NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

REVIEW OF NCUA'S RED FLAG REPORTS

Report #OIG-12-08
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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a self-initiated audit of NCUA's Red Flag (Risk) reports. Our objective for this review was to determine whether examiners were identifying and addressing high risk areas. To accomplish this objective, we judgmentally sampled 25 credit unions, five from each region, and analyzed the corresponding NCUA examination and supervision reports and related documents. We also interviewed NCUA management and reviewed NCUA guidance, policies and procedures.

We determined that regional management and staff were monitoring potential high areas of risk and ensuring issues were or would be resolved. During our initial analysis we found that of the 25 credit unions[1] reviewed, examiners addressed high risk areas at 19 (76 percent) of the sampled credit union. We found that examiner actions to address potential issues included performing follow-up for open Document of Resolution (DOR) items; onsite and offsite contacts; drafting for issuance and/or issuing Regional Director Letters[2] and Letters of Understanding and Agreement;[3] changing the overall CAMEL[4] rating; and elevating discussion items to examiner's findings. For the remaining six credit unions, the OIG determined that repeat and/or outstanding DOR items existed at four of these credit unions. At another credit union, the examiner questioned both the limited amount of time the state examiner spent onsite, and why the state examiner did not review three of the seven risk areas during the regular examination. Finally, for the remaining credit union, we found that while the state examiner identified risks, the state examiner did not issue a DOR to this CAMEL 1 credit union. According to the examiner, the state's examination report offered appropriate solutions to reduce the unacceptable risk.

We then conducted a second level review of the six credit unions where our initial data showed examiners were not addressing high risk areas. We found additional information was available for three of the six credit unions because examiners completed their examinations of these credit unions after our initial data was pulled for this review. The new examination documentation showed that at these three credit unions both NCUA and State examiners followed-up and ensured the outstanding DOR items were resolved. For the remaining three credit unions, the OIG contacted the corresponding Regional Directors to determine what follow-up action the examiner took since the last examination. Regional management indicated that follow-up contacts or reviews were in process or were planned, as we will describe later in this report.

[1] Our sample included both federally chartered (federal) and state-chartered (state) credit unions.
[2] Regions attempt to correct noted problems by sending Regional Director Letters to the credit union in question. In severe cases, the letters indicate that unless the credit union takes corrective action or makes reasonable progress, NCUA may pursue administrative action.
[3] Letters of Understanding and Agreement (LUAs) serve as supervisory tools. Regional offices sometimes use LUAs as informal administrative actions because other administrative actions often enforce violations of the terms of the LUAs.
[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.

Accordingly, we are making no formal recommendations in this report. We appreciate the courtesies and cooperation NCUA management and staff provided to us during this review.

BACKGROUND

A red flag is an indicator/warning sign of a potential problem or issue. In the course of conducting material loss reviews, we analyzed call report data which highlighted areas of increased risk and noted that this information might have helped examiners to identify potential safety and soundness issues. NCUA risk reports likewise help target credit unions that have potential high risk areas.

In 2002, NCUA implemented a Risk-Focused Examination (RFE) Program. The risk-focused supervision procedures often included reviewing off-site monitoring tools and risk evaluation reports, as well as on-site work. The RFE process included reviewing seven categories of risk: Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation. Examination planning tasks included: (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 management's demonstrated ability to manage those risks. Additionally, during 2009, NCUA developed a new examination policy that resulted in additional minimum required examination procedures based on a national review of risk. This policy directed a periodic national review of risk issues and adjustment to the minimum review procedures. NCUA's intent was to shape its examination and supervision program to consistently identify and mitigate emerging risks in response to the changing environmental factors within the credit union industry.[5]

NCUA uses a CAMEL Rating System in examining credit unions 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.

NCUA periodically issues additional guidance and enacts program changes as part of its continual improvement of the examination process. Accordingly, NCUA is establishing a uniform credit union supervision process for all regions. The National Supervision Policy Manual (NSPM)[6] will replace the individual regional supervision manuals and policies and will help ensure credit unions are treated more consistently from region to region. In addition, NCUA's Office of Examination and Insurance (E&I) implemented a new national examination and supervision quality control review process in June 2009. Under this process, E&I staff periodically sample examination and supervision reports from each region and review the most recent examination report, the administrative record, and the risk profile of each selected credit union. This new process will help E&I staff determine whether examiners addressed negative trends and included effective recommendations to resolve significant problems within acceptable timeframes. Furthermore, on November 20, 2008, the NCUA Board approved changes

[5] NCUA *Risk-Focused Examinations – Minimum Scope Requirements,* dated January 5, 2012 (Instruction Number 5000.20, Revision 3).
[6] As of the date of this report, the NSPM is in draft form with a planned implementation of July 2012.

to the RFE scheduling policy, creating the 12-Month Program.[7] 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. Moreover, beginning in 2011, all federal credit unions regardless of asset size and all federally insured state credit unions with assets greater than $250 million are required to have an annual examination completed once every calendar year.[8]

OBJECTIVE, SCOPE AND METHODOLOGY

The objective of this audit was to determine whether examiners were identifying and addressing high risk areas. To accomplish our objective, we judgmentally sampled 25 credit unions,[9] and reviewed and analyzed the corresponding NCUA examination and supervision work papers, reports and related documents. We also reviewed NCUA guidance, policies and procedures, and interviewed headquarters and regional staff.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software (AIRES) and Credit Union 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 provided NCUA management officials a discussion draft of this report and included their comments where appropriate.

We conducted this performance audit from January 2012 through June 2012 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

PRIOR AUDIT COVERAGE

We identified one NCUA OIG report issued within the past 5 years related to this subject.

OIG Capping Report on Material Loss Reviews, Report Number OIG-10-20, dated November 23, 2010.

NCUA OIG identified several shortcomings related to NCUA and SSA supervision efforts. Specifically, we identified examiner deficiencies in quality control efforts and

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[7] 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.
[8] NCUA *Annual Examination Scheduling,* dated May 28, 2010 (Instruction Number 5000.15, Revision 3).
[9] We judgmentally sampled five credit unions from each of NCUA's five regions.

examination procedures. We recommended that NCUA management issue a national instruction placing more emphasis on quarterly monitoring of Call Reports including developing offsite monitoring triggers and specific procedures to more easily "red flag" areas to be investigated as well as provide a specific time allocation. NCUA management agreed with the recommendation and stated that the Office of Examination and Insurance (E&I) planned to issue a new NSPM that would emphasize the importance of off-site monitoring of institutions via the Call Report, FPR, and National Risk Reports. The new manual would, in part, provide a means to identify which credit unions represent the most risk.

As mentioned above, the NCUA has since issued a new, draft NSPM and intends to implement it in July 2012.

RESULTS IN DETAIL

We determined that NCUA regional management and staff were monitoring potential high areas of risk and ensuring issues were or would be resolved in a timely manner.

During our initial analysis, we determined that as of January 26, 2012, of the 25 credit unions reviewed, examiners addressed high risk areas at 19 (76 percent) of the sampled credit unions. We found that examiner actions to address issues such as concentration, liquidity, and interest rate risks at the credit unions included performing follow-up for open DOR items; actual or planned onsite and offsite contacts; drafting for issuance and/or issuing Regional Director Letters and LUAs; changing the overall CAMEL rating; and elevating discussion items to examiner's findings. For the remaining six credit unions, the OIG determined that repeat and/or outstanding DORs items existed at four of these credit unions. At another credit union, the examiner questioned both the limited amount of time the state examiner spent onsite and why the state examiner did not review three of the seven risk areas during the regular examination. Finally, for the remaining credit union, we found that while the state examiner identified risks, the state examiner did not issue a DOR to this CAMEL 1 credit union. The examiner indicated that the state's examination report offered appropriate solutions to reduce the unacceptable risk.[10]

Conversely, a subsequent review of the examination documentation for these six remaining credit unions showed that both NCUA and State examiners followed-up at three of the credit unions and ensured the outstanding DOR items were resolved. The examiners completed their reviews of these credit unions after we had already pulled our initial data. For the remaining three credit unions, the OIG contacted the corresponding Regional Directors to determine what follow-up action the examiner took since the last examination. Regional management indicated that follow-up contacts or reviews were in the process of being taken or were planned.

We believe that regional management and staff are monitoring potential high areas of risk and ensuring issues were or would be resolved. Accordingly, we are not making any formal recommendations at this time.

[10] For the last two credit unions, the state examiners conducted independent examinations and the NCUA examiners performed offsite reviews and analyses of the state examiners' examination documents.

Sample Results

We determined that regional management and staff were monitoring potential high areas of risk and ensuring that issues were or would be resolved. To determine whether high risk areas (red flags) were identified and addressed, the OIG reviewed examination documentation to see what actions examiners took or planned to take to mitigate potential problems. As of January 26, 2012, our initial analysis showed that of the 25 credit unions reviewed, examiners identified and addressed high risk areas at 19 (76 percent) of the sampled credit unions. Specifically, examiners took the following actions at these 19 credit unions:

Examiner Actions	Number of Credit Unions
DOR Follow-up	6
Actual or Planned On/Off Site Contacts	5
LUA/RDL Issued or Drafted	4
Changed Overall CAMEL Rating	3
Elevated Discussion Items to Examiner Findings	1
Total	19

For the remaining six credit unions we found that at four of these credit unions,[11] examiners did not ensure outstanding and/or repeat DORs were resolved by their due dates. We also found that for one credit union, the NCUA examiner questioned the fact that the state examiner did not review three of the seven risks areas and only spent two days onsite at this credit union. At the final remaining credit union, we found that neither NCUA nor State examiners conducted any examinations or contacts during 2011 despite the examiners identifying lending control and loan underwriting issues during the 2010 examination.[12] Additionally, although the state examiner identified risks, the state examiner did not issue a DOR to this CAMEL 1 credit union. According to the examiner, the state's examination report offered appropriate solutions to reduce the unacceptable risk.

To ensure we captured updated information, we conducted a subsequent review of examination documentation for the six remaining credit unions to determine whether examiners preformed any follow-up or completed examinations after our initial review. We found that both NCUA and State examiners completed regular examinations at three of these six credit unions. For these three credit unions, the examiners indicated that the outstanding and past due DOR items were resolved by credit union management. For the remaining three credit unions, the OIG contacted the corresponding Regional Directors to determine what follow-up actions the examiner(s) took since the last examination to (1) monitor the credit union and (2) ensure corrective actions were taken.

[11] One of these four credit unions was a federally insured state credit union.
[12] According to the Regional Director, the State Supervisory Authority conducts credit union examinations on a 12-18 month rotation basis.

With regard to one of the credit unions with past due DOR items, the NCUA Regional Director informed us that the examiner had been in contact with the credit union by phone and two DOR items were resolved during the regular examination completed during March 2012. In addition, the Regional Director stated the examiner expects the DOR item on net worth to remain outstanding, with an expected resolution date of June 30, 2012. According to the Regional Director since given the net worth remains a concern, the continuation of the DOR item on net worth was warranted and was consistent with Regional and National policy.

For another credit union, the Regional Director stated that the State Supervisory Authority (SSA) did not identify material risks to the National Credit Union Share Insurance Fund. According to the Regional Director, the three risk areas not reviewed were all rated as low risk and the scope of the exam appeared to be appropriate given the risk profile of the credit union. The Regional Director further stated the SSA offered acceptable solutions to the issues found and the supervision plans were reasonable considering the credit union's risk profile.

For the final credit union, the Regional Director, while noting that the credit union's net worth to total assets was very healthy, stated that the District Examiner had reviewed the last examination and concurred with the examiner's CAMEL 1 rating. The Regional Director also stated that consistent with Regional and National policies, no onsite contacts were planned due to the asset size and CAMEL rating. According to the Regional Director, future supervision would consist of a review of the next examination which would occur within the next three months which is consistent with the SSA's target exam completion range of 12-18 months. Regional staff would then determine whether the issues were resolved conclusively.

We believe that regional management and staff were monitoring potential high areas of risk and ensuring issues were or would be resolved. Accordingly, we are not making any formal recommendations at this time.

Appendix A: NCUA Management Comments

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VIA E-Mail

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

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

SUBJ: Comments on "Review of NCUA's Red Flag Reports"

DATE: June 21, 2012

This memorandum responds to your request for review and comments of the OIG report titled *Review of NCUA's Red Flag Reports*.

The report does not offer any formal recommendations and noted that regional management and staff were appropriately monitoring elevated risk areas and ensuring resolution of problems. NCUA staff utilizes offsite surveillance tools in conjunction with the risk-focused examination process, including quarterly 5300 call reports, financial performance reports, risk trend identification reports, and problem code tracking reports. We continuously evaluate the effectiveness of these tools and modify existing or add new reports to properly identify and evaluate emerging trends and risk to the National Credit Union Share Insurance Fund (NCUSIF).

As noted in the report, NCUA plans to launch the National Supervision Policy Manual in July 2012 to ensure consistent examination and supervision practices across regions. Concurrent with the new manual, examiners will begin using an online tool to record their review of quarterly trend analysis. Supervisors will monitor the reviews, approve material changes to supervision plans as a result of the reviews, and ensure quality control.

NCUA remains committed to the continual improvement of our examination and supervision program and the staff training necessary to ensure the future safety and soundness of credit unions and the NCUSIF.

Thank you for the opportunity to comment.