

**NATIONAL CREDIT UNION ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL**

**MATERIAL LOSS REVIEW  
OF  
BEEHIVE CREDIT UNION**

**Report #OIG-11-07  
July 7, 2011**



*William A. DeSarno*

**William A. DeSarno  
Inspector General**

**Released by:**

*James W. Hagen*

**James W. Hagen  
Assistant Inspector General**

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## Acronyms and Abbreviations

ALLL	Allowance for Loan and Lease Losses
Call Report	NCUA 5300 Call Reports
CTB	Construction Take Back
DFI	Department of Financial Institutions
DOR	Document of Resolution
FCU	Federal Credit Union
FCU Act	Federal Credit Union Act
FDIC	Federal Deposit Insurance Corporation
FISCU	Federally Insured State-Chartered Credit Union
FPR	Financial Performance Reports
MBL	Member Business Loan
MLR	Material Loss Review
MOU	Memorandum of Understanding
NCUSIF	National Credit Union Share Insurance Fund
NCUA	National Credit Union Administration
NWRP	Net Worth Restoration Plan
OIG	Office of Inspector General
OTS	Office of Thrift Supervision
RFE	Risk-Focused Examination
SSA	State Supervisory Authority

## Executive Summary

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP to conduct a Material Loss Review (MLR) of Beehive Credit Union (Beehive or the Credit Union). We reviewed Beehive to: (1) determine the cause(s) of the Credit Union's failure and the resulting estimated \$27.6 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 management and regional staff, reviewed NCUA guidance, including regional policies and procedures, NCUA 5300 Call Reports (Call Report), and NCUA Financial Performance Reports (FPR).

We determined Beehive Credit Union failed for the following reasons:

- Weak Management and Board Oversight

Management did not effectively manage the risks, policies, operations, and financial position of Beehive, nor did they demonstrate an understanding of the risks inherent in their strategic decisions. In addition, both the Board of Directors (Board) and management lacked sufficient and responsive action to address repeat findings raised by examiners related to concentrations, Allowance for Loan and Lease Losses (ALLL) methodology, and asset quality. They remained too optimistic when the economy turned and did not actively or proactively address the serious economic issues developing nationally, and particularly those in Utah's real estate market.

- Inadequate Risk Management Practices

A lack of risk management policies and practices allowed management to develop a high concentration of construction and lot loans, which led to material charge-offs when the economy turned and the real estate market deteriorated. Management did not effectively plan, manage, or control liquidity risk, and relied on high-cost nonmember deposits as well as two non-committed lines of credit for liquidity. In addition, management did not develop the appropriate policies and procedures to understand and respond to the overall declining financial health of Beehive, resulting from the rapid erosion of net worth due to operating losses, ALLL funding, and high net operating costs.

- Inaccurate Financial Reporting

Management did not accurately report financial data on its Call Reports, Specifically, management used a flawed methodology to calculate and fund

the ALLL and, as a result, management masked the true financial health of Beehive. This issue became critical when the economy and real estate market values began their steep decline. Additionally, management did not monitor delinquencies in a timely manner, which caused the ALLL calculation to be inaccurate. Finally, examiners consistently identified errors in the Credit Union's Call Reports and management did not take appropriate action to resolve the accounting practices that generated the errors.

- Supervisory Lapse

We determined the Utah Division of Financial Institutions, the State Supervisory Authority (SSA), and NCUA did not conduct a supervisory contact for 32 months – from March 2006 to November 2008. Examiners explained that Beehive pursued a charter conversion to a mutual savings bank during that time, which, once complete, would have placed them under the supervision of the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). NCUA and the SSA considered the Credit Union low risk based on historical Composite CAMEL 2 ratings<sup>1</sup>. We believe this 32-month supervisory lapse prevented examiners from detecting the deficiencies and curtailing the risky lending practices that eventually led to Beehive's insolvency. In November 2008, the NCUA adopted changes to its risk-based examination scheduling policy and now requires an annual examination or material on-site supervision for FISCO's with assets greater than \$250 million, and allows for additional contact if warranted by risk profiles and negative trends. We believe this change is important and will prevent the supervision gap that occurred with Beehive.

We are making no formal recommendations as a result of the findings in this report. However, as major causes, trends, and common characteristics of credit union failures are identified in OIG Material Loss Reviews 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 make recommendations, as warranted.

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

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<sup>1</sup>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.

## **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 Beehive Credit Union (Beehive or the Credit Union), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. §1790d(j). Beehive was a federally insured state-chartered credit union (FISCU), headquartered in Salt Lake City, Utah. Beehive was located in NCUA's Region V.

### History of Beehive Credit Union

Chartered in 1954 to serve Utah state government employees, Beehive Credit Union's membership expanded over the years, eventually growing to serve two Utah counties and a number of select employee groups. As of June 30, 2010, Beehive had 18,600 members with assets of more than \$152 million. Beehive operated nine branches with 61 full-time and nine part-time employees. At the time of failure, Beehive's main lending products were speculative construction and real estate development (lot) loans.

As a FISCU, Beehive was subject to State Supervisory Authority (SSA) examinations performed by the Utah Department of Financial Institutions (DFI). We determined, however, that the NCUA participated jointly on most of the examinations of Beehive. In 2006, Beehive began the process to convert its charter from that of a credit union to a mutual savings bank. During the period of time that the Office of Thrift Supervision and the Federal Deposit Insurance Corporation reviewed Beehive's application, we determined neither the Utah SSA nor the NCUA had performed any supervisory contact. This lack of supervisory contact covered a 32 month period, from March 2006 to November 2008.

From 2004 to 2008, Beehive management allowed its real estate loan activity to grow significantly. As a result, management created heavy concentrations in construction and lot loans. In 2007 when the economic dislocation began, management did not respond timely to the declining property values, which eventually led to rising delinquencies and foreclosures, followed by declining net worth.

The 2004 and 2005 examinations resulted in Composite CAMEL 2 ratings; however, at the conclusion of the next onsite NCUA examination in September 2008, Beehive's Composite CAMEL rating had deteriorated to a 3. By the end of 2009, examiners had rated Beehive a Composite CAMEL 5 and determined the Credit Union to be significantly undercapitalized. In April 2010, NCUA and Utah SSA examiners issued a Memorandum of Understanding (MOU) to Beehive management and in July of 2010, the NCUA issued a Preliminary Warning Letter to cease certain lending activities in an effort to prevent further losses.

On December 14, 2010, the Utah DFI liquidated Beehive Credit Union and appointed the NCUA as liquidating agent. Also on this date, the NCUA, as liquidating agent, executed a Purchase & Assumption agreement transferring the assets, liabilities, and shares to Security Service Federal Credit Union (Security Service) of San Antonio, Texas. Security Service had \$5.5 billion in assets and over 760 thousand members as of June 2010. The NCUA estimated the loss to the National Credit Union Share Insurance Fund (NCUSIF) at \$27.6 million; however, NCUA will not know the final cost until all assets are sold.

### NCUA Examination Process

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

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

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis<sup>2</sup>, trend analysis<sup>3</sup>, reasonableness analysis<sup>4</sup>, variable data analysis<sup>5</sup>, and qualitative data analysis<sup>6</sup>. Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends. Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. 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

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<sup>2</sup> Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

<sup>3</sup> Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

<sup>4</sup> As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

<sup>5</sup> 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.

<sup>6</sup> 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.

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 both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation*. Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up, and (b) analyzing Call 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.

On November 20, 2008, the NCUA Board modified the risk-based examination scheduling program, creating the Annual (12-Month) Examination Scheduling Program to be implemented in three phases from 2009 through 2011.<sup>7</sup> The NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated the Annual (12-Month) Examination Scheduling Program would provide timelier, relevant, qualitative, and quantitative data to recognize any sudden turn in a credit union's performance.

### Supervision of Federally Insured State-Chartered Credit Unions

The NCUA's statutory authority and its guidelines indicate the NCUA has the legal and fiduciary responsibility to ensure the safety of the NCUSIF. Federally insured state-chartered credit unions receive the same amount of insurance coverage under the NCUSIF as federally chartered credit unions. Therefore, FISCUs are subject to the same review of risks as other credit unions. The examination of federally insured state-chartered credit unions properly belongs to and is the primary

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<sup>7</sup> On May 28, 2010, NCUA Instruction No. 5000.15 (Rev. 3) revised and further defined NCUA Instruction No. 5000.15 (Rev 2) regarding NCUA's Annual (12-Month) Examination Scheduling Program for all Federal Credit Unions (FCU) as well as any Federally Insured State-Chartered Credit Union (FISCU) with assets greater than \$250 million. The Instruction indicated the minimum timeframe between examinations could be as low as 8-months and the maximum could be as high as 23-months to ensure one examination every calendar year. .



responsibility of SSAs. The FCU Act, §1781, §201(b)(1) (*Insurance of member accounts*) states in part:

*“...examinations conducted by State regulatory agencies shall be utilized by the Board for such purposes to the maximum extent feasible.”*

The two most common types of on-site FISCU reviews are an independent insurance review and a joint examination/insurance review. In joint examination/insurance reviews, both the NCUA and the SSA focus on risk issues (including safety and soundness issues), while the state examiner focuses additionally on regulatory concerns. However, during an independent insurance review, NCUA examiners limit their role to the review and analysis of risks to the NCUSIF only, rather than a complete examination of the FISCU.

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

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

### **Objectives, Scope, and Methodology**

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

- \$25,000,000, and
- 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.

The objectives of the MLR were to:

- Determine the causes of the credit union’s failure and any material loss to the NCUSIF;

- Assess NCUA supervision of the institution, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and
- Make appropriate recommendations to prevent future losses.

To accomplish our review, we conducted fieldwork at the NCUA's Region V office in Tempe, Arizona, and conducted interviews of NCUA and Utah DFI officials and examiners. The scope of this review covers the period from June 2004 to June 2010.

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

- Prepared a chronology of examination scope and procedures, comments, and corrective actions;
- Reviewed exam files and Credit Union Board minutes;
- Reviewed external audit findings and follow-up procedures;
- Conducted interviews with NCUA and Utah DFI 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
- Reviewed NCUA Call Reports, Financial Performance Reports, and supervision as it relates to Beehive.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software 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 December 2010 through July 2011 in accordance with auditing standards generally accepted in the United States of America 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 Beehive Credit Union's management and Board of Directors' weak oversight and risk management policies, coupled with inaccurate financial reporting related to delinquencies and reserves, contributed directly to the Credit Union's failure. In addition, we concluded Utah SSA and NCUA examiners could have mitigated the loss to the NCUSIF had they performed timelier supervisory contacts and not allowed a 32-month gap in supervision to occur. We believe this supervisory lapse may have prevented examiners from detecting the deficiencies and curtailing the risky lending practices that eventually led to Beehive's insolvency.

### A. Why Beehive Credit Union Failed

#### **Weak Management and Board Oversight**

We determined Beehive Credit Union failed because management did not effectively manage the risks, policies, operations, and financial position of the credit union, nor did they demonstrate an understanding of the risks inherent in their strategic decisions. In addition, both the Board and management lacked sufficient and responsive action to address repeat findings raised by external auditors and examiners related to concentrations, Allowance for Loan and Lease Losses (ALLL) methodology, and asset quality.

In addition, we found management made decisions related to operations and spending that were not consistent or responsive to the challenges facing Beehive and the local economy. From 2008 through 2009, not only was the economy declining, but Beehive's financial condition was in rapid decline as well. Still, Beehive's Board approved the following with no consideration regarding the timing of these decisions or their detriment to liquidity and earnings:

- A \$3 million branch expansion;
- An annual budget containing high operating costs that included new computer and phone systems;
- Continued operation of all nine branches; and
- Risky lending programs that included Construction Take Back<sup>8</sup> loans.

Our review of Beehive's Board minutes determined neither Beehive management nor its Board had a sense of urgency to address the Credit Union's deteriorating financial position and rising delinquencies, particularly in 2007 when the economic dislocation began and continued through 2008. In addition, Board minutes

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<sup>8</sup> Construction Take Back loans provide funding to members who cannot obtain permanent outside financing after completion of a project's construction phase.

repeatedly reported a slowdown in lending and increasing delinquencies, yet we found no associated action plan to address these issues. In 2007, management set the construction loan concentration limit at 400 percent of capital; however, when that limit was surpassed in August 2008 (482 percent of capital), again we found no action plan required by the Board.

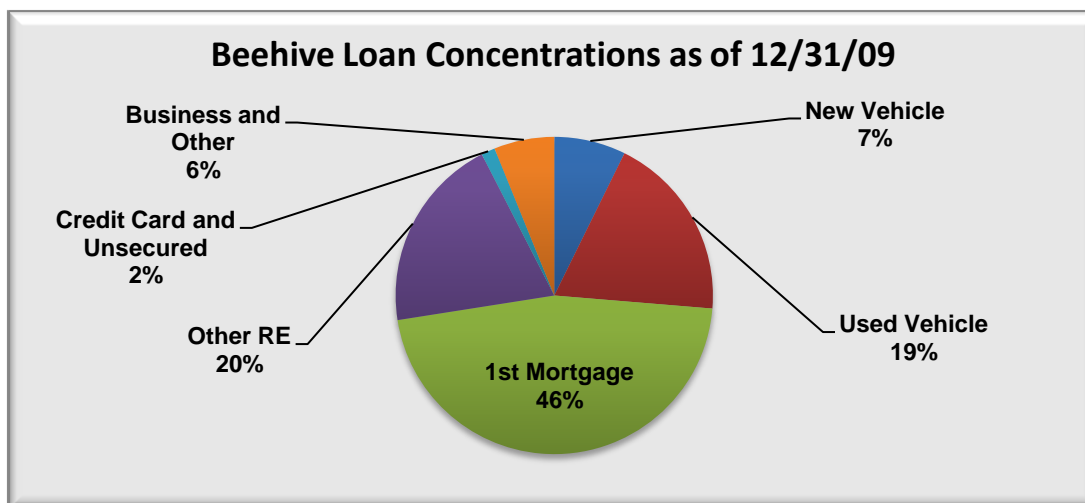
We also determined Beehive’s Supervisory Committee was inactive. Specifically, we found very few references to the Supervisory Committee in the Board minutes and no minutes specific to the Supervisory Committee. In addition, we found Beehive’s attempted conversion to a mutual savings bank distracted management from Beehive’s operations. The process, which began in 2006 and ended in 2008 when the FDIC did not give their approval, was publicly acrimonious between management and members of the Credit Union and fostered member disloyalty.

We concluded that management and the Board remained too optimistic when the economy turned and did not actively address the serious economic issues developing nationally, and particularly those in Utah’s real estate market.

#### Inadequate Risk Management Practices

We found that Beehive management developed and maintained heavy real estate concentrations, as shown on Chart A (below). Although examiners noted real estate loan concentrations as a finding as far back as 2005, we determined management did not effectively address the issue.

Chart A

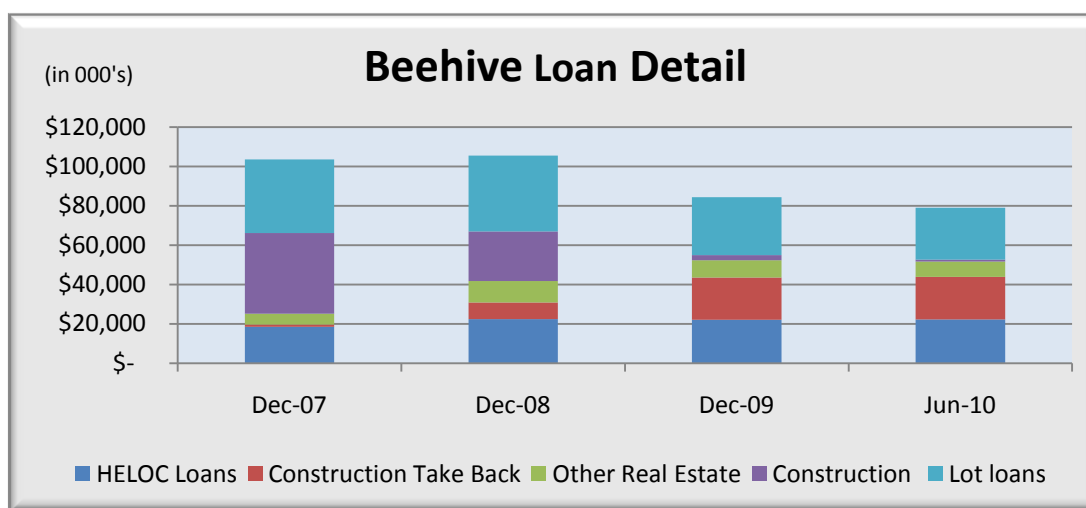


Source: *Beehive Credit Union Call Reports*

For comparison purposes, the peer group concentration average for first mortgages, which includes construction loans, was 31 percent, significantly lower than Beehive’s concentration average of 46 percent.

We determined Beehive’s real estate loan portfolio was heavily weighted with construction and lot loans, most of which were made in 2006 and 2007, making Beehive particularly vulnerable to changing property values. In addition, median home prices in the Salt Lake City area declined nearly 50 percent<sup>9</sup> from April 2007 to December 2010, leading to significant losses on real estate loans. The problem of rising delinquencies related to these loans accelerated when Beehive ceased making construction loans but began to take back real estate construction loans in late 2008. The Construction Take Back (CTB) loan product was inherently high-risk because it provided funding primarily to members who could not obtain permanent outside financing after the construction phase of the project was completed. Chart B (below) details the components of Beehive’s loan portfolio and demonstrates the growth of CTB loans when construction lending stopped.

Chart B



Source: NCUA Examinations and Regional Summary

We determined Beehive management did not effectively plan, manage, or control liquidity risk. Specifically, management allowed real estate concentrations to rise to over 66 percent of total loans, with most loans at fixed rates. Management also allowed high-cost nonmember deposits to rise to 18 percent of total deposits. In addition, Beehive management used two funding sources secured by Beehive’s assets to provide quick liquidity. We determined management did not fully understand these lines of credit were “non-committed”, which meant they could be

<sup>9</sup> Source: [www.housingtracker.net/asking-prices/salt-lake-city-utah/](http://www.housingtracker.net/asking-prices/salt-lake-city-utah/)

suspended if Beehive's financial condition deteriorated and would not be available when most needed, thus increasing Beehive's liquidity risk exposure.

Examiners noted Beehive management's inadequate risk management practices related to underwriting in the 2008 Examination Report. Findings included unsigned tax returns, the lack of sufficient employment and income verification to demonstrate repayment ability, inadequate lot loan documentation, and unsupported property valuations. Examiners also discovered underwriting irregularities, such as "For Sale" signs on property during construction of owner occupied homes.

Other risk management issues noted by examiners in the 2005, 2008, and 2009 exams included:

- Beehive's Member Business Lending (MBL) policy, approved in June 2005, did not specify maximum exposure in relation to net worth, or the elements of the debt service coverage ratio, as required by NCUA Rules and Regulations Part 723, Member Business Lending. Examiners recommended revising this policy in the December 2005 examination to comply with the regulation, however, there is no evidence in the minutes to indicate that management or the Board took action to change the policy.
- Brokered loans were the main source of Beehive's construction and lot loans as of September 2008. Examiners raised concerns about the use of out-of-area appraisers unfamiliar with the local markets, and insider relationships between broker, borrower, builder, seller, appraiser, and/or others connected with these loans.
- The September 2009 examination's Document of Resolution (DOR) required management to submit a Net Worth Restoration Plan (NWRP). The NCUA twice rejected management's NWRP, the first time in November 2009 and the second time in March 2010, because of unrealistic underlying assumptions and projections. We believe management's inability to produce a comprehensive NWRP further demonstrates that management did not have a clear understanding of the risk management process.

### Inaccurate Financial Reporting

We determined management did not accurately report financial data on its Call Reports. Specifically, management used a flawed methodology to calculate and fund the ALLL. As a result, management masked the true financial health of Beehive, which became a critical issue when the economy and real estate market values began their steep decline.

We found examiners repeatedly questioned the methodology used to calculate the ALLL and twice-required additional reserves – \$953K in September 2008 due to

construction and lot loan impairments, and \$1.1M in July 2009. Examiners noted management adjusted the ALLL account after examiners had calculated the adjustment, rather than calculate it themselves, and did not demonstrate an understanding of how to revise the methodology to reflect the changing economic environment.

We also determined Beehive management did not monitor delinquencies in a timely manner, which caused the ALLL calculation to be inaccurate in the credit union's Call Reports. For example, the July 2009 examination noted there were 35 loans in excess of 180 days delinquent with only one loan charged off, a violation of Beehive's own ALLL policy. We believe the lack of appropriately aging loans masked the inherent risk of the loan portfolio, and resulted in the underfunding of the ALLL. The September 2009 DOR required management to develop a credit risk management program that would identify, measure, monitor, report, and control loan portfolio risks, as well as measure and report on performance and risks. Management did not fully implement this program.

## B. NCUA and Utah Department of Financial Institutions Supervision of Beehive Credit Union

**Examiners Could Have Mitigated the Loss to the NCUSIF**

We determined a contributing factor in the failure of Beehive was examiners’ untimely supervision during a critical period. Specifically, Beehive was not subject to an onsite examination by either the Utah SSA or the NCUA from March 2006 to November 2008, a 32-month period, at a time when management’s decisions had begun to show dangerous trends and emerging risks. As a result, examiners missed opportunities to slow or stop management’s risky lending practices, which would have likely mitigated the loss to the NCUSIF.

Table 1 (below), provides detailed examination results showing the decline of Beehive, which deteriorated markedly, as did the economy, both nationally and in the state of Utah.

Table 1: Examination Results

Examination Effective Dates	Exam Type <sup>10</sup>	CAMEL NCUA Composite	Cap/ Net Worth	Asset Quality	Mgmt	Earnings	Liquidity
June 2004	11	2	2	2	2	3	2
December 2005	26	2	1	1	2	2	2
September 2008	26	3	2	3	2	3	2
June 2009	23	3	2	3	2	3	2
September 2009	23	4	4	4	4	4	3
December 2009	11	5	5	5	5	5	4
June 2010	23	5	5	5	5	5	4

We questioned officials from the NCUA and Utah SSA about the 32-month gap in supervision. Officials explained the gap as follows:

- Beehive was pursuing a charter conversion to a mutual savings bank, which would not be under NCUA jurisdiction.
- NCUA examiners considered Beehive low risk, historically rated Composite CAMEL 2, and looked to the Utah SSA to perform the examination.
- The Utah SSA believed that because the FDIC was conducting its own examination procedures related to the charter conversion in 2007, another examination was not necessary.

<sup>10</sup> Exam Type 11 is a full scope exam for FISCUs; Exam Type 23 is an on- site supervision, and Exam Type 26 is a report review.



The Utah SSA led the examinations with effective dates of June 2004 through June 2009, and issued the reports. NCUA examiners reviewed the reports and concurred with the assigned CAMEL ratings. Both the Utah SSA and NCUA consistently rated Beehive a Composite CAMEL 2 through 2005. During the September 2008 examination, examiners determined alarming trends had begun to develop. Beehive quickly deteriorated from a Composite CAMEL 3 to a Composite CAMEL 5 in the following 15 months. In November 2009, the NCUA transferred Beehive to Region V's Division of Special Actions.

Despite rating Beehive a Composite CAMEL 2 for both the June 2004 and December 2005 examinations, examiners called for improved accounting and reconciliation procedures, and raised concerns about loan documentation, auto and construction loan concentrations, and MBL loan regulatory compliance. We found no effective follow-up on these concerns as evidenced by the fact that these same issues were still present when Beehive failed.

The September 2008 examination resulted in a Composite CAMEL 3 rating, and examiners noted dangerous trends emerging in critical areas, including asset quality, concentrations in construction and lot loans (repeat from December 2005 examination), capital, and ALLL methodology. This examination also resulted in a DOR requiring concentration limits and additions to the ALLL reserves. We believe, given the significance of these concerns in the aggregate, and the deteriorating economy (both nationally and in Utah), as well as the repeat finding related to concentrations, an informal enforcement action such as a Memorandum of Understanding and more frequent supervisory contact would have been the appropriate action for examiners to take.

The June 2009 examination resulted in a downgrade to Beehive's Composite CAMEL rating to a 4. NCUA examiners issued a DOR after the September 2009 examination that specified Beehive management take the following actions:

- Develop and approve an ALLL funding and charge-off policy;
- Obtain appraisals on all real estate transactions;
- Cease loan modifications until a policy and appropriate procedures were developed; and
- Create a Net Worth Restoration Plan.

We believe the scope and severity of the issues raised in this September 2009 DOR further indicate that the Utah SSA and NCUA needed to take stronger supervisory action after the September 2008 examination.

By the December 2009 (Effective) joint examination, Beehive deteriorated to a Composite CAMEL 5 rating and the Utah SSA and NCUA jointly issued an MOU. In July 2010, examiners concluded Beehive was 'significantly undercapitalized', most likely moving towards becoming 'critically undercapitalized' and issued a Preliminary Warning Letter to cease certain lending activities in an effort to prevent further losses. The NCUA liquidated Beehive in December 2010.

Ultimately, we believe the 32-month gap in supervisory contact between March 2006 and November 2008, prevented examiners from detecting early warning signs in the overall financial strength of Beehive. This lapse in supervisory oversight proved to be at a very critical time. As previously mentioned, the examination of federally insured state-chartered credit unions properly belongs to and is the primary responsibility of SSAs. Historically, NCUA agreements with each SSA provide for examinations to be completed within 18 months and NCUA monitors the time elapsed for SSA examinations in relation to the desired 18-month frequency limit. We believe had the time between examinations been closer to the typical 18-month cycle, Beehive management's risky lending practices could have been curtailed and the losses could have been mitigated.

### **Recommendation**

As previously noted in the Background section of this report, in November 2008, the NCUA adopted changes to its risk-based examination scheduling policy, creating the Annual (12-Month) Examination Scheduling Program to be phased in from 2009 through 2011. The Annual (12-month) program, as its name suggests, changed the requirements for examinations or material on-site supervision contacts to annually, or as close to annually as can be scheduled. The annual schedule applies to all FCUs and to those FISCUs with assets greater than \$250 million, and allows for additional contacts if warranted by risk profiles or negative trends.

We believe this change in examination scheduling was important not only because it shortened the timetable between examinations, but also because it brought to light the importance of regularly scheduled supervisory contacts. As a result, this program should help prevent the type of supervision gap that occurred with Beehive from occurring in the future. Therefore, we are making no formal recommendations to NCUA management at this time.

## APPENDIX A

### Management Response

**SENT VIA E-MAIL**

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

**FROM:** *for* Executive Director David M. Marquis *CF*  
Office of Executive Director

**SUBJ:** Material Loss Review of Beehive Credit Union #61000

**DATE:** June 30, 2011

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review (MLR) of Beehive Credit Union*. Beehive Credit Union (Beehive) failed due to weak management and inadequate risk management practices, which led to investment in a high-risk construction real estate loan portfolio, large losses in that loan portfolio, and rapidly deteriorating net worth. The officials and management failed to understand the risk inherent in the credit union's construction loan portfolio and did not respond proactively when the national and local economy deteriorated.

The MLR Report does not make any formal recommendations. The Report did note a 32-month period from March 2006 to November 2008 where there was no examination or supervision contact, by either NCUA or the state regulator, as a contributing factor to the failure. The report correctly comments that state regulators are primarily responsible for the examination of state-chartered credit unions. As recognized in the Report, in November 2008 the NCUA Board re-instituted an annual examination cycle for all federally insured credit unions exceeding \$250 million in assets. NCUA believes this change will reduce losses to the National Credit Union Share Insurance Fund (NCUSIF). In addition, NCUA issued supervisory guidance in June 2010, which reminds examiners of the actions available to induce credit union management to correct unsafe and unsound practices or regulatory violations in a timely manner.

NCUA remains committed to the continual improvement of our examination and supervision program and the staff training necessary to ensure the future safety and soundness of credit unions and the NCUSIF.

Thank you for the opportunity to comment on the report.