NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW

OF

TAUPA LITHUANIAN CREDIT UNION

Report #OIG-14-06

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ACRONYMS AND ABBREVIATIONS

AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
AMAC	Asset Management Assistance Center
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
CDs	Certificates of Deposit
CPA	Certified Public Accountant
Credit Union	Taupa Lithuanian Credit Union
DFI	Department of Financial Institutions
DOR	Document of Resolution
EIC	Examiner-in-Charge
FCU Act	Federal Credit Union Act
FISCU	Federally Insured State-chartered Credit Union
FPR	Financial Performance Report
FRB	Federal Reserve Bank
GAGAS	Generally Accepted Government Auditing Standards
Taupa	Taupa Lithuanian Credit Union
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RFE	Risk-Focused Examination
SSA	State Supervisory Authority
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 Taupa Lithuanian Credit Union (Taupa or the Credit Union). Taupa was a federally insured state-chartered credit union located in Cleveland, Ohio. We reviewed Taupa to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated $33.5 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 and Ohio Department of Financial Institutions (DFI or Ohio SSA) examination and supervision reports, as well as related correspondence. We interviewed NCUA and Ohio SSA officials and regional staff, and reviewed NCUA guidance, including regional policies and procedures, NCUA 5300 Call Reports (Call Reports) and Financial Performance Reports (FPRs).

Examiners in this report refer to both SSA and NCUA examiners, unless otherwise noted.

We determined Taupa failed primarily due to management fraudulently overstating assets, specifically cash on deposit, and understating shares. According to the Call Report filed just prior to the discovery of the fraud, the Credit Union reported total assets of approximately $24 million, and total liabilities of $21 million, which Credit Union management reported were comprised almost entirely of member shares. When Ohio SSA and NCUA Region III officials discovered the fraud and determined the Credit Union to be insolvent, the Ohio SSA liquidated Taupa Lithuanian Credit Union on July 15, 2013, and appointed NCUA as liquidating agent.

The following factors created an environment in which such overstatement of assets could go undetected.

- <u>Lack of Management Integrity and Inaccurate Financial Reporting</u>

  We determined that Taupa management did not conduct the business of the Credit Union in the best interest of its members and, in fact, committed fraud. Specifically, examiners discovered assets overstated by approximately $15.5 million, which Taupa management fraudulently reported as cash on deposit at Corporate One Federal Credit Union, and noted an $18 million share understatement, altered documents, inaccurate Call Reports, and other suspicious transactions.

- Inadequate Board Oversight

  We believe Taupa's Board failed in their responsibilities to oversee the activities of the Credit Union. Our review of the Board minutes concluded that minutes were missing for some months and that the CEO was frequently absent from Board meetings. The Treasurer presented the financial reports to the Board where large swings in income, projections, and operating results went unchallenged. We found the Board had not signed off on some minutes and Board discussion notes were very limited with regard to audit and exam results or follow-up. We also found no substantive discussion related to policy reviews, risk management, or strategy. Examiners cited Board deficiencies in examinations effective June 30, 2006; December 31, 2007; March 31, 2009; June 30, 2010; December 31, 2011; and December 31, 2012.

We determined that examiners did not adequately identify the Transaction Risks and address the red flags that were present at Taupa, nor did they perform additional procedures related to those risks. We believe red flags, such as excessive amounts of cash on deposit, the discovery of an unaccounted for bag of coins, an overdrawn employee account for an extended period, an overdrawn line of credit at the corporate credit union, and an evasive CEO, warranted expanded examination procedures. We also believe that had examiners expanded procedures to address these risks, and required the Board of Directors to maintain the appropriate oversight of the records and activities of the Credit Union, the loss to the NCUSIF could have been mitigated.

As a result of our review, we are making two observations and reaffirming three recommendations made in recent OIG reports to NCUA management related to fraud training, independent account confirmations, and direct communication with external auditors.

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

BACKGROUND

The NCUA OIG contracted with Moss Adams to conduct an MLR for Taupa Lithuanian Credit Union, as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). Taupa was a federally insured state-chartered credit union (FISCU) located in Cleveland, Ohio, and subject to State Supervisory Authority (SSA) examinations performed by the Ohio DFI. NCUA's Region III provided supervision over the Credit Union.

History of Taupa Lithuanian Credit Union

The state of Ohio chartered Taupa Lithuanian Credit Union in 1984. The field of membership consisted of all Ohio chapter members of the Lithuanian Communities, as well as employees of the Credit Union and their families. According to its final Call Report dated March 31, 2013, Taupa reported total assets of $23.6 million and membership of 1,154.

Examinations of Taupa with effective dates of June 30, 2006, through December 2012, were performed by the Ohio SSA and reviewed by NCUA, except for the exam effective December 31, 2011, which was a joint examination. These examinations reported generally positive results; with composite CAMEL ratings of 1 or 2 for all contacts.

We reviewed examiner working papers provided by NCUA Region III and the Ohio SSA, and additional files provided by the NCUA's Asset Management and Assistance Center (AMAC). An external CPA firm issued opinion audit reports for the periods ended December 2006 through December 2012, which we also obtained and reviewed; however, we did not review the external auditor working papers.

During the examination effective June 30, 2010, Ohio SSA examiner working papers noted that the report from the external CPA firm concerning the member account verification, performed as of December 31, 2009, was unacceptable. The member verification report did not provide sufficient detail such as the number of confirmations sent, results of confirmations received, or how the CPA firm controlled the statements. Examiners issued a document of resolution (DOR) during this examination, which required Taupa management to obtain the working papers and detailed procedures used by the CPA firm in performing the December 31, 2009, member account verification and to forward the revised report to their state examiner upon receipt. We learned during interviews that the Ohio SSA examiner-in-charge (EIC) never received the report.

The next examination, effective December 31, 2011, indicated that management was in compliance for the DOR related to the member verification from the prior exam. The Ohio SSA examiner also noted the CPA firm had a member account verification in process effective December 31, 2011.

Based on information obtained from AMAC, the only report issued by the CPA firm for the December 31, 2009, member verification was the original report that the Ohio SSA EIC had deemed insufficient during the examination effective June 30, 2010.

The Ohio SSA completed the examination effective June 30, 2010, on September 20, 2010, however, did not upload it to NCUA for review until July 25, 2011, ten months after completion. NCUA performed a review of the state's examination on November 14, 2011, which was outside the 45-day NCUA requirement for reviewing state conducted examinations.

In the NCUA review of these state exam working papers, the NCUA EIC noted that the scope was severely lacking, there were multiple areas of concern including management inadequately monitoring member business loans, and a lack of regular meetings for the Board of Directors. The EIC also noted that Taupa management was not reviewing and updating policies and procedures or making account verification working papers available to the on-site examiner. In addition, the NCUA EIC noted a correlation to another failed credit union in his comment:

> *[M]BLs, policy updates, investment & record keeping errors, NO delinquency & NO charge offs in over 10 years, this CU looks, sounds & acts like St. Paul's Croation [sic] waiting to happen all over again.*

NCUA and Ohio SSA conducted the next examination, effective December 31, 2011, jointly. During this examination, examiners found two bags of coins under a sink in the Credit Union that totaled approximately $200. When examiners questioned the CEO, he stated that the coins had been under the sink for over 10 years. The EIC issued a DOR requiring management to determine the amount of the coins in the bag and to include this amount in cash, and to improve internal controls, which included purchasing locks for teller drawers, surprise cash counts for vault and teller drawers, and a review of file maintenance reports.

During this same examination, examiners found an employee account with a large negative balance from August 24, 2011, through November 29, 2011, when the account was brought positive with a $30,000 deposit. The amount overdrawn and the length of time overdrawn were significant. We learned during our interviews that during the examination effective December 31, 2011, examiners believed the CEO was unresponsive and gave the appearance of avoiding them.

Our review of Taupa's Call Reports determined the Credit Union carried a significant cash on deposit balance that was far outside the peer group averages.[1] Taupa's cash on deposit grew from approximately $7 million to $19.5 million from January 2004 to March 2013,

[1] For the purpose of this review, Taupa's peer group is comprised of ten credit unions chartered in the state of Ohio with a similar asset size.

which was a range of 36 percent to 69 percent of total assets. For the same period, the peer group average of total cash on deposit to assets was 8 percent. Taupa had no notable increase in membership during the period to explain the increases in cash. Examiners did not discuss Taupa's excess liquidity as a red flag, but did discuss it as a concentration risk. In the examination effective December 31, 2011, examiner working papers noted that even though liquidity was above the peer group average, the overall liquidity risk was low.

In addition to a cash on deposit balance significantly above peer averages, the ratio of investments to assets for Taupa compared to peers also represented an anomaly. From January 2004 to March 2013, the ratio of investments to total assets was an average of 9 percent for Taupa, compared to 26 percent for the peer group average over the same period. The examination working papers during the scope period of our review often indicated a lack of loan growth; however, there was no discussion of Credit Union management using cash for investments in lieu of loan demand, which would have been consistent with the peer group.

Taupa management told examiners that the Credit Union held its cash on deposit at Corporate One Federal Credit Union (Corporate One), a corporate credit union located in Columbus, Ohio. In July 2012, the Corporate One CEO contacted NCUA's Region III regarding suspicious transactions on Taupa's line of credit. The Corporate One CEO explained that as of May 2012, Taupa had borrowed against its line of credit 23 times, which included 14 transactions that were over its established credit limit of $300,000. Examiners noted the total amount of the 14 transactions was $2,006,448.

The Corporate One CEO indicated in an email to NCUA Region III officials that the repetitive nature of Taupa exceeding their limit on the line of credit was unusual and considered suspicious, as it was not a typical pattern of activity. NCUA Region III officials forwarded the notification from Corporate One to the Ohio SSA examiners, who then questioned Taupa's CEO about the transactions. Taupa's CEO told the Ohio SSA examiners that Taupa was establishing an account with the Federal Reserve Bank (FRB) and was transferring funds from the FRB account to the Corporate One account to cover their needs. Ohio SSA examiners accepted this explanation with no further confirmation of transactions or balances. In the Ohio SSA working papers for the examination effective December 31, 2012, there was no indication of Taupa having an account with the FRB or any reference to the May 2012, incident. Taupa's Call Reports for March 31, 2012; June 30, 2012; September 30, 2012; and December 31, 2012, reported zero dollars for the amount drawn on lines of credit.

On July 11, 2013, the CEO of Corporate One Federal Credit Union again contacted NCUA Region III and the Ohio SSA to express concerns regarding Taupa's outstanding line of credit. Taupa's $300,000 cash on deposit with Corporate One was not sufficient to cover the outstanding line of credit, nor was it consistent with Taupa's Call Reports. Corporate One's attempts to contact Taupa were unsuccessful. Immediately, the Ohio SSA reviewed both the December 31, 2012, Call Report, which indicated cash on deposit of $19.5 million, and the

December 31, 2012, examination working papers, which also reported the same amount of cash on deposit. Upon further investigation, the Ohio SSA confirmed that Taupa had provided examiners with a Corporate One statement indicating the cash reported as of December 31, 2012, of $16 million was on deposit at Corporate One Credit Union.

On July 12, 2013, Ohio SSA and NCUA examiners, while on-site at the Credit Union, discovered a number of issues raising the suspicion of fraud, including an overstatement of cash on deposit of approximately $15.5 million and the discovery of numerous physical items with the potential for use in forging bank statements and records. Additionally, confirmations sent by the external auditors appeared to have been altered and were never received by the third party institution to which they were intended. Based on these discoveries, the superintendent of the Division of Financial Institutions of Ohio executed a Notice of Involuntary Liquidation and Revocation of Charter effective July 12, 2013, and then liquidated Taupa on July 15, 2013. NCUA estimates the loss to the NCUSIF at $33.5 million. However, NCUA will not know the actual cost of the failure 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[2] 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 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,[3] trend analysis,[4] reasonableness analysis,[5] variable data

[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.
[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.

analysis,[6] and qualitative data analysis.[7] Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

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

Risk-Focused Examination Program

In 2002, 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
- 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

[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.
[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.

indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. NCUA stated that the Annual Program would provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

Supervision of Federally Insured State-Chartered Credit Unions

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

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

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

NCUA recognizes that SSA's are primarily responsible for the supervision of federally insured state-chartered credit unions. The FCU Act requires that NCUA should use the SSA examination reports to the maximum extent feasible[9]. However, NCUA reserves the right to conduct an insurance review of any FISCU as it deems necessary to determine its condition for insurance purposes.

[9] The FCU Act, 12 U.S.C., Chapter 14, § 1781 (b)(1).

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, or when unusual circumstances exist that warrant an in-depth review of the loss.[10]

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 2004 through liquidation in July 2013.

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

- Completed a risk assessment, which included a review of the Examination Overview sections from examination reports, as well as other risk considerations including minimum scope requirements for examiners.

- Prepared a chronology and summary table of regulatory examinations, which included the examination dates, examiner, CAMEL rating, supervisory actions, and significant examiner comments.

- Reviewed examination files, including examination reports, risk assessments, examination findings, DORs, confidential sections, corrective actions, examination spreadsheet files, correspondence, analysis, and other documentation.

- Reviewed Taupa's Board of Directors minutes and Board packets.

[10] 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.

- Reviewed the external reports on audits and member account verification, including results, findings, and responses, as provided.

- Conducted interviews with management and staff from NCUA's Region III, Ohio Department of Financial Institutions, and NCUA's Asset Management and Assistance Center (AMAC) involved in the examination, supervision, and/or liquidation of Taupa.

- Downloaded Call Reports and Financial Performance Reports for the scope period and performed analysis of a number of financial indicators, including yield on investments, net worth, loans compared to shares, shares compared to assets, loan delinquencies to total allowance for loan losses, and other elements of the balance sheet and income statement.

- Developed a timeline and summary of enforcement actions taken by the Ohio SSA from 2004 through liquidation.

- Assessed NCUA and Ohio SSA supervision and evaluated the timeliness of supervisory actions.

- Assessed the effectiveness of Taupa management and the level of oversight provided by the Credit Union's Board of Directors.

We relied upon materials provided by NCUA Region III, Ohio SSA, and AMAC officials, including information and other data collected during interviews.

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 conclusions.

We conducted this review 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 objectives. 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 Taupa failed due to management's fraud and related overstatement of assets by $15.5 million through the misstatement of cash held on deposit, and an $18 million understatement of shares. Upon the determination by the Ohio SSA and NCUA that the Credit Union was insolvent, the Ohio SSA liquidated Taupa within two days of discovery.

Other factors contributing to the failure included issues with management integrity, inaccurate financial reporting, and a failure of the Board to perform its duties related to oversight of the Credit Union.

A. Why Taupa Lithuanian Credit Union Failed

Management's Actions Caused Taupa to Fail

We determined that management's overstatement of assets through the fraudulent misstatement of cash held on deposit and an understatement of liabilities caused Taupa to fail.

Highlighted below are the specific factors, which we believe allowed this misstatement to occur undetected.

<u>Lack of Management Integrity and Inaccurate Financial Reporting</u>

We determined that Taupa management did not conduct the business of the Credit Union in the best interest of its members and, in fact, committed fraud. Specifically, examiners discovered assets overstated by approximately $15.5 million that management erroneously reported as cash on deposit at Corporate One Federal Credit Union. AMAC also noted issues with member share accounts and other suspicious transactions resulting in member share deposits being understated by $18 million.

On July 12, 2013, Ohio SSA and NCUA examiners went to Taupa to confront the CEO and discovered numerous physical items with the potential for use in forging bank statements and records. Examples included a Corporate One stamp and software on the CEO's computer that allowed phantom fonts to generate statements. The CEO kept the computer, stamp, and other evidence used in committing the fraud in a locked room to which employees noted only the CEO had access. The CEO of Taupa was arrested on October 21, 2013, on suspicion of fraud. In addition, a former teller, an outside bookkeeper, and a member have been charged with embezzlement. On January 15, 2014, federal prosecutors charged the former CEO with one count of conspiracy to commit bank fraud, and on February 3, 2014, he pleaded guilty to the charge. The outside bookkeeper also pleaded guilty to one count of conspiracy to commit embezzlement.

Through our review of examination working papers and later corroborated in interviews, we determined NCUA and Ohio SSA examiners agreed that the falsified statements allegedly prepared by Taupa management, looked convincing.[11] In addition, the external auditors sent confirmations to Corporate One for the cash on deposit and were satisfied that Corporate One accurately confirmed the balances. However, examiners later discovered that Taupa's CEO had intercepted and altered the addresses on the confirmations sent by the external auditors and had them mailed to a P.O. Box he controlled rather than to Corporate One.

<u>Inadequate Board Oversight</u>

Taupa's Board of Directors failed in its duties to adequately oversee the activities of management. During the scope period of our review, multiple examinations identified the need for more consistent Board of Directors meetings and adequate minutes. Examiners cited Board deficiencies in examinations effective June 30, 2006; December 31, 2007; March 31, 2009; June 30, 2010; December 31, 2011; and December 31, 2012.

Our review of the Board minutes concluded that minutes were missing for some months and we received no minutes related to the activities of the Supervisory Committee.[12] The CEO was frequently absent from Board meetings and the financial reports were consistently presented by the Treasurer. Large swings in income, projections, and operating results went unchallenged at the meetings. We found the Board had not signed off on some minutes, and Board discussion notes were very limited with regard to audit and exam results or follow-up. We also found no substantive discussion related to policy reviews, risk management, or strategy.

[11] Region III officials provided us with copies of the falsified statements and those obtained directly from third party institutions. Based on our comparative review of both documents, we agree.

[12] The State of Ohio does not require a Supervisory Committee. The Board of Directors may get approval to change their bylaws to have an independent CPA audit in lieu of a Supervisory Committee, which appears to be what Taupa elected to do.

B. Ohio SSA and NCUA Supervision of Taupa Lithuanian Credit Union

Examiners Could Have Mitigated the Loss to the NCUSIF

We determined Ohio SSA and NCUA examiners (examiners) could have reduced or mitigated the loss to the NCUSIF had they identified red flags and expanded procedures to address those issues, and required the Board of Directors to maintain the appropriate oversight of the records and activities of the Credit Union. Examiners followed current NCUA policies and procedures to gain assurance over cash balances; however, we determined current examination requirements do not require confirmation of significant balances directly with institutions. As a result, management was able to manipulate and falsify statements that allowed the cash on deposit misstatement to remain undetected by examiners. The NCUSIF incurred an estimated loss of $33.5 million, consisting of both overstated cash on deposit and negative member share accounts.

Supervisory Background

Taupa received a CAMEL Composite rating of 2 or higher for all examinations in our scope period, including the examination effective December 31, 2012, indicating strong performance. Given the size of the Credit Union and the Composite rating, NCUA involvement in the oversight of the Credit Union was within accepted practices. It was not until the final contact on July 12, 2013, when examiners identified that the Credit Union was insolvent and issued a CAMEL rating of 5, that there was any indication in the CAMEL ratings of concerns at the Credit Union. Table 1 (below) provides Composite and specific CAMEL ratings for the applicable examinations during the scope period of our review.

Table 1

NCUA Examination Results for Taupa**							
Examination Effective Date	Exam Type[13]	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2012	26	2	2	2	2	2	2
December 2011	11*, 26	2	2	2	2	2	2
June 2010	26	2	2	2	2	2	2
March 2009	26, 28	1	2	1	1	1	1
December 2007	26	1	2	1	1	1	1
June 2006	26	1	1	1	1	2	2

** NCUA on-site contact. All other contacts were off-site reviews of Ohio SSA exam reports.*

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

[13] Work Classification Code (WCC) Examination Type 11 is an NCUA regular examination, Type 26 is an NCUA review of the state examination, and Type 28 is an NCUA off-site supervision contact.

Examiners Failed to Identify and Investigate Transaction Risks

Based on interviews with examiners and our review of examination working papers, we determined that examiners failed to adequately identify the Transaction Risks and address the red flags that were present, and did not perform additional procedures to mitigate those risks.

NCUA's Examiners Guide published in June 2002, defines Transaction Risk as:

> *[t]he risk to earnings or capital arising from fraud or error that results in an inability to deliver products or services, maintain a competitive position and manage information. This risk (also referred to as operating or fraud risk) is a function of internal controls, information systems, employee integrity, and operating processes. This risk arises on a daily basis in all credit unions as they process transactions.*

This Guide further explains:

> *[A]dditionally the examination process, while not deigned to detect fraud, may warrant expanded procedures when red flags exist.*

Based on our review of examiner working papers for the scope period of our review, we determined there were multiple red flags present in the accounting records and practices of Taupa. For example, we found excessive amounts of cash on deposit, which was consistently far outside of the peer group average. We also found no discussion of the excess liquidity as a red flag, only as a concentration risk.

As noted earlier in this report, the SSA did not upload the effective June 30, 2010, examination for NCUA review until July 25, 2011. In his review of this examination, the NCUA EIC noted multiple areas of concern, including a reference to similar issues that led to the demise of St. Paul Croatian Federal Credit Union. This upload delay slowed NCUA's response to the issues identified by the NCUA EIC. A joint examination followed, with an effective date of December 31, 2011, which resulted in a CAMEL 2 rating, despite the concerns noted in the prior exam review.

In addition, we believe the bag of coins found under the sink at Taupa during the joint examination effective December 31, 2011, should have been identified as a red flag and, at a minimum, been documented in examination working papers as such. Although examiners included a DOR in this examination for improved cash controls, we determined examiners did not perform any analysis of the potential fraud risk or consideration of additional procedures, beyond a cash count.

Further, examiners did not properly address the fraud potential associated with an overdrawn account of an employee, which examiners identified during the examination effective December 31, 2011. Our review of examination working papers noted that an employee held a negative balance in their share account for three consecutive months in 2011 before a $30,000 deposit brought it positive. Given the size of the Credit Union and the small number of employees, we believe examiners should have identified this transaction as a red flag and expanded procedures to trace the deposit that cleared the overdraft to the repayment source. While this incident was included as an examiner's finding, we found no further discussion in the examination workpapers of the implications – or any questions as to the overall control environment.

Another fraud risk indicator was the overdrawn line of credit at Corporate One Federal Credit Union in May of 2012. Taupa management’s borrowing against their line of credit 23 times in one month with 14 transactions over their established credit limit was unusual and suspicious activity, as identified by Corporate One Federal Credit Union. The excessive borrowing was inconsistent with the significant amount of cash on hand reported by Taupa. Based on discussions with Ohio SSA examiners, when they questioned the CEO in July of 2012 as to the reason for the overdrawn accounts, he responded that Taupa was establishing an account with the FRB and that the transfer of funds from the FRB account to the Corporate One account was done to cover their needs. Examiners accepted the CEO’s explanation without further corroboration.

During examiner interviews, we learned that the manager of Taupa exhibited behaviors that we believe examiners should have identified as potential red flags. For example, multiple interviewees described the CEO as evasive, staying away from the Credit Union often and unavailable to answer questions. Interviewees also described the CEO as appearing to have complete control of the financial accounting and reporting practices of the Credit Union. In addition, based on our review of Board minutes, we noted he was often not present.

We believe individually and in aggregate, examiners should have identified these issues as red flags, which should have prompted examiners to perform additional procedures that may have identified the fictitious assets sooner.

<u>Failure to Confirm Institutional Balances</u>

We learned during interviews that examiners did not perform a confirmation of cash balances held at correspondent institutions and that examiners relied on statements provided to them by Taupa management as evidence of cash balances. This is consistent with NCUA policies and procedures for a credit union of this asset size and composite CAMEL rating. We found nothing to indicate that examiners did not follow NCUA policy; however, given that the cash on deposit was so far above the peer group averages, we believe an independent confirmation of the balances would have been an appropriate expanded procedure.

Also, interviewees noted the Credit Union appeared to have adequate internal controls for the size and complexity of the credit union. An external bookkeeper, who recently pleaded guilty to an embezzlement charge related to Taupa, reconciled the cash balances at the correspondent institution monthly. In addition to this segregation of duties, the external auditors issued an unqualified opinion on all of the audits during the scope period of our review. We learned that examiners assumed that because the external auditors had issued an unqualified opinion for Taupa, the auditors had properly executed the confirmation steps for cash on deposit, without exception.

Although confirmation over cash accounts is common practice as part of an opinion audit, there are no standards requiring auditors to perform these steps, i.e., they are not mandatory. Therefore, although an unqualified opinion provides some level of assurance over the records of the credit union, examiners should not assume that the external auditors directly confirm cash on deposit balances with third party institutions. In this case, the auditors performed account confirmations and examiners placed reliance on the process, but that process was ineffective.

Upon discovery of the fictitious cash on deposit account in July 2013, the NCUA and Ohio SSA discovered that the confirmations sent by the external auditors for cash on deposit balances with third party institutions appeared to have been intercepted and altered, and were never received by the third party institution to which they were intended.

Interviewees also informed us that they often reviewed external auditor working papers as a normal course of the examination process. Interviewees indicated that usually the review would include the financial statement audit report, reports on member verification procedures performed, and any additional reports to management on findings during the audit. In general, the review did not include confirmations sent by the external auditor to third party institutions.

Had examiners identified the red flags and performed expanded procedures as required, they could have confirmed cash on deposit balances directly with the third party institutions, and most likely discovered the cash on deposit misstatement sooner.

<u>Failure to Address Risk with Inadequate Board Oversight</u>

We determined examiners failed to hold Taupa's Board of Directors responsible for ensuring the accuracy of the Credit Union's records. Multiple examination findings during the scope period of our review noted the lack of consistent Board of Directors meetings and inadequate meeting minutes. Although the examinations identified the inadequate Board oversight, there was no indication of appropriate follow-up, as evidenced by the repeat finding of Board deficiencies in examinations with effective dates June 30, 2006; December 31, 2007; March 31, 2009; June 30, 2010; December 31, 2011; and December 31, 2012. Despite the repeat findings, Board oversight deficiencies were never elevated to a DOR.

Our review of the Board Minutes, as detailed earlier in this report, concluded that oversight by the Board of Directors was inadequate.

OBSERVATIONS AND RECOMMENDATIONS

A. Observations

Use of Red Flag Questionnaire

Completion of the Red Flag Questionnaire for Small Credit Unions became a requirement on April 1, 2009, based on a memo issued by NCUA's Office of Examination and Insurance, dated March 12, 2009. At the time of Taupa's failure, NCUA defined small credit unions as those with assets of $10 million or less,[14] a requirement that only applied to federally chartered credit unions, so it did not apply to Taupa, a state-chartered credit union with assets of approximately $23 million. However, prudent business practices do not limit fraud considerations to asset size. The fact that Taupa's fraud exceeded its asset size gives credence to this practice.

The Red Flag Questionnaire includes questions that could raise concern as to potential fraud. Based on our review of Taupa's examination working papers, although we found examiners sometimes included the Red Flag Questionnaires, when completed, we determined they had conflicting answers with what we had determined from other examination working papers within the file, such as those related to excess cash.

We learned from interviews with Taupa examiners that there were multiple instances of unusual and evasive behavior displayed by the CEO, however, we did not find this behavior documented in the examination working papers. In addition, because of Taupa's asset size, examiners were not required to use the Red Flag Questionnaire, which at a minimum would have required examiners to consider the CEO's behavior as a possible red flag. As a result, these types of potential fraud indicators went undetected.

We learned that NCUA plans to revise the Red Flag Questionnaire as part of the Small Credit Union Exam Program, which will provide examination procedures when examiners suspect fraud. We encourage NCUA management to consider requiring this questionnaire for all credit unions, regardless of asset size.

Metric Analysis

Based on Call Reports and FPR data, we analyzed Taupa's trends and performance in a number of metrics. Our purpose was to consider the Credit Union's reported results in light of the results of peers to determine if examiners missed red flags.

Results of these procedures revealed anomalies including significant concentration of cash on deposit well above that of peers, very little investment activity, no charge off of loans, very

[14] In 2013, NCUA changed the definition of small credit unions to those with assets of $50 million or less.

low or no loan delinquency even during the peak of the economic downturn, and dividend expense on share accounts that was higher than the results of peers.

The most glaring anomaly was Taupa's cash on deposit balance, which far exceeded peer group averages. As noted earlier, Taupa's cash on deposit grew from January 2004 to March 2013, to a range of 36 percent to 69 percent of total assets, while peer group averages were around 8 percent. Additionally, the ratio of investments to total assets was an average of 9 percent for Taupa, compared to 26 percent for the peer group average over the same period. We believe examiners should have recognized this as an anomaly. We also believe further investigation by examiners of the low percentage of investments to total assets coupled with the high percentage of cash to total assets held by the Credit Union may have led to earlier detection of the ongoing fraudulent activity at the Credit Union.

B. Recommendations

Our recommendations for Taupa Lithuanian Credit Union relate to examiner fraud training, independent account confirmations, and direct communication with external auditors. We previously presented these same recommendations in reports OIG-13-09 Material Loss Review of El Paso's Federal Credit Union, dated August 26, 2013; and OIG-13-13, Material Loss Review of G.I.C. Federal Credit Union, dated December 2, 2013.

We restate them here for reference purposes only and therefore do not require an official response from NCUA management:[15]

1. Implement a more comprehensive strategy for responding to red flags, including examiner fraud training programs, specific procedures to address fraud risks, and building fraud specific resources and tools.

2. Update policies and procedures to require third party confirmations for all accounts where the balance or activity is significant to the operations of the credit union.

3. Revise policies and procedures to require that examiners gain an understanding through direct communication with external auditors of procedures performed to verify account balances, specifically the cash, investments, brokered CD's, and member accounts. Examiners should document the results within the relevant examination working paper sections.

[15] NCUA Management previously responded to each of these recommendations in the MLR reports noted above, which can be found on our website here.

APPENDIX A: NCUA Management Response

National Credit Union Administration
Office of the Executive Director

E&I/RMB:RMB
SSIC 1920

SENT BY E-MAIL

TO: Inspector General James Hagen

FROM: Executive Director Mark Treichel Mark

SUBJ: Comments on Material Loss Review of Taupa Lithuanian Credit Union #66822

DATE: March 24, 2014

This memorandum responds to your request for official comments on the Office of Inspector General's (OIG) draft report titled Material Loss Review (MLR) of Taupa Lithuanian Credit Union #66822. Although the MLR states the recommendations are restated from previous reports and do not require an official response from NCUA management, this memo addresses what NCUA is currently doing to address the recommendations.

The MLR includes three recommendations outlined below with our current actions:

1. *Implement a more comprehensive strategy for responding to red flags, including examiner fraud training programs, specific procedures to address fraud risks, and building fraud specific resources and tools.*

   Management Response: NCUA currently has several training programs available to address fraud recognition and detection. New examiners are required to take a core class on fraud detection, which identifies the examiner's role in preventing and detecting fraud including the evaluation of internal controls. The NCUA LearnCenter also has training available on recordkeeping review. The session addresses red flags and fraud detection. Finally, all regions are encouraged to regularly discuss recent fraud cases and include fraud detection training as part of their multi-group meeting topics.

   The Office of Examination and Insurance (E&I) is working with the Regions to finalize the Small Credit Union Exam Program, which includes fraud detection procedures. We anticipate these procedures in place and available to all examiners by 2015. During the 2014 National Conference, E&I is hosting a day of training on exam techniques and will incorporate the transaction risk parts of this program for use at credit unions when the examiner suspects fraud. In addition, Region 4 is working with E&I to develop a fraud questionnaire to assist examiners when they suspect or identify fraud during an examination.

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E&I is developing a national fraud resource to include maintaining a list of the Certified Fraud Examiners on staff and maintaining a vendor resource list to assist with fraud detection and forensic accounting. The recordkeeping and internal control subject matter examiners on staff provide necessary assistance when fraud is discovered.

2. *Update policies and procedures to require third party confirmations for all accounts where the balance or activity is significant to the operations of the credit union.*

Management Response: E&I included the following step in the transaction risk scope of the Small Credit Union Exam Program:

> Verify a sample of investment balances by downloading statements from the internet, requesting the financial institution or broker fax copies of the statements directly to your Rightfax number, or confirming the balances by telephone.

These confirmations should be required as part of the annual supervisory committee audit, regardless of the audit type chosen. This requirement will be included in the next revision of the Supervisory Committee Guide providing the guidelines for non-opinion audits conducted at credit unions.

3. *Revise policies and procedures to require that examiners gain an understanding through direct communication with external auditors of procedures performed to verify account balances, specifically the cash, investments, brokered CD's, and member accounts. Examiners should document the results within the relevant examination workpaper sections.*

Management Response: Chapter 5 of the Examiner's Guide provides guidance on obtaining workpaper access and meeting with the external auditor. The examiner documents the results of any discussions with or review of the external audit in the Exam Scope. In addition, the recent changes to the exam report provide new guidelines on issuing Documents of Resolution (DOR) to address concerns affecting the viability of a credit union including incomplete or unacceptable audits.

As noted above, E&I is working with the Regions to finalize the Small Credit Union Exam Program, which will increase the exam scope in areas where there is transaction risk or they suspect fraud. We anticipate full implementation of this program by 2015.

Thank you for the opportunity to comment.

cc: DED Kutchey
DEI Fazio
DDEI Segerson
DRM Komyathy
RD Toeppe
ARDO Parrish
ARDP Hibshman

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OIG Senior Auditor Bruns
AMAC President Barton
GC McKenna
LRAO Barr