NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW
OF
CERTIFIED FEDERAL CREDIT UNION

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Acronyms and Abbreviations

AIRES	Automated Integrated Regulatory Examination Software
AMAC	Asset Management & Assistance Center (Austin, TX)
Board	Board of Directors
Call Reports	NCUA 5300 Call Reports
CEO	Chief Executive Officer
DOR	Document of Resolution
FCU Act	Federal Credit Union Act
FPR	Financial Performance Reports
IT	Information Technology
MBL	Member Business Loan
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
PCA	Prompt Corrective Action
RFE	Risk-Focused Examination
SBA	Small Business Administration
SME	Subject Matter Expert

Executive Summary

We performed a Material Loss Review (MLR) on behalf of the National Credit Union Administration (NCUA) Office of Inspector General (OIG) of Certified Federal Credit Union (Certified or the Credit Union). We reviewed Certified to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated $9 million loss to the National Credit Union Share Insurance Fund (NCUSIF); (2) assess NCUA's supervision of the Credit Union; and (3) make appropriate recommendations to prevent future losses. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence; interviewed NCUA officials and regional staff; and reviewed NCUA guidance, including regional policies and procedures, NCUA 5300 Call Reports (Call Report), and NCUA Financial Performance Reports (FPR).

We determined Certified failed for the following reasons:

- <u>Inaccurate Financial Reporting and Weak Accounting Practices and Internal Controls</u>

  Certified management and Board allowed serious internal control weaknesses to exist including inadequate segregation of duties and untrained accounting staff. These weaknesses allowed the Chief Executive Officer (CEO) to override internal controls, prepare erroneous account reconciliations from the general ledger to the subsidiary ledgers and inaccurately report financial results to the Board of Directors (Board) and in quarterly Call Reports. The CEO knowingly prepared and directed the posting of monthly journal entries that had no support or rationale other than to inflate earnings and mask serious loan quality, liquidity, and profitability issues. Additionally, investigations of accounting irregularities at the Credit Union noted improprieties and potential fraudulent activities conducted by the CEO.

- <u>Weak Board Oversight</u>

  Certified's Board was weak and unresponsive to financial risks and ethical issues and did not provide sufficient and responsive direction and follow-up to the repeated issues raised by auditors and examiners related to strategic direction, lending practices, delinquency monitoring, and inconsistent or nonexistent policies. Additionally, Certified's Board took no action when examiners first brought unusual and suspicious accounting practices on the part of the CEO to their attention in 2005.

- Inadequate Risk Management Practices

  Certified management did not adequately identify, monitor, control, or report the risk created by its strategies and carried in its loan portfolio. Management maintained high real estate loan concentrations but had weak underwriting practices, deficient liquidity and delinquency tracking, and ineffective monitoring of Small Business Administration (SBA) loans.

In addition, we determined examiners and Region V management missed opportunities to prevent or reduce the loss to the NCUSIF. Specifically, examiners did not:

- Adequately assess the Management component of the CAMEL rating system.

- Adequately consider external audit findings and reviews when developing their examination procedures; or

- Apply appropriate administrative remedies when their own fraud investigation into the CEO's fiduciary duties raised serious safety and soundness concerns due to the CEO's business practices and ethical behavior.

Based on our review of the causes of Certified's failure, we are making three recommendations to NCUA management that we believe would correct identified deficiencies. Management agrees with all three recommendations and has already or is in the process of taking corrective action.

As major causes, trends, and common characteristics of credit union failures are identified in OIG MLRs and recommendations are presented, the OIG will communicate those to NCUA management for its consideration. As resources allow, the OIG may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and also make recommendations, as warranted.

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

Introduction and Background

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) authorized Moss Adams LLP to conduct a Material Loss Review (MLR) for Certified Federal Credit Union (Certified or the Credit Union), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. §1790d(j). Certified was a federally chartered credit union located in Commerce, California. NCUA's Region V provided primary supervision over the Credit Union.

History of Certified Federal Credit Union

Certified opened in 1949 and served members residing in and around Commerce, California, with financial products that included insurance and real estate loans. Certified also offered its members a full-service website that allowed for "Banking from Home" functionality. Initially, Certified's field of membership included the employees of Certified Grocers and eventually grew to over 6,200 members with assets of more than $50 million. Certified had 18 employees located in their single main office.

In March 2008, NCUA Region V examiners imposed a moratorium on real estate lending due to high real estate loan concentrations and poor loan quality. Region V also issued a Letter of Understanding, which was accepted by Certified management after the June 2009 examination. Region V supervised Certified until NCUA management transferred the supervision of the credit union to Region IV.[1] Region IV immediately placed Certified in their Division of Special Actions.

During the first quarter of 2010, Region IV conducted an initial examination of Certified and identified significant bank reconciliation issues, including unsupported reconciling items and loan subsidiary ledgers that did not agree to the general ledger or to Call Reports. As a result, Region IV officials required Certified's Board to engage an accounting firm to have a forensic review conducted as of April 30, 2010 to investigate potential fraud at Certified. The accounting firm issued their report to the NCUA's Asset Management and Assistance Center (AMAC) on August 2, 2010.[2]

In May 2010, NCUA examiners determined the discrepancy between the subsidiary loan ledgers and the general ledger would require an adjustment of approximately $6 million to reduce total loans at the Credit Union. As a result of the adjustment, Certified fell into a deficit capital position.

[1] In 2009, NCUA management transferred supervision responsibility of Certified to Region IV due to a regional restructuring based on workload rebalancing among regional offices. Actual transition and responsibility for supervising Certified did not occur until the first quarter of 2010.
[2] AMAC received the report because the NCUA had already liquidated Certified and AMAC retained the rights to the bond claim at the time of issuance.

On July 31, 2010, the NCUA Board involuntarily liquidated Certified Federal Credit Union and appointed itself liquidating agent. Also on this date, the NCUA, as liquidating agent, executed a purchase and assumption agreement and transferred the assets, liabilities, and shares of Certified[3] to Vons Employees Federal Credit Union of El Monte, California. The estimated loss to the National Credit Union Share Insurance Fund (NCUSIF) was approximately $9 million; however, the NCUA will not know the final cost until all assets are sold.

NCUA Examination Process

The NCUA uses a CAMEL[4] 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.

Within the CAMEL Rating System, the NCUA examination process uses a total analysis approach 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 components and reviewing qualitative and quantitative measures.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis[5], trend analysis[6], reasonableness analysis[7], variable data analysis[8], and qualitative data analysis[9]. 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

[3] At the time of closure, Certified had approximately $38 million in assets and 8,500 members.
[4] The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
[5] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[6] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[7] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[8] 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.
[9] 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.

for future problems. The NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, the NCUA requires examiners to: determine whether material negative trends exist; ascertain the action needed to reverse unfavorable trends; and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

Risk-Focused Examination Program

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic,* and *Reputation.* Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up, and (b) analyzing Call Reports 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; and
- Knowledge of current events affecting the credit union.

Objectives, Scope, and Methodology

Section 216(j) of the Federal Credit Union Act (FCU Act), 12 U.S.C. §1790d(j), requires the Inspector General to conduct a material loss review when the NCUSIF has incurred a material loss.[10] Moreover, the 2010 amendments to the FCU Act, embodied in the "Dodd-Frank Wall Street Reform and Consumer Protection Act,"[11] further require the IG to conduct an in-depth review of a loss to the NCUSIF where unusual circumstances might warrant the IG's scrutiny, even where the loss did meet the statute's materiality threshold. In the case of Certified, the OIG determined the circumstances surrounding the loss to the NCUSIF were unusual enough to warrant our review, even though that loss did not exceed $25 million. Specifically, we determined that the allegations of fraud and other suspicious business practices

[10] The FCU Act deems a loss "material" if the loss exceeds the sum of $25 million or an amount equal to 10 percent of the total assets of the credit union at the time in which the NCUA Board initiated assistance under Section 208 or was appointed liquidating agent.
[11] Public Law No. 111-203, 124 Stat. 1376 (2010).

at Certified, as well as the ethical issues raised by examiners while supervising this credit union, warranted the OIG performing a full-scope MLR.

The objectives of our MLR were to:

- Determine the causes of the Credit Union's failure and any material loss to the NCUSIF;

- Assess NCUA supervision of the institution, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and

- Make appropriate recommendations to prevent future losses.

To accomplish our review, we performed fieldwork at the NCUA's Region IV office in Austin, Texas[12] and Region V office in Tempe, Arizona, and conducted interviews of NCUA officials and examiners. The scope of this review covered the period from June 2004 through liquidation in July 2010.

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

- Prepared a chronology of examination scope and procedures, comments, and corrective actions;

- Reviewed examination files and Certified's Board of Director's (Board) minutes;

- Reviewed external audit findings and follow-up procedures;

- Reviewed the forensic review dated August 2, 2010, issued by an external accounting firm;

- Conducted interviews with NCUA officials and examiners involved at various levels in the examination process;

- Reviewed policies and procedures included in examination files related to loan quality, investment quality, liquidity management, and earnings;

- Reviewed NCUA and regional rules, regulations, and guidelines; and

[12] Region V supervised Certified until November 2009 when the NCUA transferred the credit union to Region IV due to a workload rebalancing among regional offices after the 2009 regional restructuring.

- Reviewed NCUA Call Reports, Financial Performance Reports, and other documentation related to the supervision of Certified.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software (AIRES) and NCUA online systems. We did not test controls over these systems. However, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our audit conclusions.

We conducted this audit from November 2010 through August 2011 in accordance with Generally Accepted Government Auditing Standards, and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Detail

We determined Certified's Chief Executive Officer (CEO) and Board of Directors (Board) contributed directly to the Credit Union's failure. In addition, we determined the loss to the NCUSIF could have been prevented or mitigated had examiners: (1) adequately assessed and more aggressively pursued resolution to issues related to external audits and reviews; (2) properly assessed the effectiveness of the credit union's Board; and (3) aggressively pursued administrative remedies in 2005 when questionable practices committed by the CEO first surfaced.

A. Why Certified Federal Credit Union Failed

Inaccurate Financial Reporting and Inadequate Internal Controls

We determined Certified's accounting practices and related internal controls were severely lacking. Specifically, serious internal control weaknesses including inadequate segregation of duties and untrained accounting staff, allowed the CEO to override internal controls, prepare erroneous account reconciliations from the general ledger to the subsidiary ledgers, and inaccurately report financial results. Examiners also noted accounting and reporting errors related to the recording of loan sales, loan loss reserve calculations, and unsupported journal entries made by the CEO. As a result, Certified's financial condition, as reported to its Board of Directors and the NCUA in its Call Reports, was materially inaccurate.

Both examiners and external auditors consistently reported inaccurate accounting records and weak internal controls. In June 2004, an external audit report noted interest accruals did not agree to the general ledger and that reconciling items related to the CEO's real estate loans lacked support. The report noted improper segregation of duties related to the CEO who independently prepared account reconciliations, and two employees whom the CEO authorized to approve and process loans in addition to their file maintenance activities. The June 2004 NCUA examination also noted reconciliation issues with subsidiary ledgers, prepaid expense, and equity accounts. We determined, however, that Certified's management and Board did not address these issues as they continued throughout the scope of our review.

The November 2005 external audit found that third-party real estate loans did not reconcile to the general ledger. The December 2006 full-scope NCUA examination also found serious reconciliation issues that included suspense and clearing accounts.

The December 2006 examination noted the need for staff training in basic accounting. Specifically, Certified staff members made erroneous entries under the direction of the CEO due to either a lack of knowledge or fear of losing their job. The December 2009 contact concluded that neither the CEO nor the vice president of accounting had sufficient knowledge to provide accurate accounting records and financial statements.

Finally, a monthly accounting review conducted by an independent consultant in early 2010 determined that SBA, Member Business Loan (MBL), and real estate sub-ledgers did not tie to the general ledger. Certified management sold loans and did not properly book the sale, erroneously recording the offsetting credit to income, rather than reducing loans receivable. The erroneous entries resulted in an $8.8 million loss to Certified's capital.

Improprieties and Allegations of Management Fraudulent Activity

We determined Certified's CEO engaged in unethical behavior that breached his fiduciary responsibilities. An important contributor to the demise of Certified was the alleged fraud and improprieties committed on the part of the CEO. Allegations of fraud and improprieties first surfaced through anonymous telephone calls to the NCUA in April and May of 2005. In addition, in 2010, an independent consultant and an outside forensic review uncovered several other questionable activities linked to the CEO.

In 2005, after receiving the anonymous phone calls, NCUA's Region V conducted its own limited-scope fraud investigation that resulted in a finding of suspicious activity related to potential money laundering by the CEO. The fraud investigation concluded there was no evidence to substantiate the fraud allegations committed by the CEO; however, in a memorandum report of their investigation, Region V officials characterized the CEO's activity as:

> *"…inappropriate and abusive, and unusual and suspicious."*

The NCUA discussed the findings of the report with the credit union's Supervisory Committee Chair, including details regarding the inappropriate and suspicious transactions involving the CEO. Certified's Board and Supervisory Committee took no action to remove the CEO from his position.

During the first quarter of 2010 after supervisory responsibility of the credit union had transferred to Region IV and during Region IV's initial examination, Certified management hired an outside consultant to conduct an accounting review of monthly accounting practices and reconciliations to assess financial reporting accuracy and to determine if fraud indicators were present. The review determined Certified's accounting staff had made large unsupported adjusting journal entries to the general ledger at the direction of the CEO for at least two years. In addition, the review noted the CEO had insisted on "reconciling" certain balance sheet accounts but was not able to provide support for his reconciling items.

Following the accounting review, Region IV officials required Certified management to contract with an independent public accounting firm to conduct a forensic review to investigate the possibility of fraud based on the results of the accounting review. The results of the forensic review determined management had fabricated some of the financial reports provided to examiners. Specifically, the review noted that management input fictitious entries into an information technology (IT) test environment, which ran a second general ledger accounting system for the Credit Union. As a result, examiners relied on misleading financial statements and information during examinations.

The 2010 forensic review also noted the CEO had unauthorized waivers of fees related to nonsufficient funds and late payments on his accounts, modifications to his and one of his family members' loans, check kiting, and potential kick backs from vendors and from loan origination fees and commissions paid to one of the Credit Union's loan officers.

In addition, the 2010 forensic review reported that both the CEO and a loan officer maintained businesses outside the Credit Union. The CEO had a consulting company, which contracted for a 20 percent share of commissions paid to the loan officer's mortgage servicing business. The loan officer generated low quality loans with high origination fees, which were then approved by the CEO. The loan origination fees were paid by Certified in the form of commissions to the loan officer's company, which then paid the CEO's consulting business its 20 percent share.[13] The forensic review further noted that Certified did not issue the appropriate Internal Revenue Service tax forms for commissions paid to the loan officer's company for the 2007 through 2009 tax years until instructed by the NCUA in 2010 to do so.

Finally, the 2010 forensic review identified three vendors as having received significant payments beyond the expectations of a credit union of this size. Those vendors included an IT consultant who was paid $850,000 for a computer conversion, an advertising company that was paid nearly $20,000 per month in 2008 and 2009, and a contractor whose billings exceeded $400,000 for construction projects that occurred in 2007, 2008, and 2009. The report noted the contractor's billings coincided with construction projects conducted at the CEO's personal residence. The report was silent as to whether the Credit Union paid for the work conducted at the CEO's residence.

[13] Commission payment activity occurred primarily in 2008 and 2009 when the economy was in rapid decline.

Weak Board Oversight

We determined Certified's Board did not provide sufficient and responsive direction and follow-up to repeated issues raised by external auditors and examiners related to strategic direction, lending practices, delinquency monitoring, and inconsistent or nonexistent policies. Additionally, the Board took no action when unusual and suspicious accounting practices on the part of the CEO were brought to their attention. As a result, the lack of effective policies and Board inaction allowed for inappropriate employee expense reimbursements, unauthorized loan modifications, unrestricted vendor selection, and inadequate lending practices.

We also determined Certified's Board placed too much faith in the CEO and did not respond to character issues and accounting irregularities raised by anonymous callers, auditors, and examiners beginning in 2004 and persisting until the Credit Union's demise. As previously mentioned, Region V's June 2005 fraud investigation into the CEO's practices raised serious ethical and judgment issues, including a statement that the CEO

> *"…enriched himself personally at the credit union's expense."*

Specifically, the June 2005 fraud investigation found instances of unauthorized personal loan extensions, personal expenses charged to Certified of $1,085, and a personal auto loan balance converted to a Credit Union expense for $5,577. The Board took no action against the CEO; in fact, they retroactively approved the personal expenses cited in the fraud investigation memorandum.

In addition, the Board did not require management to follow up on auditor recommendations, as far back as 2005. Specifically, we determined management did not address audit recommendations to reduce operating costs, acknowledge the real estate slow down, set real estate concentration limits, develop a vendor selection policy, or correct subsidiary ledger balancing and Call Report discrepancies.

We determined a 2005 Supervisory Committee audit found unsupported reconciling items related to the CEO's real estate loans. We also learned that when the external auditor informed the Committee and Board of the results of the audit, the Board's response was to instruct the auditor not to perform any follow-up procedures. Supervisory Committee audits conducted in the following years continued to cite reconciling issues. The Board remained supportive of the CEO until Region IV informed the Board in March 2010 of the CEO's suspicious activity, which created a divide among Board members until his resignation in May 2010.

We also determined Certified's Board did not control identified risks associated with rapidly declining real estate values. For example, the 2005 Supervisory Committee audit specifically noted

> *"…the recent slowdown in the real estate market."*

However, rather than reduce their risk in real estate lending, Certified's Board approved the addition of a nontraditional mortgage program to its real estate portfolio that allowed subprime elements such as stated income and interest-only loans.

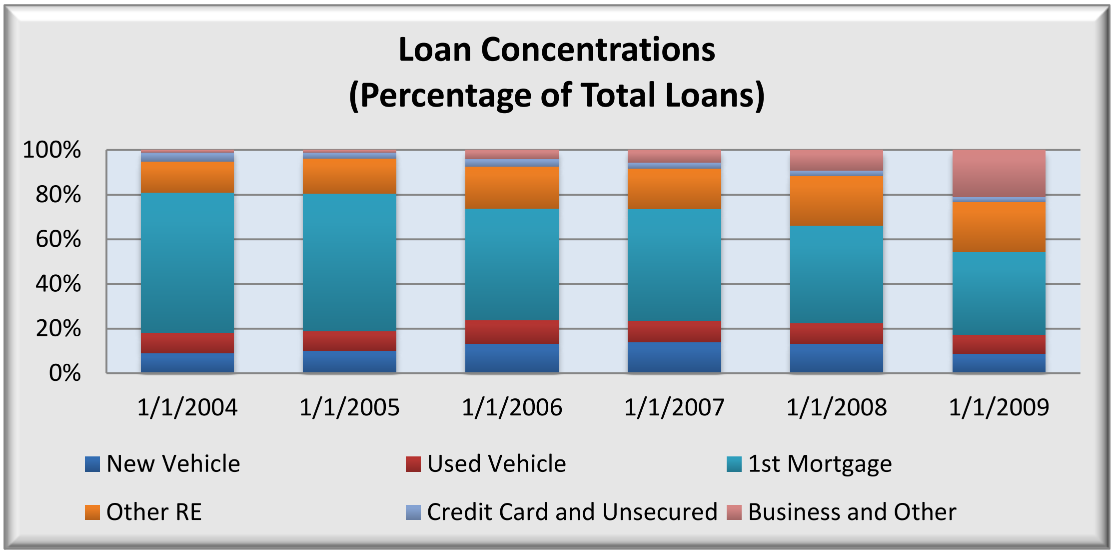
We determined Certified's lack of formal and comprehensive policies was also a recurring theme. Examiners issued a Document of Resolution (DOR) in both the June 2004 and June 2005 examinations related to the credit union's Asset/Liability Management policy and Real Estate Loan Policy, respectively. Examiners also identified a need for a policy on employee expense reimbursements related to corporate credit cards in their December 2006 examination. The Board approved a policy in 2007, stating that employees could only use corporate credit cards for Credit Union business; however, the policy was not followed and examiners cited credit card violations in the 2009 exam. External auditors also identified issues with Certified's lack of policies. For example, in the March 2005 Supervisory Committee audit, auditors noted the need for a vendor selection policy, and in June 2009, auditors recommended the development of a Loan Modification Policy.

<u>Inadequate Risk Management Practices</u>

We determined Certified management did not adequately identify, monitor, control, or report the risk created by its business strategies and carried in its loan portfolio.

Certified maintained high real estate concentrations. As shown on Chart 1 (below), real estate loans comprised a major part of the loan portfolio and did not start to significantly decline until 2008, when the underlying property values were dropping and material write-downs occurred.

Chart 1



Source: NCUA Call Reports

In June 2005, examiners noted Certified had an inexperienced loan committee; no tracking of performance by loan category; inadequate income verification processes; allowed nontraditional interest-only loans; and needed to set portfolio limits. Management did not adequately address these concerns and, as a result, examiners repeated these same issues in the March 2008 examination's DOR.

We also determined Certified management's underwriting practices did not sufficiently assess or track borrower credit worthiness and related collateral values. Throughout the period of our review, we found examiners expressed underwriting concerns related to income verification and policy compliance. Examiners also noted management did not monitor delinquencies timely or reflect them accurately in the financial statements. The DORs issued as a result of the 2005, 2008, and 2009 examinations included steps to improve the methodology and underlying data used to calculate loan loss reserves, which significantly impacted the strength of Certified's financial position.

The December 2006 Supervisory Committee audit noted that lending policies did not match current practice. For example, management made loans to nonmembers, which was against Credit Union policy.

The December 2006 examination noted liquidity pressure from Certified's large real estate portfolio; lack of monitoring of the credit scoring process to loan performance; and an allowed loan-to-value of up to 100 percent in the real estate lending policy. The examination further noted that management's strategy to rely on nonmember deposits to fund loans was not working.

Failure to manage liquidity risk was also a recurring theme, particularly when real estate concentration rose to nearly 70 percent of loans, with most of those at fixed rates. The high cost of nonmember deposits, which rose to 18 percent of total deposits, accelerated the increasing liquidity problem.

Certified management also did not properly monitor SBA lending, which resulted in the nonguaranteed portion of loans being inadequately secured. Examiners noted and warned management in their report(s) of examination that they [management] did not have the necessary expertise or infrastructure to process SBA loans. SBA loans were encouraged and generated by a loan officer who received large fees for originating and selling these loans, many of which turned into write-offs. The June 2009 examination noted the non-guaranteed portion of the SBA portfolio was nearly $1 million of the $40 million loan portfolio at June 30, 2009.

B. NCUA Supervision of Certified Federal Credit Union

Examiners Could Have Prevented or Mitigated the Loss to the NCUSIF

We determined a contributing factor in the failure of Certified was NCUA examiners and Region V management's failure to take decisive action to address serious safety and soundness concerns surrounding the CEO's business practices and unethical behavior. Specifically, examiners could have prevented or reduced the loss to the NCUSIF had they adequately considered external audit findings and reviews when developing their examination procedures; and applied swift and appropriate administrative remedies to resolve the safety and soundness concerns raised in the NCUA's June 2005 Fraud Investigation memorandum. As a result of the examiners and Region V management's failure to take decisive action, it allowed the CEO to breach his fiduciary duty and remain in his position until he resigned in May 2010.

Supervisory Background

Certified consistently received Composite CAMEL 2 ratings from June 2004 through June 2006, an indication of strong performance. However, Certified began to deteriorate beginning with the December 2006 examination when examiners downgraded Certified to a Composite CAMEL 3. At the conclusion of the June 2009 examination, examiners again downgraded Certified to a Composite CAMEL 4. In November 2009, NCUA transferred Certified to Region IV and regional management immediately placed Certified in the Division of Special Actions. By January 2010, examiners lowered Certified's Composite CAMEL rating to a 5. Table 1 (below) provides specific CAMEL ratings during the scope period of our review.

Table 1 NCUA Examination Results

Credit Union Examination Effective Dates	Exam Type[14]	CAMEL Composite	Cap/Net Worth	Asset Quality	Mgmt	Earnings	Liquidity
June 2004	10	**2**	1	2	2	3	2
March 2005	22	**2**	1	2	2	3	2
June 2005	10	**2**	1	2	2	4	2
May 2006	22	**2**	1	2	2	4	2
June 2006	22	**2**	1	2	2	4	2
December 2006	10	**3**	1	1	4	3	4
May 2007	22	**3**	1	1	4	3	4
March 2008	10	**3**	2	3	3	4	4
December 2008	22	**3**	2	3	3	4	4
June 2009	10	**4**	4	4	4	4	4
September 2009	22	**4**	4	4	4	4	4
December 2009	22	**4**	4	4	5	4	4
January 2010	22	**5**	5	4	5	5	4
March 2010	22	**5**	5	5	5	5	5
April 2010	22	**5**	5	5	5	5	5
June 2010	22	**5**	5	5	5	5	5

We noted two supervisory actions taken against Certified. In March 2008, NCUA Region V examiners imposed a moratorium on real estate lending due to high real estate loan concentrations and poor loan quality, followed by a Letter of Understanding, which examiners issued and management accepted after the June 2009 examination.

Based on our review of examination reports and supporting examination files and workpapers, we determined that NCUA could strengthen examination processes to limit NCUSIF exposure as follows:

Consideration of External Audit Findings

We determined examiners and Region V management did not adequately consider external audit findings when conducting their examinations. We base our conclusion on the following:

- External audit reports as far back as 2004 raised concerns about account reconciliations and segregation of duties in the Credit Union. In the 2004 Supervisory Committee audit, auditors raised specific findings related to

[14] Exam Type 10 is a full scope, on-site examination and Type 22 is a more limited on-site contact.

inaccurate reconciliations and inappropriate CEO authority related to accounting practices.

- The 2005 Supervisory Committee audit repeated and expanded concerns to include subsidiary ledgers that did not agree with the general ledger, inadequate vendor selection policies, and Call Reports that did not agree with the general ledger.

- Examiners advised they believed external auditors tested the reconciliation of accounts in the course of performing their external audit and that performing a reconciliation of accounts was not a required procedure for NCUA examinations. We found no evidence in the examination workpapers of procedures to review the reconciliation of accounts to the general ledger.

- The DORs issued to management in 2004 and 2005 did not address accounting irregularities and concerns raised in the external audits such as reconciliation issues; lack of proper segregation of duties involving the CEO; Call Report errors; falling net worth; weakening real estate market; insufficient borrower income verification; and excessive operating costs.

We also found no evidence until 2010 in the examination workpapers indicating that examiners adjusted the approach and procedures to follow up on the serious accounting and strategy concerns noted in the external audits. We believe this resulted in a missed opportunity to limit the loss to the NCUSIF.

<u>Administrative Remedies Not Pursued</u>

We determined examiners and Region V officials did not pursue administrative remedies to resolve serious issues uncovered during Region V's June 2005 fraud investigation. As previously noted, NCUA Region V officials conducted a limited-scope investigation to confirm or deny allegations of fraudulent activity conducted on the part of the CEO and issued an investigation memorandum detailing the results.

Although Region V officials were unable to substantiate allegations of fraud, they did determine the CEO had abused his position to enrich himself personally at the credit union's expense. Region V officials also determined the CEO used his family members' accounts at the credit union to accomplish a potential money-laundering scheme. We believe both these actions by the CEO breached his fiduciary duty to the Credit Union, which created a serious safety and soundness concern at Certified. In addition, we determined both the Board and the Supervisory Committee did not respond to the findings or recommendations detailed in the Region's investigation memorandum. As a result of examiners' and Region V officials' failure to take decisive action to address serious safety and soundness concerns surrounding the CEO's business practices and unethical behavior, the CEO remained in his position until May 2010.

The NCUA Examiner's Guide (Guide) indicates that administrative actions represent the strongest supervisory tool available to the agency to prevent, alter, or eliminate serious operational or managerial problems in a credit union. The Guide also states that NCUA can remove from office directors, officers, or committee members when they have (directly or indirectly) engaged or participated in any unsafe or unsound practice in connection with a credit union.[15] NCUA divides administrative remedies between informal and formal actions.[16]

During the June 2005 examination and an external audit, examiners and auditors identified issues including increasing credit risk; an inexperienced Loan Committee; underwriting concerns; improper accounting; reconciliation irregularities; inaccurate Call Reports, and CEO loan violations. Examiners rated Certified's Management component a CAMEL 2, which we believe is an indication that not only did examiners not adequately consider the magnitude and severity of the identified issues, but we also believe examiners viewed the ethical issues associated with the CEO as issues of competency.

During the December 2006 examination, although examiners lowered the Management component to a CAMEL 4, and the Supervisory Examiner noted in the examiner evaluation:

> *"…we must maintain continued pressure on management to perform..."*

We found no evidence in examination workpapers that examiners elevated the identified issues to the SE to begin administrative action procedures against the CEO based on his unethical behavior.

In addition, examiners indicated in their June 2005 fraud investigation memorandum that management: (1) provide the results of the fraud investigation and any documents related to suspicious activity to the Board; (2) formally notify the Credit Union's bonding company of the results of the fraud investigation, and (3) move the next contact date for Certified to an earlier date and have a specialized lending Subject Matter Expert (SME) participate.

[15] The Examiner's Guide is not the ultimate authority for removal actions; there are significant due process requirements and legal/practical limitations NCUA must consider when taking a removal action.
[16] Informal actions include items such as examination reports (with DOR), Regional Director Support Letter, Letter of Understanding and Agreement (non-published), and Preliminary Warning Letter. Formal actions include items such as Published Letter of Understanding and Agreement, Immediate and/or Permanent Cease and Desist Order, Civil Money Penalties, Involuntary Liquidation, Conservatorship, Removal and/or Prohibition, and Termination of Insurance and/or Revocation of Charter.

The only two recommendations we could determine that examiners acted upon were: (1) providing the results of the fraud investigation to the Board (which, as noted, management did not act upon), and (2) moving the next supervisory contact to an earlier date.

Although examiners completed a full scope examination on December 1, 2005 (Effective June 30, 2005), we noted no specific or expanded examiner procedures to address the considerable fraud risk indicated in Region V's fraud investigation memorandum. We also determined an SME did not participate in the follow-on examination as recommended. In addition, we found no supporting documentation in examination workpapers that examiners had completed an evaluation and assessment of the Credit Union's Board, particularly as it related to addressing the alleged fraud.

NCUA has not designed its Risk-Focused Examination Program to detect fraud and the Guide indicates that expertise in fraud and forgery detection is beyond the examiner's role. However, the Guide also states examiners must be cognizant of situations that could be conducive to fraud and/or insider abuse because it is the most common cause of losses to the NCUSIF. The Guide also states that if red flags indicate a potential for fraud or forgery exists, examiners should consult with their supervisory examiner to discuss expanding the examination scope. We found no evidence in examination workpapers prior to 2010 that examiners, faced with potential fraud committed by the CEO, consulted with the SE about this matter.

We believe given: (1) the breach of fiduciary responsibilities committed by the CEO through his inappropriate and suspicious activities; (2) the internal control weaknesses identified in every external audit and report of examination dating back to 2004; and (3) the lack of response by both the Board and the Supervisory Committee to the findings and recommendations detailed in the Region's investigation memorandum, examiners should have expanded the scope of their examinations and conducted red flag reviews as far back as 2005.[17] In addition, the expanded scope should have included utilizing the resources of an SME to assist the examiners in determining the proper course of administrative action to take.

[17] The NCUA Region V Examiners Guide indicates examiners need to expand procedures when red flag fraud indicators exist such as incomplete reconciliations, out of balance conditions, and on-going recordkeeping problems.

Recommendations

We recommend NCUA management:

1. Require examiners to document their consideration of external audit findings and recommendations in the Risk Assessment. Examiners should ensure examination procedures directly address the audit findings and examiners workpapers adequately document the review.

Management Response

Management agrees with the recommendation and is taking corrective action. Specifically, management stated, “we are in the process of implementing a National Supervision Policy Manual. This manual will require examiners to assess Transaction Risk as ‘High’ in the Final Risk Assessment section of the Scope workbook if significant or ongoing recordkeeping errors are identified. Additionally, examiners will be required to document review of the Supervisory Committee audit work papers during at least every other examination and follow-up on material concerns if applicable”.

OIG Response

We concur with the actions taken to date and planned via the National Supervision Policy Manual.

2. Expand examiner procedures to require examiners ensure amounts reported on the general ledger for all material accounts such as loans, member deposits, cash, and investments, reconcile to subsidiary ledgers and to the Call Report. Examiner procedures should also include reviewing bank and other key account reconciliations for unusual, large, or stale-dated reconciling items, as well as the underlying support.

   Auditor’s Note: NCUA Instruction 5000.20, dated December 28, 2010, requires review and testing of bank reconciliations effective January 1, 2011. As noted above, we suggest the review and testing process be extended to other key balance sheet accounts and include tying out the reconciled balance to the Call Report.

Management Response

Management agrees with the recommendation and has taken corrective action. In addition, management plans to take additional actions. Specifically, management stated, "A National Supervision Policy Manual will be issued in an effort to enhance the examination program and address OIG recommendations. This manual will require examiners that identify untimely or inaccurate bank reconcilements or other material out of balance accounts to rate Transaction Risk 'High', note as a major concern in the examination overview, and provide a Document of Resolution outlining required corrective action. Additionally, examiners are to obtain weekly status updates from the credit union and follow-up no later than 60 days after the identification of the problem with resolution within 180 days of identification. Examiners are instructed to rapidly elevate the supervision and administrative action for credit unions with persistent or pervasive recordkeeping concerns".

OIG Response

We concur with the actions taken to date and the actions planned by management.

3. Issue guidance regarding the evaluation of management with an emphasis on management integrity. The guidance should emphasize the various factors that should be considered when assessing the Management component of the CAMEL rating system. The guidance should address the principles of the Risk Focused Exam program that need to differ when addressing management integrity issues versus issues of competence.

Management Response

Management agrees with the recommendation and is planning corrective action. Specifically, management stated, "We will evaluate this recommendation and issue additional guidance addressing how the Risk Focused Examination program should differ when addressing management integrity versus competency issues if necessary".

<u>OIG Response</u>

We concur with the actions planned.

Appendix A

Management Response

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<u>**SENT VIA E-MAIL**</u>

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

FROM: Dave Marquis
Executive Director

SUBJ: Comments on Material Loss Review of Certified FCU

DATE: August 25, 2011

This memorandum responds to your request for official comments on the OIG draft report titled *Material Loss Review (MLR) of Certified Federal Credit Union.* Certified Federal Credit Union (CFCU) failed as a result of fraud.

MLR Report Recommendations
The MLR includes three recommendations. Following the recommendation cited in your report you will find our response including corrective action that has been taken or is planned.

1. *Require examiners to document their consideration of external audit findings and recommendations in the Risk Assessment. Examiners should ensure examination procedures directly address the audit findings and workpapers are adequately documented.*

   Response: We agree examiners should be required to document their consideration of external audit findings and recommendations and since 2002, have had this requirement in place. The review of the audit workpapers should be required in small credit unions with supervisory committee audits but for other credit unions, the decision to review workpapers should be a function of the size, complexity, internal control structure, and the type of audit performed.

   The Examiners Guide outlines three minimum requirements for the Risk-Focused exam program from 2002, when the Guide was updated, until 2009 when additional minimum scope requirements were added via NCUA Instruction 5000.20. In December 2010, the minimum scope requirements were expanded to include additional minimal review areas, and continues to stress the importance of reviewing the supervisory committee audit. Examiners are required to document review of this area in the Scope workbook

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and complete the Supervisory Committee and Member Account Verification Questionnaire. This questionnaire specifically asks whether the audit notes any material weaknesses, ongoing weaknesses, and if the examiner's scope was expanded based on review of the audit.

In continuing efforts to refine our examination process and address OIG recommendations, we are in the process of implementing a National Supervision Policy Manual. This manual will require examiners to assess Transaction Risk as 'High' in the Final Risk Assessment section of the Scope workbook if significant or ongoing recordkeeping errors are identified. Additionally, examiners will be required to document review of the Supervisory Committee audit work papers during at least every other examination and follow-up on material concerns if applicable.

2. *Expand examiner procedures to require examiners ensure amounts reported on the general ledger for all material accounts such as loans, member deposits, cash, and investments reconcile to subsidiary ledgers and to the Call Report. Examiner procedures should also include reviewing bank and other key account reconciliations for unusual, large, or stale-dated reconciling items, as well as the underlying support.*

> *Auditor's Note: NCUA Instruction 5000.20 dated December 28, 2010, requires review and testing of bank reconciliations effective January 1, 2011. As noted above, we suggest the review and testing process be extended to other key balance sheet accounts and include tying out the reconciled balance to the Call Report.*

Response: We agree exam procedures should require examiners to ensure amounts reported on the general ledger reconcile to the 5300. However, the number and types of accounts and overall depth of the review should be a factor of the size, complexity, and internal control structure of the credit union.

The Examiner's Guide outlines three minimum requirements for the Risk-Focused exam program from 2002, when the Guide was updated, to 2009 when additional minimum scope requirements were added via NCUA Instruction 5000.20. In December 2010, the minimum scope requirements were expanded to include additional minimal review areas, and continues to stress the importance of verifying the 5300 Call Report. Since at least 2002, review and verification of the 5300 has been a minimum requirement included in the scope workbook. Additionally, examiners are required to complete the 5300 Review Questionnaire, which asks whether adequate documentation exists to support the 5300, and if the loan, share, and investment statistics agree to the supporting documentation.

As noted above, a National Supervision Policy Manual will be issued in an effort to enhance the examination program and address OIG recommendations. This manual will require examiners that identify untimely or inaccurate bank reconcilements or other material out of balance accounts to rate Transaction Risk 'High', note as a major concern in the examination overview, and provide a Document of Resolution outlining required corrective action. Additionally, examiners are to obtain weekly status updates from the credit union and follow-up no later than 60 days after the identification of the problem with resolution within 180 days of identification. Examiners are instructed to rapidly elevate the supervision and administrative action for credit unions with persistent or pervasive recordkeeping concerns.

3. *Issue guidance regarding the evaluation of management with an emphasis on management integrity. The guidance should emphasize the various factors that should be considered with assessing the management component of the CAMEL rating system. The guidance should address the principles of the Risk Focused Exam program that need to differ with addressing management integrity issues versus issues of competency.*

   Response: We agree guidance should be provided for examiners to use when assessing the management component of the CAMEL rating system. The Appendix of Letter to Credit Unions 07-CU-12 provides guidance on assessing both the composite and component CAMEL ratings. The Management component section outlines a number of factors examiners should consider when assessing this component rating. We will evaluate this recommendation and issue additional guidance addressing how the Risk Focused Examination program should differ when addressing management integrity versus competency issues if necessary.

In addition to the actions taken on the above recommendations, NCUA has also implemented controls that we believe will help to prevent similar losses in the future. In February 2011, NCUA revised Instruction No. 5002.20 (rev 2) outlining additional Minimum Scope Requirements for Risk-Focused Examinations. This Instruction reminds examiners of the importance of proper internal controls and states "examiners are required to review internal controls as they play a critical role in mitigating risk"

As explained above in our response to your recommendations, E&I is currently in the process of developing a National Supervision Policy Manual to standardize the examination and supervision policy across regions. In future Material Loss Reviews, it would be helpful to explain the Region's policy and whether or not examiners complied with the policy. This will help to identify whether weaknesses in policy or exceptions to policy contributed to the loss.

When developing recommendations, it is important to consider whether the failure was a result of ineffective policy or exception. Recommendations to change the examination program should not be based on exceptions. Implementing policy to address every exception will decrease the overall effectiveness of the examination program and the cost of this action will outweigh any benefit. Many times appropriate policies and procedures are in place and limit losses to the NCUSIF. It is inappropriate to change these policies because of a single exception. To help reduce the number of exceptions, the National Supervision Policy Manual has built in additional surveillance steps for Supervisors and Regional Offices to identify when policies are not being followed.

In future material loss reviews we suggest including a section on "effective actions taken" to serve as a learning opportunity for examiners to see the actions that were taken to identify the problems and in many instances reduce the loss to the NCUSIF. This will also help to highlight current policies and procedures in place that, if implemented sooner, may have prevented losses and identify areas where policies and procedures are lacking.

Thank you for the opportunity to comment.