NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

OIG CAPPING REPORT ON MATERIAL LOSS REVIEWS

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CONTENTS

Section	Page
ACRONYMS	ii
INTRODUCTION AND BACKGROUND	1
OBJECTIVE, SCOPE, AND METHODOLOGY	1
RESULTS IN DETAIL	2
A. Why the Credit Unions Failed	2
B. NCUA and SSA Supervision of Credit Unions in OIG MLR Reports	20
APPENDICES	
A. NCUA-OIG Material Loss Reviews	23
B. Management Comments	24

ACRONYMS

ABS	Asset Backed Security
AIRES	Automated Integrated Regulatory Examination System
ALCO	Asset/Liability Committee
ALM	Asset Liability Management
CDO	Collateralized Debt Obligation
CEO	Chief Executive Officer
CLC	Construction Loan Company
CLTV	Combined Loan-to-Value [ratio]
CUDL	Credit Union Direct Lending
DOR	Document of Resolution
ECIE	Executive Council on Integrity and Efficiency
EIC	Examiner in Charge
FCU Act	Federal Credit Union Act
FPR	NCUA Financial Performance Report
HELOC	Home Equity Line of Credit
IRR	Interest Rate Risk
LTV	Loan-to-Value
MBL	Member Business Loans
MBS	Mortgage-backed Securities
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NINA	No Income No Assets
OIG	Office of Inspector General
PCIE	President's Council on Integrity and Efficiency
RCL	Residential Construction Loan
SSA	State Supervisory Authority

Introduction and Background

The purpose of this report is to summarize significant findings from material loss reviews (MLRs) recently issued by the NCUA Office of Inspector General (OIG). The Federal Credit Union Act (FCU Act) requires the OIG to conduct a MLR of an insured credit union if the loss to the National Credit Union Share Insurance Fund (NCUSIF) exceeds $25[1] million and an amount equal to 10 percent of the total assets of the credit union at the time at which the NCUA Board initiated assistance or was appointed liquidating agent. We issued ten MLR reports during the period from November 2008 through October 2010. The failed credit unions described in this report were located in NCUA Regional Offices I, II, III, and V. A list of OIG issued MLR reports is provided in Appendix A.

Objective, Scope, and Methodology

For the ten MLRs summarized in this report, the objectives were to: (1) determine the cause(s) of the credit union's failure and the resulting loss to the NCUSIF; and (2) assess NCUA's supervision. To achieve these objectives, we analyzed NCUA and State Supervisory Authority[2] (SSA) examination and supervision reports and related correspondence; interviewed key management and staff from NCUA headquarters and regional offices and the SSAs, as applicable; and reviewed NCUA policies and procedures, Call Reports, and Financial Performance Reports (FPRs). Based on similarities and trends found in the first ten MLRs completed by the OIG, we are making 12 recommendations to NCUA management for corrective action.

We conducted this review from August 2010 to November 2010. The MLRs issued by the OIG have been performed in accordance with generally accepted government auditing standards[3], and additional details concerning the scope and methodology of each of the prior MLRs can be found in the individual reports listed in Appendix A.

[1] On July 21, 2010, the President signed into law the Wall Street Reform and Consumer Protection Act of 2010, raising the threshold for future NCUA-OIG MLRs from $10 to $25 million.
[2] Six MLRs involved reviewing state chartered credit unions.
[3] We performed one report, NCUA-OIG Report #OIG-08-10, Material Loss Review of Huron River Area Credit Union, issued November 26, 2008, in accordance with PCIE/ECIE Quality Standards for Inspections.

Results in Detail

A. Why the Credit Unions Failed

Management's Actions Contributed to Every MLR Failure

Our MLR reports confirm overwhelmingly that credit union management's actions greatly contributed to the failure of each of the ten institutions reviewed by the OIG. Specifically, we found three significant actions that management was either unwilling or unable to effectively manage or mitigate that exposed these credit unions to significant amounts of risk: (1) poor strategic planning and decision making; (2) inadequate oversight (policies and internal controls); and (3) fraud.[4]

In all ten of our MLRs, we found management's poor strategic decisions and weak management oversight over lending or investment practices (including one fraud) contributed to the failure. In addition, we had two other MLRs that involved alleged fraud schemes perpetrated by management. Finally, we found management's actions created credit, liquidity, and concentration risks, as well as other significant issues that management did not, or could not, effectively manage because the risks and associated issues had become too interrelated and inseparable.

We also identified several shortcomings related to NCUA and SSA supervision efforts. Specifically, we identified examiner deficiencies in quality control efforts and examination procedures. We believe had examiners acted more aggressively in their supervision actions over these critical issues, the looming safety and soundness concerns that were present early-on in nearly every failed institution, could have been identified sooner and the eventual losses to the NCUSIF could have been stopped or mitigated.

[4] Center Valley Federal Credit Union's failure was determined to be caused by fraud, whereas New London Security Credit Union and St. Paul Croatian Federal Credit Union were alleged frauds.

The following chart provides a snapshot of eight major issue areas common among each of the first ten MLRs conducted by the OIG.

	Management Actions Contributing to Failure						**Supervisory Shortcomings**	
	Ineffective Management (*Poor Planning and Weak Oversight*)	Concentration Risk	New Program or Services & Third Party Due Diligence	Liquidity Risk	Credit Risk	Member Business Lending	QCR Deficiency	Poor Examination Procedures
Huron River	X	X	X	X	X	X		X
Norlarco	X	X	X	X	X	X		
New London	X	X					X	X
High Desert	X	X			X	X	X	X
Center Valley	X	X						X
Cal State 9	X	X	X	X	X			X
Eastern Financial Florida	X	X	X	X	X	X		X
Clearstar	X	X	X	X	X	X		X
Ensign	X	X	X	X	X	X		X
St. Paul	X	X		X	X	X	X	X

We found ineffective management present in all ten MLRs performed by the OIG. Specifically, we found that management made poor strategic decisions and performed inadequately in overseeing credit union operations. Chart A (below) provides a summary of management's actions and examiner's inactions related to weaknesses in effectively managing and supervising credit union operations.

Chart A

Credit Union	**MLR Issue: Ineffective Management (*Poor Strategic Planning and Decision Making and Weak Management Oversight*)**
Huron River Area Credit Union	Management developed inadequate strategic plans over its new lending program (out of state construction lending in Florida) and had weak oversight over the program. (*Note: credit union management also failed to disclose this plan to examiners.*) Examiners may not have adequately monitored or reacted prudently or timely to trends that indicated the safe and sound operation of the credit union may have been in jeopardy.
Norlarco Credit Union	Management developed inadequate strategic plans over a new lending program (out of state construction lending), had weak oversight over the program (policies and controls), and did not conduct the proper due diligence over its participation program after making the strategic decision to participate its loans to other financial institutions to meet liquidity needs. Examiners failed to adequately evaluate the safety and soundness of Norlarco's loan participation program.
New London Security Credit Union	Management's inadequate oversight and weak internal controls over investment activity allowed an alleged fraudulent scheme to occur. Examiners did not adequately evaluate the risk in New London's investment program, despite investments accounting for over 90 percent of the credit union assets. In addition, although examiners noted the lack of internal controls over investments, including the lack of a safekeeping agreement, they failed to expand examination procedures or elevate such issues for stronger supervisory actions.
High Desert Federal Credit Union	Management did not adequately oversee credit union operations regarding its real estate construction program and member business lending. The credit union's Board did not adequately monitor senior management, and senior management, in turn, showed a significant lack of involvement and knowledge of the credit union and its risks. NCUA examiners did not adequately evaluate the risk in the real estate construction portfolio due to a lack of objectivity based on a lack of staff rotation, and failed to expand examination procedures. Examiners also failed to elevate repeated DOR issues and violations of NCUA Rules and Regulations for stronger supervisory actions.
Center Valley Federal Credit Union	Management's inadequate oversight facilitated an embezzlement fraud scheme committed against the credit union by its CEO. NCUA examiners did not adequately evaluate the risks to the credit union's operations. Specifically, examiners failed to accurately assess the impact of the credit union's weak internal controls when assessing transaction risk and the Management component rating.

(Chart A Continued)

Credit Union	MLR Issue: Ineffective Management (Poor Strategic Planning and Decision Making and Weak Management Oversight)
Cal State 9 Credit Union	Management developed inadequate strategic plans over a new program (Indirect HELOCs) and had weak oversight over credit union operations. Examiners did not respond adequately or timely to credit and liquidity risks considering: (1) the rate and level of growth of the HELOC portfolio; (2) the excessive concentration of HELOCs, nearly all of which contained subprime elements; and (3) the continuing changes in the California real estate market environment.
Eastern Florida Financial Credit Union	Management developed inadequate strategic plans for investments in complex private-placement Collateralized Debt Obligations (CDOs) and construction and development loans. This was combined with management's weak oversight over credit union operations. Examiners did not take stronger supervisory action to influence the credit union's Board and management to limit the significant level of risk assumed during the institution's rapid growth period. Examiners also did not establish a more appropriate supervisory tone to prompt the Board and management to take more timely and adequate action to address examiner concerns.
Clearstar Financial Credit Union	Management's inadequate strategic plans over an indirect auto loan program and its weak and unresponsive oversight created credit and liquidity risk that management failed to monitor and control. Management's strategic plan also included making capital expansion a priority, increasing the drain on needed cash. Examiners failed to require the Board and management to make substantive changes in their lending practices, which resulted in credit and concentration risks in the credit union's loan portfolio.
Ensign Federal Credit Union	Management's inadequate strategic plans over its real estate loans and its weak and unresponsive oversight to address concentrations in the credit union's loan portfolio created credit and liquidity risk. Examiners did not adequately assess critical risks created by management decisions and strategies related to concentration, credit, liquidity, and profitability. Further, examiners did not aggressively pursue a timely resolution to concerns raised in examinations.
St. Paul Croatian Federal Credit Union	Inadequate management oversight by the credit union's Board and Supervisory Committee coupled with weak internal controls facilitated an alleged fraud scheme committed against the credit union by its CEO. Examiners did not adequately evaluate the risks to St. Paul's operations by thoroughly evaluating the credit union's internal controls when assessing transaction risk; nor did examiners ensure credit union management took corrective action on repetitive DOR issues; or expand examination procedures when "red flag" indicators were present.

Recommendations
The issues summarized in Chart A (above) highlight the importance of examiners reviewing credit union management's strategic decisions and their abilities to oversee operations, issues we believe that require NCUA management's attention. Therefore, we are making the following recommendations.

We recommend NCUA management:

1. Caution examiners that assigning CAMEL[5] composite ratings of 1 or 2 to credit unions that implement new business strategies needs to be supported with compelling, verified mitigating factors. Such mitigating factors should consider things such as the institution's corporate governance, risk management controls, allowance for loan and lease losses methodologies, concentration limits, funding sources, underwriting standards, capital levels, and whether the mitigating factors are likely to be sustainable in the long-term.

2. Require a documented secondary review of the final CAMEL ratings by the Supervisory Examiner for all credit unions over $100 million in assets prior to issuance to credit union management.

3. Issue a national instruction placing more emphasis on quarterly monitoring of Call Reports including developing offsite monitoring triggers and specific procedures to more easily 'red flag' areas to be investigated as well as provide a specific time allocation.

4. Require examiners to document and retain the specific procedures and analysis performed during their quarterly review of the 5300 Call Reports. This analysis should then be forwarded to the Supervisory Examiner for review.

Management's Comments
NCUA management agreed with Recommendations 1, 3, and 4; and partially agreed with Recommendation 2. For Recommendation 1, management indicated they are revising the Examiner's Guide to include appropriate guidance for evaluating risk related to new business strategies and are currently developing an early risk indicator process that will use a more robust examination tool within AIRES to help identify new and fast-growing programs. For Recommendation 2, management partially agreed stating that although they agree with having the Supervisory Examiner conduct a pre-delivery report review, they believe the $100 million threshold suggested by the OIG for triggering such reviews is too low. Management indicated they plan to evaluate this further and set a trigger when the policy is established. For Recommendation 3, management indicated the Office of Examination and Insurance plans to issue a new national supervision manual that will emphasize the importance of off-site monitoring of institutions via the

[5] 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.

Call Report, FPR, and National Risk Reports. The new manual will, in part, provide a means to identify which credit unions represent the most risk. For Recommendation 4, management indicated the new national supervision manual will establish a formal method to perform quarterly reviews and specify a process to communicate which credit unions represent the most risk.

Evaluation of Management's Comments

Management's current and planned actions are responsive to the recommendations. For Recommendation 2 regarding establishment of a threshold for pre-delivery report review, we agree with management's approach and believe it is prudent for management to evaluate and determine the appropriate level.

We found concentration risk present in all ten MLRs performed by the OIG. Chart B (below) provides details for each.

Chart B

Credit Union	MLR Issue: Concentration Risk
Huron River Area Credit Union	Management concentrated well over 50 percent of the credit union's total assets and 67 percent of its loan portfolio in an out of state (Florida) construction loan program. Management also committed the credit union to approximately $65 million in future loans. Although examiners in the September 30, 2001 examination identified a concentration risk associated with loans, the concentration issue involved the number of loans assigned to the credit union's third-party provider. Additionally, examiners did not identify concentration risk as an issue until six years later during the credit union's last examination in January 2007 (Effective September 30, 2006), one month prior to NCUA conserving the credit union.
Norlarco Credit Union	Management created two concentration risks: The first occurred when management entered into a $30 million monthly commitment in an out of state (Florida) residential construction lending program operated by a single third-party servicer. The second when 97 percent of the credit union's assets were in one geographic location. At its peak, Norlarco's outstanding residential construction program loans and unfunded commitments were more than 83 percent of total assets. Although examiners identified the credit union's concentration risk during the first full scope examination following the credit union's initial funding activities for the residential construction lending program, Colorado SSA examiners issued a DOR that allowed management to consider one of three methods for limiting its concentration risk. This occurred despite NCUA management officials' prior agreement with the Colorado SSA to include specific language in the DOR to require credit union management limit new construction loan commitments.
New London Security Credit Union	A fraud scheme (embezzlement) perpetrated by New London's account manager caused this credit union to fail. The credit union (operating as an investment club) had 94 percent of its assets in investments. Examiners did not view the concentration of investments as safety and soundness concerns serious enough to warrant more aggressive supervisory action.
High Desert Federal Credit Union	Beginning in 2003, management expanded 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 by September 2006 due to the increase in real estate construction loans and member business lending. Concentration in construction lending comprised over 60 percent of the loan portfolio in 2005, 2006, and 2007. We found examiners did not adequately document their evaluation of the credit union's concentration risk or how the concentration of real estate construction loans impacted the scope of their supervisory efforts.

(Chart B Continued)

Credit Union	MLR Issue: Concentration Risk
Cal State 9 Credit Union	Management created two concentration risks. The first was a significant number of indirect HELOCs made within the credit union's overall loan portfolio. The second was that substantially all of the indirect HELOCs contained subprime elements. Management allowed the credit union's indirect HELOC portfolio to grow from $4.6 million in March 2003 to $357 million by June 2007 (7,661 percent), which was 80 percent of total assets and 92 percent of total loans. Examiners did not adequately assess Cal State 9's indirect HELOC program and did not respond adequately or timely to the risks facing Cal State 9 considering that nearly all the HELOCs contained subprime elements.
Eastern Financial Florida Credit Union	Management created a concentration risk by investing in complex CDOs backed by Home Equity Loan – Asset Backed Securities. Management purchased $149 million in CDOs between December 2005 and June 2007, nearly $95 million of which were purchased in the three month period from March – June 2007. Although examiners recognized the level of complexity and sophistication in the credit union before significant problems surfaced, and commented that management was strong in the area of research and setting controls, but was often too aggressive and overlooked the need to ensure regulatory compliance. We found that earlier and stronger supervisory action may have influenced the credit union's Board and management to limit the significant level of risk assumed during the institution's rapid growth period.
Clearstar Financial Credit Union	Management created significant concentration risks in their CUDL indirect Auto and Recreational Vehicle loan program. Management allowed rapid growth in the program as indirect loan volume reached $84.5 million at June 30, 2008, 54 percent of total loans. Examiners did not adequately assess nor aggressively pursue resolution of critical risks created by Clearstar management's high risk strategies related to loan concentration.
Ensign Federal Credit Union	Management allowed a concentration in its first mortgage and other real estate loans of approximately 75%. Although examiners identified the concentration risk in the credit union's real estate loan portfolio four years prior to the eventual purchase and assumption that occurred in November 2009; examiners indicated the risk was mitigated by management conducting the appropriate ALM practices.
St. Paul Croatian Federal Credit Union	St. Paul management allowed fraudulent share secured loans to make up 88 percent of total loans and 90 percent of total assets. Examiners did not expand examination procedures when red flags indicated higher risks to the credit union. Despite the credit union's fraudulent share secured loans accounting for well over ninety percent of the credit union's total assets, examiners never expanded their review and raised concentration risk as a safety and soundness concern.

Recommendations
The issues summarized in Chart B (above) highlight the importance of examiners reviewing asset concentration, an issue we believe that requires NCUA management's attention. Therefore, we are making the following recommendations.

We recommend NCUA management:

5. Determine whether to propose and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations.

6. Develop a more specific process such as trigger reports or standards so examiners can better identify, analyze, and monitor loan concentrations during exams, as well as between exams.

7. Require a breakout of unfunded commitments by loan type on the 5300 Call Report to facilitate analysis and to better track loan concentrations.

Management's Comments
NCUA management agreed with recommendations 5, 6, and 7. For Recommendation 5, management indicated the Office of Examination and Insurance is currently drafting a revision to the risk based net worth structure in the Prompt Corrective Action regulation. For Recommendation 6, management stated they are currently redesigning the quality control process which will include a documented review by Supervisory Examiners and DOS staff for proper scoping, identification, and evaluation of risk for areas triggering a risk threshold on quarterly risk reports. For Recommendation 7, management indicated they will add two additional categories of unfunded commitments not currently captured on the 5300 Call Report: indirect and third-party loans.

Evaluation of Management's Comments
Management's current and planned actions are responsive to the recommendations.

We found that management did not conduct adequate due diligence when starting a new program or service, or when working with a third-party. Chart C (below) provides those credit unions where either new programs, third-party relationships, or both were established, and management did not conduct the appropriate due diligence.

Chart C

Credit Union	MLR Issue: New Program or Service and Third-Party Due Diligence
Huron River Area Credit Union	Huron management failed to perform due diligence over its Florida construction lending program, and conducted minimal up front due diligence of its third-party vender, the Construction Loan Company (CLC). Management delegated authority to CLC to originate, underwrite, approve, and perform all servicing and collection functions but provided virtually no over-sight of the program. Examiners determined, that credit union management did not exercise due diligence by evaluating the third party relationship held with its lender, CLC.
Norlarco Credit Union	Management failed to perform due diligence over its Florida residential construction lending program, as well as its relationship with its third-party vendor, First American. Management allowed First American complete control in making and overseeing all of the credit union's residential construction loans. This included the entire servicing function such as underwriting of the borrower, qualifying the borrower as a potential member of the credit union, arranging for the contractor to build the home, conducting the inspections, forwarding draw requests and interest payments based on its own inspections and schedule, qualifying the borrower for take-out financing, and forwarding extensions of matured loans and interest payments on those loans. Examiners did not evaluate the safety and soundness of Norlarco's overall participation program. Examiners did not associate the rapid rise of loans sold through participations as a potential safety and soundness concern to Norlarco, or to the NCUSIF, but rather examiners merely viewed participations as a means to manage Norlarco's balance sheet risk.
Cal State 9 Credit Union	Management did not take the time to gain the necessary experience needed to understand and manage all of the related risks with their newly initiated HELOC program before aggressively pursuing the program. Examiners did not adequately assess the credit union's indirect HELOC program. Specifically, examiners did not adequately assess the overall terms and characteristics of the indirect HELOC program early on.
Eastern Financial Florida Credit Union	Management and the Board did not conduct the proper due diligence prior to investing in complex CDOs and therefore did not have sufficient expertise to understand and manage the risks imposed to the credit union's net worth. Examiners did not consider the ability of credit union officials to: (1) explain the instrument's characteristics and risks; (2) obtain and adequately evaluate the instrument's market pricing, cash flows, and test modeling; (3) define, explain, and document how the high-risk investments fit into the credit union's ALM strategy; and (4) the effect that either holding or selling the high-risk bonds would have on earnings, liquidity, and net worth in different interest rate environments.

(Chart C Continued)

Credit Union	MLR Issue: New Program or Service and Third-Party Due Diligence
Clearstar Financial Credit Union	Management did not perform the appropriate due diligence over its new CUDL indirect auto and recreational vehicle lending program. In attempting to determine how examiners analyzed credit union management's risk management practices, competence, and due diligence over a new and/or fast growing program such as the credit union's .indirect auto lending program, we found no formal supporting documentation to make a determination.
Ensign Federal Credit Union	Management did not perform the appropriate due diligence over its new real estate lending program. No formal documentation was found to determine how management competence and overall risk management practices were analyzed and assessed by examiners

Recommendations
The issues summarized above highlight the importance of examiners reviewing management's due diligence over new programs or services as well as due diligence over third-party relationships. Issues we believe that require NCUA management's attention. Therefore, we are making the following recommendations.

We recommend NCUA management:

8. Re-emphasize examination guidance for third-party relationships, with particular attention to the assessment of the risk the relationship may pose to the credit union's safety and soundness.

9. Develop examination guidance for due diligence over new or fast growing programs and areas of emphasis, with particular attention to the risk the new program or new area may pose to the credit union's safety and soundness.

Management's Comments
NCUA management agreed with recommendations 8 and 9. For Recommendation 8, management indicated they will continue to emphasize the importance of monitoring and closely evaluating controls over third party relationships and moving forward into 2011 will require the completion of the existing third-party questionnaire as a minimum scope requirement. For Recommendation 9, management indicated they have previously shifted to an annual examination cycle for all federal and important state chartered credit unions and will continue to emphasize close evaluation of fast-growing programs. Management also indicated they plan to expand risk triggers and indicators, and plan to scale examination procedures and the depth of reviews on identified risks. In addition, management stated they are currently undertaking a significant redesign of the quality control process.

Evaluation of Management's Comments
Management's actions taken and planned are responsive to the recommendations.

We found liquidity issues affected the following credit unions shown in Chart D (below).

Chart D

Credit Union	MLR Issue: Liquidity Risk
Huron River Area Credit Union	Management did not ensure adequate liquidity controls in its ALM policy. Liquidity deteriorated rapidly shortly after management allowed its real estate construction program to comprise approximately 84 percent of total loans. To meet liquidity needs, management aggressively marketed all types of deposits, offered share certificate specials, sold off securities, and significantly increased its borrowings against its (already) increased line of credit.
Norlarco Credit Union	Management did not have an adequate ALM program in place to monitor its liquidity position. When Norlarco's loan growth generated by its Residential Construction Lending program reached more than 83 percent of total assets, management was unable to manage its liquidity problems. Management also sold construction loan participations. When the rate of participations began to decrease significantly, management's lack of funding sources resulted in an increasingly leveraged and illiquid position. Although examiners recognized several safety and soundness concerns, including liquidity risk, six years prior to liquidation, examiners failed to convince management to get control of their construction lending program. Examiners also failed to recognize the inherent risks in the credit union's participation program, including liquidity risk, as there was no discussion of the program in the Scope workbook or in the Examiner's Findings documents.
Cal State 9 Credit Union	Management created liquidity risk through their rapid and excessive funding of high risk subprime indirect HELOCs. The credit union's high risk in liquidity continued to increase due to poor liquidity management. To meet liquidity needs, management sold participations, liquidated investments, borrowed funds, and increased dividend rates to attract shares. Management failed to maintain the proper perspective of the interrelationships between its high concentration of variable-rate subprime loans, interest rates, and the California real estate market environment. Although examiners adequately assessed the credit union's liquidity issues during each supervision contact, examiners did not adequately monitor and did not respond aggressively or timely to the credit union's increasing liquidity risk.
Eastern Florida Financial Credit Union	Management heavily invested in HELOC ABS and CDOs funded with short-term borrowings. Management purchased $45 million worth of CDOs during March and April 2007, which raised the credit union's investments in ABS and CDOs close to the Florida Statute limit of $168 million. Management was instructed, but did not expand its liquidity policies and procedures for alternate sources and monitoring procedures under normal and stressed business conditions. Nor did management develop policy limits on leveraging to address adequate availability of credit lines and other alternative liquidity sources for potential emergency or stressed conditions. Examiners identified liquidity issues prior to the credit union ever investing in CDOs. In addition, once the credit union received approval from the Florida SSA and began to invest in CDOs, examiners recognized the "sophisticated investments" and the level of complexity needed in the credit union to operate such a program. However, despite all this, earlier and stronger supervisory action was needed given the nature and extent of the risks.

(Chart D Continued)

Credit Union	MLR Issue: Liquidity Risk
Clearstar Financial Credit Union	Management's inability to manage its high loan growth coupled with a deficient liquidity management program caused significant liquidity risk. Between March 2003 and June 2004, liquidity fell from 12 percent to seven percent. Cash plus short term investments decreased to an asset ratio of 6.65% from 8.01%, which was still significantly below peer of 14.84%. Management's concentration in loans and deposits caused the credit union to be nearly 100% loaned out. Management allowed the credit union's ALM policy and liquidity policy to become inadequate with a policy limit of 2% (actual ratio was 1.65%), well below Nevada state and federal requirements of 5-6%. In addition, management's high overhead associated with new branches, growing loan defaults, and high yielding CD's caused measurable liquidity pressure. Liquidity declined to under 4% by December 31, 2007, as management continued to allow its liquidity policies and procedures to remain inadequate. Additionally, the credit union was in violation of a Nevada State statute requiring at least 5% of member accounts be held in liquid assets. Although examiners routinely identified issues with the credit union' liquidity, examiner conclusions were not consistent or reviewed by Supervisory Examiners. In the December 2006 examination, examiners commented that credit union management was "capable" when there were obvious and serious continuing liquidity issues. In addition, examiners noted management "manages its liquidity position effectively" but later in the same report, noted that these same policies were "currently inadequate".
Ensign Federal Credit Union	Management did not understand how to adequately manage the balance sheet for proper liquidity – management did not conduct short and long-term liquidity planning. Management relied on one very large deposit relationship (a trust in the amount of $12 million) – when the trust removed the monies, the credit union lacked the liquidity to meet normal demand. Over the last several years, management did not plan its borrowings, further illustrating a lack of planning and oversight relating to liquidity. Examiners did not adequately assess critical risks created by management decisions and strategies related to liquidity.
St. Paul Croatian Federal Credit Union	Management allowed liquidity issues to persist from 2004 through 2009. Management did not address the credit union's liquidity risks identified in numerous, repetitive DORs.

Liquidity risk is an area of concern where examiners must be diligent in understanding how financial ratios and trends together can provide a more accurate financial picture than each viewed separately. 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. In OIG report number OIG-08-10, Material Loss Review of Huron River Area Credit Union, the OIG recommended NCUA management issue a Supervisory Letter to all Federal and State examiners to alert them of the need to (1) analyze and understand financial ratios and trends individually and as a group and (2) thoroughly analyze pertinent qualitative data in order to adequately assess the safety and soundness of credit union operations.

NCUA management concurred with the OIG's recommendation indicating they had reinforced the need for aggressive investigation and protection against perceived risks in Letter to Credit Unions No.: 08-CU-20 Evaluating Current Risks to Credit Unions, dated August 2008. The OIG concurred with management's response and therefore we are not making a recommendation at this time.

We found issues with credit risk in eight of ten credit unions as shown in Chart E (below).

Chart E

Credit Union	MLR Issue: Credit Risk
Huron River Area Credit Union	Management allocated $30 million for a construction loan program with a third-party, CLC, with a commitment to underwriting an additional $65 million in future loans. Delinquencies and charge-offs were slightly above average. Credit union management may have ignored warnings regarding the expected decline of housing values.
Norlarco Credit Union	Management's actions created significant credit risks in its RCL portfolio. Management allowed the credit quality of borrowers to decline steeply as it's Residential Construction Loan program progressed. Management funded many construction loans with sub-prime elements that included limited documentation to support a borrower's capacity to repay, "stated-income," and No Income No Asset (NINA), where borrowers did not disclose income or provide bank statements. Examiners recognized the increasing credit risk in the credit union's construction loan program, and attempted to have management implement corrective actions through updated policies and parameters. Ultimately, examiners failed to convince management to implement stronger internal controls over the construction lending program to address the safety and soundness concerns the credit risks represented.
High Desert Federal Credit Union	Management did not correct identified underwriting weaknesses repeatedly brought to their attention, which allowed credit risk to heighten. Deficiencies in underwriting included the excessive use of stated income, insufficient equity standards, and a lack of verification of owner occupancy. In addition, management did not follow lending guidelines and policies by allowing: (1) unreasonable modifications and extensions; (2) loan to value percentages above policy and regulatory limits, and (3) speculative lending (not identified by management to the NCUA). Also, management allowed some borrowers to make interest only payments without addressing the terms of the loan. Examiners determined the credit union had poor underwriting controls and loan monitoring and that a significant number of loans were stated income and had insufficient equity. Examiners also determined lending guidelines were not consistently followed and delinquency reporting was inaccurate. Examiners determined that borrowers of matured loans were allowed to make interest only payments without formally extending their loans. These loans were not classified as past due, thus understating the level of reported delinquent loans. However, examiners did not adequately evaluate the risk in the credit union's construction loan portfolio and failed to elevate repeated issues for stronger supervisory actions. Examiners also did not expand examination procedures when they should have done so.

(Chart E Continued)

Credit Union	MLR Issue: Credit Risk
Cal State 9 Credit Union	Management created credit risk in its indirect HELOC portfolio through weak underwriting standards, which allowed management to concentrate a significant percentage of its assets in indirect HELOCs. In addition, substantially all of the HELOCs contained elements of subprime lending such as stated income, high CLTVs, low credit scores, and being in a junior position behind negative amortization first mortgages. Although examiners adequately assessed Cal State 9's increasing credit risk during each supervision contact, examiners did not respond aggressively or timely to that risk. Specifically, examiners did not require Cal State 9 management to: (1) improve its underwriting standards for the indirect HELOC program; or (2) limit or reduce its concentration of risky HELOCs.
Eastern Florida Financial Credit Union	Management exposed the credit union to significant credit risk. Specifically, management failed to understand the significant underlying credit risk their investment in CDOs posed to the credit union's capital and net worth. Also, management allowed the credit union's commercial loan portfolio to exceed three of the maximum limitations set by Federal Regulations. Forty percent of the commercial loan portfolio (over $90 million) was in construction and development loans in Florida. Despite the weakened real estate market in Florida, which only amplified the threat to net worth and increased the credit union's overall credit risk exposure, management was still in the process of adding to the credit risk by decentralizing the lending function and increasing unsecured lower grade paper ("C", "D" and "E") loans. Finally, management allowed a large volume of its mortgage products to have a high loan-to-value (LTV) ratio, which again added to its increased credit risk. At its peak, over 34 percent of the total mortgage loan portfolio represented loans with a LTV ratio exceeding 90 percent. Approximately 8 percent of which were HELOC related loans (line of credit and credit card) where the credit union did not have a first lien. Examiners had few criticisms of credit union management or operations prior to 2007. Examiners failed to timely identify key risk areas.
Clearstar Financial Credit Union	Management originated and funded a significant amount of loans that were both poorly underwritten and made to borrowers with poor credit histories. Additionally, management used modified borrower classification matrixes that allowed them to approve loans to borrowers that were of a much higher credit risk than industry standards would expect. Also, management extended an inordinate number of delinquent loans when borrowers could not meet obligations in order to stem the flow of collection issues, despite little evidence these borrowers would have the ability to meet their obligations when the extension period expired. Finally, management focused a large portion of the loan portfolio on an indirect auto lending program for new and used vehicle loans originated by both credit union personnel and new and used auto and recreational vehicle dealers. This program coupled with liberal underwriting policies encouraged a high volume of new loans that ultimately increased delinquencies as well. Examiners did not adequately assess nor aggressively pursue resolution of critical risks created by Clearstar management's high risk strategies related to credit quality.

(Chart E Continued)

Credit Union	MLR Issue: Credit Risk
Ensign Federal Credit Union	Management failed to monitor or control credit risk associated with its real estate secured lending portfolio. Specifically, the Allowance for Loan Loss methodology was faulty, weak polices for loan-to-value (LTV) ratios were adopted (which allowed HELOC loans of up to 100 percent and 40-year mortgage terms), monitoring of interest rate risk (IRR) related to loans was inadequate, and the credit union's weak collection process created delinquencies. When combined with the excessive decline in the Las Vegas real estate market, management's actions created credit risk that ultimately contributed to the credit union's large losses and ultimately its failure. Examiners did not adequately or consistently identify key risks and failed to appropriately downgrade the CAMEL components in a timely manner, resulting in a lack of focus, communication, and attention on growing risks.
St. Paul Croatian Federal Credit Union	The CEO's fraud scheme contributed to the creation of credit risk in the loan portfolio. Loan and member business loans (MBL) policies were minimal. Real estate policies were lax with appraisals and LTV. Income verification was not performed. Members with poor credit were granted loans with the same terms as other members with good credit. Deposits could be added to share certificates and share certification could be redeemed prior to maturity without penalty.

Our MLRs identified credit risk as an area of concern where examiners must be diligent in understanding that the recent dramatic changes in the credit markets and in real estate valuations affect nearly all credit unions. NCUA issued Letter to Credit Unions No.: 08-CU-20 Evaluating Current Risks to Credit Unions, dated August 2008 to address credit risk. Therefore, we are not making a recommendation at this time.

We found MBL issues affected credit unions as shown in Chart G (below).

Chart G

Credit Union	MLR Issue: Member Business Lending
Huron River Area Credit Union	Management violated NCUA's MBL limits by failing to limit its aggregate net MBL balance to the lesser of 1.75 times its net worth or 12.25 percent of its total assets. Based on Huron's December 2006 net worth and total assets of approximately $41 million and $363 million, respectively, Huron's MBL balance should not have exceeded approximately $44 million. As of February 2007, NCUA determined Huron had approximately $187 million worth of MBLs in its Florida construction loan portfolio, an amount over four times the statutory limit.
Norlarco Credit Union	Management allowed some borrowers to own multiple properties - some on the same street, which were not reported as member business loans. By December 2006, the credit union's MBL balance was approximately $39 million, or 1.15 times its net worth and 10.9 percent of its total assets, which was within NCUA's statutory limits. After reclassifying the loans, the MBL balance increased to $86.7 million, nearly three times it's net worth and double its statutory limits. The credit union's ratio of MBLs to assets was more than 24 percent. Although examiners did not have accurate information regarding the credit union's MBL balance because of misclassified MBLs, examiners failed to recognize the borrower's intent was often misrepresented on the loan applications underwritten by the credit union's third-party provider, First American. In fact, not until the credit union was placed in NCUA's Special Actions did NCUA officials learn that management's internal controls over the RCL program were so lax that the Board and management failed to recognize the vast majority of the loans in the RCL portfolio were for investment purposes. Additionally, officials in Special Actions determined some borrowers owned multiple properties - some on the same street, which were not being reported as member business loans (MBLs). As a result, NCUA Special Actions required management to reclassify every construction loan as a MBL until each borrower could be contacted to verify the intent of their loan.
High Desert Federal Credit Union	Management did not have an adequate MBL policy, particularly related to equity requirements and lack of proper recordkeeping to monitor compliance with an MBL waiver issued in August 2003, and ensuring income verification for MBL borrowers. Although examiners identified the credit union's MBL issues such as underwriting and permissible MBLs through DORs in every examination from 2003 through 2008, examiners did not draw management's attention to the fact that the credit union's DOR issues were repeat issues that should have been addressed more timely.

(Chart G Continued)

Credit Union	MLR Issue: Member Business Lending
Eastern Florida Financial Credit Union	Management violated numerous MBL regulatory limits. Also, MBL underwriting was not robust. Approximately $51 million of the MBL balances remained on the credit union's delinquency report for the first three Call Report cycles in 2008. One of the larger MBLs in delinquent status was not properly classified in the credit union's Call Report resulting in an understated delinquent loan ratio. Examiners needed earlier and stronger supervisory action, which may have influenced the credit union's Board and management to limit the significant level of risk assumed during the institution's rapid growth period, especially in their CDO leverage strategy and MBL activities, where they suffered the largest losses that caused the failure.
Clearstar Financial Credit Union	Management continued to make MBLs despite being undercapitalized, a violation of NCUA Rules and Regulations.
Ensign Federal Credit Union	Management violated NCUA Rules and Regulations over member MBL limitations for construction and development loans, MBLs to one individual or associated group, and aggregate MBLs, respectively. All repeat violations from a prior examination.
St. Paul Croatian Federal Credit Union	Management had no MBL policies in place despite having MBLs in the portfolio.

Our MLRs identified member business lending as an area of concern. NCUA has provided guidance to examination staff and credit unions related to business lending, through issuance of Letter to Credit Unions No.: 10-CU-02 Current Risks in Business Lending and Sound Risk Management Practices, dated January 2010, and has made improvements to the Supervision and Quality Assurance for critical risk areas such as business lending through the addition of member business/specialized lending staff positions to assist field examiners, and through current efforts to revise business lending rules and regulations that if adopted, will tighten business lending risk management. As a result of NCUA's recent and planned actions in the area of business lending, we are not making a recommendation at this time.

B. NCUA and SSA Supervision of Credit Unions in OIG MLR Reports

Examiners Could Have Mitigated the Losses to the NCUSIF

As previously noted, we also identified several shortcomings related to NCUA and SSA supervision efforts. Specifically, we identified examiner deficiencies in quality control efforts, examination procedures, the economic environment, as well as enforcement issues. We believe had examiners acted more aggressively in their supervision actions over these critical issues, the looming safety and soundness concerns that were present early-on in nearly every failed institution, could have been identified sooner and the eventual losses to the NCUSIF could have been stopped or mitigated.

Chart I (below) identifies credit unions with examination quality control deficiencies.

Chart I

Credit Union	MLR Issue: Examination Quality Control
New London Security Credit Union	Examiner's failed to follow-through on regional quality control review issues. In addition, examiners failed to adequately document their examinations, and examiners were not regularly rotated.
High Desert Federal Credit Union	The examination team remained the same for more than eight years, with EIC responsibilities merely rotating between the same two examiners. These examiners became overly familiar with credit union management, staff, processes, and culture, which created a lack of objectivity in the evaluation of the risks impacting the credit union.
St. Paul Croatian Federal Credit Union	NCUA did not adequately rotate examiners in accordance with requirements in the Examiner's Guide.

Recommendations

We recommend NCUA management:

10. Review the current requirements and levels that trigger a Quality Control Review and expand the process as necessary. Provide national guidelines for the Quality Control Review process so that all Regions are consistent in their reviews.

11. Require Supervisory Examiners to provide a written response to the results of Quality Control Review on any recommendations made by the Quality Control Review.

Management's Comments

NCUA management agreed with recommendations 10 and 11. For Recommendation 10, management indicated in 2010 they had implemented a Quality Review process which included a sampling of examinations and all associated supervision and quality assurance documentation from each Region with plans to issue a national summary

review report. Management also indicated that the previously mentioned new national supervision manual will standardize the quality control review process nationwide. In addition, management stated they are currently restructuring the quality assurance process. For Recommendation 11, management plans to implement a system requiring supervisory examiners to respond to material weaknesses identified by regional quality reviews.

Evaluation of Management's Comments
Management's current and planned actions are responsive to the recommendations.

Chart J (below) identifies credit unions with deficiencies with their examination procedures.

Chart J

Credit Union	MLR Issue: Poor Examination Procedures and Enforcement
Huron River Area Credit Union	Examiners did not develop or follow-up on liquidity "red flag" issues, neither did examiners adequately monitor or respond to liquidity trends in the Call Report.
New London Security Credit Union	Examiners did not properly assess the credit union's internal control environment. Specifically, examiners never completed any of the following examination checklists: investment controls, investment accounting controls, investment third party controls, investment custodial controls, or Red Flag Procedures.
High Desert Federal Credit Union	Examiners did not expand examination procedures over issues. Specifically, neither the Guide nor the Manual specifies a process to effectively correct repeat DOR issues from prior examinations.
Center Valley Federal Credit Union	Examiners did not properly assess the credit union's lax internal control environment, which made an environment susceptible to fraud.
Cal State 9 Credit Union	Examiners did not respond aggressively or timely enough to Cal State 9's increasing credit and liquidity risks. Examiner believed that they did not have any leverage to be more forceful with management because management was not breaking any rules. In addition, examiners relied too heavily on management's statements and presentations regarding the credit union's risk management program rather than focusing on the magnitude of the credit risk the examination processes revealed. Also, examiners did not use available mechanisms to timely and adequately test and monitor the portfolio to validate or dispute management's asserted ability to manage the risks through monitoring reports.

(Chart J Continued)

Credit Union	MLR Issue: Poor Examination Procedures and Enforcement
Eastern Florida Financial Credit Union	Examiners should have performed further evaluation of management's lack of understanding of the risks and characteristics of the CDO investments earlier in the process. Further evaluation would have concluded that the credit union's ownership of the high-risk securities represented an undue risk to the credit union, and could have required management to place more prudent limits on CDO holdings, or otherwise required earlier divestiture.
Clearstar Financial Credit Union	Examiners did not adequately assess nor aggressively pursue resolution of critical risks created by management's high risk strategies related to loan concentration and credit quality. Further examiner processes impeded detection and effective enforcement of corrective actions.
Ensign Federal Credit Union	Examiners did not adequately assess critical risks created by management decisions and strategies related to concentration, credit, liquidity, and profitability. Further, examiners did not aggressively pursue a timely resolution to concerns raised in the exams, resulting in missed opportunities to mitigate those risks and limit NCUSIF exposure.
St. Paul Croatian Federal Credit Union	Examiners did not properly monitor trends.

Recommendation
We recommend NCUA management:

12. Determine whether credit unions with repeat DORs have taken appropriate corrective action. In the event that corrective action has not been taken, examiners should be instructed to elevate the supervisory response, including the taking of enforcement action when necessary.

Management's Comments
NCUA management agreed with recommendation 12. Management indicated the identification of repeat DOR items and appropriate examiner response is already part of the regional quality control review process and will continue to be emphasized in the new national supervision manual. Management also indicated they are currently evaluating other methods to better capture repeat DOR items.

Evaluation of Management's Comments
Management's current and planned actions are responsive to the recommendations.

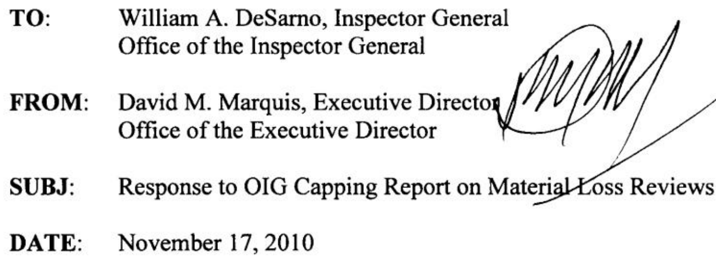
Appendix A – NCUA-OIG Material Loss Reviews

Report Title	Report Number	Date Issued
Material Loss Review of Huron River Area Credit Union	OIG-08-10	November 26, 2008
Material Loss Review of Norlarco Credit Union	OIG-09-01	May 11, 2009
Material Loss Review of New London Security Federal Credit Union	OIG-09-03	October 23, 2009
Material Loss Review of High Desert Federal Credit Union	OIG-10-01	March 17, 2010
Material Loss Review of Center Valley Federal Credit Union	OIG-10-02	April 14, 2010
Material Loss Review of Cal State 9 Credit Union	OIG-10-03	April 14, 2010
Material Loss Review of Eastern Financial Florida Credit Union	OIG-10-04	May 5, 2010
Material Loss Review of Clearstar Financial Credit Union	OIG-10-14	September 22, 2010
Material Loss Review of Ensign Federal Credit Union	OIG-10-15	September 23, 2010
Material Loss Review of St. Paul Croatian Federal Credit Union	OIG-10-16	October 7, 2010

Appendix B – Management Comments

VIA E-MAIL

EI/LFD:ld
SSIC #1920



TO: William A. DeSarno, Inspector General
Office of the Inspector General

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

SUBJ: Response to OIG Capping Report on Material Loss Reviews

DATE: November 17, 2010

Attached you will find a table outlining our response to the twelve recommendations included in the subject report. In summary, we agree with the recommendations set forth therein and will work diligently to address the major areas of concern identified in an effective manner.

It is our goal to ensure that the agency takes appropriate corrective measures when significant deficiencies in our examination or supervision programs are identified. Moreover, we understand that it is only through an effective risk management program that we can identify emerging areas of risk and take the steps necessary to minimize losses to the share insurance fund.

Thank you for the opportunity to comment. Please contact me if you have any questions or concerns.

OIG Capping Report
Response (3).docx

Attachment

cc: E&I Director Melinda Love
E&I Deputy Director John Kutchey
DDOS Tim Segerson
DDRM Wendy Angus

OIG Capping Report on Material Loss Reviews – Report #OIG-10-20
NCUA Management Response

MLR Issue: Ineffective Management (*Poor Strategic Planning and Decision Making and Weak Management Oversight*)

Recommendation	Agree/ Disagree	Comments
1. Caution examiners that assigning CAMEL composite ratings of 1 or 2 to credit unions that implement new business strategies needs to be supported with compelling, verified mitigating factors. Such mitigating factors should consider things such as the institution's corporate governance, risk management controls, allowance for loan and lease losses methodologies, concentration limits, funding sources, underwriting standards, capital levels, and whether the mitigating factors are likely to be sustainable in the long-term.	Agree	We are revising the Examiner's Guide to include appropriate guidance for evaluating risk related to new business strategies. We believe that the implementation of a new business strategy alone does not necessarily pose an undue level of risk. However, it is clear from the material loss reviews that the rapid growth of new programs without proper controls represents risk to an institution's net worth. To address this issue, we currently have quarterly risk reports and AIRES trending tools that identify growth in major balance sheet categories. Additionally, examiners are directed to address shortfalls in the planning or risk management of a new product/service or a change in strategic direction before implementation (Letter to Credit Unions 08-CU-20). We are in the process of developing a more robust examination tool within AIRES that will help identify new and fast-growing programs as part of an early risk indicator process. Examiners will be required to document their review of these trends and support why the indicators are (or are not) a concern.
2. Require a documented secondary review of the final CAMEL ratings by the Supervisory Examiner for all credit unions over $100 million in assets prior to issuance to credit union management.	Partially Agree	We agree with a pre-delivery report review for large institutions and will work to develop an effective method by which we can implement this recommendation while still providing field staff appropriate flexibility in the process. The $100 million threshold on initial review seems too low for this increased administrative review process, but it is something we will evaluate further and set when we establish the policy.
3. Issue a national instruction placing more emphasis on quarterly monitoring of Call Reports including developing	Agree	The Office of Examination & Insurance plans to issue a new national supervision manual which will emphasize the importance of quarterly off-site

offsite monitoring triggers and specific procedures to more easily 'red flag' areas to be investigated as well as provide a specific time allocation.		monitoring of institutions via the Call Report, Financial Performance Reports (FPR), and National Risk Reports. The new manual will also establish a formal method by which the review is to be performed and will provide a vehicle through which credit unions representing the most risk are identified and reported. The drafted manual is currently in the latter stages of review. The Office of Examination & Insurance also has plans underway to further formalize and automate the quarterly call report review process via an online tool. The automated process will require a documented review by both the district examiner and supervisory examiner. We plan to establish time frames for completion of the review to ensure that negative trends can be identified and addressed on a timely basis. With regard to a specific time allocation, we believe the hours already budgeted each quarter for review and analysis is sufficient with supervisors having the flexibility to allocate more time as needed on difficult or high risk cases.
4. Require examiners to document and retain the specific procedures and analysis performed during their quarterly review of the 5300 Call Reports. This analysis should then be forwarded to the Supervisory Examiner for review.	Agree	The national supervision manual will establish a formal method by which this review is to be performed and specifies a process for communicating to both supervisory examiners and regional offices which credit unions represent the most risk.

MLR Issue: Concentration Risk

Recommendation	Agree/ Disagree	Comments
5. Determine whether to propose and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and	Agree	To address both institutional and systemic concentrations of risk, the Office of Examination & Insurance and Office of General Counsel are currently drafting

OIG Capping Report on Material Loss Reviews – Report #OIG-10-20
NCUA Management Response

soundness risk and determine an appropriate range of examiner response to high risk concentrations.		a revision to the risk based net worth (RBNW) structure in the Prompt Corrective Action regulation. The objective is to issue new risk based capital standards that require higher levels of capital from a credit union with one or more concentrations in risk weighted assets. A key component of this evaluation will focus on capital premiums for concentration risk that will create natural barriers to excessive concentrations and high capital cushions for credit unions with elevated concentrations of risk assets.
6. Develop a more specific process such as trigger reports or standards so examiners can better identify, analyze, and monitor loan concentrations during exams, as well as between exams.	Agree	Current risk reports, FPRs, and AIRES worksheets provide an abundance of reports for monitoring the growth of loan concentrations during and in between examinations. Further, our Division of Risk Management is constantly reviewing our processes and reports to identify more effective tools. We will continue to strive to enhance our practices and modify our processes as more effective tools are identified. With regard to standards, Letter to Credit Unions 10-CU-03 (March 2010) Supervisory Letter Loan Concentrations, provides guidance on how to identify, measure, monitor and control risk associated with a concentration in assets. We are currently undertaking a significant redesign of our quality control process. This will include a documented review by supervisory examiners and DOS staff for proper scoping, identification and evaluation of risk for areas triggering a risk threshold on our quarterly risk reports.
7. Require a breakout of unfunded commitments by loan type on the 5300 Call Report to facilitate analysis and to better track loan concentrations.	Agree	Page 10 of the Call Report specifically requires a breakout of unfunded commitments by loan types. There are currently 12 categories collected and NCUA will add the other two categories that are the focus of your comment: indirect or third party loans.

OIG Capping Report on Material Loss Reviews – Report #OIG-10-20
NCUA Management Response

MLR Issue: New Program or Service and Third-Party Due Diligence

Recommendation	Agree/ Disagree	Comments
8. Re-emphasize examination guidance for third-party relationships, with particular attention to the assessment of the risk the relationship may pose to the credit union's safety and soundness.	Agree	We intend to require the completion of the existing third-party questionnaire as one of the minimum scope requirements for 2011. This questionnaire requires examiners to perform a comprehensive review of the credit union's current vendor/third party relationship management practices. We will continue to emphasize the importance of monitoring and closely evaluating controls over third party relationships. The following are several examples of guidance provided in this area: Risk Alert 05-Risk-01, Letters to Credit Unions 07-CU-13, 08-CU-09, and 08-CU-19, and emphasized again in related Letters to Credit Unions 10-CU-03 and 10-CU-15.
9. Develop examination guidance for due diligence over new or fast growing programs and areas of emphasis, with particular attention to the risk the new program or new area may pose to the credit union's safety and soundness.	Agree	We continue to emphasize close evaluation of fast growing programs as well as strategic management and controls over newly developed programs. As part of our AIRES redesign underway, we are expanding risk triggers and indicators and scaling examination procedures and the depth of our review on identified risks. We believe this improves emphasis on identified risk indicators during the examination process. Our approach will also enhance our ability to evaluate to assure consistent quality over identified areas of risk. A more structured review of new programs will also be captured as part of the revised exam process with the issuance of the revised Examiner's Guide. NCUA also shifted to an annual examination cycle for all federal credit unions and systemically important state chartered federally insured institutions. An annual cycle provides greater oversight with rapidly growing programs. We are currently undertaking a significant redesign of our quality control process. This will include a documented review by supervisory examiners and

		DOS staff for proper scoping, identification and evaluation of new and or fast growing programs.

MLR Issue: Examination Quality Control

Recommendation	Agree/ Disagree	Comments
10. Review the current requirements and levels that trigger a Quality Control Review and expand the process as necessary. Provide national guidelines for the Quality Control Review process so that all Regions are consistent in their reviews.	Agree	The new national supervision manual mentioned previously will standardize the quality control review process nationwide and set forth expectations for regional office reviews based on more refined risk indicators. We are also engaged in a comprehensive restructuring of the quality assurance process which will be incorporated into the supervision manual during 2011. It will include a multi tiered quality assurance program over the examination program, other supervision processes and selected risk areas. Our goal is to develop a comprehensive redesign of the decision management system and data flow to ensure more complete monitoring. The policy will also include quality reviews (audits) of various segments of the quality assurance program on a rolling basis. Nationally, the office of Examination and Insurance implemented a 2010 Quality Review process which included a sampling of examinations and all associated supervision and quality assurance documentation from each Region. We are currently working on the final segment and plan to issue summary review reports nationally, in addition to evaluate any needed policy and exam procedure changes.
11. Require Supervisory Examiners to provide a written response to the results of Quality Control Review on any	Agree	We plan to implement a system by which supervisory examiners will be required to respond to material weaknesses identified by regional quality

recommendations made by the Quality Control Review.		reviews. We see value in an open dialogue between the office and the field and believe this process will encourage discussion.

MLR Issue: Poor Examination Procedures and Enforcement

Recommendation	Agree/ Disagree	Comments
12. Determine whether credit unions with repeat DORs have taken appropriate corrective action. In the event that corrective action has not been taken, examiners should be instructed to elevate the supervisory response, including the taking of enforcement action when necessary.	Agree	Agency staff and the credit union industry have received clear direction from Chairman Matz in this regard over the last 12 months via personal appearances and webinars. In July of this year, the Office of Examination & Insurance led a webcast entitled Administrative Remedies/Enforcement Actions and Recent Failure Red Flags which addressed this very issue and outlined both the formal and informal remedies available. The identification of repeat DOR items and appropriate examiner response are already a part of regional quality control review processes and will continue to be emphasized with the new national supervision manual. We are currently evaluating other methods to better capture repeat DOR items. Our Examiner Guide and Supervision Manual will emphasize greater oversight where appropriate. We currently have reports developed from problem codes in the AIRES system. The information can be useful in evaluating repeat problem areas, however we are currently exploring methods to improve the robustness of the tool for greater precision and efficiency.