision to pursue the construction loan program; lack of due diligence					
	E – Losses due to liquidating FL construction loans					
	L – Negative liquidity due to excessive borrowing and open Lines of Credit (LOC) to fund FL construction loan program					

Appendix B: Correlation of Michigan State Supervisory Authority Examination Findings and Recommendations to Huron Deficiencies Noted during the Final Examination of Huron Before it was Declared Insolvent

ISSUE	[MANAGEMENT] OVERSIGHT OF CLC	LOAN DOCUMENTATION LACKING	CONCENTRATION OF RISK WITH CLC	MISCLASSIFICATION OF LOANS
Exam Effective Date	**Findings/Statements/Recommendations**			
Aug 31, 1999	Incomplete internal control over the construction loan program.	There was no loan documentation for a number of loans[75] reviewed.		
	The reliance placed on the outside vendor for underwriting the construction loans is a concern.	The loans CLC presents to Huron must contain sufficient information and documentation to minimize any risk involved.		
Sep 30, 2000	Unsatisfactory internal control and oversight of CLC by Huron management.	Huron loan files were incomplete.		
	Management allowed the vendor and the title company much of the responsibility for making and overseeing construction loans.			

[75] The loans included real estate loans.

	Management relied on photocopies and facsimiles from the vendor – the exam noted this as a safety and soundness concern.			
	Examiners noted that during the past examination, management did not fully agree with the amount of oversight necessary to control the construction loans. However, they believed that they convinced management this time that they had to rethink their controls over the construction loan vendor and be more cautious			
Sep 30, 2001	The exam indicated the board of directors was to continue the close oversight of CLC.		The exam noted concerns with the concentration of loans and credit to CLC.	The exam noted concerns with misclassification of loans to CLC and Multiple Services Credit Union Services Organization, Inc
			The additional lines of credit granted since the last examination increased the concentration of risk.	The exam indicated Huron should have classified two loans to CLC as business loans.

				The exam directed management to revise the Call Report for September 30, 2001 to reflect the correct classification of business loans
Sep 30, 2002	No issues or concerns were noted in the review of the agreement with CLC.	A review of a sample of … real estate ,… and business loans revealed that loan files contained evidence of sound credit analysis, current credit reports, and proof of lien and insurance		The exam indicated one of the loans addressed in the prior exam was still considered a business loan. *OIG Note: There was no indication that Huron reclassified the loan in the Call Report.*
Jun 30, 2003		The exam loan review did not disclose any critical concerns or issues in the underwriting. *OIG Note: We reviewed one exam file of real estate loans that did not indicate any documentation issues. However, we also reviewed the loan exceptions exam file that contained real estate loans, which did reveal documentation issues*.		*OIG Note: There was no indication that Huron reclassified the loan from the Sept 2001 exam in the Call Report.*
	NCUA Code 26 recommended a construction and business lending review.			
Mar 31, 2005				*OIG Note: There was no indication that Huron reclassified the loan from the Sept 2001 exam in the Call Report.*
	While this exam did not note any of the prior issues with oversight of CLC, loan documentation and loan classifications. NCUA identified significant issues with Michigan loans, some of which dated back to May 1999. The issues included loan documentation issues, misclassified loans and questionable loan practices.			

	. NCUA Code 26 recommended a construction and business lending review			
Sep 30, 2006	Inadequate oversight of the third party vendor responsible for the Florida program.	Poor loan quality.	Excessive concentration risk in a Florida real estate market.	Excessive unreported member business loans (outstanding MBLs were over four times the regulatory limit).
	Inadequate due diligence for the Florida construction loan member identification program. Underwriting personnel did not adequately verify and document identities or require that borrowers fill out membership cards completely	Inadequate underwriting and documentation.		

Appendix C: Chronology of Events Surrounding Huron's Relationship and Agreements with CLC and the Florida Construction Loan Program

2003

2003	**January 31**						**October 27** (eff June 30, 2003)
	Huron ratifies agreement to fund $30 million (+) in Florida construction loans						Michigan SSA conducts Code 11 exam

2004

2004			**February 3**		**September 16**	**September 17**		
			CLC and Huron prepare agreement for CLC to service first mortgages and interim construction loans		NCUA completes June IRR Review	**Huron ratifies agreement for CLC to service first mortgages and interim construction loans. Potential $50 million (+) loan portfolio.**		

2005

2005			**(On or about) June 1**	**June 13** (eff March 31, 2005)	**September 19**	**December**
			Huron begins funding FL loans	Michigan SSA conducts Code 11 exam	Huron responds to March exam	NCUA examiner "investigated a noted change in the balance sheet when Huron's real estate loan volume first started to increase"

2006

2006			**April**							
			NCUA questions rapid construction loan growth							
			Huron responds with detailed overview of the construction loan program							

Appendix D: Summary of the First Three Stages of a Financial Institution's Failure

I: Strategy	Industry	NCUA	Huron	II: Growth	Industry	NCUA	Huron	III: Deterioration	Industry	NCUA	Huron
Change in philosophy	X	X	X	Violations of laws and regulations	X	X	X	Increased resistance to supervisory concerns	X	X	
Aggressive business plan	X	X	X	Insider abuse	X	X		Independent public accountant problems	X	X	
Inattentive board	X	X	X	Disregard for examiner's concerns	X	X		Memorandum of Agreement/Board of Director Resolutions	X		
Emergence of dominant person	X	X	X	Overpayment for services and assets		X		Withholding documents		X	X
High-risk lending	X	X	X	Poor/Reduced risk diversification	X	X	X	Distortion of financial records		X	X
Lack of expertise in high risk niche lending area	X	X	X	Financially strong image	X	X	X	Earnings plateau/decline	X	X	
Computer conversion	X			Rapid growth in high-risk niche area	X	X	X	Inadequate/underfunded Allowance for Loan and Lease Losses (ALLL)	X	X	X
Lack of strategic plan	X		X	High level of loan fee income	X	X		Capital impaired	X		
Weak risk management	X	X	X	Poor credit administration	X	X	X	Emergence of loan problems worsened by a declining economy / Overwhelmed with delinquent loans	X	X	X
Weak internal controls for loans	X	X	X					Significant loan amounts by type	X		X
Liberal Underwriting		X	X					Loan Growth plateaus	X		X
Aggressive loan growth	X		X								

Appendix E: NCUA Management Comments

VIA E-Mail

TO: William DeSarno, Inspector General
Office of Inspector General

FROM: Executive Director J. Leonard Skiles /S/
Office of the Executive Director

SUBJ: Response to Material Loss Review of Huron River Area Credit Union

DATE: November 19, 2008

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review of Huron River Area Credit Union* (MLR).

I concur with the recommendation NCUA aggressively investigate and protect against perceived risk Federally Insured State Credit Unions (FISCUs) may pose to the insurance fund. NCUA recently reinforced the need for aggressive investigation and protection against perceived risks in Letter to Credit Unions No.: 08-CU-20 Evaluating Current Risks to Credit Unions, dated August 2008. This letter includes supervisory guidance given to NCUA examiners about diligent examination and supervision when potential risk to a credit union is identified.

Additionally, I want to clarify examination reports referenced in the MLR are SSA Michigan examination reports not joint SSA/NCUA examinations. NCUA did perform two on-site contacts during the time period the MLR covers. NCUA performed an interest rate risk review in 2004 and participated in a joint SSA/NCUA examination and report in 2007. NCUA did complete SSA examination report reviews for the MLR time period.

We concur in principle with the suggestion made on page 31 of the report where the regional Division of Supervision (DOS) provides a secondary review of national risk reports and off-site monitoring for individual cases. However, if adopted on a national level, the specific procedures should be left to each regional director to determine the proper flow of information through their chain of command.

Thank you for the opportunity to review and comment on the Material Loss Review of Huron River Area Credit Union.

cc: Director David M. Marquis
Office of Examination and Insurance

Assistant Inspector General for Audits Jim Hagen
Office of Inspector General