NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF ST. PAUL CROATIAN FEDERAL CREDIT UNION

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CONTENTS

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review (MLR) of St. Paul Croatian Federal Credit Union (St. Paul). We reviewed St. Paul to (1) determine the cause(s) of the credit union's failure and the resulting 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 III; and reviewed NCUA guidance, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPR).

We determined a suspected fraud was the direct cause of St. Paul's failure. As of December 31, 2009, the credit union had approximately $238.8 million in total assets. St. Paul had a substantial majority of its assets in loans that were supposedly secured by members' shares. During the December 31, 2009, examination, NCUA found the majority of the loans were not actually share secured and a number of them were allegedly fraudulent. NCUA also found that St. Paul's chief executive officer (CEO) manipulated loan records and masked the suspected loan fraud by constantly refinancing certain loans or making advance payment on those loans. NCUA projected an estimated loss of $170 million to NCUSIF.

We also determined that credit union management failed to meet their required obligations to implement proper internal controls and oversight. Specifically, management did not (1) ensure adequate internal controls were in place; (2) ensure adequate policies were in place and adhered to; and (3) resolve prior examiner findings in a timely fashion. For example, because the CEO handled most of the accounting and lending processes, credit union staff lacked the fundamental knowledge to run operations without the CEO's direction after NCUA placed the credit union into conservatorship. In addition, during previous examinations, credit union staff told NCUA examiners that the data processing system did not have the capability to freeze the shares used to secure loans. However, we found that the failure to freeze the shares was not due to system capability, but rather that the CEO purportedly instructed the credit staff not to freeze the shares. Furthermore, the annual Supervisory Committee audits, although in compliance with NCUA regulations, were insufficient for a credit union of the size and complexity of St. Paul because the external auditor's review process could not adequately address the needs of the credit union. Although the CEO allegedly perpetrated the fraud, the credit union Board of Directors and Supervisory Committee should have been more involved to prevent such issues from occurring in the first instance.

We further determined NCUA examiners did not adequately evaluate the risks to St. Paul operations. Specifically, examiners did not (1) thoroughly evaluate the credit union's internal controls when assessing transaction risk; (2) ensure credit union management took corrective action on repetitive Document of Resolution (DOR) issues; and (3) expand examination procedures when red flags indicated higher risks

to the credit union. We found that prior to the discovery of the alleged fraud, NCUA examiners were aware of some internal control weaknesses yet failed to rate transaction risk as high. For example, during one examination the examiner noted no significant transaction risk concerns existed. However, the examiner reported a $99,000 wire transfer and a $64,000 automated clearinghouse transaction were not posted to the credit union books. In addition, examiners did not ensure St. Paul's management took corrective actions on repetitive DOR items, which included: (1) freezing shares used as collateral; (2) obtaining an annual audit that adhered to generally accepted accounting principles and generally accepted auditing standards; and (3) addressing liquidity and asset liability management issues. Additionally, examiners did not test for hidden delinquency or expand examination procedures when unusual financial performance ratios, abnormal real estate trends and inappropriate member business loans existed. Furthermore, we found the examiners noted multiple red flags during the examinations conducted at St. Paul, but did not follow-up on the exceptions or deficiencies found.

Finally, we found that NCUA's Quality Control Program was not effectively present for this credit union. Of the three Supervisory Examiner (SE) evaluations conducted, none of them addressed any of the multiple red flags that the examiners noted during the examinations or the need for stronger supervisory actions for repeated DORs. Moreover, we believe the SEs should have questioned the continuous zero delinquency and required the examiners to expand examination procedures and test for zero delinquency. Additionally, we found NCUA Region III Division of Supervision was not required to evaluate[1] and review St. Paul's written examination reports and did not select any of St. Paul's examinations for a random review.

In addition, we reviewed industry observations regarding occupational fraud. We believe the industry's observations apply directly to issues we observed during our review. We determined St. Paul's lax internal control environment created an environment susceptible to fraud. Our comparative analysis can be found in Section C of this report.

This report does not contain recommendations, but provides observations and suggestions. However, the OIG plans to issue a Material Loss Review capping report with recommendations based on issues raised in this report as well as the other nine Material Loss Reviews conducted by the OIG. In addition, as resources allow, the OIG may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make additional recommendations, as warranted.

[1] According to NCUA guidelines, Region III Division of Supervision was not required to perform a quality control review on St. Paul's examinations because St. Paul was coded a CAMEL 2 and reported less than $250 million in assets.

Auditor observations made as a result of our review of St. Paul's failure include:

- Examiners did not consider the lack of adequate internal controls serious enough to rate transaction risk high at St. Paul even though this issue is an inherent problem in smaller credit unions. We believe the lack of internal controls and the repeatedly alleged data processing system issues indicated material weaknesses may have existed, warranting expanded examination procedures. Opportunities existed for management to reinforce the need for additional procedures.

- Examiners need to be reminded of the importance of understanding that DORs are to be developed to outline plans to reduce areas of unacceptable risk, with particular emphasis on the types of safety and soundness concerns that were clearly present in the years leading up to St. Paul's failure. Further, any reminder provided to examiners on the DOR process would be remiss if DOR follow-up in subsequent examinations were not also emphasized.

- A lack of emphasis on the importance of additional procedures, such as the Red Flag review, and expanding procedures when red flags are detected. Specific monitoring triggers could be developed to more easily 'red flag' areas to be investigated, as well as provide a specific time allocation.

Finally, we found NCUA took or planned to take actions that would address changing the effective dates of the examinations, testing for zero or abnormal delinquency, and loan file reviews.

We appreciate the courtesies and cooperation NCUA management and staff provided to us during this review.

BACKGROUND

St. Paul Croatian Federal Credit Union

St. Paul Croatian Federal Credit Union (St. Paul) was located in Cleveland, Ohio. It was chartered as a Federal Credit Union (FCU) in 1943 to serve members of St. Paul Croatian Parish, spouses of persons who died while within the field of membership of this credit union, employees of the credit union, persons retired as pensioners or annuitants from the credit union, members of their immediate families, and organizations of such persons. St. Paul had two branches, ten full-time employees, seven Board members and three Supervisory Committee members. As of December 31, 2009, the credit union reportedly had approximately $238.8 million in total assets and served 5,399 members. St. Paul was located in NCUA's Region III.

On April 23, 2010, NCUA placed St. Paul into conservatorship and subsequently, on April 30, 2010, the NCUA Board placed St. Paul into involuntarily liquidation pursuant to section 207(a)(1)(A) of the Federal Credit Union Act[2] (FCU Act) and appointed itself as liquidating agent. St. Paul's failure resulted in a loss to the NCUSIF of approximately $170 million.

NCUA Examination Process

Total Analysis Process

NCUA uses a total analysis process that includes: collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL[3] components, and reviewing qualitative and quantitative measures.

NCUA uses a CAMEL Rating System to provide an accurate and consistent assessment of a credit union's financial condition and operations. The CAMEL rating includes consideration of key ratios, supporting ratios, and trends. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. During an examination, examiners assign a CAMEL rating, which completes the examination process.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[4] trend analysis,[5] reasonableness analysis,[6] variable

[2] 12 U.S.C. §1787(a)(1)(A).
[3] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset/Liability Management.
[4] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[5] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[6] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

data analysis,[7] and qualitative data analysis.[8] 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.

St. Paul received composite CAMEL code 1 rating in March 2004. From December 2004 through March 2009, the credit union received composite CAMEL code 2 rating. (See Appendix A Table A-1 for St. Paul CAMEL ratings.)

Risk-Focused Examination Program

In May 2002, NCUA announced its new Risk-Focused Examination (RFE) Program, for implementation in the fall of 2002. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. 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 Report and FPR trends. The extent of supervision plans depends largely on the severity and direction of the risks detected in the credit union's operation and on 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 Call Reports,
- Communication with credit union staff,
- Knowledge of current events affecting the credit union.

[7] 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.

[8] 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.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the 12-Month Program.[9] NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the 12-Month Program will provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

Objectives, Scope and Methodology

The FCU Act[10] requires that the NCUA Office of Inspector General (OIG) conduct a material loss review when the NCUSIF incurs a material loss with respect to an insured credit union. The Act defines a material loss as (1) exceeding the sum of $10 million[11] and (2) an amount equal to 10 percent of the credit union's total assets at the time at which the Board initiated assistance or was appointed liquidating agent. NCUA notified the OIG that the estimated loss reserve for St. Paul would exceed $10 million. Consequently, in accordance with the FCU Act and Chapter 3 of the NCUA Special Assistance Manual, we initiated a material loss review (MLR).

The objectives of our review were to (1) determine the cause(s) of St. Paul's failure and the resulting loss to the NCUSIF, and (2) assess NCUA's supervision of the credit union. To accomplish our objectives we conducted fieldwork at NCUA's headquarters in Alexandria, VA, at the regional office located in Atlanta, GA, and in Cleveland, Ohio. Our review covered the period from December 2004 to April 2010, St. Paul's liquidation date.

To determine the cause of St. Paul's failure and assess the adequacy of NCUA's supervision we:

- Analyzed NCUA examination and supervision work papers, reports and related correspondence;
- Reviewed NCUA Regional and E&I staff summary reports;
- Interviewed NCUA staff; and
- Reviewed NCUA guidance, policies and procedures, Call Reports (5300 Reports), and FPRs.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software (AIRES) and Credit Union Online systems. We did not the test

[9] The 12-month program requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling eligibility.
[10] The FCU Act §216(j), 12 U.S.C. §1790d(j).
[11] On July 21, the President signed into law the Wall Street Reform and Consumer Protection Act of 2010, raising the threshold for future material loss reviews to $25 million.

controls over these systems. However, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our audit conclusions.

This report does not make recommendations but provides observations and suggestions. However, the OIG plans to issue a Material Loss Review capping report with recommendations based on issues raised in this report as well as the other nine Material Loss Reviews conducted by the OIG. In addition, as resources allow, we may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted

We conducted this performance audit from April 2010 through October 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Management reviewed a discussion draft of this report and we incorporated their suggested changes where appropriate.

RESULTS IN DETAIL

We determined a suspected misappropriation of credit union funds through allegedly fraudulent loans most likely caused the failure of St. Paul. We also determined that St. Paul's management inactions facilitated the suspected fraudulent activity. In addition, we determined that, had NCUA examiners performed additional procedures when indicators of potential problems, such as examination red flags, were present, NCUA might have mitigated or even prevented the loss to the NCUSIF.

A. Why St. Paul Croatian Federal Credit Union Failed

Suspected Credit Union Loan and Share Fraud

We determined a suspected fraudulent act committed by St. Paul's CEO, through allegedly fictitious loans, caused the credit union to fail. Specifically, the CEO allegedly misappropriated funds by manipulating records for loans reportedly issued by St. Paul and this resulted in an estimated loss of $170 million to the NCUSIF.

In January 2010, representatives from the Federal Bureau of Investigation (FBI) and the Internal Revenue Service (IRS) met with NCUA staff regarding NCUA's examination program and process. The Federal representatives were concerned that potential criminal activity was occurring at St. Paul. Consequently, NCUA started an in-depth examination and hired an independent certified public accounting firm to perform a fraud audit. NCUA staff and the firm both concluded there were large concentrations of loans with insufficient collateral or collateral owned by unrelated members.

St. Paul had a substantial majority of its assets in loans. In addition, all of St. Paul's real estate loans were non-traditional five-year balloon loans. NCUA examiners determined there was rapid loan growth that exceeded peer ratios[12] and continued even during the recent economic downturn. For example, the loans to asset ratio increased from 95 percent to 98 percent from 2004 to 2009, while peer ratios decreased from 65 percent to 64 percent. In addition, the majority of these loans were designated as share secured.[13] Specifically, 52 percent of all loans were share secured in 2004, 70 percent in 2005, 66 percent in 2006, 76 percent in 2008, and 88 percent in 2009. Furthermore, many of the loans were supposedly secured by shares of members not related to the loan recipient. However, NCUA staff subsequently determined that the majority of the loans were not actually share secured and a number of them were allegedly fraudulent.

During an interview conducted by NCUA staff, credit union employees alleged the CEO maintained a list of loans that the CEO constantly refinanced. According to credit union employees, during previous examinations when NCUA examiners

[12] Peer ratios are a benchmark against credit unions of similar asset size measuring a variety of credit union functions and performance.
[13] Share secured loans required less documentation and had little or no loan underwriting.

requested loan files, the CEO stated the files were stored at the other branch and the CEO would have them available the next morning. The credit union employees alleged the CEO gathered the entire staff that evening and directed them to create loan documentation to support the loans the examiners selected. Since a majority of the loans was supposedly share secured, the CEO instructed the staff to find a member with sufficient shares in their account to cover the pledged shares. This account was listed on the share pledge security agreement for that borrower. Credit union staff would then allegedly "witness" forged signatures on the share pledge agreement. Furthermore, credit union staff members stated they would have members with large share balances sign blank share pledge agreements in the event credit union members needed a loan in a hurry.

According to NCUA staff, the CEO would then deliver the alleged fraudulent loan documents to the examiners the following day. However, if a member had a real estate loan or a car loan, those loan documents were more likely authentic. NCUA staff also discovered the CEO allegedly maintained a list of loans from which he would instruct credit union employees to either refinance the loan or advance sufficient funds on the loan to make up to three monthly payments. The refinancing and the loan advances with subsequent payments on the same loans masked any loan delinquency. For example, NCUA AIRES loan download statistics showed a large percentage of the loans reported as paid ahead or with accrued interest greater than the payment, yet no loans were reported as delinquent.

Limited Oversight by Management

We determined that credit union management, which includes the Board of Directors and Supervisory Committee, failed to meet their required obligations to implement proper internal controls and oversight. Specifically, management did not (1) ensure adequate internal controls were in place; (2) ensure adequate policies were in place and adhered to; and (3) resolve prior examiner findings in a timely fashion. As a result, the CEO was able to conduct the suspected fraud for an undetermined amount of time.

According to NCUA guidance, supervisory committees are responsible for ensuring that credit union Boards of Directors and management establish practices and procedures that sufficiently safeguard member assets.[14] In addition, the supervisory committee must determine whether policies and control procedures are sufficient to safeguard against error, conflict of interest, self-dealing, and fraud.[15] Furthermore, federally insured credit unions are required to obtain a supervisory committee audit at least once every calendar year.[16] If an audit is performed or contracted out, a review of the structure of the credit union's internal controls and accuracy of the credit union's record must be performed.[17]

[14] NCUA Rules and Regulations Section 715.3(a)(2).
[15] NCUA Rules and Regulations Section 715.3(b)(4).
[16] NCUA Rules and Regulations Section 715.4, 715.5, 715.7.
[17] Supervisory Committee Guide 4.03.

Lack of Segregation of Duties

According to NCUA management, the CEO handled most of the accounting and lending processes and the credit union staff was only allowed to take specific instructions from the CEO. For example, the CEO prepared and certified 2009 year-end call report and the staff was instructed to perform certain functions, some of which were possibly illegal. In addition, credit union staff lacked the fundamental knowledge to run operations without the CEO's direction after NCUA placed the credit union into conservatorship. Consequently, there were no institutional constraints on the CEO to prevent him from committing the suspected loan fraud.

Information System Issues

Several information system issues existed at St Paul. For example, during previous examinations, credit union staff told NCUA examiners that the data processing (DP) system could not freeze the shares used to secure loans. As a result, during the December 31, 2007, examination, and repeated in the December 31, 2008, examination and the March 31, 2009, supervision contact, the examiner identified as a Document of Resolution (DOR) item the need for the manager to contact the software provider regarding the inability to freeze shares. However, during the December 31, 2009, examination examiners determined the shares could be frozen and the CEO purportedly instructed the staff not to freeze the shares.

Additionally issues include the DP system truncating large numbers, for instance $1.8 million appeared as $.8 million. This occurred when printing loan documents with a large amount. In addition, the DP system did not generate reports that ensured Bank Secrecy Act (BSA)[18] compliance. For example, the system did not differentiate cash transactions from check transactions. If a member conducted a transaction with both cash and checks, the transaction was designated as a mixed deposit on the activity monitoring report, which did not allow for adequate suspicious activity monitoring. Unless the transactions were completely conducted in cash, it would have been necessary to review each deposit ticket to determine the actual nature of the mixed deposit and whether a suspicious activity report was necessary.

Supervisory Committee Audits Not Sufficient

NCUA examiners determined the annual Supervisory Committee audits, though in compliance with NCUA regulations were not sufficient for a credit union of this size. The credit union engaged an external auditor to complete the Supervisory Committee annual audit. However, given the size and complexity of St. Paul, the auditor's review process was not sufficient to address the needs of the credit union. For example, while the liquidity issues had been a concern for many years, the

[18] BSA requires United States financial institutions to keep records of cash purchases of negotiable instruments, file reports of cash transactions exceeding $10,000 (daily aggregate amount), and to report suspicious activity that might signify money laundering, tax evasion, or other criminal activities.

auditor only noted the liquidity ratios and did not provided input regarding performance concerns. We found the following concerns:

- The 2006 and 2007 Supervisory Committee reviews were completed on work papers from an obsolete NCUA Supervisory Committee Guide;

- The reviews focused only on verifying balance sheet accounts and did not include income statement testing or alternate delinquency testing;

- There are no tests of internal controls noted in the audit reports;

- The loan review work papers were full of white out and cross out corrections, and it was difficult to determine what the corrections signified;

- It was highly irregular that audit work papers contained white outs; and

- Since the modifications were not initialed, it was impossible to determine who made the corrections.

NCUA determined, and we agree, the reviews seem more appropriate for a $10 million credit union than for a $240 million credit union.

BSA/OFAC Controls Did Not Ensure Compliance

Following the discovery of the alleged fraud, NCUA staff subsequently concluded that St. Paul had not exercised due diligence in complying with BSA and Office of Foreign Assets Control[19] (OFAC) requirements. NCUA examiners discovered that the credit union's BSA records were insufficient to ensure compliance. As stated earlier, there was no system in place to separate mixed check and cash deposits. Examiners also determined St. Paul's Board did not complete the required BSA training. In addition, examiners found the following deficiencies: OFAC lists of suspicious persons were not verified against the recipients of out-going wire transfers; the wire transfer log was manually kept; documentation for wire transfers was inadequate; and St. Paul staff did not update the OFAC list on a regular basis.

Loan and Policies/Practices Were Minimal

Although most loans were supposedly share secured, financial performance report data from December 2004 through December 2009 showed St. Paul had unsecured loans. However, no unsecured loan or member business loan (MBL) policies existed. During the December 31, 2009, examination, examiners discovered that many of the loans reported as share secured were in fact not share secured and included MBLs.

[19] Under OFAC regulations, credit unions must block or freeze the assets, funds transfers, and all transactions of all designated countries and their agents, specially designated terrorists, foreign terrorist organizations, specially designated narcotics traffickers and blocked persons. In addition, OFAC may require the credit union to reject or return incoming transfers from prohibited sources.

Furthermore, real estate loan policies were scant. For NCUA examinations conducted from 2004 through 2009, the real estate loan exceptions work papers showed loan appraisal issues and high loan to values (over 94 percent). Specifically, examiners noted during the December 31, 2004, examination that very few loans had income verifications in the loan files; moreover, during the December 31, 2009, examination, examiners noted income verification was not required on any loan. These were strong indications of poor management oversight. Furthermore, during the December 31, 2009, examination, examiners found loan documentation contained unapproved corrections marked on the documents, and tax assessment values were used instead of real estate appraisals. Although the CEO allegedly perpetrated the fraud, the credit union board and Supervisory Committee needed to be more involved to prevent such issues from occurring.

B. NCUA Supervision of St. Paul Croatian Federal Credit Union

Credit Union Risks Not Adequately Evaluated

We determined NCUA examiners did not adequately evaluate the risks to St. Paul operations. Specifically, examiners did not (1) thoroughly evaluate the credit union's internal controls when assessing transaction risk; (2) ensure credit union management took corrective action on repetitive DOR issues; and (3) expand examination procedures when red flags indicated higher risks to the credit union. As a result, NCUA missed opportunities to mitigate the loss to the NCUSIF caused by St. Paul's failure.

NCUA's risk focused examination process should determine the adequacy of internal controls and the degree of reliance on the work efforts completed by competent, professional individuals and documented in reports and audits.[20] For example, evaluating internal controls involves:

- Identifying the internal control objectives relevant to the credit union;
- Reviewing pertinent policies, procedures, and documentation;
- Discussing controls with appropriate levels of personnel;
- Observing the control environment;
- Testing transactions as indicated by the level of risk;
- Sharing findings, concerns, and recommendations with the board of directors and senior management; and
- Determining that the credit union has promptly corrected noted deficiencies.[21]

[20] NCUA Examiner's Guide, Chapter 1.
[21] NCUA Examiner's Guide, Chapter 4.

In addition, NCUA guidance indicates examiners should base the scope, type, and depth of an internal control review on the credit union's size, complexity, scope of activities, and risk profile. An assessment of the credit union's audit function plays an important part in this determination. When management or examiners note internal control weaknesses, the credit union should take immediate action to correct the deficiencies.

Furthermore, according to NCUA guidance, internal control is the process, developed by a credit union's board of directors, management, and other personnel, designed to provide reasonable assurance in the effectiveness and efficiency of its operations, the reliability of its financial reporting, and the credit union's compliance with applicable laws and regulations. NCUA internal control examination objectives help to:

- Determine whether the credit union has implemented efficient and effective operations and risk management systems;
- Determine whether the credit union accurately records transactions;
- Determine timeliness and reliability of financial reporting;
- Determine whether the credit union complies with regulations, internal policies, and internal procedures; and
- Assess whether the credit union has implemented adequate internal controls to safeguard assets.[22]

In our opinion, NCUA did not adequately achieve any of these objectives. Although the examiners, Supervisory Committee and external auditor may have performed their required minimum procedures, none of them properly assessed the adequacy of the credit union's internal control structure nor tested its operational effectiveness. We reviewed NCUA examinations[23] conducted prior to the discovery of the alleged fraud and determined NCUA examiners were aware of some of the internal control weaknesses. For example, when the examiners arrived to conduct the examinations, the CEO stated the loan files were stored at the other branch and would make them available the following morning. In addition, while the credit union staff repeatedly claimed the data processing system did not allow pledged shares to be frozen, NCUA examiners failed to elevate the repeated DOR items for stronger supervisory action.

We found NCUA examiners did not determine that internal controls were weak until the discovery of the alleged fraud. We believe the examiners did not adequately

[22] NCUA Examiner's Guide, Chapter 4.
[23] We reviewed NCUA examinations and supervision contacts from December 31, 2004 through December 31, 2008, and the pre-scheduled the December 31, 2009, examination that was conducted after NCUA met representatives from two Federal agencies. However, NCUA significantly expanded the number of hours for the December 2009 examination after the meeting.

assess the risks to St Paul during the examinations and contacts conducted prior to the alleged fraud discovery. Specifically, NCUA examiners did not rate transaction risk high until after the suspected fraud was uncovered. Appendix B contains the nine factors comprising the transaction risk indicators.

Transaction Risk Not Rated High

Examiners did not consider the following issues serious enough to rate transaction risk high at St. Paul:

- Weak internal controls;
- Serious weaknesses in audit coverage;
- Significant weaknesses in transaction and information processing activities; and
- Failure of management to make required corrections to improve transaction-processing risk controls.

Specifically, we found:

- During the December 31, 2004, examination, the examiner noted no significant transaction risk concerns existed. However, the examiner reported that a $99,000 wire transfer and a $64,000 automated clearinghouse transaction were not posted to the credit union books.
- The examiner rated transaction risk low during the December 31, 2005, examination because the review of major general ledger accounts showed amounts traced back to supporting documentation, employees had a tradition of long-term tenure, the annual audit was performed by an outside vendor, and membership was limited to the church parishioners. Furthermore, the examiner did not note any concerns or problems with the Supervisory Committee audit. Nevertheless, the examiner found all documentation for the last call report supported the report except for nonmember deposits.
- During the June 30, 2007, supervision contact, the examiner noted for the first time that St. Paul had outgrown its current audit provider. A DOR item from the December 31, 2007, examination stated the audit should conform to generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). In addition, the examiner noted a review of the hardware and software operations showed there were several areas for improvement. Yet, the examiner only rated transaction risk as moderate.
- The examiner noted during the December 31, 2008, examination that oversight of the financial condition and internal controls were still being viewed

from the perspective of a small credit union. The examiner also noted that, as a result, adjustments made to the year-end call report were indicative of the need for a more detailed analysis. Although the examiner further noted instances were created where reporting under GAAP was questionable, the examiner only rated transaction risk as moderate.

We also found that the examiners noted on the Supervisory Committee Audit and Verification Review checklists, from December 31, 2004 through December 31, 2009, that there were no reportable conditions or material weaknesses found during review of the credit union's audit reports. However, we believe that the lack of segregation of duties and lack of internal controls over share secured loans were material weaknesses. Additionally, we found no evidence that the examiner reviewed whether anyone performed any internal control reviews. Furthermore, the examiners stated that, for most examinations there were no Supervisory Committee minutes. Consequently, NCUA examiners did not perform additional, or expanded examination procedures.

(See Appendix A, Table A-2 for risk ratings)

Examiners Did Not Elevate Repeated DOR Issues for Stronger Supervisory Actions

Examiners did not ensure St. Paul's management took corrective actions on repetitive issues detailed in DOR items to prevent them from becoming problems. This included freezing shares used as collateral, obtaining an annual audit that adhered to GAAP and GAAS, and addressing liquidity and asset liability management issues. We believe the delay in issuing a DOR, the multiple instances of repeat DORs and the failure to take more stringent supervisory actions resulted in missed opportunities to uncover the suspected loan fraud.

The credit union allegedly did not have a system in place to ensure shares used to secure loans were frozen, thereby preventing the same shares from being used to secure other loans or being withdrawn. We found during the December 31, 2007, examination, a DOR item required the credit union's manager to contact the software provider to determine the procedure necessary to show that funds were frozen as collateral on loans and to ensure that they were not accidently used twice. The examiners repeated this as a DOR item for the December 31, 2008, examination and the March 31, 2009, supervision contact, yet it was never resolved. In addition, we found examiners were aware of the issue as far back as the December 31, 2002, examination. In a summary report, NCUA staff determined that during the December 31, 2002, examination, the examiner noted St. Paul's management was in the process of ensuring that shares securing loans were properly identified in the data processing system to prevent withdrawals. However, there was no formal requirement in the examiner findings or a DOR to correct the issue until 2007. NCUA staff also determined that during the December 31, 2004, examination a team member reviewing loans issued a memo to the examiner in charge stating St. Paul management needed to devise a method to track accounts or certificates securing loans to ensure the same account does not secure more loans than funds existing in the deposit account. In addition, the examiner noted that one loan had insufficient shares as collateral and that the same share certificates backed two loans, but were insufficient to cover both loans.

We also found that during the June 30, 2007, supervision contact, the examiner determined St. Paul had outgrown its audit provider and needed to consider obtaining an annual opinion audit.[24] Furthermore, during the December 31, 2007, examination, the examiner recommended that the credit union obtain a CPA[25] audit performed by a firm with an in-depth understanding of credit union operations and knowledgeable of GAAP and GAAS. The examiners listed this as a repeat DOR item on the next and final two examinations. For instance, during the December 31, 2008, examination, examiners noted the auditor only documented the general ledger and balancing of accounts, and that management needed to engage the auditor to perform the next audit in conformance with GAAP and GAAS requirements.

We further found, for six of the eight examinations and supervision contacts[26] conducted prior to the December 31, 2009, examination, the examiners issued repeated DORs for liquidity risks. Specifically, for five of the six contacts, NCUA examiners recommended St. Paul revise its funds management/liquidity policy for ratio limits. During the June 30, 2007,[27] contact, the examiner stated St. Paul needed to increase liquidity to five percent of assets. In addition, one of the DOR items from the March 31, 2009, contact directed the credit union to establish a line of credit with another source other than the corporate credit union. Furthermore, for four of the eight examinations and supervision contacts,[28] the examiner issued repeated DORs for St. Paul to (1) develop an asset liability management policy addressing interest rate risk; (2) establish cash flow risk limits; and (3) develop internal controls and reporting requirements.

We found the examiners did not elevate any of these issues to the Supervisory Examiner for stronger supervisory actions such as a Regional Director's Letter, or a Letter of Understanding and Agreement. As a result, NCUA missed opportunities to mitigate the loss to the NCUSIF caused by St. Paul's failure.

(See Appendix C for DORs)

[24] An opinion audit expresses an opinion on the fair presentation of the financial statements in all material respects in accordance with generally accepted accounting principles.
[25] Certified Public Accountant.
[26] The six examination and supervision contact dates were December 31, 2004, December 31, 2005, June 30, 2007, December 31, 2007, December 31, 2008, and Mar 31, 2009.
[27] The five of six examination and supervision contact dates were December 31, 2005, June 30, 2007, December 31, 2007, December 31, 2008, and Mar 31, 2009.
[28] The four of eight examination and supervision contact dates were December 31, 2004, December 31, 2007, December 31, 2008, and March 31, 2009.

Examination Procedures Not Expanded When Red Flags Present

We found loans amounted to well over ninety percent of St. Paul's assets and the examiners rated credit risk low prior to the December 31, 2009, examination primarily based upon the assumption that the majority of loans were share secured and the credit union was reporting zero delinquency. In fact, the credit union reported zero delinquency and charge-offs from, at least, 2004 through 2009. Examiners believed this was reasonable, stating that faith-based credit unions such as St. Paul usually have low delinquency. It was not until the December 31, 2009, examination that the examiners rated credit risk high. The examiners determined that many of the loans were in fact not share secured, loan documentation contained many unauthorized corrections, and data processing controls were weak.

We also found examiners did not perform sufficient testing and analysis when risks were readily apparent. Specifically, the examiners did not test for hidden delinquency or expand examination procedures when unusual financial performance ratios, abnormal real estate trends, and inappropriate member business loans existed. We found that the examiners noted multiple red flags during the examinations conducted at St. Paul, but did not follow-up on the exceptions or deficiencies found. In addition, NCUA guidance[29] indicates examiners should be aware of any red flags, which may indicate that the examiner needs to expand analysis and review of the applicable operations. We found the following red flags existed at St. Paul:

<u>Delinquency/Loan File Red Flags</u>

In spite of the economic downturn and contrary to other credit unions, St. Paul reported zero loan delinquency and charge-offs from 2004 through 2009. We determined that the delinquency/loan file red flags the examiners found, but for which they did not expand examination procedures, listed by examination, included:

- December 31, 2004
    - Eight of twenty-three paid-ahead loans reviewed were technically delinquent since monthly loan payments were not made;
    - Very few loans had income verifications in the loan file;
    - Numerous credit reports had scores in the 400 to 600 range; and
    - Two loans had old credit reports, one loan showed several accounts in collection, and two contained credit reports obtained after the loan was approved, of which one also showed several accounts in collection.

[29] NCUA Examiner's Guide, chapter 7.

- December 31, 2007

    - Minor exceptions existed mostly for high risk loans with no explanation on poor credit reports;

    - Three loans with balances between $416,000 and $658,000 appeared to be delinquent. Specifically, one showed no payment on the principal, one had accrued interest of four months and the third had five months of accrued interest;

    - Four loan files had credit quality issues such as a credit report showing delinquent loans and the loan amount greater than the secured collateral; and

    - Three real estate loans were listed as loan exceptions.

- December 31, 2008

    - Four loan security agreements were corrected without member approval;

    - Three loans files showed bad credit history. Two members had bankruptcies and one member had a past due real estate loan;

    - One loan document disclosed the wrong payment;

    - One car loan security agreement did not list the vehicle identification number ; and

    - A large number of share loans were secured by shares from accounts other than the loan recipient.

The delinquency/loan file red flags the examiners found, during the December 31, 2009, examination and after the allegation of suspected criminal activity included:

- Loans encoded as share secured did not always contain the required share collateral documentation in the loan file;

- Actual share secured loans largely secured by individuals not party to the loan;

- Share pledge agreements were not always signed;

- Loan files did not always contain an assignment of shares;

- Data processing system did not have sufficient record length to support size of large loans;
- Correction fluid commonly used on loan documents without authorization;
- No income verification required on any loan; and
- Fifty-four consumer loan exceptions consisted of mostly share secured documentation issues

Financial Performance Red Flags

Although the nation's economy took a downturn in 2007, St. Paul's financial performance appeared to be excellent. For example, St. Paul's return on assets (ROA) was over two percent, while peer ratio ROA steadily dropped and loan growth was always above the peer ratio. In addition, member loan yields were higher than peer credit unions, and loan delinquency and charge-offs both were reported as zero. We found examiners did not expand procedures or test for hidden delinquency even though there were inherent risks with a reported zero delinquency. Moreover, we found no evidence that examiners performed more than minimal procedures when assessing St. Paul's financial performance. See the below chart for St. Paul alleged financial performance versus peer credit unions' performance.

St. Paul Financial Performance Ratios						
Ratio	2004	2005	2006	2007	2008	2009
ROA	2.26	2.55	2.30	2.21	2.28	2.38
Peer	*0.9*	*0.8*	*0.77*	*0.64*	*0.29*	*0.01*
Loan Growth	42.51	22.29	13.99	6.28	14.75	21.98
Peer	*10.56*	*10.54*	*7.45*	*5.36*	*6.88*	*4.41*
Loan Yield	7.46	7.51	7.46	7.46	7.47	7.47
Peer	*6.37*	*6.28*	*6.64*	*6.9*	*6.77*	*6.5*
Loan Delinquency	0	0	0	0	0	0
Peer	*0.77*	*0.8*	*0.75*	*1.01*	*1.39*	*1.71*
Charge Offs	0	0	0	0	0	0
Peer	*0.54*	*0.54*	*0.46*	*0.49*	*0.72*	*0.98*

Real Estate Loan Red Flags

The real estate market was the primary driver in the 2007 economic downturn. St. Paul's total real estate portfolio was relatively constant, averaging approximately $34 million from 2004 to 2006. While this amount dropped in 2007 to $22 million, primarily due to a participation loan agreement with another credit union, real estate loans increased to $42 million in 2008 and to $63 million in 2009. This occurred even as the economic downturn affected most of the county. In addition, all of these loans were non-traditional five-year balloon notes with payments amortized over 30 years. We found the examiners did not expand procedures even though there were inherent risks with these types of real estate loans. We determined that during reviews of real estate loan files, the examiners found multiple loan exceptions that were red flags and should have led to expanded examination procedures. Those red flags, listed by examination, included:

- December 31, 2004
    - One real estate loan file contained an appraisal for a previous loan, for which the purchase price was greater than appraisal. The file also contained a credit report that was over one year old;
    - Another loan file contained a credit report, which showed the borrower had several accounts in collection and a low credit score. In addition, there was no final insurance policy. Also, the examiner noted that it may have been a business loan since the purchase agreement included items needed to operate a pizza parlor;
    - One real estate loan was due to be refinanced; and
    - One loan file contained a credit report dated after loan date and the credit report showed several collection accounts.
- December 31, 2007
    - One loan was for an amount greater than the collateral used and the hazard insurance was less than the loan amount;
    - One loan file contained a year old credit report; and
    - One loan file did not have the final title commitment or the recorded mortgage.
- December 31, 2008
    - All four of the real estate loans reviewed by examiners contained loan exceptions;

  - One loan had a loan to value of 94 percent, which was greater than St. Paul's policy of 80 percent;

  - Another loan file did not contain an updated mortgage lien. The loan had been refinanced, but the enclosed lien was for a loan due October 2003;

  - One loan file contained a credit report that was obtained after the note was signed, the loan to value was 95 percent and the mortgage had not been filed; and

  - For one loan, the property evaluation was based on the tax assessment instead of a real estate appraisal and the mortgage had not been filed.

During the December 31, 2009, examination, examiners determined policies were inadequate to control risk, specifically for geographic area of operation and appraisal requirement.

<u>Member Business Loans Red Flags</u>

Member business loans (MBL) were present, but were not viewed as MBLs. The examiners apparently took at face value that these loans were share secured and therefore not MBLs. We found no evidence of any additional procedures performed by examiners even though the following red flags were present. For example:

- During the December 31, 2004, examination the examiner stated "there were two loans that might have been business loans";

- The examiner noted for the December 31, 2007, examination that a large number of share secured loans were for large dollar amounts and It appeared that this was a way for the credit union to make business loans without a lot of documentation;

- For the December 31, 2008, examination, the examiner noted there was evidence of MBLs, but all the loans were apparently share secured and therefore, not subject to NCUA MBL Rules and Regulations;

- Examiners did not take exception to many issues until after the FBI and IRS met with NCUA staff in January 2010. For example, during the December 31, 2009,[30] examination the examiners found:

  - St. Paul had an MBL portfolio of 133 loans valued at $68.6 million with $2.4 million originated prior to 2008, $18.6 million in 2008, $41.8 million in 2009, and the remainder during 2010;

[30] December 31, 2009, is the effective date of the examination. The examiners conducted this examination from February to April 2010.

- Evidence that some of the MBLs had been on the credit union's books for years;
- Several loans classified as share secured loans were actually MBLs;
- The credit union did not have an MBL policy;
- The data processing system did not track MBLs; and
- Business loans were not supported by adequate documentation such as corporate designation of authority to borrow.

In addition, we found strategic, transaction and compliance risks existed prior to the discovery of the alleged fraud. However, examiners did not view the risks as safety and soundness concerns until the December 31, 2009, examination. Specifically the red flags were:

<u>Transaction Risk Red Flags</u>

NCUA defines transaction risk as the 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.[31] Prior to the December 31, 2009, examination, in addition to the freezing of the share issues, examiners also voiced concerns that the annual audit was not sufficient for the size and complexity of this credit union. However, neither issue was ever resolved. Subsequently, examiners found the data processing system truncated numbers on loan documents and loan documentation was very poor. During the December 31, 2009, examination, NCUA staff found a lack of segregation of duties with the CEO handling most functions and the staff apparently unable to perform anything but the most basic tasks. Examiners also noted several areas as having transaction risk issues. For example, DOR items included training the staff on document preparation, ensuring monitoring reports contain sufficient information, and taking action to correct or place sufficient internal controls on loan advances.

We determined that member account confirmations did not include a verification of pledged shares. We also determined that although it is not required, it would have seemed prudent to verify pledged shares, considering other controls were absent on these shares. We further determined there was little evidence that examiners focused much attention on the above internal control concerns, since we saw no evidence that they performed any additional substantive examination procedures.

[31] NCUA Examiner's Guide, chapter 1.

Strategic Risk Red Flags

According to NCUA guidance, strategic risk is the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.[32] We found that although St. Paul continued to have severe liquidity issues from at least 2004 through 2009, the examiners did not take stronger enforcement actions. In addition, the credit union did not have adequate policies, procedures and internal controls. Furthermore, one of the most critical internal controls was the credit union's continued lack of resolution on the freezing of pledged shares. NCUA examiners noted, as far back as the December 31, 2002, examination, that the credit union was in the process of ensuring shares securing loans were properly identified in the data processing system to prevent withdrawals. However, the examiners did not make this a DOR item until the December 31, 2007, examination. While this was a repeated DOR item in subsequent examinations, NCUA examiners neither performed additional procedures nor held St. Paul's management accountable by taking stronger enforcement actions. During the December 31, 2009, examination, examiners found there were a lack of segregation of duties, lending policies, and internal controls, and subsequently rated strategic risk as high. However, prior to this examination, strategic risk was only rated moderate; consequently, examiners did not perform any additional procedures.

Compliance Risk Red Flags

Compliance Risk is the current and prospective risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards.[33] During the December 31, 2009, examination, examiners determined that St. Paul's data processing system reports were not sufficient to ensure compliance with BSA. Specifically, system reports did not separate checks and cash when both cash and checks were deposited at the same time. Although the examiner had previously noted this issue, the credit union never corrected the problem. In addition, the examiner noted significant BSA violations during the December 31, 2005, examination, which according to the examiner all but one of the seven violations were resolved by September 30, 2006. Furthermore, the wire transfer log was a manual system and was not sufficient for OFAC and BSA purposes. In addition, non-members partied to wire transfers were not matched against the OFAC listing. Although examiners discovered these issues prior to the December 31, 2009, examination, the issues were never corrected.

See Appendix A, Table A-2 for risk ratings

[32] NCUA Examiner's Guide, chapter 1.
[33] NCUA Examiner's Guide, chapter 1.

NCUA's Quality Control Review Was Ineffective

An objective of NCUA's examination evaluation and review process is to measure the quality and effectiveness of its examination and supervision program by assessing the quality of examiner problem identification, recommendations for resolution and risk mitigation, and effectiveness of communication with officials. To help ensure quality control, NCUA evaluates and reviews examination reports through Supervisory Examiner (SE) and Division of Supervision (DOS) reviews. SEs evaluate all of the examiners' work as part of the examiner's development and overall appraisal; and DOS analysts perform a quality control function, and as such, limit their review to the written reports. According to NCUA guidance, the quality of the examination report can cause a risk to the NCUSIF.

SEs must select at least five reports each year from each examiner for formal evaluation. These evaluations should determine the following:

- Examiners receive consistent, prompt feedback regarding the quality of their work, including the strengths, weaknesses, and suggestions for improving performance;

- Examiners prepare an appropriate and effective scope and report that adequately addresses risk, identifies problems, and makes sound recommendations to resolve major problems within acceptable time frames;

- Examiners have written a report that stands alone and documents a complete administrative record of the examination contact; and

- Examiners minimize NCUSIF losses through adequate identification and resolution of problems.

DOS analysts review all reports meeting the following criteria:

- All credit unions coded CAMEL 4 or 5 with assets greater than $100,000;

- All credit unions coded CAMEL 3 with assets greater than $50 million;

- All credit unions coded CAMEL 3 for longer than 36 months and with assets greater than $5 million;

- All credit unions with assets greater than $250 million; and

- A selected sample of examinations and supervision contacts determined by the regional director.

DOS analysts review reports to identify existing or emerging trends, common or frequently occurring findings, and systemic risk factors. DOS analysts can further observe trends within the credit unions and in the examination process. DOS reviews focus on quality control and should address whether the report:

- Addresses risk through an appropriate and effective scope;
- Focuses on results and includes plans for correcting problems promptly;
- Addresses negative trends and includes sound recommendations to resolve major problems within acceptable time frames;
- Complies with uniform examination, insurance review, and supervision standards;
- Presents a stand-alone document of the examination contact; and
- Provides a complete administrative record of the examination contact.

The SEs and DOS analysts will conduct the evaluation and review processes independently. Both SEs and DOS analysts will complete and disseminate their evaluations and reviews within 30 days of the report upload. Regional policy determines whether the region will release DOS Reviews to examiners. Each region will develop its own policy to identify and resolve material differences between DOS Reviews and SE Evaluations.[34] According to NCUA Region III current guidelines, the DOS forwards the quality control report to the SE and the SE then forwards it to the examiner.[35]

We believe NCUA's Quality Control Program was not effectively present for this credit union. Specifically, we found that through 2009, NCUA SEs conducted three evaluations[36] of St. Paul examinations. However, none of the evaluations addressed any of the multiple red flags that the examiners noted during the examinations. Moreover, for each evaluation, the SEs agreed with the examiner's risk assessments and/or assigned the CAMEL ratings. We believe the SEs should have questioned the continuous zero delinquency and required the examiners to expand examination procedures and test for zero delinquency. Furthermore, the SEs did not address the need for stronger supervisory actions for repeated DORs such as freezing the shares used as collateral or having an annual audit that conformed to GAAP and GAAS.

According to NCUA guidelines, Region III DOS was not required to perform a quality control review on St. Paul's examinations. From December 2004 through March 2009 because St. Paul was coded a CAMEL 2 and reported less than $250 million in assets, Region III DOS was not required to evaluate and review St. Paul's written examination reports. We found that Region III DOS did not select any of St. Paul's examinations for a random review.

[34] NCUA Examiner's Guide, chapter 22.
[35] NCUA Region III Guide, section IX.
[36] The evaluations covered the December 31, 2005, December 31, 2007 and December 31, 2008 examinations.

C. Observations

We reviewed industry observations regarding occupational fraud.[37] We believe the industry's observations apply to issues we observed during our review of St. Paul's failure. For example, the Association of Certified Fraud Examiners (ACFE) reported in their 2008 report to the nation[38] that the implementation of anti-fraud controls has a measurable impact on an organization's exposure to fraud. ACFE examined 15 specific anti-fraud controls and measured the median loss in fraud cases depending on whether organizations did or did not have a given control in place at the time of the fraud. In every comparison, the ACFE found significantly lower losses when controls had been implemented. We determined St. Paul's lax internal control environment created an environment susceptible to fraud.

The following table lists other industry observations regarding fraud and how they compare to our observations about St. Paul's failure:

Industry Observations of Fraudulent Activity	NCUA OIG Observations of St. Paul's Failure
Lack of adequate internal controls is the most common factor that allows fraud to occur.	Lack of segregation of duties. Data Processing system control issues.
Small businesses have been determined to be most susceptible to occupational fraud.	Lack of segregation of duties due to low number of employees (ten employees for two offices). One person handled most of the accounting and lending processes.
Lack of management review allows fraud to occur.	Supervisory Committee not fully active. Repeated DOR items not addressed.

Although we determined that more diligent and aggressive supervision on the part of NCUA may have mitigated the loss, we believe the cause of St. Paul's failure was directly attributable to the suspected fraud committed against its members through the actions of one individual.

[37] The Association of Certified Fraud Examiners defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."
[38] Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud and Abuse.

Auditor observations made as a result of our review of St. Paul's failure include:

- Examiners did not consider the lack of adequate internal controls serious enough to rate transaction risk high at St. Paul even though this issue is an inherent problem in smaller credit unions. We believe the lack of internal controls and the repeatedly alleged data processing system issues indicated material weaknesses may have existed, warranting expanded examination procedures. Opportunities existed for management to reinforce the need for additional procedures.

- Examiners need to be reminded of the importance of understanding that DORs are to be developed to outline plans to reduce areas of unacceptable risk, with particular emphasis on the types of safety and soundness concerns that were clearly present in the years leading up to St. Paul's failure. Further, any reminder provided to examiners on the DOR process would be remiss if DOR follow-up in subsequent examinations were not also emphasized.

- A lack of emphasis on the importance of additional procedures, such as the Red Flag review, and expanding procedures when red flags are detected. Specific monitoring triggers could be developed to more easily 'red flag' areas to be investigated, as well as provide a specific time allocation.

Appendix A: Examination and Supervision History

The following provides a summary of NCUA's supervision of St. Paul, which includes examinations, and on-site and off-site supervision contacts from December 2004 through the December 2009 examination during which NCUA placed St. Paul under conservatorship.

Table A-1

St. Paul Assets and CAMEL Ratings – 2004 to 2009

Examination or Contact Date	Assets[39]	Composite	C	A	M	E	L
12/31/2009	$238.8	4	4	4	5	5	4
3/31/2009	$202.5	2	1	1	3	1	3
12/31/2008	$195.8	2	1	1	3	1	3
12/31/2007	$171.0	2	1	1	2	1	3
6/30/2007	$161.3	2	1	1	2	1	3
9/30/2006	$156.9	2	1	1	2	1	3
6/30/2006	$151.9	2	1	1	2	1	3
12/31/2005	$144.2	2	1	1	2	1	3
12/31/2004	$108.7	2	1	2	1	1	2

C=Capital; A=Asset Quality; M=Management; E=Earnings; L=Liquidity

Table A-2

St. Paul Risk Ratings – 2004 to 2009

Examination or Contact Date	SR	TR	CMR	CRR	IR	LR	RR
12/31/2009	High	High	High	High	High	High	High
3/31/2009	Mod.	Mod.	Mod.	Low	Mod.	High	Mod.
12/31/2008	Mod.	Mod.	Mod.	Low	Mod.	High	Mod.
12/31/2007	Mod.	Mod.	Mod.	Low	Mod.	High	Mod.
6/30/2007	Mod.	Mod.	Low	Low	Low	High	Mod.
9/30/2006	N/A	N/A	N/A	Low	N/A	N/A	N/A
6/30/2006	N/A	N/A	N/A	Low	N/A	N/A	N/A
12/31/2005	Mod.	Low	High	Low	Low	High	Low
12/31/2004	Mod.	Low	Low	Low	Mod	High	Low

SR=Strategic Risk; TR=Transaction Risk; CMR=Compliance Risk; CRR=Credit Risk; IR=Interest Rate Risk; LR=Liquidity Risk; RR=Reputation Risk; Mod= Moderate; N/A=Not Applicable

[39] Dollar amounts are in the millions.

Table A-3

St. Paul Balance Sheet Composition – 2004 to 2009

Examination or Contact Date	Assets[40]	Loans	Shares	Loans/Assets Ratio
12/31/2009	$238.8	$233.6	$208.5	97.82%
12/31/2008	$195.8	$191.5	$169.9	97.80%
12/31/2007	$171.0	$166.9	$147.0	97.63%
12/31/2006	$161.1	$157.0	$139.4	97.48%
12/31/2005	$144.2	$137.8	$130.4	95.55%
12/31/2004	$119.1	$112.7	$108.7	94.60%

[40] Dollar amounts are in the millions.

Appendix B: Risk Indicators

The following summarizes NCUA Examiner's Guide, Chapter 2, Attachment 2.1, which provides examiners with guidance in the assignment of risk level.

Transaction Risk Indicators

Factor	Low	Moderate	High
Board and Operational Management Understanding	Fully understands all aspects of transaction risk.	Reasonably understands key aspects of transaction risk.	Does not understand, or chooses to ignore key aspects of transaction risk.
Responsiveness to Market and Technological Conditions	Anticipates and responds well to changes.	Adequately responds to changes.	Does not anticipate or take timely or appropriate actions in response to changes.
Risk Exposure	Only a slight probability of damage to reputation, capital, or earnings.	Possible loss to reputation, earnings or capital exists but is mitigated by adequate internal controls.	Weak internal controls expose the credit union to significant damage to reputation, or loss of earnings or capital.
Transaction Processing Controls	History or sound operations. Likelihood of transaction processing failures is minimal due to strong internal controls.	History of adequate operations. Likelihood of transaction processing failures is minimized by generally effective internal controls.	History of transaction processing failures. Likelihood of future failures is high due to absence of effective internal controls.
Systems and Controls	Strong control culture that results in systems, internal controls, audit, and contingency and business recovery plans that are sound.	Adequate operating and information processing systems, internal controls, audit coverage, and contingency and business recovery plans are evident.	Serious weaknesses exist in operating and information systems, internal controls, audit coverage, or contingency and business recovery plans.
MIS	Satisfactory	Minor deficiencies may exist that relate to transaction and information processing activities.	Significant weaknesses in transaction and information processing activities.
New Products or Services	Favorable performance in expansions and introductions of new products and services.	Planning and due diligence prior to introduction of new services are performed although minor weaknesses exist.	Inadequate. CU is exposed to risk from the introduction or expansion of new products and services.
Conversion Management	Conversion plans are clear, comprehensive, and followed.	Conversion plans are evident, although not always comprehensive.	CU may be exposed to processing risks due to poor conversion management, either from the integration of new acquisitions with existing systems, or from converting one system to another.
Problem Identification and Corrective Action	Management identifies weaknesses quickly and takes appropriate action.	Management recognizes weaknesses and generally takes appropriate action	Management has not demonstrated a commitment to make the corrections required to improve transaction processing risk controls.

Strategic Risk Indicators

Factor	**Low**	**Moderate**	**High**
Risk Management Practices	Practices are an integral part of strategic planning.	Quality is consistent with the strategic issues confronting the credit union.	Practices are inconsistent with strategic initiatives. A lack of strategic direction is evident.
Strategic Planning	Strategic goals, objectives, culture, and behavior are effectively communicated and consistently applied throughout the institution. The depth of management talent enhances strategic direction and organizational corporate efficiency.	Demonstrated the ability to implement goals and objectives and successful implementation of strategic initiatives is likely.	Operating policies and programs inadequately support strategic initiatives. The structure and talent of the organization do not support long-term strategies.
Management/Staff Turnover	Changes in key management or staff are well managed and minimal. Succession plans are documented and effective.	Key management or staff changes recently occurred. Succession plans are adequate.	Key management or staff turnover is high and poorly managed. Succession plans are non-existent, inadequate, or ignored.
Track Record	Management has been successful in accomplishing past goals and is appropriately disciplined.	Management has a reasonable record in decision-making and controls.	Deficiencies in management decision-making and risk recognition do not allow the institution to effectively evaluate new products, services, or FOM expansions.
MIS	Management information systems effectively support strategic direction and initiatives.	Management information systems reasonably support the credit union's short-term direction and initiatives.	Management information systems supporting strategic initiatives are seriously flawed or do not exist.
Risk Exposure	Exposure reflects strategic goals that are not overly aggressive and are compatible with developed business strategies.	Exposure reflects strategic goals that are aggressive but compatible with business strategies.	Strategic goals emphasize significant growth or expansion that is likely to result in earnings volatility or capital pressures.
Impact and Risk of Initiatives	Initiatives will have a negligible impact on capital, systems, or management resources. The initiatives are well supported by capital for the foreseeable future and pose only nominal possible effects on earnings volatility.	Actual practices have only minor inconsistencies with planned initiatives. Initiatives are reasonable considering the capital, systems, and management. Decisions are not likely to have a significant adverse impact on earnings or capital and can be reversed without significant cost or difficulty.	The impact of strategic decisions is expected to significantly affect net worth. Strategic initiatives may be aggressive or incompatible with developed business strategies. Decisions are either difficult or costly to reverse.
Appropriateness of New Products & Services	New products/services are supported by sound due diligence and strong risk management. The decisions can be reversed with little difficulty and manageable costs.	New products/services will not materially alter business direction, can be implemented efficiently and cost effectively, and are within management's abilities.	Strategic goals are unclear or inconsistent, and have led to an imbalance between the credit union's tolerance for risk and willingness to supply supporting resources for new product/service offerings.

Compliance Risk Indicators

Factor	**Low**	**Moderate**	**High**
Board and Operational Management Understanding	Fully understands all aspects of compliance risk and exhibits a clear commitment to compliance. Commitment is communicated throughout the institution.	Reasonably understands the key aspects of compliance risk. Commitment to compliance is reasonable and satisfactorily communicated.	Does not understand, or has chosen to ignore, key aspects of compliance risk. The importance of compliance is not emphasized or communicated throughout the organization.
Authority and Accountability	Authority and accountability for compliance are clearly defined and enforced.	Authority and accountability are defined, although some refinements may be needed.	Management has not established or enforced accountability for compliance performance.
Response to Changes	Anticipates and responds well to market or regulatory changes.	Adequately responds to market or regulatory changes.	Does not anticipate or take timely or appropriate actions in response to market or regulatory changes.
Product and Systems Development	Compliance considerations are incorporated into product or systems development.	While compliance may not be formally considered when developing product or systems, issues are typically addressed before they are fully implemented.	Compliance considerations are not incorporated in product or systems development.
Violations & Risk Exposure	Violations, noncompliance, or litigation are insignificant, as measured by their number or seriousness.	The frequency or severity of violations, noncompliance, or litigation is reasonable.	Violations, noncompliance, or litigation expose the credit union to significant impairment of reputation, value, earnings, or business opportunity.
Error Detection and Corrective Action	When deficiencies are identified, management promptly implements meaningful corrective action.	Problems can be corrected in the normal course of business without a significant investment of money or management attention. Management is responsive when deficiencies are identified.	Errors are often not detected internally, corrective action is often ineffective, or management is unresponsive.
Risk Management	Good record of compliance. The CU has a strong control culture that has proven effective. Compliance management systems are sound and minimize the likelihood of excessive or serious future violations.	Compliance management systems are adequate to avoid significant or frequent violations or noncompliance.	Compliance management systems are deficient, reflecting an inadequate commitment to risk management.
Controls and Systems	Appropriate controls and systems are implemented to identify compliance problems and assess performance.	No shortcomings of significance are evident in controls or systems. The probability of serious future violations or noncompliance is within acceptable tolerance.	The likelihood of continued violations or noncompliance is high because a corrective action program does not exist, or extended time is needed to implement such a program.
Training and Resources	Training programs are effective and the necessary resources have been provided to ensure compliance.	Management provides adequate resources and training given the complexity of products and operations.	Management has not provided adequate resources or training.

Appendix C: Enforcement Actions

The following tables provide a summary of repetitive recommendations/DORs to correct problems identified by examiners from December 31, 2004 through March 31, 2009. The DORs are categorized by issue.

Table C-1

Liquidity Risk

Examination or Contact Date	DOR Items
12/31/2004	Develop liquidity policy and standard including ratio limits, projected cash flows, prioritized funding sources, monitoring responsibilities and report requirements.
12/31/05	Revise funds management/liquidity policy for ratio limits, minimum cash available, reporting requirements, cash flow analysis, monitor unused LOCs, quarterly reports to board on borrowings and non-member deposits, and break out non-member shares on the general ledger.
6/30/07	Increase liquidity to 5% of assets.
	Revise funds management/liquidity policy for ratio limits, minimum cash available, reporting requirements, cash flow analysis, establish sufficient LOCs, quarterly reports to board on borrowings and non-member deposits, and break out non-member shares on the general ledger.
12/31/07	Revise funds management/liquidity policy for ratio limits.
12/31/08	Revise funds management/liquidity policy for ratio limits.
3/31/09	Revise funds management/liquidity policy for ratio limits. Establish and maintain sufficient liquidity levels of overnight funds. Execute mortgage loan sale/participation. Develop strategies to fund non-member CDs as they mature. Establish LOC other than at the corporate.
12/31/09	Revise funds management/liquidity policy for ratio limits. Establish and maintain sufficient liquidity levels of overnight funds. Execute mortgage loan sale/participation. Develop strategies to fund non-member CDs as they mature. Establish LOC other than at the corporate.
	Adopt Investment policy to meet 12CFR Part 703.

Table C-2

Credit Risk

Examination or Contact Date	DOR Items
12/31/09	Have an independent third party review all loans, especially MBLs for adequate documentation of validity and value of pledged collateral.
	Obtain legal opinion on enforceability of Assignment of CD and Loan and Security Agreement and Disclosure Statements, which were altered.
	Place moratorium on MBLs until the credit union is in compliance with NCUA Rules and Regulations. Refrain from refinancing MBLs.
	Revise RE loan policy to include geographic areas, types of properties and required documentation.
	Develop and adopt formal policy for RE appraisals.

Table C-3

Strategic Risk

Examination or Contact Date	DOR Items
12/31/04	Review and revise business plan including long and short term goals, products and services.
12/31/05	Develop a plan to reduce non-member deposits to a maximum of 20% of total shares. Address the rapid growth in deposits and loans by setting limits and goals.
12/31/07	Develop and revise written IT policies and procedures where needed.
12/31/09	Develop business plan to divest of impermissible accounts.
	Document annual business plans.
	Monitor activity to bring about changes in products and services.
	Ensure sufficient research is performed up front with new products and services for regulatory issues, compliance issues and sound internal controls.

Table C-4

Compliance Risk

Examination or Contact Date	DOR Items
12/31/05	Complete independent testing of BSA program. Update BSA policy to achieve effective internal controls for required SAR filings, provide adequate due diligence to monitor accounts for suspicious activity, require CIP information prior to opening an account.
12/31/08	CU has not been verifying wire transfers with non-member parties for OFAC – *Examiner Finding.*
12/31/09	Ensure all non-real estate loans will not exceed a 15-year maturity including five-year balloons.
	Develop BSA training program for officials.
	Develop and maintain appropriate records to monitor all aggregate cash deposits and withdrawals.
	Institute procedure to document wire transfers. Should be on an electronic spreadsheet.
	Complete annual OFAC audit.
	Timely compare entire membership to a current OFAC list
	Ensure all non-members who are a party to any transaction are compared to the most current OFAC listing.
	TIL – Ensure loan documents are signed by all interested parties to the loan.
	TIS – Ensure additional deposits are not made to CDs.
	Institute procedure to properly complete membership cards.
	Ensure business accounts are within the FOM.

Table C-5

Interest Rate Risk

Examination or Contact Date	**DOR Items**
12/31/04	Develop ALM policy with NW goals, addressing interest rate risk, establish cash flow risk limits, and develop internal controls and reporting requirements.
12/31/07	Develop ALM policy addressing interest rate risk, establish cash flow risk limits, and develop internal controls and reporting requirements.
12/31/08	Develop ALM policy addressing interest rate risk, establish cash flow risk limits, and develop internal controls and reporting requirements.
3/31/09	Develop ALM policy addressing interest rate risk, establish cash flow risk limits, and develop internal controls and reporting requirements.
12/31/09	Develop ALM policy addressing interest rate risk, establish cash flow risk limits, and develop internal controls and reporting requirements.

Table C-6

Transaction Risk

Examination or Contact Date	**DOR Items**
6/30/07	Have annual audit conform to GAAS and GAAP standards – *Examiner Finding.*
12/31/07	Have annual audit conform to GAAS and GAAP standards.
	Contact software provider to determine procedure necessary to freeze shares used as loan collateral.
12/31/08	Have annual audit conform to GAAS and GAAP standards.
	Contact software provider to determine procedure necessary to freeze shares used as loan collateral.
	Prepare formal reconciliations of all major balance sheet accounts. Investment activity had some improper recording - *Examiner Finding.* Small payroll cash account was not reconciled – *Examiner Finding.*
3/31/09	Have annual audit conform to GAAS and GAAP standards.
	Contact software provider to determine procedure necessary to

	freeze shares used as loan collateral.
	Prepare formal reconciliations of all major balance sheet accounts.
12/31/09	Require “freezing” of share accounts and certificates that are pledged to secure loans.
	Address record length for printing loan documents accurately.
	Address ability to enter security on Loan and Security Agreement and Disclosure Statement.
	Establish reasonable reporting parameters for BSA/AML.
	Obtain DP input training for staff.
	Establish internal controls to disallow loan advances on closed end loans to make payments on other loans or to make wire transfers to make payments on other loans; capitalizing interest on closed end loans; adding a deposit to an existing CD; redeeming a share certificate without penalty and paying accrued interest at redemption.

Table C-7

Reputation Risk

Examination or Contact Date	**DOR Items**
12/31/09	Independent third party to review MBLs to assess potential loss.
	Independent third party to review share secured loans for existence of security.
	Independent third party to review membership cards for verification of eligibility. Establish membership eligibility process.
	Independent third party to review loan documentation for corrections.

Appendix D: NCUA Management Comments

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SENT 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 St. Paul Croatian FCU, #5049

DATE: September 30, 2010

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review (MLR) of St. Paul Croatian Federal Credit Union.* St. Paul Croatian Federal Credit Union (St. Paul) failed due to a suspected fraud. The credit union officials' failure to implement proper internal controls and oversight created an environment susceptible to fraud.

MLR Report Observations

1) Examiners did not adequately evaluate risks to St. Paul's operations and examiners did not expand examination procedures for apparent red flags.

Under the risk focused examination program implemented in 2002, NCUA directed examiners to evaluate the adequacy of the credit union's risk management processes and to determine whether officials have implemented internal controls commensurate with the size and complexity of the credit union.

The Examiner's Guide discusses the importance of thoroughly evaluating credit union management's due diligence over risk management and instructs examiners to conduct their own transaction tests to validate management's assertions. The Guide also provides guidance on identifying "red flags" which may require the examiner to expand his/her review of the applicable operations and management's controls over those operations.

NCUA has developed many questionnaires, available in the AIRES examination software, to assist examiners in validating a credit union's controls over operations, programs and services. We provide ongoing training for both new and tenured examiners to evaluate risks in all areas of operations, to document noted weaknesses and to develop actions to correct those weaknesses.

NCUA conducted a "red flag" training session in July 2010 to remind examiners to look beyond the numbers and to be aware of operating results which appear too good to be true. NCUA's 2010 regional conferences also focused on identifying emerging risks with one session specifically targeted at analysis using credit union 5300 reports, financial performance reports, on line National Risk Reports and regional risk monitoring tools.

2) Examiners did not elevate repeated corrective action items for stronger supervisory actions.

The Examiner's Guide and each region's supervision guide establish procedures to review the prior findings and outstanding corrective actions to scope the current examination reviews. The Guide also provides procedures to document repeat concerns. Over the past few years, NCUA has altered the automated examination software to better track unresolved corrective action items. We have also developed an internal on-line monitoring mechanism staff may use to monitor outstanding corrective action items. These tracking mechanisms provide staff with better means to scope their supervision and address repeat concerns.

NCUA recognizes the value of resolving problems before they become insurmountable. In June 2010, NCUA issued *Supervisory Letter 10-04, Administrative Remedies and/or Enforcement Actions* reminding examiners of the actions available to induce credit union management to correct unsafe and unsound practices or regulatory violations. The Office of Examination and Insurance and the Office of General Counsel led webcast training to all NCUA staff on the content of this supervisory letter. While we generally attempt to work closely with credit union management to jointly develop appropriate solutions, we do find it necessary to elevate corrective actions if management does not take timely or prudent steps to appropriately address the concerns.

3) NCUA's quality control review was ineffective.

The observation indicates the review process for St. Paul failed to address the apparent risks at multiple levels. Because there was apparent record manipulation at St. Paul, it posted very good financial results. The region followed the quality control review protocol since St. Paul did not trigger the typical review requirements. NCUA is committed to improving risk monitoring mechanisms and providing quality control at both the regional and national levels. As such, we have implemented additional national risk monitoring tools to review risk trends and monitor supervision efforts. We have also added several new risk parameters and altered existing risk parameters to better identify risk trends. We have specifically added risk measurements to target financial performance that on the surface appears too good to be true. We are also in the process of a comprehensive review of our examination quality control program.

Other Relevant Information

NCUA evaluates emerging risks on an ongoing basis to use resources most efficiently and ensure timely supervision of high-risk cases. We are committed to improving our existing supervision mechanisms and providing necessary staff training to enhance our risk monitoring and supervision processes.

Thank you for the opportunity to comment on the report.

cc: Jim Hagen, Deputy Inspector General for Audit
Tim Segerson, Director E&I DOS
Wendy Angus, Director E&I DRM

2