# NATIONAL CREDIT UNION ADMINISTRATION

# OFFICE OF INSPECTOR GENERAL

**MATERIAL LOSS REVIEW OF**
**O.U.R. FEDERAL CREDIT UNION**

**Report #OIG-12-11**
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***Released by:***

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## Table of Contents

## ACRONYMS AND ABBREVIATIONS

| | |
|---|---|
| AEP | Annual Examination Scheduling Program |
| AIRES | Automated Integrated Regulatory Examination System |
| AUP | Agreed Upon Procedures |
| Board | Board of Directors |
| Call Reports | NCUA 5300 Call Reports |
| CAMEL | [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management |
| Credit Union | O.U.R. Federal Credit Union |
| DOR | Document of Resolution |
| FCU Act | Federal Credit Union Act |
| FICU | Federally Insured Credit Union |
| GAGAS | Generally Accepted Government Auditing Standards |
| LICU | Low Income Credit Union |
| LUA | Letter of Understanding and Agreement |
| MLR | Material Loss Review |
| NCUA | National Credit Union Administration |
| NCUSIF | National Credit Union Share Insurance Fund |
| NWRP | Net Worth Restoration Plan |
| OIG | Office of Inspector General |
| O.U.R. FCU | O.U.R. Federal Credit Union |
| P&A | Purchase and Assumption |
| PCA | Prompt Corrective Action |
| RFE | Risk-Focused Examination |

## EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of O.U.R. Federal Credit Union (O.U.R. FCU or the Credit Union), a federally insured federal credit union (FCU). We reviewed O.U.R. FCU to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated $3.7 million loss to the National Credit Union Share Insurance Fund (NCUSIF); (2) assess NCUA's supervision of the Credit Union; and (3) provide appropriate suggestions and/or recommendations to prevent future losses. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence, interviewed NCUA officials and regional staff, and reviewed NCUA guidance, including regional policies and procedures, and NCUA 5300 Call Reports (Call Reports).

We determined O.U.R. Federal Credit Union failed for the following reasons:

- <u>Suspicious Activity</u>

  The manager of O.U.R. FCU was involved in highly suspicious activities that deliberately manipulated the accounting and misstated financial reports. Numerous inconsistencies and unsupported entries were found, the most flagrant of which was a $1.6 million imbalance between the member share subsidiary and the general ledger.

- <u>Ineffective Board of Directors Oversight</u>

  Board of Directors (Board) oversight and responsiveness of O.U.R. FCU was not effective. Governance issues of particular concern related to undisclosed related party activity, incomplete minutes, and the lack of understanding of financial results, as well as the lack of due diligence to develop strategy, manage risk, or follow-up on examination findings.

- <u>Weak Control Environment</u>

  Management created a weak control environment at O.U.R. FCU, which allowed for inaccurate account reconciliations, control deficiencies in cash handling, and a lack of timely recording of transactions, preparation of account reconciliations, and monthly financial close. Additionally, segregation of duties and/or mitigating controls were inadequate due to the lack of competent accounting staff and the manager's unrestricted access to the general ledger.

- <u>Inaccurate Accounting</u>

  Deficient accounting and financial reporting practices at O.U.R. FCU resulted in inaccurate accounting, unsupported journal entries, lack of timely monthly financial closings and submission of Call Reports, as well as unusual and unexpected income and expense trends.

In addition, we determined examiners missed the opportunity to prevent or reduce the loss to the NCUSIF due to:

- Incomplete exam procedures, including the lack of an adequate reconciliation of member share accounts;
- Ineffective resolution of issues raised in the examinations;
- Inadequately assessed risks related to this low income Credit Union given the weak internal control environment, and procedures did not fully address those risks.

We identified similar issues during this review as those found in a prior OIG MLR report.[1] Therefore, we are re-emphasizing the recommendations from that MLR and are making two suggestions to NCUA management related to AIRES downloads and expanded examination procedures. Management's response to the OIG's re-emphasized recommendations and two new suggestions can be found in their entirety at Appendix A.

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

[1] Material Loss Review of Vensure Federal Credit Union (OIG-12-05), dated February 29, 2012.

## INTRODUCTION AND BACKGROUND

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP to conduct a Material Loss Review (MLR, review, audit) for O.U.R. Federal Credit Union (O.U.R. FCU or the Credit Union), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). O.U.R. FCU was a federally chartered Credit Union located in Eugene, Oregon. NCUA's Region V provided supervision over the Credit Union.

### History of O.U.R. Federal Credit Union

O.U.R. Federal Credit Union was a Community Development Financial Institution chartered in 1969. The Credit Union operated out of one location in Eugene, Oregon. O.U.R. FCU's mission was to serve the residents of Lane County, Oregon who participated within the past 12 months in programs of the Lane County Department of Community Health and Social Services. As of March 31, 2011, the Credit Union reported $4.3 million in assets and 2,184 members.

The Credit Union relied heavily on nonmember deposits and secondary capital, mainly in the form of grants, to supplement operating capital. The frequency and amounts of these grants were irregular and hard to predict, creating on-going capital concerns.

In May of 2011, a specialist, hired by the interim manager, discovered an imbalance of $1.6 million between the share accounts and the general ledger. After the specialist made the necessary accounting adjustments to reflect their financial position, it was apparent that O.U.R. FCU was insolvent.

On June 24, 2011, NCUA placed O.U.R. FCU into conservatorship. On December 2, 2011, NCUA liquidated the Credit Union and completed a Purchase and Assumption (P&A) of certain assets and member shares with Northwest Community Credit Union of Springfield, Oregon. The failure of O.U.R. FCU resulted in a loss to the NCUSIF of $3.7 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[2] components, and reviewing qualitative and quantitative measures.

[2] The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.

NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the National Credit Union Share Insurance Fund (NCUSIF), and for identifying those institutions requiring special supervisory attention or concern. 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[3], trend analysis[4], reasonableness analysis[5], variable data analysis[6], and qualitative data analysis[7]. Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. The NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, the NCUA requires examiners to determine whether material negative trends exist, ascertain the action needed to reverse unfavorable trends, and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

*Risk-Focused Examination Program*

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. 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 as well as the risks

[3] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[4] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[5] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[6] Examiners can often analyze an examination area in many different ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to assess the financial condition, quality of service, and risk potential.
[7] Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the Credit Union's current condition, and 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.

detected in the credit union's operations and in 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 quarterly Financial Performance, Risk, and Call Reports;
- Communication with credit union staff; and
- 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 Annual Examination Scheduling Program (AEP)[8]. 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. The NCUA stated that the Annual Program would provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

## OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this material loss review to satisfy the requirements of Section 216(j) of the FCU Act, 12 U.S.C. §1790d(j), which requires the OIG to conduct a material loss review when the NCUSIF has incurred a material loss.[9] Moreover, the 2010 amendments to the FCU Act, embodied in the "Dodd-Frank Wall Street Reform and Consumer Protection Act,"[10] further require the OIG to conduct an in-depth review of any loss to the NCUSIF where unusual circumstances exist that might warrant an in-depth review of the loss. In the case of O.U.R. FCU, the loss did not exceed the $25 million threshold. However, the OIG determined the circumstances surrounding the loss to the NCUSIF were unusual enough to warrant a review. Specifically, the OIG determined that the manager's highly suspect activities warranted performing a full-scope MLR.

The objectives of the MLR were to:

1. Determine the cause(s) of the Credit Union's failure and the resulting loss to the NCUSIF;

[8] The AEP requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling availability.
[9] The FCU Act deems a loss "material" if the loss exceeds the sum of $25 million or an amount equal to 10 percent of the total assets of the credit union at the time in which the NCUA Board initiated assistance under Section 208 or was appointed liquidating agent.
[10] Public Law 111-203–July 21, 2010, 124 Stat.1939.

2. Assess the NCUA's supervision of the institution, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and

3. Make appropriate observations and/or recommendations to prevent future losses.

To accomplish our review, we performed fieldwork at the NCUA's Region V office in Tempe, Arizona. The scope of this review covers the period from September 2006 through conservatorship in June 2011.

To determine the cause(s) of O.U.R. FCU's failure and assess the adequacy of NCUA's supervision, we:

- Prepared a chronology of examination scope and procedures, comments, and corrective actions;

- Reviewed examination files, including exam reports, risk assessments, findings, Documents of Resolution (DOR), confidential sections, corrective actions, off-site monitoring, correspondence, and analysis;

- Reviewed the Board of Directors minutes and Board packets, as well as any Supervisory Committee minutes provided;

- Reviewed Agreed Upon Procedures (AUP) attestation engagements and member account verifications, including results, findings, and responses;

- Reviewed information related to the potential fraud, including the AUP report dated July 1, 2011, which was prepared to support the bond claim;

- Conducted interviews with NCUA officials and examiners involved at various levels in the examination process;

- Prepared detailed data tables, graphs, and analyses comparing O.U.R. FCU with a peer group of comparable low income credit unions;

- Reviewed NCUA and regional rules, regulations, and guidelines; and

- Reviewed NCUA Call Reports and other documentation related to the supervision of O.U.R. FCU.

We used computer-processed data from NCUA's AIRES 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 2012 in accordance with Generally Accepted Government Auditing Standards (GAGAS) 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 O.U.R. Federal Credit Union's manager and Board contributed directly to the Credit Union's failure. Suspicious activity by the manager was facilitated by ineffective Board oversight, a weak control environment, inaccurate accounting, and misstated financial reports. In addition, we determined the loss to the NCUSIF could have been prevented or reduced had examiners: (1) required a system generated download of member accounts that reconciled to the general ledger; (2) more aggressively pursued resolution to issues raised by examiners; and (3) properly assessed and addressed the risks of the internal control environment.

### A. Why O.U.R. Federal Credit Union Failed

**Suspicious Activity by the O.U.R. Manager**

We determined that the manager of O.U.R. FCU was involved in highly suspect activities that deliberately manipulated the Credit Union's accounting records and misstated its financial reports. We identified these suspicious activities dating back to 2005.

Specific examples include:

- Financial reports included in Board packets contained inconsistencies that were not addressed in the minutes or accompanied by valid explanations. At December 31, 2005, for example, the "New and Closed Shares Report" for the month showed a total of 11 new share accounts that were manually crossed out. The account with the most significant dollar balance had a share balance of $100,000. The account belonging to the manager was also crossed out with no explanation.
- We obtained the daily general ledger activity reports for the month of December 2006, called 584 Reports. The 584 Reports include all general ledger entries made during the day. On December 1, 2006, we noted two 584 Reports. The first 584 Report had 1,251 transactions and was 26 pages long. The length of the report and number of transactions was consistent with other daily 584 Reports. The second 584 Report, also run on December 1, 2006, had 10 transactions and was one page in length, with all of the transactions posted by the manager. The result was a $760,000 increase to the investment in the NCUSIF account, a decrease of $71,000 to internal cash accounts, and an increase of $689,000 to total member shares and certificates of deposit. No explanation for the entries was noted.
- There were also two daily reports called *"O.U.R Federal Credit Union Board, G/L Trial Balance, After Clear/Close"* run on December 1, 2006. One of the reports shows the Investment NCUSIF account with a balance of $832,190, which included current period activity (month of December) of $760,000,

entirely related to 10 transactions made by the manager, as discussed above. The second report with the same date shows a balance in the Investment NCUSIF account of zero and current period activity balance of zero, entirely inconsistent with the prior report. The Investment NCUSIF zero balance in this report agrees to the December 31, 2006, internally generated balance sheet included in the Board packet.

- We noted someone manually crossed off seven certificate of deposit accounts totaling $585,000 from the December 2007 system-generated certificate report given to the Board. The total certificates on the financial statements included in the Board packet and in the Call Report agreed to the certificates report only *after* the manual adjustments were included. We noted no discussion in Board minutes regarding these apparent discrepancies.

- On the December 28, 2007 daily transaction register, we noted a $100,000 entry posted by the manager to reduce teller cash and increase the share account for Oregon Metro Credit Union despite the fact this account closed in 2004 due to a merger[11]. The manager provided no explanation in the register.

- We obtained teller deposit slips for December 31, 2008, which were posted by the manager. We noted that the manager posted transactions to increase certain share accounts with the offset to Oregon Metro Credit Union, a credit union that, as previously noted, had closed in 2004. The teller deposit slips stated that the Credit Union hours on December 31, 2008, were 10 a.m. to 2 p.m. Transactions, totaling $1,034,470, were made before 10 a.m. on that day to increase certificate of deposit share accounts with nonmembers and to offset those share increases to Oregon Metro Credit Union. At this point, end of day reports and member statements could have been run that would have reflected the erroneous share balances. On that same day, after 2 p.m., when the Credit Union was closed, entries were recorded to reverse the entries that had been made in the morning – with some reversals being offset to accounts other than the original entries, including accounts owned by Board members.

- In May of 2011, NCUA called in a specialist to help with the development of O.U.R. FCU's Net Worth Restoration Plan (NWRP). In performing those duties, the specialist discovered that the general ledger was out of balance with the share account subsidiary by nearly $1.6 million, validating that someone had manipulated the share account balances.

- To follow up on the share account imbalance, an independent auditor performed an AUP attestation engagement to identify improprieties related to cash and share accounts and to support a potential bond claim. On

[11] Oregon Metro Credit Union merged with First Technology Credit Union in 2004.

July 5, 2011, the auditor cited missing documents and suspicious activity related to petty cash, payments to the manager's account, payroll draws, vault and teller cash and prepaid accounts, in addition to manipulation of share accounts.

We believe irregular and unsupported general ledger entries, member account and financial results manipulation, and overall suspicious activity performed by the manager raise serious concerns that improprieties occurred, which materially influenced O.U.R. FCU's failure.

Ineffective Board Oversight

The Board is responsible for overseeing the activities of the Credit Union, including establishing policies, developing strategy, monitoring financial performance, and reviewing the performance of management. We determined the oversight and responsiveness of the Board of O.U.R. FCU was not effective. Governance issues of particular concern relate to undisclosed related party activity, incomplete minutes, the lack of understanding of financial results, as well as the lack of due diligence to develop strategy, manage risk, or follow-up on exam findings.

In our review of the September 30, 2010 examination (effective) and supporting documents, which included a listing of related party loan and deposit accounts, we noted the list included two accounts belonging to a Board member, who was also on the Supervisory Committee. In addition, our review of all share accounts revealed that this same member had five additional share accounts each with the same address. There was no discussion in the Board minutes concerning related party activity, nor why this Board member did not disclose these additional related party accounts.

We determined O.U.R. FCU's financial statements included in the Board packets contained inconsistencies that no one addressed in the minutes or supported with valid explanations. For example, the December 2005 financial reports had manual cross-outs of certain account balances, including the manager's own account, making it difficult to reconcile the system-generated report to the financial statements. We found no explanation or discussion in the Board minutes for the crossed out accounts or the effect those changes had on the financial statements.

We found no Board minutes for some months and for those we located, many were not signed. In addition, all the Board minutes were very general and informally written, with some noting the author's opinion and personal comments. We found very little substantive discussion related to strategy, risk management, or the issues raised in the examinations, nor any diligent follow-up to those examiner findings. We found the Board minutes only vaguely discussed risk management and operational issues with no strategic planning specific to financial improvement. In our opinion, the Board appeared very lenient and sympathetic to the manager and did not address repeated examiner concerns regarding accounting processes that resulted in consistently late Call Report submissions.

Examiners noted that O.U.R. FCU's Supervisory Committee performed verifications in accordance with NCUA Rules and Regulations, with no discrepancies noted. Examiners documented the Supervisory Committee performed these verification procedures internally until 2010. A Certified Public Accountant issued Agreed Upon Procedure (AUP) reports effective March 31, 2010, July 5, 2011 and June 30, 2011 and reported findings related to account reconciliations, board oversight, unusual journal entries and missing member information. The 2011 AUP reports were part of an investigation related to the member share account imbalance and to identify other suspicious activity. We found no Supervisory Committee minutes or documented evidence of any other Supervisory Committee activity, nor did we find any indication that O.U.R. FCU ever received a full scope opinion audit.

We believe the lack of effective governance by O.U.R. FCU's Board allowed for undetected errors in financial reporting, unresolved examiner findings, and the retention of an incompetent manager.

Weak Control Environment

We determined O.U.R. FCU's Board and management created a weak control environment, which allowed for: (1) inaccurate account reconciliations; (2) control deficiencies in cash handling, and (3) a lack of timely recording of transactions, preparation of account reconciliations, and monthly financial close. Additionally, the lack of competent accounting staff and the manager's unrestricted access to the general ledger created inadequate segregation of duties. Best business practices for all credit unions suggest a strong internal control environment is essential to accurate financial reporting and the prevention of fraud.

We believe the opportunity to commit fraud was ever present. For example, we determined management did not ensure account reconciliations were accurate or timely. Examiners noted in their September 30, 2010 examination (effective) that accounting staff did not keep bank reconciliations up to date and that the staff needed training to perform the reconciliations in a timely manner. Although small credit unions have less flexibility to limit access or segregate daily activities, we believe the Credit Union's segregation of duties and/or mitigating controls were insufficient and allowed the manager to write and sign checks, as well as make deposits, which occurred on a regular basis. Examiners further noted in the June 30, 2009 examination (effective) that accounting staff only performed a reconciliation of subsidiary accounts to the general ledger annually. In addition, examiners noted that the Credit Union staff did not properly download the loan subsidiary and did not perform reconciliations of loans to the general ledger.

We determined cash controls were deficient. Examiners noted that Credit Union staff did not open and record the deposits made in night depositories under dual control. As a standard internal control, management should maintain dual access control to night depository funds and mail deposits, and require the presence of both persons when removing, processing, and logging the contents. An interviewee further noted that there were no controls over vault cash.

The manager had overriding control of the accounting and reporting function and it appears was the only employee involved in the preparation or reporting of the financial results. Interviewees noted that the manager often worked after hours and had full access to the general ledger and related reports. Examiners noted that the manager consistently failed to close the books in a timely manner, which delayed preparation of the monthly financial reports and submission of Call Reports.

We believe the lack of internal controls allowed for: (1) the manipulation of accounts; (2) erroneous and infrequent reconciliations; and (3) the highly suspect accounting activity by the manager, which all contributed to the failure of O.U.R. FCU.

Inaccurate Accounting

Accurate and timely financial reports form the basis of the financial management system. We determined the deficient accounting and financial reporting practices at O.U.R. FCU resulted in inaccurate accounting, unsupported entries, lack of timely closing of the books and submission of Call Reports, as well as unusual and unexpected income and expense trends.

Irregular and infrequent posting of transactions created inaccurate financial reporting and erratic trends in income and expenses. For example, after O.U.R. FCU went through a system conversion in March 2008, many automated accrual entries and prepaid expenses were only posted quarterly instead of monthly. In addition, depreciation schedules did not tie to asset files and the manager did not post the depreciation entries manually on a regular basis. We also determined reconciliation of subsidiary accounts to the general ledger was performed only once per year.

The manager did not perform month-end processing in a timely manner, which caused delays in completion of monthly financial statements and quarterly Call Reports. This was a recurring and unresolved issue cited in multiple examinations. The manager was able to convince the Board and examiners that for a variety of reasons, she could not meet the deadlines.

Financial statements did not accurately reflect the financial condition of O.U.R. FCU and were misleading to the Board and to the examiners. When the specialist calculated the appropriate adjustments in May 2011 and revealed the true financial condition of the Credit Union, it became apparent that O.U.R. FCU was insolvent.

## B. NCUA Supervision of O.U.R. FCU Federal Credit Union

**Inadequate Examination Procedures**

We determined examiners did not conduct adequate examination procedures. Specifically, there was an inadequate reconciliation of member share accounts; ineffective resolution of issues identified in examinations, and insufficient assessing or addressing of internal control weaknesses. As a result, we believe examiners missed the opportunity to mitigate the loss to the NCUSIF.

Supervisory Background

O.U.R. FCU received a CAMEL Composite rating of 2 in the September 30, 2006 and March 31, 2008 examinations (effective), an indication of strong performance. Examiners began to note the Credit Union's deterioration beginning with the June 30, 2009 examination (effective) when they downgraded the Credit Union to a CAMEL Composite 3 rating. Beginning with the next contact effective on March 31, 2010 until the contact effective on April 30, 2011, examiners again downgraded the Credit Union to a CAMEL Composite 4. By May 31, 2011 (effective), examiners lowered O.U.R. FCU's CAMEL Composite rating to a 5. Table 1 (below) provides specific CAMEL ratings during the scope period of our review.

**Table 1**

| NCUA Examination Results | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Credit Union Examination Effective Dates** | **Work Code[12]** | **CAMEL Composite Rating** | **Cap/Net Worth** | **Asset Quality** | **Mgmt** | **Earnings** | **Liquidity** |
| September 2006 | 10 | **2** | 2 | 2 | 2 | 3 | 2 |
| March 2008 | 10 | **2** | 1 | 2 | 2 | 3 | 2 |
| June 2009 | 10 | **3** | 4 | 2 | 2 | 4 | 3 |
| March 2010 | 22 | **4** | 4 | 2 | 3 | 4 | 3 |
| June 2010 | 22 | **4** | 4 | 2 | 3 | 4 | 3 |
| September 2010 | 10 | **4** | 4 | 2 | 3 | 4 | 3 |
| March 2011 | 22 | **4** | 4 | 2 | 3 | 4 | 3 |
| April 2011 | 22 | **4** | 4 | 2 | 3 | 4 | 3 |
| May 2011 | 22 | **5** | 5 | 5 | 5 | 5 | 5 |
| June 2011 | 22 | **5** | 5 | 5 | 5 | 5 | 5 |

[12] Work Classification Code (WCC) 10 is a regular on-site examination of a federally chartered credit union and WCC 22 is a more limited supervision on-site contact of a federal credit union.

We noted that O.U.R. FCU was working under a NWRP since March 2010. In addition, the NCUA issued a Letter of Understanding and Agreement (LUA) in August 2010, which specifically listed concerns and expectations related to record keeping, the debit card program, interest rate risk, and capital levels.

Incomplete Exam Procedures and Ineffective Follow-Up on DOR Issues

O.U.R. FCU was designated a low income Credit Union (LICU) because it served members meeting the low-income criteria. The NCUA has issued supervisory guidance to credit unions and examiners in a 2005 Letter to Credit Unions titled *"Supervising Community Development Credit Unions"* and in a 2010 Supervisory Letter to examination staff titled *"Supervising Low Income Credit Unions and Community Development Credit Unions."* The Supervisory Letter is intended to help examiners understand LICU's unique characteristics and to help those credit unions compete and survive in their financial markets within the constraints of regulations and safety and soundness. Based on interviews conducted for this review, we determined examiners believed this guidance allowed some latitude in resolving issues and findings.

We believe the most serious instance of an examiner allowing too much latitude occurred during the examination effective March 31, 2008. During this examination, the examiner accepted that the AIRES download of share accounts was not available or even possible to generate without significant cost to the Credit Union – which was not the case. An AIRES download, while not required, is a normal and efficient procedure typically used by examiners in the reconciliation of share accounts. Examiners are expected to obtain the subsidiary downloads directly from the system to mitigate the possibility of account manipulation. The download, when compared to the general ledger, would have revealed the out-of-balance condition in the share accounts. The manager was persuasive in her explanations and rationalizations to the examiner that the AIRES download was not available, and the examiner accepted her excuses. In lieu of the AIRES download, the manager created a substitute report, which matched the general ledger. Once the examiner received the substitute report, he conducted no further verification. We believe had the examiner pushed harder to obtain an AIRES or other system generated download, or looked behind the numbers in the substitute report, the manipulation of share accounts would have most likely been uncovered in 2008, which could have reduced the loss to NCUSIF.

Beginning in 2008, examiners consistently raised concerns about O.U.R. FCU's inability to achieve the strategic plan, late Call Report submissions, delays in monthly financial closings, high operating costs, and account reconciliations in arrears. Again, the manager convinced the Board and the examiners that she was working on the issues – though she made little progress. Examiners did not elevate these concerns for stronger supervisory action until August 2010, when they issued an LUA.

Peer group comparisons, though not a required examination procedure, are a commonly used tool examiners use to identify inconsistent results or unexpected trends. Examination workpapers included peer group information for credit unions of similar asset size, but we found no evidence that the examiner conducted an analysis of comparative data or variances. We believe an effective peer group analysis would have provided an opportunity to detect anomalies and risk areas on which to focus expanded examination procedures.

NCUA's 2002 Examiners Guide recommends that examination workpapers include a *Red Flag Procedures* questionnaire as well as *Internal Control* questionnaires. We did not find these questionnaires or reference to them in the examination files. In addition, AIRES has a *Red Flag Checklist*; however, we found no evidence examiners used it during any of the O.U.R. FCU examinations during the scope period of our review. The checklist specifically identifies red flag indicators such as the lack of account reconciliations, report timeliness, lack of adequate segregation of duties, weak cash controls, and a domineering manager, which based on our analysis, all were present at O.U.R. FCU and would have warranted expanded examination procedures.

<u>Risks Not Adequately Assessed or Addressed</u>

We determined examiners did not adequately assess or address numerous internal control risks present at O.U.R. FCU. The aforementioned NCUA guidance relating to LICU's allows for additional sources of funding and resources, including nonmember deposits and secondary capital. Again, the guidance specifies that examiners should afford these credit unions the opportunity to survive, which we determined through interviews that examiners believe this affords some latitude. However, the guidance also acknowledges that LICU's present unique supervisory challenges and pose a higher risk.

In addition, NCUA guidelines state it is imperative that examiners properly evaluate the internal control environment because it provides reasonable assurance in the effectiveness and efficiency of the credit union's operations, the reliability of its financial reporting, and its compliance with applicable laws and regulations. NCUA guidance also directs examiners to base the scope, type, and depth of an internal control review on the credit union's size, complexity, scope of activities, and risk profile.

Furthermore, according to NCUA guidance, NCUA internal control examination objectives help to:

- Determine whether the credit union has implemented efficient and effective operations and risk management systems;
- Determine whether the credit union accurately records transactions;

- Determine timeliness and reliability of financial reporting;
- Determine whether the credit union complies with regulations, internal policies, and internal procedures; and
- Assess whether the credit union has implemented adequate internal controls to safeguard assets.[13]

Although examiners may have performed minimum procedures and did raise some internal control matters, in our opinion, examiners did not adequately consider or achieve these internal control objectives, particularly those related to the control environment and governance, as previously discussed in the preceding section.

During our review of the Credit Union's Call Reports, we noted that O.U.R. FCU held a significant amount of cash on hand given its operations and compared to peers. We further noted that O.U.R. FCU was subject to a large fraud in the mid 1990's. Although examiners documented in the June 30, 2009 and September 30, 2010 examinations (effective), that internal controls over cash, particularly cash on hand, were weak, we believe the combination of weak internal controls over cash, combined with significantly large amounts of cash on hand, resulted in an environment at greater risk of fraud. We found no evidence examiners specifically identified or addressed this risk in their examination procedures. We believe examiners should have had a heightened awareness of the risk and the opportunity for fraud and tailored their examination procedures to address those risks.

We noted examiners rated the Credit Union's Management component a CAMEL 2 until they downgraded this component to a CAMEL 3 in the March 30, 2010 examination (effective). Examiners consistently cited accounting irregularities, high operating costs, late monthly closings, and Call Report submissions as problem areas. Additionally, the Supervisory Examiner (SE) Evaluation completed in June 2009 cited concerns about the manager's knowledge and skills, but did not suggest a rating change from the examiner's Management component CAMEL 2. We believe the assigned CAMEL 2 rating in Management indicates that examiners improperly assessed the risk associated with Credit Union management given the level of operational issues noted in the examinations, the knowledge, skills, and experience of the manager and Board, the operating results, and the manager's highly suspicious activities.

**Suggestions**

As previously noted, we identified similar issues in our previous OIG MLR report of Vensure FCU to those issues identified during this review. Specifically, examiners did not fully evaluate questionable financial data and did not fully investigate potential red flag issues. We are therefore re-emphasizing the two

[13] NCUA Examiner's Guide, Chapter 4.

recommendations from the Vensure FCU MLR report and note that the OIG concurs with NCUA management's actions taken or planned related to the following recommendations from that report:

- *"Remind examiners to fully evaluate questionable items in financial data consistent with a reasonable risk assessment and evaluation of the level of risk exposure, and to seek assistance from Supervisory Examiners or other specialists when significant risk issues are identified.*

- *Develop additional off-site triggers for Call Reports and other financial performance reports, including specific procedures to require supervision examiners to review and sign off on those items raised as "red flag" issues to ensure such items are fully investigated by examiners."*

Additionally, we are making the following two new suggestions.

We suggest NCUA management:

1. Remind examiners to obtain an AIRES download, when available, for loan and deposit subsidiary ledgers to manually reconcile balances to the general ledger.

**Management Response**

Management agreed with the suggestion. Management indicated the National Supervision Policy Manual requires examiners to request an AIRES share and loan download for every examination whenever possible. Management also indicated that if a credit union will not, or cannot, provide an AIRES share and loan download, examiners are to notify their supervisor for alternative solutions.

**OIG Response**

We concur with management's response.

2. Remind examiners to expand examination procedures when they detect red flag issues such as ineffective board oversight, weak internal controls, lack of segregation of duties, inaccurate financial reporting, and late financial filings.

**Management Response**

Management agreed with the suggestion. Management indicated The National Supervision Policy Manual contains a chapter dedicated to audits, recordkeeping, and fraud. Management also indicated there are a number of tools available to assist examiners in determining when to expand procedures and will continue to emphasize the importance of these topics in regional group meetings.

**OIG Response**

We concur with management's response.

## APPENDIX A: NCUA Management Comments

National Credit Union Administration

EI/AMP:ap
SSIC 1920

**SENT VIA E-MAIL**

**TO:** William DeSarno, Inspector General
Office of Inspector General

**FROM:** Dave Marquis
Executive Director

**SUBJ:** Material Loss Review of O.U.R. Federal Credit Union

**DATE:** September 25, 2012

We reviewed the Office of Inspector General's (OIG) draft report titled "Material Loss Review (MLR) of O.U.R. Federal Credit Union #19768." O.U.R. Federal Credit Union failed as a result of fraud. Below are our comments regarding the recommendations and suggestions provided in the report.

**MLR Report Recommendations**

The MLR reemphasizes the following recommendations from the Vensure Federal Credit Union MLR dated February 29, 2012:

- *Remind examiners to fully evaluate questionable items in financial data consistent with a reasonable risk assessment and evaluation of the level of risk exposure, and to seek assistance from Supervisory Examiners or other specialists when significant risk issues are identified.*

- *Develop additional off-site triggers for Call Reports and other financial performance reports, including specific procedures to require supervision examiners to review and sign off on those items raised as "red flag" issues to ensure such items are fully investigated by examiners.*

As noted in this MLR, OIG concurs with the actions we have already taken or plan in relation to these recommendations.

**MLR Report Suggestions**

In addition to the aforementioned recommendations, OIG provides two suggestions. Following the suggestions below you will find our response including corrective actions taken or planned.

1. *Remind examiners to obtain an AIRES download, when available, for loan and deposit subsidiary ledgers to manually reconcile balances to the general ledger.*

**Response:** We agree examiners should obtain an AIRES download whenever possible. On July 1, 2012, the National Supervision Policy Manual (NSPM) became effective. It requires examiners to request an AIRES share and loan download for every examination. If a credit union will not or cannot provide an AIRES share and loan download, examiners will notify their supervisor examiner (SE) while the on-site fieldwork is in process. The SE will work with the examiner on options for obtaining the AIRES download or an equivalent format such as a text file with share and loan information.

2. *Remind examiners to expand examination procedures when they detect red flag issues such as ineffective board oversight, weak internal controls, lack of segregation of duties, inaccurate financial reporting, and late financial filings.*

   **Response:** We agree with the recommendation. The NSPM contains a chapter dedicated to audits, recordkeeping, and fraud. The chapter instructs examiners to review material general ledger accounts including, but not limited to, loans, member deposits, cash, investments, subsidiary ledges, and the call report when an examination reveals significant recordkeeping concerns.

   We have a number of tools available to assist examiners in determining when to expand procedures and which additional procedures to perform. Since March 2009, the *Red Flags* questionnaire has been part of the required minimum scope for all credit unions with less than $20 million in assets.[1] Additionally, the *Red Flags* questionnaire provides a list of expanded exam procedures examiners can use if they have identified issues.

   We will continue to emphasis the importance of internal controls and accurate recordkeeping at regional group meetings and remind examiners to expand review procedures in credit unions with weak internal controls and/or inadequate recordkeeping.

Thank you for the opportunity to comment.

[1] In 2012, the requirement to completed this questionnaire changed to credit unions with less than $10 million in assets.