NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW

OF

TELESIS COMMUNITY CREDIT UNION

Report #OIG-13-05
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ACRONYMS AND ABBREVIATIONS

AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
ALLL	Allowance for loan and lease losses
AMAC	Asset Management Assistance Center
BP	Credit Union Business Partners CUSO
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
CEO	Chief Executive Officer
CFR	Code of Federal Regulations
CRE	Commercial real estate
Credit Union	Telesis Community Credit Union
CUID	CU Indirect CUSO
CUSO	Credit union service organization
CUV	CU Vehicles CUSO
DFI	California Department of Financial Institutions
DOR	Document of Resolution
EVP	Executive Vice President
FCU Act	Federal Credit Union Act
FHLB	Federal Home Loan Bank
FPR	Financial Performance Report
GAGAS	Generally Accepted Government Auditing Standards
HRD	Human Resources Director
LOC	Line of credit
LUA	Letter of Understanding and Agreement
MBL	Member business loan
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NET	National Exam Team
OIG	Office of Inspector General
P&A	Purchase and Assumption
PCA	Prompt Corrective Action
Premier	Premier America Credit Union
RFE	Risk-Focused Examination
SBS	Small Business Services
TCCU	Telesis Community Credit Union
WCC	Work Classification Code

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 Telesis Community Credit Union (TCCU or the Credit Union), a federally insured credit union chartered under the California Department of Financial Institutions (DFI). We reviewed TCCU to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated $77 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, as well as related correspondence. We interviewed NCUA officials and regional staff, and reviewed NCUA guidance, including regional policies and procedures, and NCUA 5300 Call Reports (Call Reports) and Financial Performance Reports (FPRs).

We determined Telesis Community Credit Union failed for the following reasons:

- Loan Concentration

  TCCU management maintained a heavy concentration in member business loans (MBLs), particularly commercial real estate (CRE) loans, based on its exception to NCUA Rules and Regulations Part 723.[1] TCCU management built its portfolio primarily around a five-year balloon payment structure that grew quickly and became geographically dispersed. As the state of the Credit Union eroded, management sold the best performing loans in an effort to offset shrinking net worth, ultimately leaving an unhealthy loan portfolio.

- Allowance for Loan and Lease Loss

  Comments regarding the Allowance for Loan and Lease Loss (ALLL) appeared in all examinations reviewed. The Credit Union failed to properly impair individual loans and use loss rates on the loan pools that were reflective of current conditions. These failures resulted in $8 million in NCUA and external auditor prompted adjustments between 2006 and 2008.

- Business Model and Strategy

  Strategic misreads by the Board and management led to increased commercial real estate lending and a dependence on fee and service income from its majority-held credit union service organization (CUSO) without consideration of the effects of a significant economic downturn on either source. In addition, purchases of the unprofitable AutoSeekers and Autoland CUSOs without appropriate due diligence led to increased operating expense and impairment loss.

[1] 12 CFR 723.17

- Management Decisions and Board Oversight

  Auditors and examiners noted several internal control failures, including an ineffective internal audit function. The Credit Union also made strategic missteps in acquiring the AutoSeekers and Autoland CUSOs. In addition, our review of NCUA working papers noted the potential that these purchases were for the benefit of a party related to the TCCU Chief Executive Officer (CEO). In this same vein, Autoland and the Business Partners (BP) CUSOs both held the TCCU Executive Vice President (EVP) as their CEO and the TCCU CEO as the Chairperson of the Board. Twice, the TCCU CEO, in her dual roles as Autoland Chairperson and TCCU CEO, requested and approved, respectively, a line of credit extended to Autoland.

  Conversely, BP held significantly greater deposits with TCCU than was insured by NCUSIF, despite the CAMEL rating and net worth of the Credit Union, again indicating transactions at less than arm's length. These transactions did not appear to have been discussed by the Board which itself appears to have been hindered by late delivery of voluminous Board packets. Eventually, the EVP accused both the CEO and Chairman of the Board of unethical behavior. Although not quantifiable, we consider this evidence of conflicts of interest.

- Excessive Operating Expenses

  TCCU's operating expenses were high relative to industry standards and exceeded revenue from 2007 through its demise in 2012. There were several contributing factors to the high level of operating expenses, including administrative salaries and benefits, building costs, and recognition of impairment related to the acquisition of the Autoland CUSO. Total expenses were likewise high, due to the aforementioned operating expenses, and additional provision for loan and lease losses proposed by examiners and external auditors.

We concluded that management underestimated the potential effects of downturns in the real estate market and overall economy on the loan portfolio and its ability to generate revenue from the BP CUSO.[2] This was seen in both the size and character of the loan portfolio, and the methodology used to reserve for related losses, i.e., the ALLL.

We determined NCUA could have prevented or mitigated the loss to the NCUSIF had they taken a more timely and aggressive supervisory approach regarding TCCU's concentration risks in its loan portfolio. We also determined NCUA could have coordinated more effectively with the California DFI, and not created a lack of continuity in the supervision of TCCU from an ever-shifting regional authority, which may have contributed to the lack of an aggressive approach.

[2] We consider TCCU's business strategy a separate but related contributor to the demise of the Credit Union, which is discussed in more detail later in the report.

As a result of our review, we made three observations as well as identified an issue related to CUSOs similar to one reported in a prior OIG MLR and are therefore re-emphasizing the corresponding recommendation. In addition, we are making two new recommendations. The first relates to higher capital requirements and the second relates to the adequate assessment and documentation of the analysis of the capital requirements.

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

INTRODUCTION AND BACKGROUND

The National Credit Union Administration Office of Inspector General contracted with Moss Adams, LLP to conduct an MLR for Telesis Community Credit Union, as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). TCCU was a state chartered credit union located in Chatsworth, California.

History of Telesis Community Credit Union

In 1965, NCUA chartered Telesis Community Credit Union under the Federal Credit Union Act as "Teledyne Employees Federal Credit Union." The original field of membership included employees of the three Teledyne Companies, but grew to include a geographic membership encompassing the area northeast of Los Angeles, as well as employees of over 500 businesses including the ancestors of the original Teledyne companies. Membership as of the March 2012 Call Report was 37.5 thousand with total assets of $301 million.

On October 2, 1998, NCUA granted TCCU an exception to the aggregate MBL limits in NCUA Rules and Regulations Part 723, because member business lending was the Credit Union's core business. In 1999, the Credit Union applied for and received a state charter from the California Department of Financial Institutions (California DFI).[3] Also at this time, the Credit Union changed its name to Telesis Community Credit Union,[4] and still retained its exception to the aggregate member business lending limits.

In 2002, TCCU established the Credit Union Business Partners (BP) CUSO as a single-member California limited-liability corporation. The TCCU EVP acted as the CUSO's registering agent and later became the CUSO's CEO. The Chairman of the Board for the CUSO was also the TCCU Chief Executive Officer.

The model behind BP was to participate and service MBLs originated by owner credit unions, including TCCU. By 2010, seventeen credit unions held equity in BP although TCCU remained the majority shareholder.

In 2007, TCCU purchased two additional CUSOs, AutoSeekers and Autoland.[5] The CEO of AutoSeekers at the time was a related party to TCCU's CEO. TCCU purchased AutoSeekers in April 2007 and disbanded it in December of the same year. Autoland showed consistent losses from the time of acquisition through conservatorship.

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[3] According to TCCU's 2010 Employee Handbook, this re-chartering was in response to restrictions on opportunity for field of membership expansion resulting from lawsuits initiated by the banking industry.
[4] In 1990, the Credit Union had undergone a name change from Teledyne Employees Federal Credit Union to Teledyne Federal Credit Union to reflect changing membership.
[5] TCCU assimilated AutoSeekers into the CU Indirect (CUID) CUSO and assimilated Autoland into the CUV, LLC CUSO.

For the year ended December 31, 2007, TCCU posted both its highest total revenue and expense since at least 2002. The result was a net loss of approximately $13.5 million. The Credit Union posted consistent net losses throughout the remainder of its operating life, 2009 through 2011, with an average net loss of approximately $10.8 million per year.

In January 2009, supervision of the Credit Union passed from Region V to the National Examination Team (NET),[6] where it remained for approximately one year. Supervision moved from the NET to Region III in January 2010.

In June 2010, the NCUA signed a Letter of Understanding and Agreement (LUA) with the Credit Union, which NCUA amended in May 2011 to allow NCUA to run the bidding process for a potential merger partner. NCUA held a bidders' meeting in November 2011, and NCUA's Office of the General Counsel approved an emergency merger. However, several weeks later, the Credit Union could not identify an appropriate merger partner.

In March 2012, the NCUA approved an NCUSIF-guaranteed line of credit for $73 million. Shortly thereafter, the NCUA authorized a temporary Cease and Desist Order and subsequently the California DFI placed the Credit Union under the conservatorship of the NCUA. On June 1, 2012, the California DFI placed Telesis into liquidation and appointed the NCUA as liquidating agent. Premier America Credit Union (Premier) of Chatsworth, California immediately purchased and assumed Telesis' members, deposits, core facilities, and consumer loans. NCUA estimated the loss to the NCUSIF at approximately $77 million; however, NCUA will not know the final cost until all assets are sold.

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[7] components, and reviewing qualitative and quantitative measures. NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the 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

[6] In response to the economic downturn, NCUA activated the National Examination Team (NET) in 2009. The team was a specialized group of examiners responsible for supervising credit unions experiencing difficulties as well as a select group of mostly more complex credit unions. NET was dissolved by NCUA on January 1, 2010.
[7] 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.

financial condition. At the conclusion of an examination, examiners assign a CAMEL rating.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[8] trend analysis,[9] reasonableness analysis,[10] variable data analysis,[11] and qualitative data analysis.[12] 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 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

[8] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[9] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[10] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[11] 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.
[12] 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.

- 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).[13] 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.[14]

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;

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 III office in Atlanta, Georgia. The scope of this review covered the period from January 2006 through conservatorship in March 2012.

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

- Completed the Risk Assessment, which included a review of the Exam Overviews as well as other risk considerations, including the CUSO subsidiaries and the effects of the CFR Part 723 Member Business Loan statutory exception to the aggregate loan limit.

[13] 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.
[14] 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.

- Prepared a chronology and summary table of regulatory examination, reviewed exam files, including exam reports, risk assessments, findings, documents of resolution, confidential sections, corrective actions, off-site monitoring, correspondence and analysis, and summarized findings.

- Reviewed the Board of Directors minutes and Board packets, as well as Supervisory Committee minutes provided. Also reviewed NCUA Board minutes related to the conservatorship of TCCU.

- Reviewed the external consolidated financial audits, related management letters, and member account verification reports, including results, findings and responses.

- Conducted interviews of key individuals involved with the examination and supervision of TCCU, including NCUA regional examiners and directors, Problem Case Officers, and an official from AMAC. We also interviewed examiners from the California DFI and an official of Premier, the financial institution that purchased certain assets of TCCU's during the liquidation process.

- Prepared industry and peer comparisons, correlations and ratios on a variety of factors including net worth, expenses, return on assets, net interest margins, loans, shares, and members.

- Evaluated loan activity by type and geography, as well as the methodology and calculation of loan loss provisions and allowances.

- Developed a timeline and summary of enforcement actions taken by the NCUA from 2006 through liquidation. Assessed NCUA supervision, considered the joint exams NCUA conducted with the California DFI, and evaluated the timeliness of supervisory actions, including examiner comments and findings, as well as communication and follow up procedures.

We relied upon the materials provided by the NCUA OIG and Region III officials, including information and other data collected during interviews as well as during examinations performed by the California DFI. Where appropriate, we also relied on information gathered from electronic files seized from TCCU Management.

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 review from June 2012 through March 2013, 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.

The scope of this audit included an analysis of TCCU from January 2006 to March 2012, the date the California DFI placed the Credit Union under the conservatorship of the NCUA. Our review also included an assessment of NCUA regulatory supervision during the same period.

RESULTS IN DETAIL

We determined that Telesis Community Credit Union's (TCCU) management and Board caused the failure and resulting loss to the NCUSIF. Specifically, TCCU management and Board made poor strategic decisions which led to an over reliance on member business lending, particularly in commercial real estate, and a dependence on fee and service income from its CUSO. Several other factors contributed to the demise of the Credit Union including management not establishing an appropriate ALLL methodology, and allowing for an excessive level of operating expenses. Although not a direct cause for the failure, we also determined management did a poor job over the acquisition of its CUSOs by not performing appropriate due diligence, and created the appearance of a conflict of interest in the CUSO acquisitions. We also determined NCUA could have prevented or mitigated the loss to the NCUSIF had they taken a more timely and aggressive supervisory approach regarding TCCU's concentration risks in its loan portfolio. In addition, we determined NCUA could have coordinated more effectively with the California DFI, and been more consistent when assigning supervisory responsibility of the Credit Union.

A. Why Telesis Community Credit Union Failed

Heavy Loan Concentration in MBLs Led to TCCU's Failure

TCCU maintained a heavy concentration in member business loans, particularly commercial real estate loans. TCCU held an NCUA Rules and Regulations Part 723 exception granted by NCUA during the period when TCCU was a federally chartered credit union. The Credit Union retained this exception when it later became a state chartered credit union. The Credit Union leveraged this exception to originate a number of large business loans with industry and geographic concentrations in areas vulnerable to economic downturns. TCCU management contributed to the Credit Union's demise by using an inappropriate ALLL methodology for reserving for the MBLs by using estimates that were dependent on historical factors that did not reflect rapid changes in economic conditions.

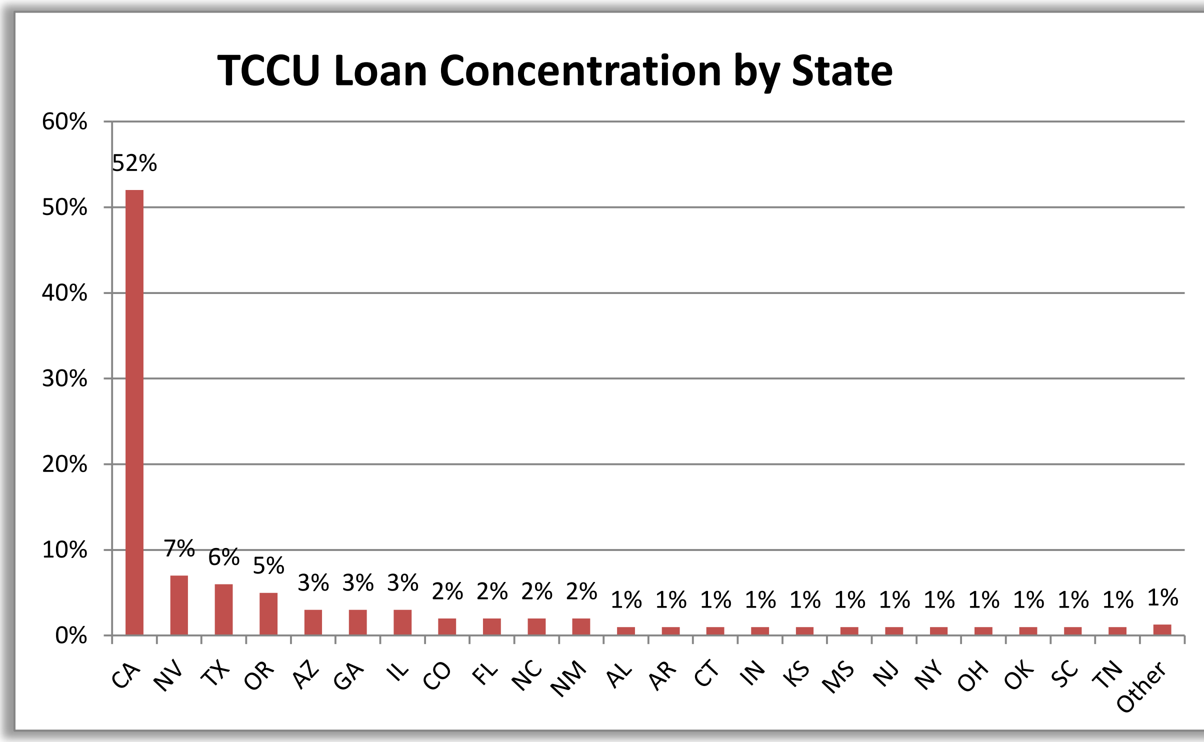
Our analysis of TCCU's Financial Performance Reports (FPRs) noted that from 2006 to 2011, the Credit Union's loans averaged 118 percent of shares, an amount significantly higher than the industry average of 77 percent for the same period. In order to originate loans, TCCU borrowed from the Federal Home Loan Bank (FHLB) and Western Corporate Credit Union, which resulted in significant borrowing costs. Additionally, in the September 2011 examination (Effective), examiners noted the necessity to pledge loans as collateral created pressure to inflate their grading. The fact that TCCU failed to adopt a policy to appropriately grade substandard loans in response to the DOR issued during the December 2009 examination (Effective) corroborates this.

Further, we determined that TCCU commonly used loan terms based on a five-year balloon structure in order to generate fees. Regional officials told us they believed

TCCU grew too fast, continuing to originate loans although the Credit Union began modifying loans as early as 2006. The result was a balance sheet susceptible to economic downturns.

In addition to the overall size of TCCU's portfolio, its geographic profile presented significant risk. During our inspection of the BP loan trial balance obtained during the 2010 NCUA CUSO review, we determined that the majority of the loans were to businesses located in California (52%), with additional loans originated to businesses in Nevada (7%), Arizona (3%), and Florida (2%). Each of these states experienced significant commercial real estate contraction during the economic downturn. Table 1 (below) presents TCCU's loan concentration percentage by state.

Table 1



Conversely, we noted that TCCU's overall portfolio showed loans in 29 states.[15] Such a wide dispersion indicates that management was branching into areas outside of its area of geographic expertise.[16]

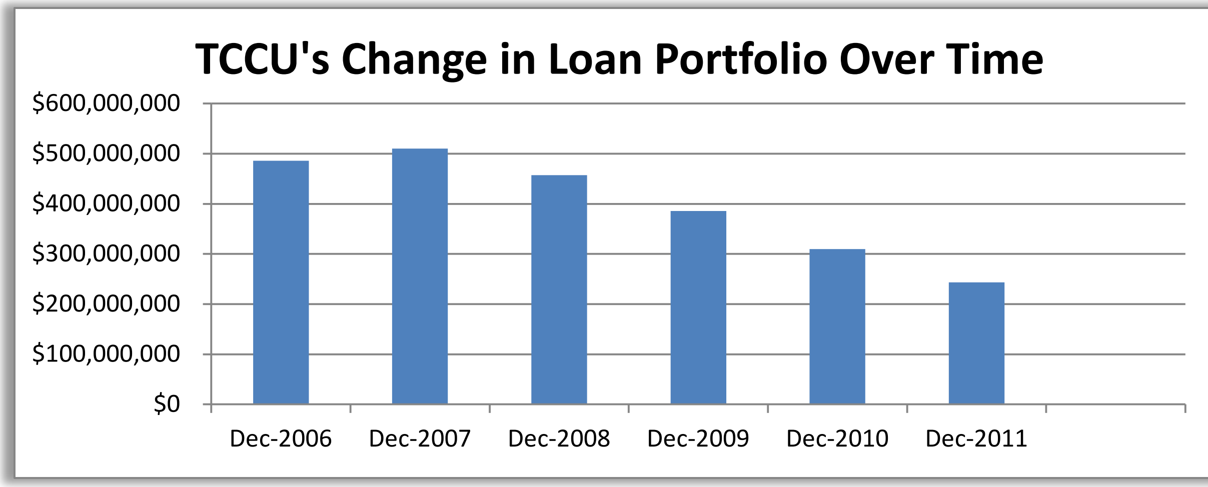
We determined that examiners were aware of the risk presented by the MBL portfolio. Specifically, the September 2007 examination (Effective) noted concerns

[15] Table 1 includes only those loans originated by TCCU.
[16] The category "Other" in Table 1 includes Idaho, Montana, South Dakota, Utah, Washington, and Wyoming, each of which represented less than 1 percent of the total portfolio and for clarity, are shown in aggregate.

about concentration risk related to individual borrowers and to CRE loans in general, which were $274.8 million, or 44 percent of assets. The examiner noted that the sub-prime meltdown could affect commercial real estate and that TCCU was at particular risk. As predicted by the examiners, between 2007 and 2011, TCCU had difficulty generating income because of high loan losses and decreased loan demand, which resulted in lower loan and fee income. As discussed elsewhere in this report, excessive operating costs amplified the effect of the downturn on net worth.

Part 702 of the NCUA Rules and Regulations specify mandatory and discretionary actions based on net worth categories. Therefore, the net worth ratio takes on particular significance for the credit union industry. In the face of eroding net worth, TCCU management compensated by adopting a strategy of decreasing total assets. Our review of TCCU's loan portfolio during this period showed a significant decrease in the total loan portfolio as shown in Table 2.

Table 2



Examiners concluded that this strategy eliminated TCCU's healthy loans from the portfolio, which were attractive to buyers, leaving only the underperforming loans. By 2012, delinquencies had risen to twice the net worth of the Credit Union.

Inaccurate Allowance for Loan and Lease Loss Calculations

Inherently, a large MBL portfolio covering a wide geographic area presents a valuation risk and requires a robust methodology for calculating the ALLL. TCCU's calculations included inappropriate assumptions about individually considered loans and relied upon historical trends, which did not reflect actual conditions, to anticipate losses in loan pools.

Regarding TCCU's ALLL issues, we determined that examiners commented on the ALLL in every examination conducted, with the severity and frequency of their comments increasing as time went forward. As previously noted, many of the issues related to TCCU's ALLL were due to failure in impairing individual loans and using an inappropriate basis for loss projections on loan pools. For instance, examiners noted in several examinations between December 2006 and 2009 that the Credit Union consistently used historical factors that were not a realistic reflection of prevailing economic conditions. TCCU was applying a zero percent historical loss rate over MBLs based on three-year historical data when current delinquency data internally and industry-wide predicted significantly higher loss rates.

Examiners noted the following in the September 2008 examination:

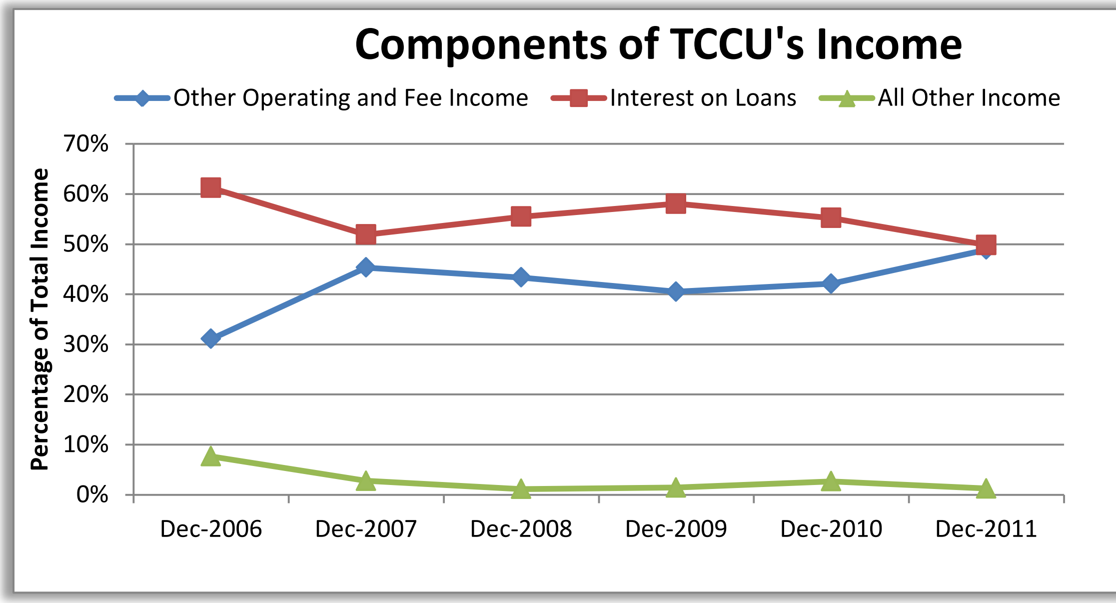
> *"The ALLL methodology and adequacy of funding does not adequately address and prepare the credit union for the potential loan losses in 2009. The contention that the credit union has not suffered sufficient historical losses in many of these pools does not provide any assurance it will not in the future; in fact, recent events across the entire savings, thrift, and credit union industry have proven this theory flawed. The loan portfolio contains very large and complex loans that could cause sudden and material effects on the credit union's net income; from relatively little charge offs. Methodology was revised and additional $6M funding done at 12/31/08."*

TCCU's ALLL grew from $1.2 million in 2006 to $23.7 million in 2011, which included $8 million in adjustments required by examiners and external auditors. In September 2011, examiners noted that since December 31, 2009, TCCU had reduced assets through Federal Home Loan Bank (FHLB) borrowing pay offs and run-off of brokered certificates of deposit. This resulted in a reduction of assets from $478.7 million to $334.1 million. As discussed above, management culled the best performing loans, leaving a smaller and less healthy CRE portfolio with an underfunded ALLL.

TCCU's Business Model and Strategy Lacked Judgment

As previously mentioned, TCCU relied upon a single product – business loans – to generate most of its interest income, which was but one strategy among several management developed without sufficient consideration and judgment. Another TCCU management strategy relied on the Credit Union's majority-held CUSO, Credit Union Business Partners (BP). BP sold loan participations and generated servicing income from loans originated by TCCU and other shareholders. As shown in Table 3 (below), from 2006 to 2011, Other Operating Income and Fees accounted for nearly 50 percent of the Credit Union's total income, indicating management relied heavily on sources of income outside of their loan portfolio.

Table 3



Following 2007, the Credit Union's operating income, fee income, and interest on loans all declined sharply, which began the degradation of TCCU's net worth and consequently, its net worth ratio. TCCU's lending strategy led to a situation where the economy restricted options to participate and service loans. To maintain its net worth ratio and stave off regulatory action, TCCU sold its loans, thus reducing its capacity to generate its main source of income – loan interest.

TCCU management's strategic missteps were not solely limited to the MBL arm of the Credit Union. In 2007, the Credit Union acquired the AutoSeekers CUSO without conducting a comprehensive financial and operational analysis and did not follow the due diligence guidance provided by NCUA in a Letter to Credit Unions.[17] The CUSO was disbanded later that same year and TCCU purchased another CUSO, Autoland, again without performing appropriate due diligence. Purchasing Autoland was intended to exploit "opportunities" to capture the auto lending market share; however, there was no assessment to identify adverse effects from this purchase on TCCU's financial condition. As a result, in 2008 and 2009, auditors recognized impairments related to goodwill and trademark/logo acquired in this purchase. Losses were $2.0 million and $2.1 million, respectively.[18]

Autoland was never profitable to TCCU. Despite examiner recommendations that it be divested, it remained a part of TCCU through cessation.

[17] Letter to Credit Unions 01-CU-20, "*Due Diligence Over Third Party Service Providers*."
[18] This report discusses other issues related to the purchases of the AutoSeekers and Autoland CUSOs in the Management Decisions and Board Oversight section of this report.

Questionable Management Decisions and Board Oversight

We determined TCCU's management and Board made a series of questionable decisions. Specifically, examiners noted poor internal controls in the December 2009 examination (Effective), which observed that the internal audit function was neither adequate nor effective, and that the internal audit manager did not provide written recommendations or findings to the Supervisory Committee or Board of Directors. The internal auditor reported directly to the CFO.

In addition, when TCCU acquired the AutoSeekers and Autoland CUSOs in 2007, the CEO of AutoSeekers was related to the CEO of TCCU, which we believe raises the question of whether the purchase of Autoseekers constituted an arm's length transaction. We noted no discussion of this potential conflict of interest in the TCCU Board minutes.

Like AutoSeekers, Autoland was acquired without appropriate due diligence, and NCUA examiners and Regional officials told us they believe that TCCU purchased both AutoSeekers and Autoland for the benefit of the related party. Although we found no evidence to substantiate the examiners' and Regional officials' belief, we were able to determine that no discussions surrounding potential conflicts of interest ever took place among members of the TCCU Board.

In a related transaction, TCCU management extended a $1.2 million line of credit (LOC) to the unprofitable Autoland in 2008. In 2009, this LOC was upgraded to $5 million dollars. In both cases, TCCU's CEO, who also acted as Chairperson of the Autoland Board, approved the LOCs. Although we found no evidence that the initial LOC was approved by the TCCU Board, our review of the June 2009 Board minutes revealed that the Board approved the LOC upgrade, and actually increased it from the $4 million originally requested to $5 million.

Examiners also noted that conflicts of interest existed in the organization of the BP CUSO where the TCCU CEO served as Chairperson of the Board and the TCCU EVP served as CEO. Further, examiners noted that BP held shares equal to $12 million at TCCU. This deposit was well over the insured limit at a time when TCCU was known to be under-capitalized, indicating that decisions were undertaken that did not satisfy the requirement of an arm's length transaction.

Based on our review of TCCU's Board minutes, we concluded that managerial decisions were concentrated in two people, the CEO and the EVP, with very little depth or reliance on the skills of the rest of the Credit Union's staff. The CEO appears to have had a persuasive and aggressive management style. The CEO was well known in the industry and viewed as strategically successful, particularly due to the historical success of BP. Thus, the Board tended to follow her recommendations with little discussion.

We found some of the minutes for both the Board and the Supervisory Committee were missing. Although the packets we did obtain contained voluminous reports, we found very little substantive discussion related to strategy, risk management, or related party activity. We were also unable to identify diligent follow-up on issues raised by examiners. We were told that the delivery of packets to Board members was so late that a thorough read and understanding of the details and trends was unlikely.

We found evidence the CEO controlled information through a misleading statement communicated in the Treasurer's report, which was recorded in the TCCU Annual Meeting minutes dated May 25, 2011. The minutes noted the following excerpt from the Treasurer's report:

> *"[T]elesis continues to be a strong, safe and stable institution, serving over 38,000 members. In 2010, we returned nearly $3.5 million in the form of dividends to those members, and we continued to be a well-capitalized institution. Telesis continues to meet the challenges of the unpredictable economy while always remembering to put our members first; holding firm to the cooperative spirit of 'people helping people."*

TCCU was under an LUA at the time, which was followed by the temporary Cease and Desist Order issued in March 2012.

In carrying out its fiduciary duty first as Conservator, then as Liquidator, NCUA seized files from TCCU. Within these documents, we noted a response made by the TCCU Human Resource Director (HRD) to allegations made by the EVP in September and October 2011 (during the period when NCUA approved an emergency merger) against the CEO. These included assertions that the CEO had acted unethically and threatened retaliatory action against the EVP. For those allegations investigated directly by the HRD, he concluded there was no supporting evidence. We believe such infighting between the two most senior members of management reflects a failure to put the needs of the members first during a period when the Credit Union most needed clear leadership.

Although we cannot quantify the effects of questionable decisions made by management or the apparent lack of oversight by the Board, it is reasonable to assert that the evidence indicates ineffective Board oversight contributed to poor strategic decisions at TCCU.

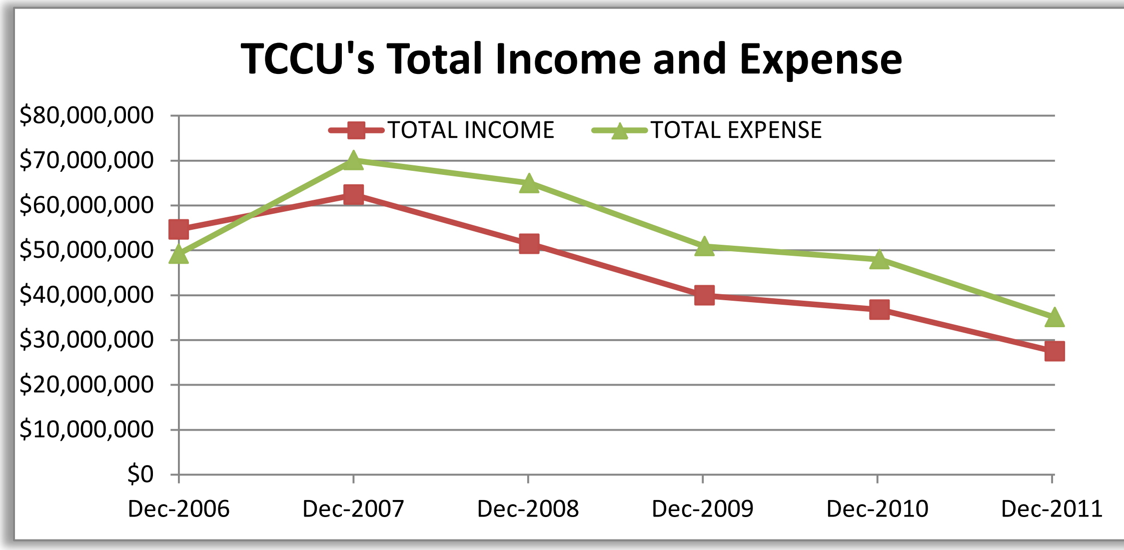
Excessive Operating Expenses

TCCU's operating expenses were higher than industry standards. TCCU experienced adjustments to its ALLL and impairments of its intangible assets; however, we determined TCCU had more rapid growth of operating expenses versus revenue prior to these adjustments, a trend that continued through the period up to December 2007, when income was increasing. Further, once income began to fall, expenses failed to decline as quickly, continuing the degradation of net worth.

TCCU's total expenses exceeded its ability to generate revenue. We determined that the last time TCCU's total revenues exceeded their total expenses (by $5.4

million) was in 2006. By 2007, the year when revenues reached their peak, TCCU's total expenses exceeded total revenues by $7.6 million and continued to exceed revenues by an average of $10.2 million per year throughout the remainder of the Credit Union's existence. Table 4 (below) presents TCCU's total income and expenses from 2006 through 2011.

Table 4



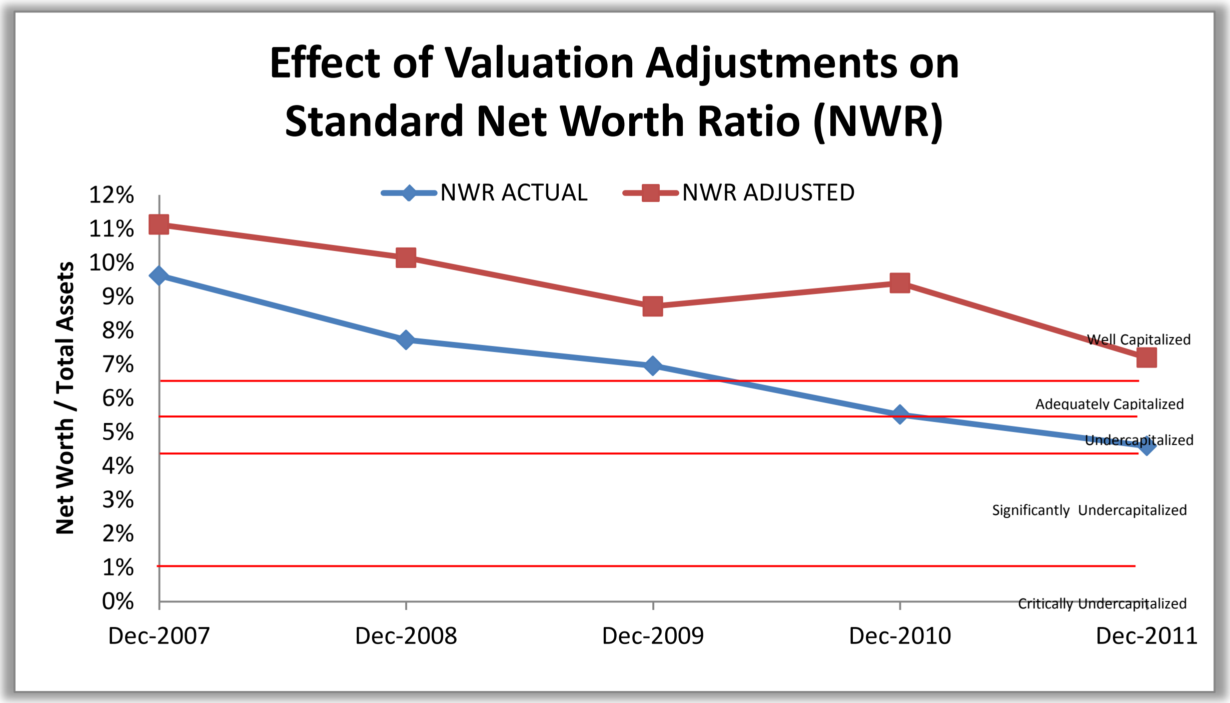
During the September 30, 2008 examination (Effective), NET examiners identified an inadequate operating budget, high operating expenses, a lack of full and fair disclosure related to goodwill/intangible asset impairments and the ALLL (management changed its methodology for impairment resulting in a decrease in ALLL). In addition, examiners noted other areas of concern including high cost of funds, insufficient alternative sources of liquidity, deficient loan administration practices, and the lack of discussion in Board meetings on operating expenses, despite the fact that said expenses were contributing substantially to the negative earnings.

Examiners also noted in the September 2008 examination that the 2009 budget projected a loss of $5.6 million, with a significant rise in operating costs due to an increase of $2.4 million in salary expense. Of that amount, examiners noted that $1.7 million related to the new retirement plan for the CEO and EVP.

Through our review of NCUA working papers, we learned that TCCU management contributed further to the excessive operating costs by constructing two buildings that were far bigger than necessary and the construction costs went far over budget because material costs, particularly steel costs, were not set prior to building and increased dramatically during the period of construction.

In order to determine the effects of operating costs independent of valuation adjustments, we prepared an analysis of the trend in the net worth ratio eliminating the provision for loan and lease losses expense and the two intangible asset impairments related to the CUSO.[19] Table 5 (below) presents the effect the valuation adjustments had on TCCU's net worth ratio for the period from 2007 through 2011.

Table 5



The result of this analysis demonstrates that operating expenses were excessive relative to income. This analysis also supports our earlier assertion that the business model of the Credit Union did not properly consider the potential effects of over-reliance on business lending and dependence on fee revenue from the BP CUSO. When the sub-prime meltdown began, revenues declined sharply. Operating expenses, which were excessive, could not change direction as swiftly, contributing to consistent net losses as previously shown in Table 4.

[19] Table 5 assumes no provision for loan and lease loss expense. Realistically, we could expect some level of provision for loan and lease losses as part of normal operations for a credit union. We therefore consider our calculations to be conservative.

B. NCUA Supervision of Telesis Community Credit Union

NCUA Could Have Prevented or Mitigated the Loss to the NCUSIF

We determined NCUA could have prevented or mitigated the loss to the NCUSIF had they taken a more timely and aggressive approach regarding TCCU's concentration risks in its MBL portfolio. We also determined NCUA could have coordinated more effectively with the California DFI, and that NCUA management created a lack of continuity in the supervision of TCCU from an ever-shifting regional authority, which may have contributed to the lack of an aggressive approach.

Supervisory Background

TCCU received a CAMEL Composite rating of 2 in the December 31, 2006 examination (Effective), an indication of strong performance. Examiners noted the Credit Union's deterioration beginning with the next examination, the September 30, 2007 examination (Effective), when they downgraded the Credit Union's CAMEL Composite to 4. Examiners kept the Credit Union's Composite CAMEL rating at 4 until the June 30, 2011 examination (Effective), when they downgraded it to a Composite Camel rating of 5. The Credit Union remained a Composite CAMEL 5 through liquidation in 2012. Table 6 (below) provides Composite and specific CAMEL ratings for the applicable examinations during the scope period of our review.

Table 6

NCUA Examination Results for TCCU**								
Examination Effective Date	Region	Type[20]	CAMEL NCUA Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2006	Region V	11	2	1	2	2	2	2
September 2007	Region V	23	4	3	3	4	4	4
March 2008	Region V	23	4	3	3	4	4	4
June 2008	Region V	23	4	3	3	4	4	4
September 2008	NET	11	4	3	3	4	4	4
June 2009	NET	23	4	3	3	4	4	4
September 2009	NET	23	4	3	3	4	4	4
January 2010	Region III	11	4	4	5	4	5	4
March 2010	Region III	23	4	4	4	4	5	4
June 2010	Region III	23	4	4	5	4	5	4
June 2011	Region III	23	5	5	5	5	5	4
October 2011	Region III	11	5	5	5	5	5	4
March 2012	Region III	23	5	5	5	5	5	5

***Examination information provided by NCUA's Region III.*

<u>Part 723 Exception and Loan Concentration</u>

NCUA granted TCCU an exception to NCUA Rules and Regulations Part 723 for aggregate MBL limits during its time as a federally chartered credit union, on the basis that member business lending was its primary occupation. TCCU retained this exception following its move to a state charter. The exception allowed the Credit Union to originate member business loans above the aggregate limitations imposed by Part 723 without the ability of NCUA to revoke this status directly.

We determined TCCU's loan concentrations and degradation of the quality of the loan portfolio were the main cause of the demise of the Credit Union. The California DFI cited the rise of delinquencies to an amount greater than that of the Credit Union's total net worth among its reasons for issuing the Order of Conservation in March 2012.

We found no evidence that the NCUA directly communicated a recommendation to the California DFI to rescind or modify the exception until NCUA examiners issued an LUA in June 2010. We believe such an act prior to 2007 may have slowed the

[20] Work Classification Code (WCC) Examination Type 11 is an examination or insurance review of a state-chartered credit union. WCC Type 23 is a supervision contact of state-chartered credit union.

growth of both TCCU's operations and its loan portfolio, which ultimately may have prevented or mitigated the loss incurred by the NCUSIF.

Timing and Level of Enforcement Actions

We noted that NCUA examiner's enforcement actions were not timely or aggressive in limiting the loss to the NCUSIF. Despite examiner concerns prior to the LUA signed in June 2010 regarding loan quality, the ALLL methodology, high operating expense, and deteriorating net worth, only Documents of Resolution (DORs) were issued to TCCU to correct identified safety and soundness concerns.

Region V examiners gave TCCU a Composite CAMEL rating of 2 during the December 2006 examination (Effective), which declined to a Composite CAMEL 4 in the September 2007 examination (Effective), a significant decline. The subsequent September 2008 examination (Effective) performed by the NET again resulted in a Composite CAMEL rating of 4, with examiners issuing DORs to correct identified issues but no formal enforcement action.

During the September 2007 examination (Effective), examiners identified rapidly declining trends in net worth and loan quality. We believe these declining trends coupled with the severe economic downturn and TCCU's heavy concentration in MBLs should have prompted examiners to take immediate and more aggressive action. However, these same trends continued and examiners again noted them during the March and September 2008 examinations (Effective). Ultimately, we determined examiners took no formal corrective action at the conclusion of each of these examinations.

During our review, we noted examiners expressed frustration in NCUA's reliance on 6 percent to define an "adequately capitalized" institution. In the case of TCCU, examiners estimated that the capital needed to support the risk in TCCU's heavily concentrated loan portfolio would have needed to be at least 15 percent. As previously mentioned, TCCU management controlled its balance sheet to maintain an adequately capitalized status. Examiners told us they felt they had no grounds to employ enforcement actions until TCCU broke the 6 percent adequately capitalized benchmark. However, our review of NCUA Rules and Regulations does not support the examiner's stance. Although there are mandated actions resulting from a status of adequately capitalized and below, Section 702.1 of the NCUA Rules and Regulations specifies the following:

> *[N]either § 1790d[21] nor this part in any way limits the authority of the NCUA Board or appropriate State official under any other provision of law to take additional supervisory actions to address unsafe or unsound practices or conditions, or violations of applicable law or regulations. Action taken under this part may be*

[21] This footnote is in Section 702.1 of NCUA Rules and Regulations and refers to the Federal Credit Union Act.

taken independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA Board or appropriate State official, including issuance of cease and desist orders, orders of prohibition, suspension and removal, or assessment of civil money penalties, or any other actions authorized by law.

We believe once NCUA and the California DFI took a more aggressive approach, their actions were not swift and forceful and appeared to be more reactive than proactive. For example, TCCU signed an LUA developed in conjunction with NCUA in June 2010, shortly after oversight of TCCU had moved to Region III. After nearly one year, in May 2011, the parties amended the LUA to allow the NCUA to run the bidding process for a potential merger partner. NCUA held the first bidders meeting six months later in November 2011, however the meeting yielded no merger partners.[22] The Credit Union continued to languish when NCUA began the process to conserve but halted their efforts when the California DFI advised NCUA that they would take the lead to conserve TCCU. In March 2012, nearly two years after taking a more aggressive approach, the California DFI conserved TCCU and appointed NCUA as conservator.

Coordination with State Oversight Agency

Based on our review of the examinations conducted for the period under scope, we noted poor coordination between the NCUA and the California DFI. We found the documentation in the NCUA examination working papers was overly broad in its description of the extent and type of work performed by each agency during the examinations, failed to record discussions held between the NCUA and the California DFI, and did not assign responsibilities for follow-up or enforcement. Based on available information, we determined that the NCUA and California DFI each performed approximately half of the total test work between January 2006 and March 2012.[23]

In addition, NCUA officials indicated that once they had determined an appropriate enforcement action, the California DFI sent mixed messages regarding whether they would agree to the NCUA examiners' recommendations and took considerable time to negotiate a final resolution. NCUA officials also stated that for the NCUA to take an action independently from a state oversight agency, in this case the California DFI, it would be a long and difficult process.

Conversely, a DFI official stated that the NCUA process to enforce conservatorship requires many steps with final approval necessary by the NCUA Board. The official

[22] NCUA was able to use the bids from the November bidder's meeting to negotiate the eventual liquidation and Purchase and Assumption (P&A) in June 2012 with Premier.
[23] During fieldwork, NCUA provided only examination working papers prepared by NCUA examiners; however, Region III officials noted that from 2010 to 2012, they performed a majority of the examination work due to resource limitations in the California DFI.

indicated this last step requires coordination with the Board's meeting schedule, which caused further delays.[24]

We found very little documentation in the working papers to support the NCUA's or the California DFI's positions noted above. However, had there been better documentation and, more importantly, better coordination between the California DFI and the NCUA, we believe there would have been more timely actions taken, which may have mitigated the loss to the NCUSIF.

Continuity of NCUA Oversight

During the scope period of this review, TCCU successively came under the jurisdiction and thus the supervision of three separate examination units within the NCUA: Region V (2006-2008), the National Exam Team (2009), and Region III (2010-2012). Data was insufficient to determine whether the unusual succession of examiners resulted in additional delays. However, we concluded there appeared to be reasonable communication between examiners from among the different regions. In addition, we also found that examination rigor and the frequency and aggressiveness of Document of Resolution comments increased as time passed and oversight of the Credit Union progressed successively from Region V to the NET to Region III.[25]

Although NCUA successfully handed-off TCCU internally during its supervision, we believe it is reasonable to presume that the lack of continuity was not in the best interest of satisfying the NCUA's goal of providing optimal oversight for the Credit Union. In addition, we believe NCUA's ever-shifting regional authority may have resulted in the aforementioned lack of a more timely and aggressive supervisory approach to address the safety and soundness concerns identified as far back as 2007.

OBSERVATIONS

Important observations from the failure of TCCU include:

- When examination officials make the decision to use enforcement actions, those actions must be executed swiftly and firmly at all levels to effect genuine corrective action. The issues identified during TCCU's supervision that represented safety and soundness concerns should have been elevated to a higher level of enforcement action sooner.

- NCUA's actions to shift oversight responsibilities within the agency, as well as conflicts of oversight between NCUA and the California DFI may have

[24] NCUA Regulations, Section 791.5, allows special meetings to be held upon the Board Chairman's initiative or within fourteen days of an appropriately supported request from two Board members.
[25] We were unable to determine whether this trend related to differences between regional offices or the increasing difficulties experienced by the Credit Union.

inhibited a more aggressive approach. Although NCUA seamlessly transitioned oversight of TCCU between regional offices and the NET, we believe the number of changes in supervision inherently presented obstacles to taking more aggressive enforcement actions.

- The results of our inquiry of both NCUA and the California DFI determined there was little collaboration in the approach to taking enforcement actions against TCCU, as evidenced by the lack of correspondence documentation regarding enforcement actions with the California DFI in NCUA's examination working papers. We believe such documentation would have allowed for a clear audit trail of any discussions and actions taken between NCUA and the California DFI.

RECOMMENDATIONS

The *Examiner's Guide*, Chapter 25, notes that examiners may consider recommending a CUSO review if an examination of an affiliated credit union shows the financial condition of the CUSO significantly affects the operation of the credit union. [26]

Examiners issued a DOR on September 30, 2007 (Effective) requiring TCCU to "meet or exceed" BP's budgeted net income, evidencing that NCUA considered the financial condition of the BP CUSO important to the operation of TCCU. However, NCUA examiners did not review the BP CUSO until December 31, 2010 (Effective), although earlier examinations did review aspects of the lending process undertaken at BP.

We do not consider the lack of a timely CUSO review to have been a major contributor to the failure of TCCU, nor do we consider it likely that an earlier review of the BP CUSO would have reduced the loss to the NCUSIF. However, we do believe that examiners should have conducted a review of the CUSO to determine the level of risk posed by the CUSO given the relationship between the two CEOs, and the financial relationship between the two institutions.

We noted a similar failure by examiners to perform a timely CUSO review in OIG Report #OIG-12-14, *Material Loss Review of Eastern New York Federal Credit Union*, where the OIG reported that a timely review would have reduced the overall loss. Given that examiners in both cases failed to perform appropriate reviews, we consider it important to reemphasize the Recommendation from that report:

> *"[R]eview current examination procedures over CUSOs to not only ensure regulatory compliance but most importantly, to determine*

[26] The Examiner's Guide includes other reasons examiners can recommend a CUSO review; which are not directly relevant to this MLR.

whether current procedures are adequate to identify the degree of risk the CUSO poses to the affiliated credit union."

Management Response

Management reiterated their response to the reemphasized recommendation from OIG Report #OIG-12-14, which stated they agreed that examination procedures should ensure regulatory compliance and adequately identify the degree of risk a CUSO poses to an affiliated credit union. Management also indicated they will evaluate the feasibility of expanding examination procedures over CUSOs and whether to include a review of the credit union and CUSO as standalone entities with regards to profitability. Management's entire response is provided in Appendix A.

OIG Response

We concur with management's response.

In addition, we recognize that NCUA management does not have the latitude to adjust current net worth levels because such levels are driven by statute. However, to more effectively capture the concentration and other risks on an institution's balance sheet, we are making the following two recommendations:

1. We recommend NCUA management identify and amend, as applicable, NCUA Rules and Regulations to require a higher level of risk based net worth for credit unions with higher levels of concentration or other risks in their member business loan portfolio.

Management Response

Management agreed and in 2013 plans to make appropriate amendments to NCUA Rules and Regulations to require a higher level of risk based net worth for credit unions with a higher level of concentration or other risks in their member business loan portfolio.

OIG Response

We concur with management's planned actions.

2. We recommend NCUA management ensure that for those credit unions identified as having higher levels of concentration or other risks as outlined in Recommendation 1 above, examiners should specifically assess the risks and adequately document their review and analysis in the examination working papers.

Management Response

Management agreed citing several tools examiners use to identify and monitor risk, including concentration risk in credit unions. Management indicated they will continue to reinforce their expectation with examiners to document concentration risk and risk conclusions. Management also indicated they plan to reinforce with examiners analyzing appropriate capital levels through training.

OIG Response

We concur with management's planned actions.

Appendix A – NCUA Management Response

National Credit Union Administration
Office of Examination and Insurance

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SENT BY E-MAIL

TO: Inspector General William DeSarno

FROM: Executive Director Mark Treichel

SUBJ: Comments on Material Loss Review of Telesis Community Credit Union #68396

DATE: March 12, 2013

This memorandum responds to your request for official comments on the Office of Inspector General's (OIG) revised draft report titled Material Loss Review (MLR) of Telesis Community Credit Union #68396.

MLR Report Recommendations
The MLR reemphasizes the following recommendation from the MLR of Eastern New York Financial FCU:

- *Review current examination procedures over Credit Union Service Organizations (CUSOs) to not only ensure regulatory compliance but most importantly, to determine whether current procedures are adequate to identify the degree of risk the CUSO poses to the affiliated credit union.*

As noted in that MLR, OIG concurs with the actions taken or planned by NCUA management in relation to this recommendation. Below is our official response to this recommendation that was including in the MLR of Eastern New York Financial FCU.

> **Response:** We agree examination procedures should ensure regulatory compliance and adequately identify the degree of risk a CUSO poses to an affiliated credit union. Chapter 25 of the Examiner's Guide outlines examination procedures regarding CUSOs. One of the examination objectives is to determine the degree of risk the CUSO poses to the affiliated credit union.
>
> Within the last year, and after the exam period in question, NCUA expanded the Scope Workbook including CUSO examination steps as well as a CUSO questionnaire. We believe there is currently sound direction regarding which CUSO related information should be reviewed during each examination. However, guidance does not require a review of a credit union's ability to generate income independent of its CUSOs, which was a key issue with Eastern NY. We will evaluate the feasibility of expanding

1775 Duke Street - Alexandria, VA 22314-3428 - 703-518-6300 examination procedures over CUSOs, and whether to include a review of the credit union and CUSO as standalone entities with regards to profitability. Examiners may currently review Schedule C on the 5300 Call Report to see a breakout of income for wholly-owned CUSOs.

NCUA does not have regulatory authority over CUSOs, although proposed changes to Part 712 of NCUA's Rules and Regulations would require all CUSOs to file financial reports directly with NCUA. Currently, Part 712 requires an FCU, prior to investing in or lending to the CUSO, obtain written agreements that require the CUSO to provide NCUA and its representatives with complete access to any books and records of the CUSO and the ability to review CUSO internal controls, as deemed necessary. Chapter 7, Section 1 of the NSPM states examiners are responsible for identifying potential problems in CUSO-provided services based on information gathered during routine credit union reviews and insurance reviews. Information normally reviewed includes financial statements and audit reports. Examiners should make a determination regarding the financial health of the CUSO if it provides a material amount of income to the credit union. If deemed necessary, NCUA may perform a CUSO review following guidance in Chapter 25 of the Examiner's Guide and Chapter 7 of the NSPM.

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

1. *We recommend NCUA management identify and amend, as applicable, NCUA Rules and Regulations to require a higher level of risk based net worth for credit unions with higher levels of concentration or other risks in their member business loan portfolio.*

   Response: We agree. NCUA has latitude to adjust risk based net worth components under Part 702 of NCUA's Rules and Regulations. We are currently reviewing Part 702 in relation to risk based net worth requirements to improve the efficacy of the risk based net worth schema in several areas, especially pertaining to risk concentrations like member business loan (MBL) concentrations. We plan to make appropriate adjustments during 2013.

2. *We recommend NCUA management ensure that for those credit unions identified as having higher levels of concentration or other risks as outlined in Recommendation 1 above, examiners should specifically assess the risks and adequately document their review and analysis in the examination working papers.*

   Response: We agree. NCUA makes use of several tools to identify and monitor risk, including concentration risk in credit unions. As an example, our internal risk reporting tools dedicate three specific reports to MBL growth and concentrations, as well as a separate concentration report that identifies concentrations in all real estate related assets. In addition, we now have a risk report historical trend tool that allows examiners to identify negative trends over time throughout our suite of risk triggers. The examination process requires examiners to identify and address those areas for review that present as risks in our risk reporting regimen. AIRES examination software permits both a historical trending and a prospective view of risk. We will continue to reinforce our expectation that examiners document concentration risk and risk conclusions, and plan to reinforce analyzing appropriate capital levels, via training, as part of our revisions to Part 702.

Thank you for the opportunity to comment.

cc: DED Kutchey
DEI Fazio
DDEI Segerson
DRM Komyathy
RD Yolles
ARDO Toeppe
ARDP Hibshman
DIG Hagen
OIG Senior Auditor Bruns
AMAC President Barton
GC McKenna
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