NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW
OF
CLEARSTAR FINANCIAL
CREDIT UNION

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ACRONYMS

AMAC	Asset Management & Assistance Center (Austin TX)
ARDO	Associate Regional Director Operations
ARDP	Associate Regional Director Programs
C&D	Cease and Desist Order
CUDL	Credit Union Direct Lending Program
CUMIS	Credit Union Member Insurance Society
DDs	Division Director
DMS	Division of Management Services
DOI	Division of Insurance
DOR	Document of Resolution
DOS	Division of Supervision
DSA	Director of Special Actions
E&I	Examination & Insurance
EIC	Examiner In Charge
EX	Examiner
FPR	Financial Performance Reports
FOM	Field of Membership
Guide	NCUA Examiner's Guide
Manual	Region V Supervision Policy Manual
MBL	Member Business Loan
NFID	Nevada Department of Business and Industry Financial Institutions Division
OED	Office of Executive Director
ORD	Office of Regional Director
PACA	Office of Public and Congressional Affairs
PCO	Problem Case Officer
PWL	Preliminary Warning Letter
RD	Regional Director
RO	Regional Office
SSA	State Supervisory Authority
SE	Supervisory Examiner
SME	Subject Matter Expert
TDR	Troubled Debt Restructure

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP to conduct a Material Loss Review (MLR) for the Clearstar Financial Credit Union (Clearstar or the Credit Union). We reviewed Clearstar to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated $12.2 million loss to the National Credit Union Share Insurance Fund (NCUSIF) (2) assess NCUA's supervision of the Credit Union, and (3) make appropriate recommendations to prevent future losses. To achieve these objectives, we analyzed NCUA and Nevada Department of Business and Industry, Financial Institutions Division[1] (NFID) examination and supervision reports and related correspondence, interviewed management and staff from NCUA Regions I & V, and reviewed NCUA guidance. We also reviewed Regions I & V policies and procedures, NCUA 5300 Call Reports, and NCUA Financial Performance Reports (FPR).

We concluded Clearstar failed because its Board and management did not implement proper risk management policies and procedures related to credit and concentration risk. Specifically, management originated and funded a significant amount of loans that were both poorly underwritten and to many borrowers that had poor credit histories. Because of this, over time, the Credit Union's loan portfolio increased in credit risk.

Additionally, the Credit Union used modified borrower classification matrixes that allowed them to approve loans to borrowers that were of a much higher credit risk than industry standards would expect. Also, in late 2008, management began extending an inordinate number of delinquent loans when it became obvious borrowers did not have the ability to meet their obligations. This was done to stem the flow of collection issues the Credit Union was facing; despite very little evidence borrowers would have the ability to meet their obligations when the extension period expired.

Finally, the Credit Union focused a significantly large portion of its loan portfolio on new and used vehicle loans originated both internally by Credit Union personnel, as well as externally through an indirect loan program. Clearstar's indirect loan program originated loans from new and used auto and recreational vehicle (RV) dealerships.[2] This program coupled with liberal underwriting policies enabled the Credit Union to generate a high volume of new loans. As more of these loans were originated, Clearstar's default rate increased as well. When coupled with the

[1] The NFID is Nevada's State Supervisory Authority.
[2] An indirect auto loan is where a car or RV dealership acts as an intermediary between the financial institution and the borrower.

economic recession that began in 2008, the Credit Union's failure was largely unavoidable.

NFID and NCUA examiners determined, and we agree, that Clearstar management:

- Significantly increased credit risk through weak underwriting standards and poor collection practices.
- Created concentration risk by allowing a large portion of their loan portfolio to be concentrated in new and used vehicle loans.

We concluded that despite examiners' concerns and recommendations for improvement, management's inability to effectively manage the risks created by their own decisions led to Clearstar's failure.

Although NFID and NCUA examiners identified the issues that ultimately led to Clearstar's failure, they failed to require management and the Board to make substantive changes in their lending practices. As a result, the credit and concentration risk in the Credit Union's loan portfolio continued to increase as more poor quality loans were originated.

We concluded a more diligent and focused effort by the examiners would have forced management to act more quickly and aggressively to resolve the underlying loan quality issues. Also, quarterly monitoring of the Credit Union through analysis of the Credit Union's Call Reports did not detect the increasing levels of delinquent loans and loan charge offs between the 2006 and 2008 examinations. Examiners did not take a strong stance with the Credit Union related to the high concentration of new and used vehicle loans generated through its indirect auto loan program. As a result, we determined examiners missed opportunities to prevent the failure of Clearstar and, at the very least, mitigate the loss to the NCUSIF.

This report makes one recommendation, as well as five observations. However, the OIG plans to issue an MLR capping report with recommendations based on issues raised in this report as well as the other nine MLRs conducted by the OIG. As resources allow, the OIG may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and also make recommendations, as warranted.

Auditor observations made as a result of our review of Clearstar's failure include:

- Examiners need reminded of the importance of understanding that DORs are to be developed to outline plans to reduce areas of unacceptable risk, with

particular emphasis on the types of safety and soundness concerns that were clearly present in the years leading up to Clearstar's failure.

- NCUA's off-site monitoring process could be improved by placing more emphasis on quarterly monitoring of 5300 Call Reports and better documentation of the analysis and specific procedures performed during examiner quarterly reviews of 5300 Call Reports.

- Inconsistencies over examination documentation and lax review processes warrant consideration of a documented secondary review by the Supervisory Examiner of the final CAMEL ratings.

- The development of a stronger more specific process to better identify, analyze, and monitor loan concentrations during examinations, as well as between examinations.

- Re-emphasize to examiners the importance of evaluating management's due diligence over new and fast growing programs, as well as other areas of emphasis, to ensure appropriate analysis was considered by management and to provide support for examiner ratings.

We also made one recommendation to NCUA management requiring examiners to document and retain all documentation on significant findings from prior examinations until such time the finding is satisfactorily remediated. Management agreed with our recommendation. We have included management's comments in their entirety in Appendix B.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this review.

Background

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP to conduct a Material Loss Review (MLR) for the Clearstar Financial Credit Union (Clearstar or the Credit Union), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j).[3] Clearstar was a federally insured state chartered credit union, headquartered in Reno, Nevada. Clearstar was located in NCUA's Region V until January 2009 when through an NCUA restructuring, the state of Nevada was transferred to NCUA's Region I.

History of Clearstar Financial Credit Union

Clearstar Financial Credit Union was originally chartered in 1949 as the Reno Teachers Federal Credit Union, serving Reno School District #10 employees and their families. In 1975, the name was changed to Sierra Schools Federal Credit Union and the charter expanded to nine more Nevada counties as well as other teacher associations. Sierra Schools FCU became a state chartered institution in 1997 and, eight years later in 2005, a 13 county community charter was approved and the name was changed to Clearstar Financial Credit Union. Clearstar served about 16,000 members through five branches in the Reno-Sparks, Nevada area.

In June 2008, the Nevada Department of Business and Industry, Financial Institutions Division (NFID) and NCUA conducted a joint examination of Clearstar and concluded the Credit Union was in an "unsatisfactory condition" with a CAMEL composite rating of 4. The exam cited several "Document of Resolution" (DOR) matters for management to address.

In April 2009, the NFID issued Clearstar a Cease and Desist (C&D) order placing restrictions on its lending activities, dividend rates paid on shares, share drafts, and share certificates, as well as requirements on more extensive liquidity monitoring.

On September 25, 2009, Clearstar was placed into liquidation by NFID and appointed the NCUA Board as Liquidating Agent. The NCUA Board accepted this appointment and in its capacity entered into a Purchase and Assumption (P&A) Agreement with United Federal Credit Union. The loss to the National Credit Union Share Insurance Fund (NCUSIF) is estimated at $12.2 million; however, the final cost to the NCUSIF will not be known until all assets are sold.

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[3] On July 21, the President signed into law the Wall Street Reform and Consumer Protection Act of 2010, raising the threshold for future MLRs to $25 million.

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[4] 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. During an examination, examiners assign a CAMEL rating, which completes the examination process.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[5] trend analysis,[6] reasonableness analysis,[7] variable data analysis,[8] and qualitative data analysis.[9] 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.

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[4] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
[5] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[6] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[7] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[8] 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 assess the financial condition, quality of service, and risk potential.
[9] 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 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.

Risk-Focused Examination Program

In 2002, NCUA adopted a Risk-Focused Examination (RFE) Program. 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 Reports 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,
- Knowledge of current events affecting the credit union.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the 12-Month Program[10]. NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. NCUA stated that the 12-Month Program will provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

Supervision of Federally Insured State-Chartered Credit Unions (FISCU)

NCUA's statutory authority and its guidelines indicated the agency has the legal and fiduciary responsibility to ensure the safety of the NCUSIF. Federally insured state-chartered credit unions receive the same amount of 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. In joint examination/insurance reviews, both NCUA and the State Supervisory Authority (SSA) focus on risk issues (including safety and soundness issues), while the state examiner focuses additionally on regulatory concerns. However, during an independent insurance review, NCUA examiners limit

[10] The 12-month program requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling eligibility.

their role to the review and analysis of risks to the NCUSIF only, rather than a complete examination of the FISCU.

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.

Objectives, Scope, and Methodology

We performed this MLR as required by section 216 of the Federal Credit Union Act, 12 U.S.C. 1790d(j) for Clearstar Financial Credit Union. Section 216(j) of the FCU Act provides that the Inspector General must conduct a review when the NCUSIF has incurred a material loss. For purposes of determining whether the fund has incurred a loss that is "material," a loss is material if it exceeds the sum of:

- $10,000,000;[11] and
- An amount equal to 10 percent of the total assets of the credit union at the time at which the Board initiated assistance under Section 208 or was appointed liquidating agent.

The objectives of the MLR were to:

- Determine the causes of the Credit Union's failure and any material loss to the NCUSIF;
- Assess NCUA supervision of the institution, including implementation of the Prompt Corrective Action requirements of Section 208 of the FCU Act; and
- Make appropriate recommendations to prevent future losses.

To accomplish our review, we conducted fieldwork at the NCUA's Region I office in Albany, New York, and conducted interviews of NCUA and NFID officials and

[11] On July 21, 2010, the President signed into law the Wall Street Reform and Consumer Protection Act of 2010, raising the threshold for future NCUA-OIG MLRs to $25 million.

examiners. The scope of this review covers the time period from June 2004 to September 2009.

To determine the cause(s) of Clearstar's failure and assess the adequacy of NCUA's supervision we:

- Prepared a chronology of examination scope and procedures, comments, and corrective actions.
- Reviewed exam files and Credit Union Board minutes.
- Reviewed external audit findings and follow-up procedures.
- Conducted interviews with NCUA and NFID examiners involved at various levels in the examination process.
- Reviewed policies and procedures included in examination files related to loan quality, investment quality, liquidity management, and earnings.
- Reviewed NCUA and Regional rules, regulations, and guidelines for Region's V & I.
- Reviewed NCUA Call Reports, Financial Performance Reports, and supervision as it relates to Clearstar.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software and NCUA online systems. We did not test controls over these systems. However, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our audit conclusions.

We conducted this audit from March through September 2010 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Detail

We determined that Clearstar Financial Credit Union management and Board of Directors contributed directly to the Credit Union's failure. Further, we determined that the Nevada SSA and the NCUA examiners could have reduced the loss to the NCUSIF had they adequately assessed and more aggressively pursued resolution to issues related to the Credit Union's high credit risk and concentration of new and used vehicle loans.

A. Why Clearstar Financial Credit Union Failed

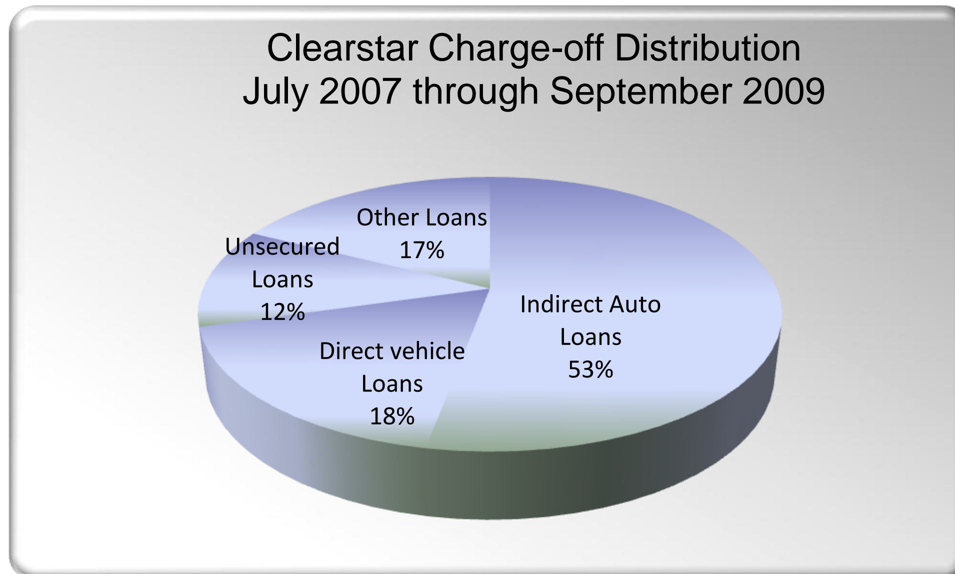
Management's inadequate risk management and lack of Board oversight led to Clearstar's failure. Management of Clearstar adopted strategies that created a high level of risk, particularly related to concentration and credit, without the necessary risk management policies and procedures to monitor and control these risks. Clearstar charged off in excess of $9 million in loans between July 2007, and September 2009. The magnitude of these charge offs was a significant factor in the Credit Union's failure.

Clearstar's Board and management focused on growing the loan portfolio without an apparent understanding of credit and concentration risk in that portfolio. In order to accelerate growth, liberal credit policies, minimum underwriting standards, and excessive loan modifications were approved and implemented. This resulted in the Credit Union's loan portfolio becoming increasingly more risky as higher risk loans were originated. A large portion of the loans originated between 2004 and 2008 were through an indirect loan program in partnership with new and used automobile and recreational vehicle (RV) dealers. The underwriting standards employed by the Credit Union allowed high loan to values (LTV) and attractive loan rates for borrowers with low Fair Isaac Corporation (FICO) scores.[12] The high risk nature of the loan portfolio was generally not understood, as evident in the 2008 exam, which noted that indirect auto loans had grown to $52 million and included approximately $11 million of subprime loans.

Chart A (below) provides the percentage breakdown of the over $9 million of loans charged off by the Credit Union from July 2007 through September 2009 by loan type, and shows that a significant portion was related to new and used vehicle loans.

[12] A "FICO score" is a method of measuring an individual's creditworthiness. A FICO score is a quantification of a variety of factors in an individual's background, including a history of default, the current amount of debt, and the length of time that the individual has made purchases on credit. A FICO score ranges between 350 and 850. In general, a score of 650 is considered a "fair" credit score, while 750 or higher is considered "excellent." A FICO score is a convenient way to summarize an individual's credit history and is included in a credit report. The term comes from the Fair Isaac Corporation, which created the system.

Chart A



Source: Clearstar Board Packets

Based on our procedures, we determined Clearstar management:

- Created unnecessary credit risk through weak underwriting standards that included the use of much more liberal credit grading than generally accepted industry standards would indicate, and

- Created concentration risk by allowing new and used vehicle loans to account for a large portion of its total loans.

We believe Clearstar's Board placed a heavy reliance on management to effectively operate the credit union and appeared too compliant and trusting, particularly of the CEO, who demonstrated a lack of understanding of the risky nature of the lending strategies he advocated. We found no evidence in Clearstar's minutes or in its Board packets of diligent risk management and monitoring processes that would enable an adequate understanding or control of risks. Additionally, as new strategies were adopted and executed, such as the branch expansion to Sparks, Nevada, in 2007, due diligence on the associated risk and profitability was neither discussed in the minutes nor noted by the examiners.

Credit Risk

Throughout the scope of our review, inadequate underwriting and lenient lending practices had become prevalent and included excessive loan extensions and renewals, LTV lending in excess of 100 percent, nonstandard borrower

classifications, faulty scoring matrices to evaluate borrowers, lack of adequate collateral, and liberal lending policies that attracted subprime borrowers at a much higher volume than management was aware. For example, in June 2006, the Board approved loan policy changes broadening scoring for auto loans and allowing interest only home mortgage loans. Loans for RVs were also liberalized to allow for 100 percent LTV, 240 month financing on RV loans over $100k, and as low as $100 minimum payments on small RV loans. In 2007, the Board approved a LTV of 100 percent for new and used motorcycles and jet skis, and not until December 2007 were real estate LTVs reduced from 100 percent to 85 percent on all borrowers.

NCUA and NFID examiners identified in the June 2008 examination that Clearstar had weak underwriting standards. During the exit meeting with management, examiners detailed the underwriting weaknesses they identified during their loan review, which included:

- Granting extensions on delinquent consumer loans without adequate due diligence being performed to:
  - Evaluate the borrower's cash flow to repay the debt,
  - Assess the value of collateral, and
  - Support the rationale for the extension, considering the borrower's derogatory credit.
- Poor and inadequate underwriting policies related to indirect auto loans.

In the December 2008 joint examination by NFID and the NCUA, examiners noted continued issues with underwriting and collection standards. In particular, even though the Credit Union had revised its loan policy, examiners criticized management for making an inordinate number of exceptions to the newly revised policy, which completely voided the attempt to improve the Credit Union's credit risk. Additionally, examiners noted in November 2008 that management had accelerated the number of extensions being granted. Specifically, between November 2008 and February 2009, management extended over $2.2 million in loans beyond maturity, with over $1.0 million extended in February 2009 alone. Examiners concluded this was an attempt to stem the increasing tide of loan defaults the Credit Union was experiencing. However, in many instances the loans extended after November 2008 were to borrowers who were unemployed or had their income reduced to the point where there was little evidence the borrower could repay their obligations once the extension periods expired.

We determined Clearstar management did not perform proper credit risk analysis of their loan portfolio. Although management developed credit scoring matrices used

as guidelines for granting credit, in most cases the matrices bore little resemblance to any industry standard matrix and did not classify borrowers in accordance with industry standard guidelines or NCUA guidance.

Additionally, examiners noted management classified borrowers based on FICO scores that were inconsistent with industry standards. An analysis prepared by examiners noted that management's classification matrix considered a borrower with a FICO score greater than 650 as "A" paper, whereas industry standard classification would have considered a FICO score greater than 720 as "A". Table 1 (below) provides a complete analysis of the differences noted by examiners between Clearstar's classifications and industry standard classifications.

Table 1

Borrower Classifications – Clearstar vs. Industry Standards				
Paper Type	Number of Loans	Indirect to Total Indirect Loans (Percent)	Total Loans	Percent of Net Worth
Clearstar Classification				
Total A Paper	3194	82.94%	$53,593,204.86	417%
Total B Paper	497	12.91%	$9,131,395.96	71%
Total C Paper	106	2.75%	$2,094,877.17	16%
Total D Paper	54	1.40%	$554,165.76	4%
Total Loans	**3851**	**100.00%**	**$65,373,643.75**	**509%**
Industry Standard Classification				
Total A Paper	1618	42.02%	$24,933,578.29	194%
Total B Paper	931	24.18%	$16,370,319.94	127%
Total C Paper	809	21.01%	$14,884,124.17	116%
Total D Paper	493	12.80%	$9,185,621.35	72%
Total Loans	**3851**	**100.00%**	**$65,373,643.75**	**509%**

Source: June 2008 Joint NFID and NCUA examination workpapers.

Most notably, Table 1 above shows the large discrepancy between the dollar amount of the loans Clearstar management classified as "C" and "D" paper and the dollar amount of the loans industry standards would classify as "C" and "D" paper, $2.6 million and $24.1 million, respectively.

These issues, noted in the June 2008 DOR, persisted after this examination. Examiners noted in the subsequent December 2008 joint examination that, although management had revised their lending matrix, they were still not using industry standards. As a result, examiners found validating the model difficult and a complete analysis of credit risk impossible. As an alternative, examiners prepared the following data, presented as Table 2 (below), segregating the Credit Union's loan portfolio by FICO scores at December 31, 2008.

Table 2

Credit Score Range	Dollar Amount	Life of Loan Default Rates[13]
740+	$37,335,547	0.60%
720-739	11,559,652	1.90%
700-719	12,123,851	2.80%
680-699	12,812,636	4.30%
660-679	10,598,369	6.70%
640-659	8,721,868	10.20%
620-639	5,879,534	13.60%
600-619	4,150,779	18.00%
Sub Total	**$103,182,236**	
580-599	2,259,855	21.10%
560-579	1,880,743	26.30%
540-559	1,696,770	31.50%
520-539	1,876,970	38.70%
500-519	1,546,861	47.50%
< 500	13,250,726	57.30%
Sub Total	**$22,511,925**	
Total	**$125,694,161**	

Source: December 2008 Joint NFID and NCUA Examination Overview

As highlighted in Table 2 above, examiners determined approximately $22.5 million (approximately 20 percent) of Clearstar's loan portfoilo had credit scores of less than 600, with a probability of default ranging from 21 to 57percent. The risk inherent in low credit scores, further compounded by weak underwriting and the lack of adequate collateral, resulted in very high deficiency balances, which were ultimately charged off and further reduced the Credit Union's capital.

Clearstar management's liberal underwriting standards and inconsistent borrower classifications based on FICO scores, eventually increased the credit union's credit

[13] Default rates were obtained from NCUA Risk Alert 05-Risk-01: Specialized Lending Activities – Third Party Subprime Indirect Lending & Participations.

risk. Further, management did not employ adequate monitoring and reporting tools to monitor credit risk. As a result, neither management nor the Board fully understood the credit risk exposure that eventually grew to an unmanageable level. This, coupled with the economic market dislocation that began in 2008, created a financial situation where institutional failure was all but assured.

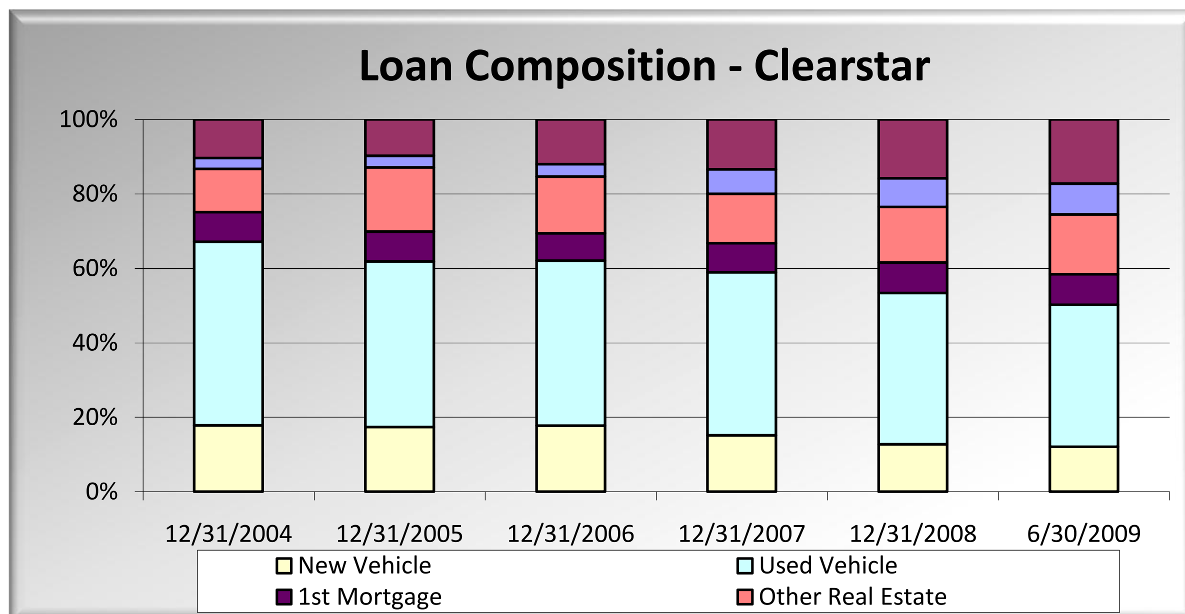
Concentration Risk

Historically, Clearstar was considered a well run credit union, consistently receiving CAMEL composite code 2 ratings from the NFID and NCUA through June 2008.

As early as 2001, Clearstar's management focused the Credit Union's lending activities on originating indirect vehicle loans. The program was aggressively and intentionally grown with active support of the Board. At its height, the new and used vehicle loan program accounted for more than 65 percent of the Credit Union's loan portfolio, a much higher percentage than other credit unions of similar size.

Charts B and C (below) depict the composition of Clearstar's loan portfolio compared to Peer[14] for the period covering December 2004 to June 2009.

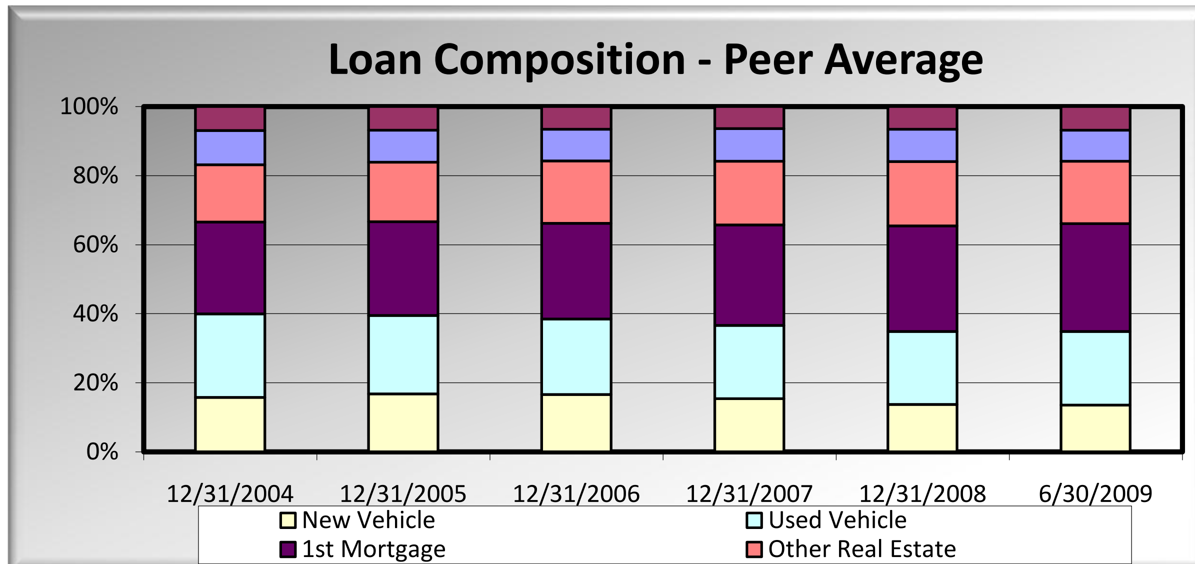
Chart B



Source: 5300 Call Reports

[14] The peer group consisted of all credit unions with assets between $100 and $160 million as of June 30, 2009.

Chart C



Source: 5300 Call Reports.

As shown in Charts B and C, Clearstar invested a much larger portion of their loan portfolio in new and used vehicle loans than did the peer group. Specifically, used vehicle loans were nearly double that of the peer group. Additionally, in the June 2008 joint NFID and NCUA examination, examiners noted that approximately 34 percent of the indirect vehicle loan portfolio was considered subprime. Also, examiners noted the following elements regarding the indirect and direct vehicle loan portfolio:

- Lending policy that allowed high LTV on indirect auto loans, up to 135 percent,
- Excessive extension and renewal practices,
- Weak and understaffed collection efforts that caused collections to occur very slowly further eroding the value of the underlying collateral, and
- Nonstandard classifications of borrower grades. For example, borrowers with at least a 650 FICO score were "A" paper, while industry standards would dictate "A" paper as a FICO score of 720 and above.

This high concentration of one particular loan type left the Credit Union highly exposed to the economic market dislocation that began in 2008 and ultimately was a contributing factor in the failure of Clearstar.

B. Nevada State Supervisory Authority and NCUA Supervision of Clearstar Financial Credit Union

We determined that examiners did not adequately assess nor aggressively pursue resolution of critical risks created by Clearstar management's high risk strategies related to loan concentration and credit quality. Further we believe that NCUA processes impeded detection and effective enforcement of corrective actions.

The rapid decline of Clearstar is noted on Table 3 (below). The first two exams of the Credit Union in our scope period of 2004 - 2009 resulted in a CAMEL composite 2 rating indicating strong performance. However, the Credit Union quickly deteriorated in the subsequent examination 18 months later to a CAMEL composite 4 and then to a CAMEL composite 5 in the final joint state/NCUA exams as of December 31, 2008, as detailed in the following table.

Table 3

Credit Union Examination Dates	**June-04**	**Dec-06**	**June-08**	**Dec-08**
Contact Type	State 11	Joint 11&26	Joint 11&26	Joint 11&26
CAMEL Composite	**2**	**2**	**4**	**5**
Capital/Net Worth:	2	1	4	5
Asset Quality:	2	2	4	5
Management:	2	2	4	5
Earnings:	2	2	5	5
Liquidity/Asset Liability Management (ALM):	2	2	4	4

Based on our review of these examination reports and supporting workpapers, we determined that certain NCUA exam processes could be strengthened that would serve to limit exposure for the NCUSIF, as follows:

<u>Examination Findings Repeated and Unresolved</u>

We determined that examiners identified the following critical deficiencies and risky practices in the 2004 exam that went unresolved by management and eventually led to the demise of the Credit Union:

- High charge-offs with no real plan of how to reduce them, nor an expectation that they would decrease in the short term. Examiners further noted that charge offs were more than twice that of peers.

- Improvement needed in underwriting processes. Examiners noted the high credit risk contained in the indirect loan portfolio and recommended improvements in policies and procedures. External auditors were engaged by the Credit Union to perform quarterly loan reviews to remedy 'serious control deficiencies' reported to the Board on March 31, 2004.

- High concentrations in the indirect auto lending program. Examiners noted poor quality loans from dealerships occurred in the past and that these loans currently made up more than 50 percent of the loan portfolio.

- Allowance for Loan and Lease Losses (ALLL) policy that did not match current methodology and practice. Examiners noted that the ALLL was underfunded and management had not made needed adjustments in a timely fashion.

- Liquidity declined significantly since the last exam from approximately 12 percent to 7 percent due to loan growth.

- Errors on the 5300 Call Reports.

- ALM monitoring deficiencies.

We determined that examiners appropriately noted these concerns in 2004 but did not document any follow up nor did they prepare a DOR for those issues considered to be a safety and soundness concerns.

According to the NCUA Examiners Guide, a DOR is used to outline plans and agreements reached with officials to reduce areas of unacceptable risk. An area of unacceptable risk is one for which management does not have the proper structure for identifying, measuring, monitoring, controlling, and reporting the risk.

In our opinion, the serious and continuing nature of these issues indicates that examiners should have issued a DOR for the 2004 exam. The 2006 exam reported that these issues and trends were continuing, but again there was no mention of them in the 2006 DOR, and, as a result, management did not focus on resolving these problems. Further, there was no indication of tracking or monitoring efforts to address these issues by examiners or management. Ultimately, this less than aggressive pursuit to resolve these critical issues contributed to the Credit Union's failure.

NCUA's total analysis and risk-focused examination process guides examiner judgment by providing the requisite and appropriate tools and guidance with which to

assess the safety and soundness of credit union operations and any risk to the NCUSIF. Although examiners used these processes to adequately identify the critical deficiencies and risky practices created by Clearstar's indirect auto lending program early on, we believe examiners did not view these concerns as issues that required a DOR to resolve. We believe NCUA management should establish a renewed emphasis to examiners on the importance of understanding that DORs are to be developed to outline plans and reduce areas of unacceptable risk, with particular emphasis on the types of safety and soundness concerns that were clearly present in the years leading up to Clearstar's failure. Further, we caution NCUA management that any discussion with examiners on DORs would be remiss if DOR follow-up in subsequent examinations were not also emphasized.

Recommendation

This finding highlights the importance of examiners providing sufficient evidence to document the results of examinations by exposing a weakness in the area of examination documentation; an issue we believe requires NCUA management's attention. Therefore, we are making the following recommendation.

We recommend the Director, Examination and Insurance:

1. Require examiners to document and retain all documentation on significant findings from prior examinations until such time the finding is satisfactorily remediated.

Management's Comments

NCUA Management agreed with our recommendation. Management indicated guidance currently exists to support this requirement and recent directives to staff reinforce these issues. Management also stated that examiners document and electronically store exam findings and DORs in AIRES files. The AIRES DOR module along with the DOR reports module, help NCUA and the state supervisory authorities to document and monitor problem resolution.

Evaluation of Management's Comments

Management's comments are responsive to the recommendation.

Quarterly Monitoring of Call Reports Needs Improvement

We determined examiners did not adequately monitor Clearstar's Call Reports to identify important trends and issues that were occurring within the credit union. Clearstar achieved a CAMEL composite 2 rating in both the June 2004 and December 2006 examinations, but dropped to a CAMEL composite 4 in the June 2008 examination and eventually a CAMEL composite 5 just six months later. As a result, Clearstar's dramatic decline was not detected by examiners soon enough to make changes that could have minimized the losses.

As part of NCUA's examination process, credit unions are required to file Call Reports on a quarterly basis. Quarterly monitoring helps examiners identify important trends and issues such as increasing delinquencies, charge offs, and operating losses; all issues we believe should have been identified in the June 2004 and December 2006 examination reports. In fact, not only did examiners not adequately detect and communicate these deteriorating trends and issues in the two previously noted examinations above, they made no contact with Clearstar until the next regularly scheduled examination in June 2008, *eighteen months later*, when the economic market dislocation had become evident.

Although we acknowledge examiners have access to numerous off-site monitoring tools that provide various red flags and other measures developed to highlight potential risk such as Call Report edits, historical warnings within the Credit Union Online system, Financial Performance Reports, online National Risk Reports, and regional risk monitoring tools, we believe these tools are of little use if examiners make no contact between examinations, as was the case with Clearstar.

In addition, despite NCUA budgeting time each quarter for examiners to review Call Reports and off-site monitoring tools (one hour per state chartered credit union and two hours per federally chartered credit union), one NCUA examiner told the OIG that it is their belief that examiners are not allocated sufficient time to appropriately analyze the quarterly 5300 Call Reports.

Finally, we believe the questionnaire and checklists supporting the examiners' quarterly review of 5300 Call Report data does not sufficiently document issues identified or the analysis performed.

Observation

One method NCUA examiners use to monitor the financial condition and the progress of FISCUs are through 5300 Call Reports. However, we believe improvements could be made in the off-site monitoring process if NCUA management were to develop and issue a national instruction to all regional offices placing more emphasis on quarterly monitoring of 5300 Call Reports. The

instruction should outline the process and include specific monitoring triggers to more easily 'red flag' areas to be investigated, as well as provide a specific time allocation. In addition, we believe any newly developed national instruction should include the requirement that examiners document and retain the specific procedures and analysis performed during their quarterly review of 5300 Call Reports.

Examination Documentation and Review Processes Appear Inconsistent

Although each NCUA Regional office has its own policies and practices, examination files lacked consistent documentation of sampling methods, sample sizes, and overall risk assessment procedures performed during examinations. Also, there was little or no evidence of routine exam workpaper review.

We determined that NCUA has no required documentation standards at the national level for workpapers related to risk assessments and sample sizes. Instead, each Regional office has its own procedures, which can create procedural differences that unfortunately in the case of Clearstar, we believe may have potentially contributed to an inconsistent CAMEL composite rating. Specifically, Region V rated Clearstar a CAMEL composite 2 during the December 2006 examination. At the next supervisory contact in June 2008, examiners downgraded the credit union to a CAMEL composite 4. When Region I took over supervision of Clearstar due to restructuring, examiners further downgraded the Credit Union to a CAMEL composite 5 during the December 2008 examination. We believe this rapid decline in CAMEL composite ratings from a 2 to a 5 in just a two year period indicates that any 'red flags' that may have been present during the December 2006 examination, were not properly assessed, thus leaving open the possibility that the resulting CAMEL composite 2 rating may not have been appropriate.

Our review also determined examiner conclusions in the December 2006 and June 2008 examinations were not consistent. For example, in the December 2006 examination, examiners commented that Clearstar management was "capable" when there were obvious and serious continuing concentration, underwriting, and liquidity issues. At the next supervisory contact in June 2008, examiners noted the same management team's "lax oversight." Also, in the Examination Overview section of the June 2008 Examination Report, examiners noted that Clearstar management:

> *"manages its liquidity position effectively"* and that *"ALM policies and procedures appear adequate at this time"* but later in the same report, noted that these same policies were *"currently inadequate".*

In our opinion, it appears the inaccurate conclusions drawn on management's competence, as well as the inconsistent evaluation of Clearstar's ALM policies and

procedures are strong indicators that examination workpapers were not consistently reviewed. We believe these inconsistencies should have been detected and corrected prior to issuance of the Report of Examination to Clearstar management.

Finally, our review determined that a lack of workpaper standardization and policies between regions allows for inconsistent administrative policy and resulting CAMEL ratings. Specifically, we found informal enforcement actions, at a minimum, appear to have been warranted during the December 2006 examination where Clearstar received a CAMEL composite 2 and a DOR noting only regulatory compliance issues.

Observation

One goal of NCUA's risk-focused supervision process is to enable examiners to streamline workpaper documentation to support areas of risk while improving the quality of workpaper documentation and support for conclusions. NCUA guidance indicates that examiners must retain a copy of all workpapers, schedules, checklists, forms, and examiner-prepared notes used to support their conclusions. Although Supervisory Examiners (SEs) are currently required to read all reports prepared by examiners and document their evaluations of a limited number of reports for each examiner in their group, the supervisory efforts of Clearstar highlights inconsistencies over examination documentation and a lax review process that warrants consideration of a documented secondary review by the SE of the final CAMEL ratings. A required and documented secondary evaluation prior to issuance to credit union management would ensure examination evidence gathered is sufficient, competent, and relevant, to reasonably support the CAMEL ratings.

Concentration and Loan-to-Value Guidelines and Processes were Inadequate

Our review determined examiners did not clearly identify and analyze Clearstar's loan concentrations. In addition, the risk associated with concentrations was not adequately considered in establishing the CAMEL ratings during Clearstar's examinations. We further noted that LTV requirements were not well defined or consistently applied.

Examiners noted in June 2008 that concentration in vehicle loans was more than 50 percent of the loan portfolio and that LTV for some auto loans exceeded 135 percent. The Credit Union Board approved a lending policy in 2007 that included 100 percent LTV on recreational vehicles, new and used motorcycles, and boats. In our opinion, NCUA guidance on loan concentrations and loan to value ranges is lacking. An NCUA official noted the need for explicit LTV guidelines "with teeth" to assure compliance.

Although NCUA recently emphasized to credit unions' the need to be aware of concentration risk (identifying, monitoring, and controlling) through issuance of Letter to Credit Unions,[15] examiners must also be aware when concentration risk presents a safety and soundness concern.

We believe the flexibility credit unions have in developing their lending policies and risk profile related to concentrations and allowable LTV on loan products needs to be better scrutinized by examiners when concentration risk is identified. In Clearstar's case, aggressive and competitive marketing just prior to the economic market dislocation and subsequent recession resulted in excessive risk taking with dire consequences.

Observation

Examiner guidelines state that indicators such as concentration activities can serve as triggers of changing risk and possible causes for future problems. Based on loan concentrations not adequately identified and considered in Clearstar's loan portfolio, we believe the risk-focused examination process would benefit from the development of a stronger more specific process to better identify, analyze, and monitor loan concentrations during examinations, as well as between examinations. Finally, and most importantly, NCUA management should consider whether to propose and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations. The development of asset concentration guidelines would assist both examiners and credit unions in identifying and monitoring the associated risks.

Risk Management, Management Competency, and Due Diligence Practices Were Lacking

We found no formal supporting documentation to determine how examiners analyzed Clearstar management's risk management practices, competence, and due diligence over new and/or fast growing programs.

We found minutes of Clearstar's Board meetings were general in nature and did not fully explain risk management practices and due diligence performed when a new product was proposed, or a program was growing rapidly. In the case of Clearstar's "Payday" loan product, approved by the Credit Union Board in May 2006, the only documented Board concern was related to Clearstar's image, and not the risk or profitability to the credit union. We also found no mention of this new "Payday" loan product noted in examination files.

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[15] Letter to Credit Unions 10-CU-03, "Concentration Risk" issued March 2010.

In addition, we determined management proposed liberal loan policies that were adopted by the Board in 2007 and 2008. These loan policies accelerated the high concentration and delinquency trends. These lending policies also provided for generous credit scoring, interest only home loans, $100 minimum payments for small RV loans, as well as 100 percent LTV and 240 month financing on large boats and RVs.

Management competence can be measured by the policies adopted, loan products developed, and the risk management practices incorporated, as well as the financial results achieved. Examiners can gather further insight through interviews, which should be documented. We found no evidence in examination files, however, of a focused assessment on management's competence and risk management practices, both of which factored significantly in the failure of Clearstar. Further, we found no documentation related to any kind of due diligence review of new products, policies, and strategies implemented by Clearstar management, a critical aspect of successful operations.

Observation

Evaluating the quality and the effectiveness of management is an important part of the total analysis process and a major examination objective. Examiners evaluate the quality of management by determining the effectiveness of the Board, the committees, and operational management. Effective management includes providing adequate support, planning, and oversight when the credit union enters new business ventures, or begins offering a new product and/or service. In addition, management must perform due diligence to ensure that products and services coincide with the credit union's overall risk profile.

Although NCUA has issued numerous Letters to Credit Unions over the past 12 months to address higher risk issues and risk management processes, our review found that Clearstar management engaged in very limited discussions over its risk management practices in addition to performing little or no due diligence over its new indirect auto lending program. As a result, we believe NCUA management should consider establishing a renewed emphasis on evaluating management's due diligence over new or fast growing programs, as well as other areas of emphasis, with particular attention to the risk the new program or new area may pose to the credit union's safety and soundness.

Appendix A – Examination History

The following details Nevada SSA and NCUA supervision contact conducted from 2004 through the final contact June 30, 2009, for Clearstar Financial Credit Union. The information provided is limited to key findings and associated Documents of Resolution with concentration, credit, and liquidity risk.

Effective date: June 30, 2004 **Code 11 Joint Exam** **CAMEL Composite Rating: 2**
• Examiners indicated that charge offs remain high with no evidence when they would decrease, and that overall credit risk remains high. • Examiners expressed loan quality concerns and noted deficiencies in the indirect loan program resulting in high losses. • Examiners determined that liquidity had declined from 11.8% at March 31, 2003, to about 7% at June 30, 2004, due to high loan growth. • Examiners noted that ALLL policy changes, better ALM monitoring, and control practices were needed. • Examiners concluded that management is knowledgeable and experienced.
DOR – none issued but Examiner Findings report noted improvement needed for quality control and risk concentration limits on indirect loans, ALLL underfunding of $187k, errors on the 5300 reports, and the need for more frequent ALCO meetings and a Liquidity Policy.

Effective date: December 31, 2006 **Code 11 Joint Exam** **CAMEL Composite Rating: 2**
Regarding Credit Risk, examiners determined that delinquency ratios remain stable and under control; however, verification of employment or income is not required for members with a FICO score of over 680. Regarding Liquidity, examiners recognized: • As of December 31, 2006, cash plus short term investments decreased to an asset ratio of 6.65% from 8.01% at December 31, 2005, and significantly below peer of 14.84%, primarily due to high loan growth. • Clearstar is concentrated in loans and deposits, and is nearly 100% loaned out. • The Credit Union has an ALM policy and liquidity policy that is currently

inadequate with a policy limit of 2%, well below the state and federal requirements of 5-6%. As of September 30, 2006, Clearstar's actual ratio was 1.65%. In the summary section of the Examination Overview, it was inconsistently noted that the ALM policy was adequate.

Regarding Management and Strategy, examiners noted that management has demonstrated the ability to implement goals and objectives so successful implementation of strategic initiatives is likely.

DOR – issues related to regulatory compliance only.

Effective date: June 30, 2008
Code 11 Joint Exam
CAMEL Composite Rating: 4

This exam reported a marked change in the condition of the Credit Union with serious concerns about its future viability resulting in a capital-based prompt corrective action (PCA) and a CAMEL 4 rating.

Regarding Credit Risk, examiners noted that asset quality has deteriorated and that 34% of the indirect portfolio is considered subprime. Loans were not being promptly charged off, the ALLL methodology is faulty and an adjustment to the ALLL account is needed of $2.8 million. Loan policy was liberal, allowing up to 135% on indirect vehicle loans. Concerns were also raised related to excessive extension and renewal practices, nonstandard borrower classifications and grading and insufficient collateral.

Regarding Liquidity, examiners recognized that high overhead associated with the new branches, growing loan defaults, and high yielding CD's have caused measurable earnings and liquidity pressure. Liquidity had declined to under 4% as of December 31, 2007, and high unfunded commitments. ALM practices as well as Liquidity policies and procedures were deemed inadequate. Additionally, Clearstar was in violation of a Nevada State statute requiring at least 5% of member accounts be held in liquid assets.

Examiner comments regarding management were severe and included lax Board oversight, inadequate lending and underwriting practices, dramatic deterioration of asset quality, an unwillingness to charge off loans timely, and ineffective collections, resulting in earnings that were 'critically deficient'.

DOR – The DOR was extensive and examiners required Clearstar to take the following actions by September 30, 2008, or sooner:

Regarding Credit Risk,

- Develop quarterly target goals for delinquencies and net charge off ratios.
- Improve collections to meet the quarterly goals outlined above.
- Review charged-off loans to identify weaknesses in underwriting and/or collections.
- Evaluate the real estate portfolio for potentially high risk loans.
- Realign the tier structure on consumer loans to more closely adhere to industry standards.
- Establish portfolio risk limits for "C" and "D" borrowers after revising the tier structure in accordance with stricter standards.
- Reduce or eliminate indirect lending until all provisions in this Document of Resolution concerning consumer lending are fully implemented, and it is safe and sound to proceed with such lending.
- Restrict the loan to values on indirect loans to not exceed 100%.
- Revise the Loan Policy to include specific loan underwriting Guidelines.
- Establish an internal loan audit program to monitor new loans.
- Review loan extension and refinancing processes and develop procedures and tracking mechanisms.
- Track due date changes and term extensions for all delinquent loans.
- Make adjustments to increase the ALLL by $2,818,233 to provide for full and fair disclosure requirements and charge off the $905,439 in nonperforming loans identified in this examination.
- Ensure that nonperforming loans and deficiency balances are charged off in at timely manner.
- Adjust your historical loss ratios for environmental factors.
- Ensure all future repossessions are booked at the fair market value of the collateral less costs to sell at the time of repossession.

Regarding Liquidity Risk:

- Restore liquidity risks to a safe and sound level.
- Revise your liquidity policy to address at a minimum the issues addressed in the Examination Overview.
- Improve earnings performance.
- Develop a plan to increase net worth to at least 7% by June 30, 2009.

Regarding Management and administrative oversight:

- Follow generally accepted accounting principles related to the allowance and charge-off adjustments, charge-off loans timely, adjust historical loss ratios

for environmental factors, and ensure all future repossessions are booked properly.
- Include troubled debt restructurings on the 5300 report.
- Submit the financial reports monthly to NCUA and Nevada FID
- Provide the Board of Directors with a copy of the monthly status report on compliance with the examination report.

Effective date: December 31, 2008
Code 11 Joint Exam
CAMEL Composite Rating: 5

Examiners noted a continued rapid deterioration of Clearstar's financial condition, marked by high loan and operating losses, leaving it 'significantly undercapitalized'.

Regarding Credit and Liquidity risk, examiners noted:
- High exposure to subprime loans and rising loan defaults, poor underwriting and insufficient collateral. Nearly 20% of loans were determined to be subprime with $11 million of the $52 million indirect loan portfolio made to borrowers with a credit score below 600.
- Exceptions to loan policy were frequent and new scoring matrices were not standard in the industry.
- Extensions and modifications had increased, some to members who were unemployed or had no real ability to repay.
- Collections were outsourced but effectiveness monitoring was lacking.
- Deficient liquidity management program with insufficient forecasting and monitoring tools.
- No integrated risk management processes were present.

Examiners determined that management oversight was weak, including their failure to monitor and control credit risk as well as their decision for capital expansion, which increased the drain on cash. Huge net operating losses generated by management's policies and lack of oversight factored significantly in Clearstar's failure.

Examiners concluded that Clearstar will likely not survive and suggested a merger as the only real option.

DOR – The DOR was extensive and examiners required Clearstar to develop a Merger Plan and a New Worth Restoration Plan, and also to take the following actions by June 30, 2009, or sooner:

Regarding Credit Risk,

- Amend the ALLL Calculation Work Sheet to reflect proper stratification of the indirect loan portfolio for the months prior to June 2008.
- Prepare a trending analysis worksheet/graph for delinquency and charge offs.
- Adjust the collateral in process repo report within your ALLL Worksheet.
- Establish an environmental loss factor for the extension/modification loan pool.
- Establish environmental loss factors to address credit risk.
- Provide the trending analysis to ALCO and the Board of Directors for review and inclusion in the minutes.
- Review all outstanding lines of credit on HELOCs.
- Review all outstanding unsecured lines of credit and reduce or revoke lines where borrowers exhibit deterioration of creditworthiness.
- Develop a validation process for the Fast Start Model to determine if the current scoring tiers and pricing is accurately reflecting the level of credit risk.
- Eliminate multiple credit scoring models (matrix) currently in use for different loan products. Use one credit scoring matrix for all loans and continue to use FICO classic scores concurrently as a “second opinion” in assessing credit risk.
- Use a validation chart to assess and determine scoring ranges in the pricing matrix so that approval and pricing is commensurate with the level of credit risk.
- Do not approve an extension for a loan if the member is more than 30 days past due as per your lending policy.
- Ensure that the member is gainfully employed prior to approving an extension or modification. Verify the member’s income and document the debt ratio analysis in their loan file.
- Document concise and supportable reasons in writing for any loan extensions or modifications you approve.
- Implement controls that will identify any loans that receive a second extension or modification within a 12-month period.

Regarding Liquidity risk;

- Amend the liquidity policy to clearly define responsibilities to ensure accountability.
- Develop a written net cash flow analysis and establish a monthly net cash flow target.
- Evaluate available liquidity contingency resources and prioritize.

- Determine if resources exist to meet projected liquidity needs under current and stressed economic conditions.

Regarding Management and Board oversight;

- Provide ALCO and the Board of Directors with a comprehensive log. of all modifications and extensions approved each month as well as the collections log provided by the GILA Group.
- Prepare a cost/benefit analysis of using GILA Group vs. bringing collections in-house.
- Update the collection policy.
- Cease granting Member Business Loans in accordance with NCUA R & R Part 702.202(a) (4) as a result of being "undercapitalized."
- Review and revise your Lending Policy to provide for safe, sound, and consistent lending practices that addresses all loan products.
- Create and utilize a comprehensive checklist or some format for quality control review of all loans granted.
- Integrate balance sheet risk management with your strategic and financial planning.
- Amend the existing ALCO agenda to ensure all key business activities effecting Clearstar's risk exposures are consistently reviewed.
- Conduct a thorough review of ALM model assumptions to ensure earnings simulation and net economic value (NEV) reasonably assess Clearstar's potential risk exposures.
- Ensure all general ledger account reconciliations contain the source document to which the account reconciled.
- Maintain a file of all supporting documentation to verify the NCUA 5300 Call Report.
- Provide the Regulator (DIF) and Insurer (NCUA) with quarterly progress reports in addressing the corrective actions prescribed in the December 31, 2008, joint examination report.
- Develop a merger plan.
- Develop a net worth restoration plan as required by Part 702.206 of management by the NCUA Rules and Regulations.

Effective date: June 30, 2009
Code 23 Offsite Supervisory Exam

The purpose of the contact was to review the financial condition, loan loss provision and compliance with the Cease and Desist order issued by NFID on April 15, 2009.

- Examiners noted continued deterioration of Clearstar financial condition.
- Examiners recognized that loan losses continued to be high and were

depleting reserves.

- Examiners calculated an ALLL adjustment that reduces net worth to 'critically undercapitalized.'

On September 25, 2009, NFID placed Clearstar into liquidation and NCUA Board entered into a Purchase and Assumption agreement with Untied Federal Credit Union.

Appendix B

MANAGEMENT'S COMMENTS

EI/BSM:bsm
SSIC1920

SENT VIA E-MAIL

TO: William DeSarno, Inspector General
Office of Inspector General (OIG)

FROM: Executive Director David M. Marquis /S/
Office of Executive Director

SUBJ: Material Loss Review of Clearstar Financial CU #68269

DATE: September 20, 2010

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review (MLR) of Clearstar Financial Credit Union.* Clearstar Financial Credit Union failed due to the credit union officials' failure to manage credit and concentration risk related to an indirect lending program. Economic weaknesses in Nevada also contributed to this failure.

NCUA recognizes that strong supervisory attention is necessary for credit unions with high-risk assets and inadequate risk monitoring processes. NCUA has recently intensified the monitoring and supervision of all federally insured credit unions to ensure more timely corrective actions.

MLR Report Recommendation

The MLR includes one recommendation: "Require examiners to document and retain all documentation on significant findings from prior examinations until such time the finding is satisfactorily remediated."

I agree with the recommendation. Guidance currently exists to support it and recent directives to staff reinforce these issues. The Examiner's Guide recommends examiners review findings and outstanding issues from prior exams to determine scope and assign initial risk ratings. Significant or recurring findings warrant a Document of Resolution (DOR) or other administrative remedy to ensure the credit union corrects the issue. Examiners document and electronically store exam findings and DORs in AIRES files. The AIRES DOR module along with the DOR reports module, help NCUA and the state supervisory authorities to document and monitor problem resolution.

MLR Report Observations

Quarterly Monitoring of Call Reports Needs Improvement. The MLR suggests issuing a national instruction that places more emphasis on quarterly monitoring of Call Reports including specific monitoring triggers to easily 'red flag' areas for investigation along with a specific time allocation. The report also suggests a more formal documentation process for the Call Report reviews.

NCUA continues to emphasize the need for effective off-site monitoring. In April 2010, I issued an updated directive regarding the processing and review of quarterly data. NCUA allocates time each quarter for examiners to review the 5300 Call Report and offsite monitoring tools.

Also in April 2010, NCUA staff received training during the Regional Conferences to reinforce the importance of off-site monitoring tools. Staff has access to numerous off-site monitoring tools including Call Report edits and historical warnings within the Credit Union Online system, Financial Performance Reports, online National Risk Reports, and regional risk monitoring tools. Each of these tools include various red flags and other measures developed to highlight potential risk.

NCUA currently has a team developing a national supervision policy manual. One of the issues addressed is increasing national consistency in the documented review of Call Reports.

Examination Documentation and Review Processes Appear Inconsistent. The MLR suggests the Supervisory Examiner (SE) document a review of the final CAMEL ratings prior to issuance to credit union management.

The national supervision policy team will consider this observation. Currently, SEs read all reports prepared by examiners and document evaluations of a minimum number of reports for each examiner in their group. In general, SEs and regional management are more closely involved in higher risk examinations and larger institutions providing input prior to issuing the report. In addition, staff is conducting a comprehensive evaluation of the quality control process, which will include recommended adjustments to the current program.

Concentration Guidelines and Processes Were Inadequate. The MLR suggests NCUA consider asset concentration guidelines to assist examiners and credit unions in identifying and monitoring risks.

In March 2010, NCUA issued Letter to Credit Unions 10-CU-03, "Concentration Risk." The letter provided credit unions with the supervisory letter issued to examiners that discusses identification, monitoring, and management of concentration risk. The letter also reemphasized the need for oversight of third party providers.

NCUA staff is in the process of evaluating Risk Based Net Worth (RBNW) requirements per Part 702 of the NCUA Rules and Regulations, to determine if higher capital requirements should be set for higher risk assets and concentrations in these assets. This action would not impose specific limits on asset categories, but would require credit unions participating in higher risk activities to hold more capital.

Risk Management, Management Competency, and Due Diligence Practices Were Lacking. The MLR suggests NCUA management consider establishing renewed emphasis on evaluating due diligence over new or fast growing programs, as well as other areas of emphasis.

I agree with the observation made in the report and this continues to be an area of emphasis. Current economic strains in the marketplace continue to require modification of examination procedures. Accordingly, NCUA provides ongoing guidance to examination staff and credit unions related to higher risk issues and risk management processes, including due diligence expectations. Recent examples of issuances over the last 12 months include the following Letters to Credit Unions:

- 10-CU-16: Reverse Mortgage Products: Guidance for Managing Compliance and Reputation Risks, August 2010
- 10-CU-15: Indirect Lending and Appropriate Due Diligence, August 2010

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- 10-CU-14: Strengthening Funding and Liquidity Risk Management, August 2010
- 10-CU-07: Commercial Real Estate Loan Workouts, June 2010
- 10-CU-06: Interagency Advisory on Interest Rate Risk, May 2010
- 10-CU-03: Concentration Risk, March 2010
- 10-CU-01: Current Risks in Business Lending and Sound Risk Management Practices, January 2010
- 09-CU-23: Reviewing Adequacy of Earnings, November 2009
- 09-CU-19: Evaluating Residential Real Estate Mortgage Loan Modification Programs, September 2009

Other Relevant Information

NCUA evaluates emerging risks on an ongoing basis to use resources most efficiently and ensure timely supervision of high-risk cases. In recent years, NCUA transferred the supervision of credit unions in Nevada and California from region 5, to regions 1 and 2 respectively. This allowed staff faced with competing priorities to focus on problem cases and minimize the risk of delaying supervision of high-risk cases. This case supports the need to take such actions to rebalance resources when economic weaknesses and related problems are concentrated in specific regions or geographic areas.

Thank you for the opportunity to comment on the report.

cc: Jim Hagen, Deputy Inspector General for Audit
Tim Segerson, Director E&I DOS
Wendy Angus, Director E&I DRM