NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF HIGH DESERT FEDERAL CREDIT UNION

Report #OIG-10-01
March 17, 2010

PREPARED FOR THE
NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
BY MOSS ADAMS LLP

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EXECUTIVE SUMMARY

We have performed a Material Loss Review (MLR) on behalf of the National Credit Union Administration (NCUA) Office of Inspector General (OIG) of High Desert Federal Credit Union (HDFCU or the Credit Union). We reviewed HDFCU to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated $24.3 million loss to the National Credit Union Share Insurance Fund (NCUSIF); and (2) assess NCUA's supervision of the Credit Union. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence, interviewed management and staff from NCUA Region I & V, and reviewed NCUA guidance, as well as Region V policies and procedures, NCUA 5300 Call Reports, and NCUA Financial Performance Reports (FPR).

We determined HDFCU failed primarily due to a high concentration of real estate construction loans coupled with the dramatic decline in nationwide real estate values caused by the credit crisis. The Credit Union grew its construction lending exposure to over 60 percent in 2005, 2006, and 2007, making it particularly vulnerable to the market decline.

In addition, the underwriting and monitoring of these loans did not meet NCUA guidelines, and included a significant number of loans based on stated income, insufficient equity, and infrequent site visits to construction properties.

Lending guidelines were not consistently followed and delinquency reporting was inaccurate. As the credit crisis deepened, borrowers of matured loans were allowed to make interest only payments without formally extending the loans. These loans were not classified as past due, thus understating the level of delinquent loans reported to the Board and the NCUA.

Management of HDFCU did not respond effectively to findings of NCUA examiners and external auditors. We noted several instances of repeat findings in both NCUA examination reports and external auditor reports beginning in 2003. Additionally, management did not monitor and maintain adequate internal controls surrounding loan underwriting and monitoring. In addition, loan personnel lacked proper training and experience for the volume of construction lending they were performing.

The Board of Directors placed heavy reliance on management to identify and correct operational issues and did not adequately monitor their progress. Senior management showed a significant lack of involvement and knowledge of the Credit Union and its risks.

We determined NCUA examiners did not adequately evaluate the risk in the HDFCU's real estate construction portfolio. As noted, real estate construction loans accounted for over 60 percent of the Credit Union's loan portfolio for three consecutive years. NCUA examiners noted the high concentration and the lack of proper underwriting and monitoring controls, including repeat violations of Part 723.3 of the NCUA Rules and Regulations.

They failed, however, to elevate these repeated issues for stronger supervisory actions. Consequently, examiners did not expand examination procedures when they should have done so, which could have mitigated the loss to the NCUSIF.

We also determined NCUA examiners did not ensure that Credit Union management took corrective action on repetitive Document of Resolution (DOR) issues by elevating those issues to their superiors for stronger supervisory actions. Further, we noted a "Supervisory Examiner Appraisal" review was prepared requesting a follow-up visitation at HDFCU as a result of a DOR issued during 2003. The follow-up visitation did not occur within the timeframe outlined in the review. The NCUA did not ensure the examiner took the recommended corrective actions in a timely manner.

Additionally, we found little evidence that NCUA officials and examiners monitored waivers granted to HDFCU in August 2003 for compliance, and the Credit Union did not establish a process to monitor compliance with the waiver either.

Finally, the examiners in charge remained the same for more than eight years, with in charge responsibilities rotating between the same two examiners. These examiners became overly familiar with the Credit Union, management, staff, processes, and culture, which created a lack of objectivity in the evaluation of the risks impacting the Credit Union.

This report does not make recommendations but provides observations and suggestions. As major causes, trends, and common characteristics of financial institution failures are identified in OIG MLR reviews, the OIG will communicate those to management for its consideration. As resources allow, the OIG may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted.

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

INTRODUCTION AND BACKGROUND

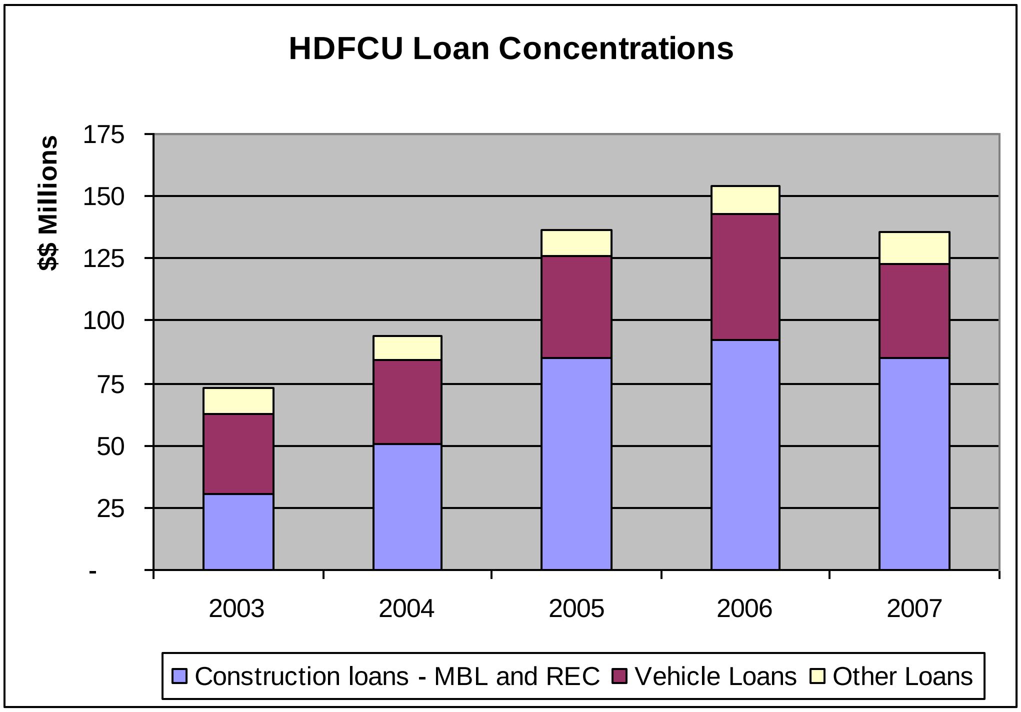
The National Credit Union Administration (NCUA) Office of Inspector General (OIG) authorized Moss Adams LLP to conduct a Material Loss Review (MLR) for the High Desert Federal Credit Union (HDFCU or the Credit Union), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). HDFCU was a federally chartered Credit Union operating in the "High Desert" area of San Bernardino County in California, ultimately serving about 11,000 members. HDFCU was located in NCUA's Region V.

History of High Desert Federal Credit Union

Chartered in 1951, High Desert Federal Credit Union initially served the personnel and employees of George Air Force Base in Victorville, California. The Credit Union established itself as a leader in residential real estate construction and development lending, primarily in the Victorville, Hesperia, and Apple Valley areas of San Bernardino County. In 1982, HDFCU converted to a community charter and then expanded in December 2004 to serve all of San Bernardino County.

Financial Condition of HDFCU (as of December 31)					
Source: Audited Financial Statements *($ = millions)*	**2003**	**2004**	**2005**	**2006**	**2007**
Total Assets	$113	$133	$172	$183	$166
Total Member Shares	$100	$117	$144	$157	$150
Total Loans	$73	$94	$136	$154	$136
Net loan growth rate	18%	29%	45%	13%	-12%
Net income (loss)	$3	$3	$3	$2	($5)

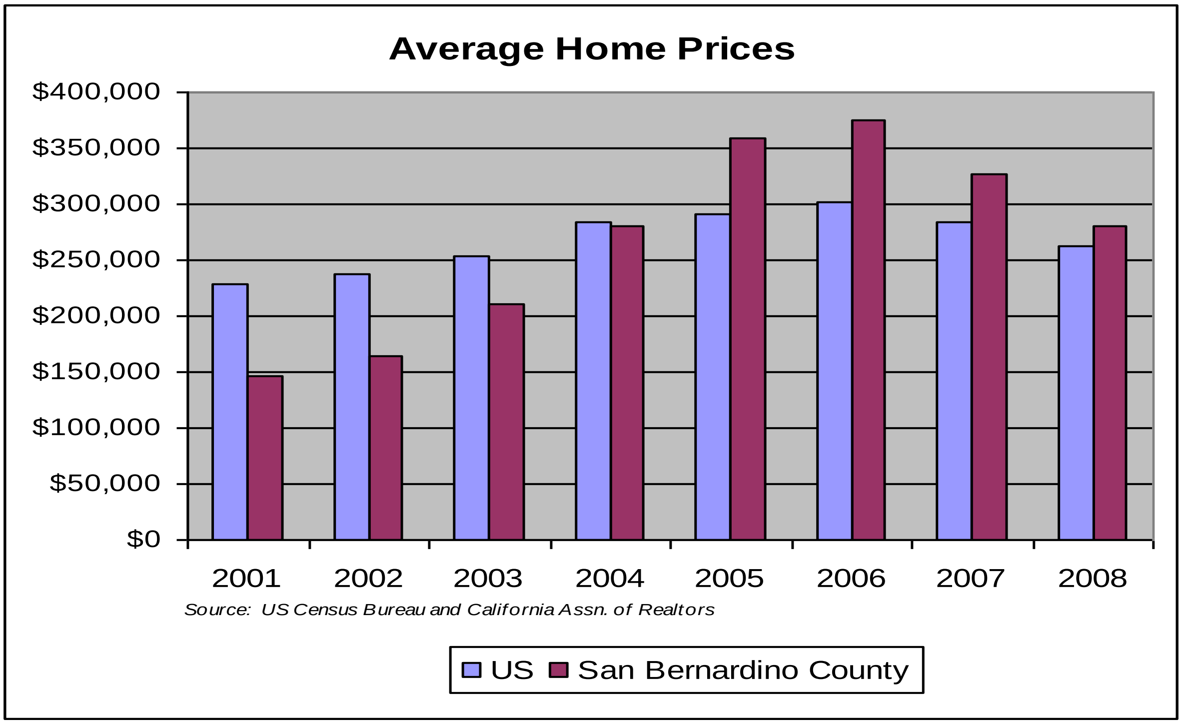
Beginning in 2003, HDFCU began to expand the level of real estate construction lending both as member originated and as member business loans. The Credit Union's assets grew from $60 million in 2000 to more than $180 million in September 2006. The primary catalyst for this growth was the increase in real estate construction loans and member business loans for builders of residential real estate. Concentration in construction lending comprised over 60 percent of the loan portfolio in 2005, 2006, and 2007.



Source: Audited Financial Statements as of December 31

Economic Conditions

The long-term trend for rising home prices accelerated rapidly from 2000-2006 throughout the United States and particularly in California, where home prices doubled during that time period. Rising real estate prices were fueled by rapid population growth, low interest rates, and easy credit conditions.



The graph above shows the marked increase in home values in the United States, and even more significantly for San Bernardino County. Housing prices peaked in 2006, followed by a swift and dramatic decline both in real estate values and credit availability.

On October 16, 2008, HDFCU was placed into conservatorship. Subsequently, the purchase and assumption of certain HDFCU assets, liabilities, and shares was completed by Alaska USA Federal Credit Union. The loss to the NCUSIF is estimated at $24.3 million.

OBJECTIVES, SCOPE, AND METHODOLOGY

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

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

The objectives of the MLR were to:

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

The scope of this review included an analysis of NCUA examinations and the Credit Union's transactions and activities from 2003-2008.

To achieve the objectives, our methodology included the following procedures:

- Completed the Risk Assessment based on review of NCUA examination files.
- Prepared a chronology of examination scope and procedures, comments, and corrective actions.
- Prepared data tables and analysis related to lending activities.
- Reviewed board minutes.
- Summarized external audit findings and follow-up procedures.
- Conducted interviews with NCUA officials involved at various levels in the examination process.
- Evaluated risk management and internal controls, including effectiveness of corporate governance, management oversight, and decision making.
- Performed loan quality procedures, particularly related to concentrations, underwriting, and documentation.
- Reviewed policies and procedures included in examination files related to investment quality, liquidity management, and earnings.
- Reviewed NCUA and Region V rules, regulations, and guidelines.
- Assessed NCUA supervision as it relates to HDFCU.

We conducted this audit from October 2009 thru March 2010 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

RESULTS IN DETAIL

A. Cause of Material Loss

As a result of the aforementioned procedures and analysis, we have determined the main causes of the failure of High Desert Federal Credit Union and assessed NCUA's supervision as it relates to HDFCU, as follows:

Loan Concentrations: Concentration of construction loans was excessive

High Desert Federal Credit Union enjoyed a period of significant growth in its loan portfolio from 2003 through 2006 before the market began its decline. Population growth in the High Desert area drove the increase in construction lending, which grew to be over 60 percent of outstanding loans in 2005, 2006, and 2007.

Loan Volume History (Includes member business loans)					
	12/31/2003	12/31/2004	12/31/2005	12/31/2006	12/31/2007
Number of loans originated during the year	453	505	450	344	185
Amount of loans originated during the year	$85M	$118.1M	$138.8M	$116.4M	$66.2M

Management did not put adequate monitoring and reporting tools in place to identify this concentration risk. As a result, neither management nor the Board monitored the concentration exposure nor did they recognize the changing real estate market in a timely manner so that concentration risk could be managed.

Finally, we did not find any documentation in the NCUA Examiners materials detailing how the Credit Union's concentration risk was evaluated or impacted the scope of the Credit Union's examinations.

Governance: Management competence and Board oversight were inadequate

Included in each monthly Board of Directors packet was extensive information surrounding the operations and financial results of the Credit Union, including information about the Credit Union's loan portfolio. Each month, the Credit Union's Director of Lending provided detailed reporting on the following information related to HDFCU's real estate construction portfolio including the following:

- A report on delinquent real estate loans.
- A Construction Loan Report.[1]

[1] The Construction Loan Report provided management with the number of construction loans between 12-18 months past the original maturity date, as well as the number of construction loans greater than 18 months past the original maturity date.

In analyzing these two reports from March 2004 through December 2007, we discovered two items which should have served as early warning signs to management and the Board of Directors. First, the number of construction loans reported as delinquent during this time period remained virtually unchanged at two or three until September 2007, when the number of delinquent construction loans increased to thirteen. Second, the number of loans reported as more than 12 months past their original maturity date grew from nine in March 2004 to 158 in September 2007. In September 2007, nearly 45 percent of the total construction loan portfolio was greater than 12 months past the original maturity date. This was due to management simply extending a loan once it matured. In many cases, management extended loans numerous times rather than start foreclosure procedures. We believe had management recognized this trend and taken immediate corrective action, the loss to the Credit Union could have been minimized.

Additionally, delinquent loans were not properly identified or reported. As noted above, loan defaults by borrowers were not considered past due if interest-only payments were paid. In addition, the Credit Union's quarterly Call Report data (NCUA form 5300) for "Total Delinquent" loans did not agree with the total amount of delinquent loans reported to HDFCU's Board of Directors in their monthly board packets. Specifically, from March 31, 2005, through December 31, 2007, total delinquent loans reported in the Credit Union's Call Reports were (in nearly every case) less than the total amount reported to the Board of Directors. We reviewed virtually every monthly Board packet as well as each quarterly Call Report for the Credit Union to try and determine why these variances existed and which amounts were correct. However, we were unable to determine the reason for the differences. We inquired of NCUA officials specifically if they noted these differences and they indicated they had not.

Despite not being able to determine which report was correct, we determined that HDFCU either misreported to the NCUA or to its Board of Directors $1,215,715 in delinquent loans during this timeframe.

The Board placed heavy reliance on management to identify and correct operational issues. Based on the information noted above, it was obvious senior management showed a significant lack of involvement and knowledge of the growing credit risk the Credit Union was exposed to. Despite repeated DOR comments from the NCUA, neither management nor the Board ensured the Credit Union implemented appropriate risk management processes to correct the issues facing it related to the construction loan portfolio.

In addition, we determined that although NCUA examiners reviewed the Credit Union's Board packets during their exams, they did not identify the information noted above. Finally, we found significant variations in how examiners prepared their summary workpapers to document the review of Board minutes and no indication that examiners noted the issues discussed above. As a result, the NCUA missed an opportunity to early identify the deterioration in the Credit Union's loan portfolio and therefore mitigate the loss to the NCUSIF caused by the failure of HDFCU.

<u>Underwriting: Management did not correct identified underwriting weaknesses</u>

Weak underwriting processes were identified and repeatedly brought to the attention of HDFCU management by both NCUA examiners and external auditors beginning in 2003. Deficient processes included the excessive use of the borrower's stated income, insufficient equity standards that allowed for borrower equity to be based on market values rather than money invested by the borrower, lack of verification of owner occupancy, and infrequent site visits to monitor the progress of construction projects.

<u>Lending: Lending guidelines were not followed</u>

As real estate values began their steep and rapid decline, lending guidelines and policies were not followed. Unreasonable modifications and extensions were negotiated, including loan to values in excess of policy and regulatory limits, and increasingly high concentrations of speculative lending that were not identified by Credit Union management or reported to the NCUA. Also, collection efforts on a matured loan were not consistently implemented and borrowers, instead, were allowed to continue making interest only payments without HDFCU extending the loans.

B. NCUA Supervision of High Desert Federal Credit Union

The CAMEL Rating System (1 is highest, 5 is lowest) provides a consistent assessment of a credit union's financial condition and operations in the areas of Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity/Asset Liability Management (ALM). Until the March 31, 2008, examination, HDFCU had received composite CAMEL Ratings of 1 or 2, indicating a long track record of strong performance.

HDFCU Examination Dates	**Mar-03**	**Sep-04**	**Dec-04**	**Sep-06**	**Mar-08**
Completion date	7/28/2003	11/18/2004	3/17/2005	11/17/2006	5/31/2008
Type	10	22	10	10	10
CAMEL composite	**2**	N/A	**1**	**2**	**4**
Capital/Net Worth:	1	N/A	1	1	3
Asset Quality:	2	N/A	2	2	4
Management:	2	N/A	1	2	4
Earnings:	1	N/A	1	1	4
Liquidity/ALM:	1	N/A	1	2	3

NCUA's December 2004 examination resulted in a composite CAMEL 1 rating and noted that management had addressed all prior exam concerns. Increased losses in the Credit Union Direct Lending (CUDL) program[2] were noted, as were exceptions to Member Business Loan (MBL) underwriting policies. There were no Document of Resolution (DOR) items.

[2] CUDL is an indirect auto loan program developed by credit unions and auto dealers to assist consumers with auto financing.

Based on findings noted in the September 2004 DOR related to MBL loan underwriting and repeated in the September 2006 examination, the lack of any DOR items in the December 2004 examination appears to be an error by the examination team.

The September 2006 examination resulted in a composite CAMEL 2 rating. Examiners noted that the CUDL program grew 75 percent and that management had strengthened its underwriting criteria after some significant losses. Construction loans had grown to $98M and were reported to be operating "in a sound manner," though some cooling off in the housing market was noted. MBL policy violations were noted, particularly related to equity requirements and lack of proper recordkeeping to monitor compliance with the waiver issued in August 2003. The DOR reported five areas of concern along with corrective actions, including MBL policy and waiver compliance monitoring, and ensuring income verification for MBL borrowers.

Subsequent to the September 2006 examination, HDFCU's residential real estate construction program experienced rapid deterioration caused primarily by poor initial underwriting and local real estate market stresses. The total delinquent loan ratio rose from 6 percent at December 31, 2007, to over 26 percent as of April 30, 2009. This increase was driven almost entirely by the REC loan portfolio in which there were increasing delinquencies due to construction delays, borrower delays in obtaining permanent financing, and, most pronounced, borrowers defaulting on their obligation to obtain permanent financing.

The March 31, 2008, examination reported serious issues including construction loans outside the field of membership, weak underwriting processes, inaccurate reporting of delinquencies, and lack of owner occupancy verification. As a result, HDFCU was downgraded to a composite CAMEL 4. The DOR called for a plan to mitigate the financial deterioration, cease new construction loans, provide more complete delinquency reporting, and increase monitoring of loan modifications and extensions.

During a June 30, 2008, follow-up examination, examiners noted severe underwriting and loan quality concerns, and HDFCU was subsequently downgraded to a CAMEL 5 following the NCUA Board's October 16, 2008, conservatorship action.

The NCUA examiner team for the Credit Union remained the same for over eight years with in-charge responsibilities rotating between the same two examiners. Over their long involvement, these examiners became very familiar and comfortable with Credit Union staff, policies, and procedures.

<u>Documents of Resolution</u>

The Board of Directors of the Credit Union first approved their MBL policy in November 2002. During the March 2003 examination, NCUA examiners noted the following comments, which resulted in a DOR. The items listed in the DOR are below:

- Report impermissible member business construction loans to CUMIS.

- Ensure that underwriting for multiple construction loan borrowers includes:
  - Comment sheets describing the borrowers' expertise and the Credit Union's previous experience with the borrower.
  - Documentation and analysis of the member's ability to repay.
  - For corporate borrowers, legal documents required to establish authorization to obligate the corporation and encumber corporate assets.
  - Provide training of in-house personnel or use an outside third party with competency in this type of lending to perform financial analysis.
- Continue self-imposed moratorium on member business lending until either the requested waiver is approved or until loan volume falls below 15 percent net worth.

In addition to these comments in the DOR, the exam also listed the following comments related to the MBL policy and recommendations for improvement in the examination overview:

- The MBL policy does not address the MBL market area.
- The policy permits 80 percent loan to value collateral protection while Part 723.3 of NCUA Rules and Regulations requires 35 percent member equity.
- The policy permits an aggregate total of 10 percent of assets to be invested in member business loans while the regulation limits construction/development business loans to 15 percent of net worth.

As a result of the March 2003 exam findings, the Credit Union requested a waiver from the Regional Director (RD) of some of the requirements outlined in NCUA Rules and Regulations Part 723.

On August 12, 2003, the RD granted the Credit Union two MBL waivers from the restrictions contained in NCUA Rules and Regulations Part 723. The waivers allowed management to grant MBLs with the following minimum equity interest limits:

- The 20 percent minimum equity interest limitation applied to one-at-a-time and multiple-at-a-time[3] construction loan programs. For multiple-at-a-time construction loans, approval was based on the Credit Union hiring a qualified MBL underwriter experienced in granting these loans or outsourcing the due diligence review to a qualified underwriter experienced in these types of loans.
- The three percent minimum equity interest limit applied to the one-at-a-time construction loan program approvals and were based on two conditions:

[3] One-at-a-time construction loans refer to a member building one speculative or custom home, selling it, and paying off the related construction loan before additional construction loans are granted to the member. Multiple-at-a-time construction loans refer to more than one construction loan outstanding to a member at a given time.

  - The maximum aggregate in one-at-a-time construction loans with equity interests less than 20 percent, but three percent or more does not exceed 85 percent of the Credit Union's net worth and;
  - A written take out commitment letter exists from another lender to fund the permanent financing upon completion of the construction.

As a result of the waiver approval noted above, the Credit Union increased its origination of MBL construction real estate loans until December 31, 2007. At that time, total MBL construction loans outstanding were $18.53 million. Additionally,

- The Credit Union continued to receive DOR comments related to this portfolio in each examination following the March 2003 exam; and
- There was no evidence that HDFCU management ever developed a system for tracking the total amount of outstanding MBL loans that were granted under the waiver issued in August 2003. The September 2004 contact by the NCUA cited MBL underwriting weaknesses, primarily related to the documentation of income verification and the calculation of loan to values on loan requests involving real estate construction.

The September 2004 onsite examination resulted in the issuance of another DOR related to the MBL portfolio, involving updating the MBL policy and proper training for real estate loan officer on loan documentation and calculation of equity parameters. Examiners noted that the sources of loan losses needed to be monitored and underwriting criteria improved related to the CUDL program.

The December 2004 examination indicated all exceptions noted in the September 2004 contact related to the MBL program were cleared. However, in the September 2006 exam, the Credit Union received another DOR related to MBL issues including the following:

- Revise the MBL policy to comply with Part 723 of the RD's MBL waiver and relevant NCUA General Counsel opinions;[4]
- Report impermissible loans to the bonding company;
- Implement a tracking report to ensure that MBLs granted with more than three percent and less than 20 percent equity do not exceed the 85 percent of net worth limitation included in the August 12, 2003, MBL waiver;[5] and
- Ensure income is verified for all MBL borrowers.[6]

In July 2003, the Supervisory Examiner (SE) completed a "Supervisory Examiner Appraisal" form for the March 2003 examination. In the appraisal, the SE commented

[4] This was the third time in four exams or contacts the Credit Union was cited for this issue. The only time it was not noted was in the December 2004 exam, which appears to have been in error based on the findings in the September 2006 exam.
[5] We found no evidence the Credit Union ever implemented a tracking report.
[6] This was a repeat comment from prior exams.

that in light of the issues noted related to the MBL program, the examiner in charge (EIC) should make a follow-up visit to the Credit Union by the end of the year. We determined this visit was not performed until November 2004 (effective September 30, 2004), which was well outside of the time frame originally requested in the appraisal.

C. Internal Control Deficiency

<u>Responsiveness: Examination findings were repeated and unresolved</u>

Beginning with the March 2003 report of examination, examiners included comments in the DOR section related to:

- MBL underwriting;
- Impermissible MBLs;
- Training of Credit Union loan officers;
- Updating the Credit Union’s loan policy to bring it into compliance with Part 723 of NCUA Rules and Regulations; and
- Monitoring the Region V waiver received in August 2003.

In each subsequent examination up through and including the March 2008 exam, examiners included comments in the DOR section related to MBLs, with the exception of the December 2004 examination, which as previously explained, did not include any DOR items.

In the September 2004 and the September 2006 examinations, examiners were very critical and issued DORs related to the Credit Union’s MBL and construction loan portfolio.

We also noted an instance where the SE, as part of their “Risk Focused Exam - Appraisal Form,” dated July 2003, requested the EIC follow up by year end on the issues included in the DOR from the March 2003 exam. This follow-up request was not completed until November 2004, nearly a year after it was due.

NCUA’s Examiner’s Guide (Guide) sets forth the processes and procedures to be used by examiners to assure credit union compliance with NCUA policies and includes a detailed explanation of the Risk Focused Examination program, as well as the scope, planning, analysis, and reporting requirements to be used in each exam. In addition, the Guide indicates the DOR, if applicable, is a required workpaper and states, “When the examiner must repeat a Document of Resolution from a previous examination because the officials failed to sufficiently correct the area of concern, the examiner should emphasize the repeated agreement. The examiner should place an asterisk beside the item and footnote the lack of corrective action to draw management’s attention to the ongoing problem.” Examiners are encouraged in both the Guide and in the Region V Supervision Policy Manual (Manual) to reach agreement with management; however, if that is not possible, they should consider, but are not required, to contact the SE or RD.

During our review of HDFCU, we determined an internal control weakness exists within the DOR process. Specifically, neither the Guide nor the Manual specifies a process to effectively correct repeat DOR issues from prior examinations. Although the Guide does provide a clear process to assure repeat issues are visible to credit union management, the Guide is not clear regarding when a DOR is applicable or what follow-up procedures are necessary, particularly if the composite CAMEL rating is above a 3. In addition, the Guide is not clear regarding what the next step must be if there is no resolution. As a result, issues in the DOR process are not consistently resolved.

OBSERVATIONS

Concentration guidelines: Develop concentration risk guidelines and establish a process to identify, analyze and monitor exposure

Loan concentrations are not clearly identified and analyzed. In addition, the risk associated with the concentrations does not appear to have been considered in establishing the CAMEL and Risk Focused ratings during the examinations.

- ❑ NCUA should consider developing a more specific process to identify, analyze, and monitor loan concentration during exams as well as between exams. The NCUA should give strong consideration to a more detailed breakout of loan types on the 5300 Call Report to facilitate this analysis. Additionally, NCUA should consider developing concentration guidelines to assist both examiners and the credit unions in identifying and monitoring concentration risk.

Responsiveness: Examination findings were repeated and unresolved

- ❑ NCUA should consider amending the Examiner's Guide to provide a more specific DOR process that will give examiners clear guidance on when a DOR is required, detailed follow-up procedures and documentation requirements on repeat findings, and a defined process to elevate issues within the NCUA that have not been appropriately resolved. At a minimum, NCUA should consider requiring examiners to document their follow-up on significant findings from prior examinations until the finding is properly remediated. Documentation should be retained by the examiners supporting the remediation of previous findings until the next examination.

Examiner Familiarity: Examiner in-charge rotation was ineffective

The examiner team remained the same for more than eight years, with EIC responsibilities rotating between the same two examiners. These examiners became overly familiar with the HDFCU management, staff, processes, and culture, which created a lack of objectivity in the evaluation of the risks impacting the Credit Union.

- ❑ NCUA should consider implementing a rotation program that requires a new lead examiner in reasonable and regular intervals. This should not be merely a role change among returning examiners and should be standard across all NCUA regions.

Waivers: Waiver not monitored

NCUA granted a waiver to HDFCU without the ability to monitor and track the credit union's compliance. Specifically, in August 2003, Region V granted a waiver to HDFCU related to "one-at-a-time" and "multiple-at-a-time" construction real estate loans and Part 723.3 of the NCUA Rules and Regulations. The parameters of this waiver were very detailed and required tracking two specific elements of HDFCU's MBL construction loans. The first element required disclosure of the number of construction loans the member currently had on file with the Credit Union. The second element required disclosure of the amount of equity, or down payment, the member included for each loan. Although NCUA officials indicated the region had an MBL monitoring process in place at the time the RD granted HDFCU its waiver, we determined the region's process lacked the ability to track a waiver of such detail as HDFCU's. Specifically, the region's process requires the verification and cross-reference of the aggregate MBL limits to all outstanding waivers on file, which essentially uncovers those credit unions without an approved waiver. As a result, we determined the NCUA does not capture, through quarterly Call Reports or other financial reporting systems, the type of detailed information that would allow examiners to adequately monitor and track compliance with a waiver as specific as the one granted to HDFCU.

In addition, despite the NCUA's inability to track specific detailed wavier information, examiners can, through the DOR process, require credit union management to track the specific requirements of a waiver and report this information to the NCUA. We determined, however, examiners did not require HDFCU management to implement such a tracking system until three years after the waiver was granted.[7] As a result, HDFCU never developed its own tracking system to capture the information required by the August 2003 waiver.

NCUA Region V officials explained they enhanced their MBL waiver monitoring process in 2009 by requiring examiners to confirm whether credit unions were utilizing waivers in a safe and sound manner and whether any waivers should be terminated.

We believe the following suggestions will also enhance NCUA's waiver process:

- NCUA should consider the ability of the region or credit union to track waivers. If a waiver requires the generation of detailed information from the recipient credit union that is not already captured in the Call Report or other financial reporting system, the NCUA should take into account the ability of credit union and the region's staff to adequately monitor the waiver.
- Implementation of the monitoring process should be in place before granting a waiver.
- Failure by a credit union to properly monitor and track a waiver, or noncompliance with a waiver during an examination, should result in suspension of activity allowed under the waiver until the credit union can reestablish an appropriate tracking model or become compliant with the waiver.
- NCUA should consider a renewal period and/or a sunset provision for waivers granted related to significant risk areas of a credit union. At a minimum, this would include waivers related to loan concentrations, liquidity management, capital, or certain regulatory matters.

[7] The September 2006 examination report included a DOR comment requiring HDFCU management to implement a tracking system for the August 2003 waiver.

Documentation: Examiner documentation was inconsistent and incomplete

Examination files lacked consistent documentation of sampling methods, samples sizes, and overall risk assessment procedures performed during the examination. In addition, the questionnaire and checklists supporting the examiner's quarterly review of 5300 Call Reports did not sufficiently document issues identified and analysis performed.

- NCUA should consider more detailed documentation standards be adopted to better explain the process and testing procedures used in the exams. Further, the specific procedures and analysis performed by the examiner during their quarterly review of the 5300 Call Reports should be well documented and retained.

Appendix A: NCUA Management Comments

VIA E-Mail

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

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

SUBJ: Material Loss Review of High Desert Federal Credit Union #7366

DATE: March 11, 2010

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review of High Desert Federal Credit Union #7366 (MLR).*

High Desert Federal Credit Union (HDFCU) failed due to a high concentration of real estate construction loans coupled with the dramatic decline in nationwide real estate values caused by the credit crisis. In addition, the underwriting and monitoring of these loans did not meet NCUA guidelines, and included a significant number of loans based on stated income, insufficient equity, and infrequent site visits to construction properties. HDFCU Management did not monitor and maintain adequate internal controls surrounding loan underwriting and monitoring, and did not respond effectively to findings of NCUA examiners and external auditors.

NCUA examiners noted the high concentration of real estate construction loans and the lack of proper underwriting and monitoring controls, including repeat violations of Part 723.3 of the NCUA Rules and Regulations. In the September 2004 and September 2006 examinations, examiners were very critical and issued Documents of Resolution (DORs) related to HDFCU's member business lending and construction loan portfolio. Subsequent to the September 2006 examination HDFCU's residential real estate construction program experienced rapid deterioration caused primarily by poor initial underwriting and local real estate market stresses. The March 31, 2008 examination reported serious issues including construction loans outside the field of membership, weak underwriting processes, inaccurate reporting of delinquencies, and lack of owner occupancy verification. As a result, HDFCU was downgraded to a composite CAMEL 4. During a June 30, 2008 follow-up examination, examiners noted severe underwriting and loan quality concerns, and HDFCU was subsequently downgraded to a CAMEL 5 following the NCUA Board's October 16, 2008 conservatorship action.

NCUA recognizes that strong supervisory attention is necessary for credit unions with high concentrations of member business lending and construction real estate lending programs. Updated guidance reminding examiners to take appropriate action when these risks are not adequately managed has been issued. We review our 5300 Call Report on a quarterly basis and modify, as necessary, the information captured to assist us in analyzing, monitoring and addressing emerging risks.

Thank you for the opportunity to review and comment on the report.

Appendix B: Glossary

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