

**NATIONAL CREDIT UNION ADMINISTRATION**

**OFFICE OF INSPECTOR GENERAL**

**NCUA's Risk-Focused Examination  
Process for Federal Credit Unions**

**Report #OIG-06-08**

**October 16, 2006**



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## EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) commits the majority of its resources promoting a system of financially sound, well managed, federally insured credit unions. A key element in this process was the change in 2001 to risk-focused examinations (RFE) for federal credit unions. The objective of the RFE process is to enable NCUA to identify and address risks before they become major problems. As of December 31, 2005, there were approximately 8,700 federally insured credit unions with insured deposits of \$577 billion. Of this total, 5,400 federal credit unions had insured deposits of \$285 billion, and 3,300 federally insured state chartered credit unions had insured deposits of \$292 billion.

Due to the importance and emphasis by NCUA on the examination and supervision function, we identified the RFE process for review. Our review objective was to determine whether NCUA has a process in place to provide assurance that high risk areas are identified and addressed throughout the RFE process.

Our work primarily covered calendar years 2004 and 2005. Our procedures included a review of the applicable legal requirements and agency guidance; staff interviews; and a random sample of 90 federal credit union examinations from three NCUA regions. We performed reasonableness testing of our review data by a comparison of certain NCUA database information with NCUA published information.

### *Risk-Focused Examination Process Appears Adequate*

Overall, we found that the RFE process appears adequate. Regional staff are preparing the examination forms and documentation in accordance with agency guidance with few exceptions. Agency guidance indicates Documents of Resolution (DOR) are normally prepared to correct unacceptable risk situations, and not to address minor issues. CAMEL 1 credit unions are normally those credit unions with only minor weaknesses that can be handled in a routine manner by the board of directors and management. However, we found DOR were issued for 12 of the 36 CAMEL 1 sample examinations we reviewed. We found examination scheduling is usually performed in accordance with agency guidance. Scheduling for the risk-focused examinations we reviewed coincided with agency guidance in 83 of the 90 exams in our sample.

Part of regional monitoring and quality control for the RFE involves the preparation of formal Quality Control Reviews (QCR) by regional supervision analysts in specific instances to ensure standards are met by the examiner. Also, periodic formal evaluations of specific examinations are prepared by supervisory examiners for examiner staff development. We found that 94 percent of the required QCR were completed. After our discussion with region management, plans were initiated to ensure all future QCR are performed in a timely manner. We found that formal supervisory examiner evaluations were being prepared in accordance with agency guidance.

*NCUA Identifies and Addresses High Risk Areas in Federal Credit Unions*

Our discussions with NCUA staff validated by our review of recent examination documentation for 90 credit unions in three regions indicated that examiners are identifying and addressing high risk areas in credit unions. Regional office QCR and supervisory examiner formal evaluations of examinations placed special emphasis on examiner identification of the high risk areas and the development of DOR as needed to address identified high and moderate risks.

Monitoring and follow-up of high risk areas also appears to be reasonable. Monitoring and follow-up of high risk areas at credit unions begins with the district examiner. The work performed, monitoring of progress made by the credit union, as well as planned follow-up is detailed in the examination scope work book and other examination work papers for each assigned credit union. Our sample review indicated that DOR were prepared for 93 percent of identified high risk, and 50 percent of moderate risk areas with planned follow-up by the examiner. Our sample review of 90 examinations completed in 2003-2005 showed that compliance was rated most often (25 times) as a high risk area of the seven risk categories. Strategic risk and credit risk were identified 13 and 12 times respectively as high risk while the other categories were identified as high risk in 6 or fewer examinations. Further, our sample review indicated high levels of documented plans of action (DOR) for high risk areas identified during the examinations.

Our report includes one recommendation to NCUA to clarify guidance regarding the assignment of CAMEL composite ratings in relation to the development of Documents of Resolution (DOR) for Federal Credit Unions rated CAMEL 1. Management agreed with our recommendation and is in the process of taking corrective action.

## REVIEW BACKGROUND

The National Credit Union Administration (NCUA) Strategic Plan 2000-2005 addressed five strategic goals. NCUA commits the majority of its resources to the first goal: “Promote a system of financially sound, well managed, federally insured credit unions able to withstand economic volatility.” According to the Strategic Plan, the first strategy to achieve this goal is to “emphasize risk based reviews and flexible scope examinations in NCUA training programs, supervisory approach, and when implementing the new Automated Integrated Regulatory Examination System (AIRES).”

The NCUA Office of Inspector General (OIG) has not previously evaluated the risk-focused examination (RFE) process. Due to the importance of the examination and supervision process, as well as NCUA’s continued emphasis on the RFE program, the OIG identified the RFE process for review.

### **Legal Background**

In July of 2001, NCUA implemented a risk-based examination program that eliminated the requirement to perform annual examinations in low risk credit unions (See Letter to Credit Unions 01-FCU-05, issued in August 2001). Rather, credit unions posing minimal or no risk to the National Credit Union Share Insurance Fund (NCUSIF) could receive an examination twice every three years. The credit union system had undergone a variety of changes that prompted NCUA to move from an examination and supervision approach that was primarily focused on reviewing transactions, to an approach that focused NCUA resources on high-risk areas within a credit union.

#### *Statutory Authority*

NCUA looked to its broad statutory authority under the Federal Credit Union Act to support its decision to implement and conduct a risk-focused program. In interpreting the authority granted to it under the statute, the Agency concluded that the examination cycle for credit unions should be determined by risk to the NCUSIF, economic trends, and staff and resource availability. (See also, Instruction 5000.15, September 13, 2001.)

#### *NCUA Instructions*

The Agency initially implemented the risk based examination scheduling concept by issuing NCUA Instruction 5000.15 (September 13, 2001), with an effective date of January 1, 2002. (Please refer to Appendix A.) Instruction 5000.15 established guidelines for the risk-based examination scheduling program and outlined the agency policy for risk-based examination

scheduling. A revision to the instruction, NCUA Instruction 5000.15 (August 23, 2005), had an effective date of January 1, 2006. The purpose of the instruction revision was to simplify NCUA’s Risk Based Examination Scheduling Policy for Federal Credit Unions.

## *NCUA Examiner's Guide*

The Examiner's Guide sets out guidance for NCUA examiners on the examination and supervision of credit unions. The primary goal of the information in the Guide is to ensure the overall safety and soundness of the credit union system. Toward that goal, Chapter 1 of the Guide covers the "Risk Focused Program." A key change made to this chapter, to account for the shift to a risk-based program, is that examiners must exercise more judgment in assessing what activities pose the highest risk to a credit union. Chapter 1 provides guidance to examiners for reviewing areas containing the most risk for an individual credit union. Chapter 1 further provides instruction about how to conduct an examination using the risk-based method.

The Examiner's Guide, as well as regional office instruction guides and bulletins that supplement the Guide, provide dependable guidance for NCUA examiners and supervisors, but are not necessarily the best or final approach in every situation. Rather, the risk-focused approach requires that examiners exercise their professional judgment to assess the risk inherent in a given credit union operation and determine the scope of the examination, taking into consideration the many variables presented by the individual credit union.

### **Purpose and Objective**

NCUA has consistently devoted the majority of agency resources to promoting a system of financially sound federally insured credit unions able to withstand economic volatility, emphasizing risk based reviews and flexible scope examinations. As mentioned above, a key part of the strategy to achieve this goal is the use of RFEs. Due to the importance of the examination and supervision process, as well as the emphasis the Agency places on the program, we decided to conduct a review of the RFE process. Our objective was to determine whether NCUA has a process in place to provide assurance that high risk areas are identified and addressed throughout the process.

### **Scope and Methodology**

In general, we addressed the RFE process in effect since 2001-2002. Our review relied upon examination information and data for Federal Credit Unions (FCU) primarily for the period from 2004 through September 2005. In addition, we reviewed applicable agency guidance for the RFE process. (Please refer to Appendix B for additional detail.)

We primarily interviewed NCUA personnel located in the Office of Examination and Insurance (E&I) and Region III (Atlanta). We also obtained additional information from Region II (Capital), and Region V (Tempe).

Our analysis of statistical data from the NCUA database provided information regarding the examination universe for all five regions including survey Region III, and review Regions II, III, and V. We did not verify or test NCUA database information except to compare certain data for reasonableness with published NCUA information. Data identified was used to judgmentally select the survey sample of thirteen CAMEL 3 FCUs in Region III, and randomly select 90

additional FCUs from CAMEL codes 1 through 4 in Regions II, III, and V (30 examinations in each region).

Our review focused on the RFE process, including compliance with agency guidance, and reasonableness of actions taken by NCUA to identify and address the following seven risk factors: (1) credit; (2) interest rate; (3) liquidity; (4) transaction; (5) compliance; (6) strategic; and (7) reputation. In addition, we elected to identify the most common high risks and determine the relationship between identified high and moderate risks with Documents of Resolution developed to address the high and moderate risks. We did not review or address the timeliness of problem risk resolution. We intend to perform a follow-on review regarding the timeliness of problem risk resolution. The documentation for the review sample included the following available forms: (1) examination query; (2) Form 110; (3) Scope Workbook; (4) Document Of Resolution; (5) Division of Supervision Quality Control Review form; and (6) Supervisory Examiner evaluation form.

Overall, we gained an understanding of the NCUA RFE process as well as the primary guidance available to examiners. Our internal controls review was limited to staff interviews and our review and analysis of the relevant agency guidance and sample examination documentation. We did not note any irregularities in the sample documentation we reviewed.

Our review was conducted in accordance with Generally Accepted Government Auditing Standards.

# REVIEW RESULTS

## Section I

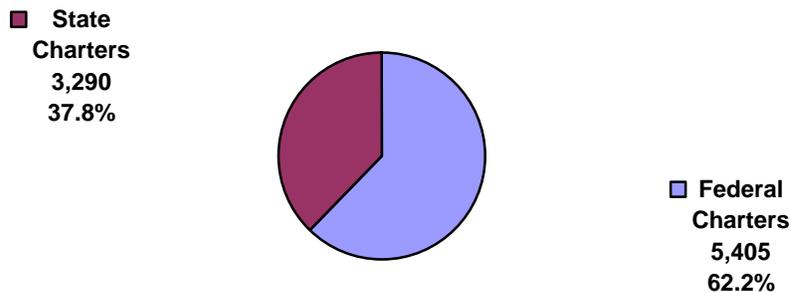
### Risk-Focused Examination Process Appears Adequate

We found that the NCUA risk focused examination process involving examiners, regional office staff, and the use of agency guidance was adequate and effective. In particular, we noted few examination exceptions to the guidance. However, we suggest that consideration be given to clarifying some guidance (please refer to the Matter for Consideration section of this report).

The NCUA is responsible for the regulation and supervision of FCUs. The agency refined its supervision and examination process effective in 2001-2002 and, in so doing, developed a RFE process. The key agency staff involved in the RFE process are NCUA examiners; the key guidance the examiners rely upon to conduct examinations under the RFE process are the NCUA Examiner Guide, and national and regional instructions. Consequently, we reviewed NCUA-issued guidance pertinent to the RFE process. In addition, we reviewed a random sample of recent examinations performed in Regions II, III, and V. Finally, we evaluated the relationship between agency guidance and examination performance.

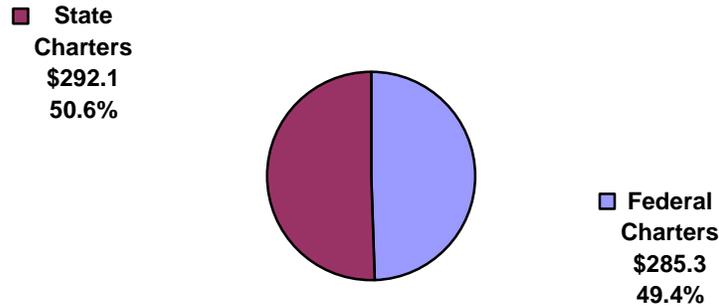
As of December 31, 2005, there were \$285.3 billion of insured shares in 5,405 natural person FCUs. FCUs represented 49 percent of federally insured shares and 62 percent of federally insured credit unions (FICUs) (please refer to graphs below)

#### Number of Federally Insured Credit Unions: 8,695



Source: NCUA 12-31-05

## Federally Insured Credit Union Shares: \$577.4 Billion



Source: NCUA 12-31-05

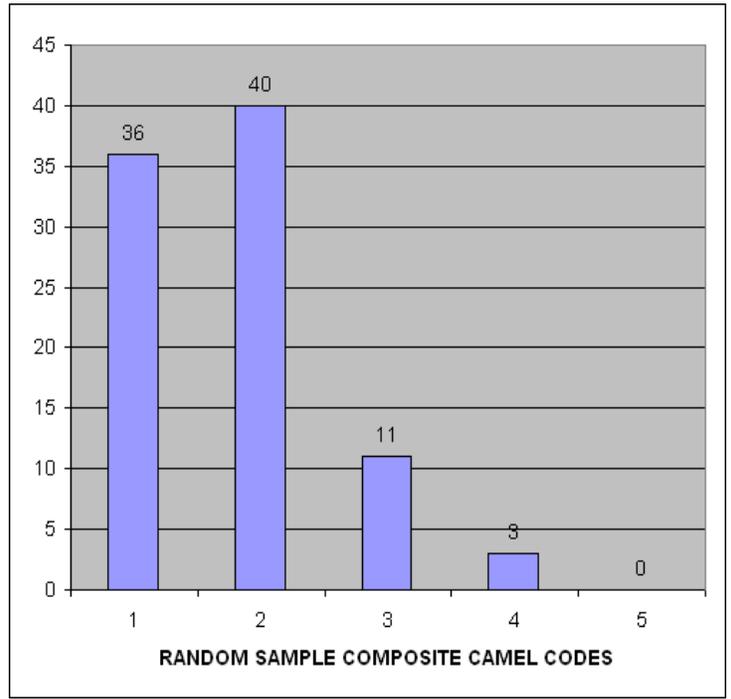
### NCUA Guidance

Agency guidance relevant to the RFE process includes specific national and regional instructions and the NCUA Examiner's Guide. We reviewed this guidance to determine whether examiners and regional offices were appropriately conducting and documenting risk focused examinations. We also reviewed the guidance so that we would be able to identify weaknesses, if any, in internal controls within the reviewed regions during the examination sample review. Overall, our sample review found that examiners in the regions we sampled were complying with the issued guidance.

### Examination Database Analysis

We obtained and analyzed examination information from the NCUA database. The purpose of our analysis was to identify the entire audit universe and to specifically identify the audit universe for all composite CAMEL 1, 2, 3, and 4 FCUs with a RFE completed December 2003 through September 2005. We used the results to randomly select the review examination sample. To test the reasonableness of our audit universe information, we compared our summarized information for assets, shares, insured shares, and number of credit unions by credit union type (FCUs versus FISCUs) and compared to December 31, 2004 NCUA published

reports. We found no discrepancies between our review information and the NCUA published reports. We selected our random sample selection from a cross section of FCUs in Regions II, III, and V, both in CAMEL composite codes and size of the credit union (please refer Appendix B for additional detail). The following graph depicts our credit union examination sample by composite CAMEL code.



**Totals    36        40        11        3        0        90**

6-22-06 Summary Sample CAMEL FCU Regions II, III, V

Our random sample was composed of five large, ten medium, and fifteen small credit unions for a total of 30 credit unions from each of the review regions, a total of 90 credit unions for the review. A comparison of the review sample number of FCUs and dollar amount of insured shares (shares) with the review universe and total FCU universe indicates that the sample 90 FCUs represented 3 percent of the 3,306 FCUs in Regions II, III, and V (review regions), and 2 percent of the total of 5,405 FCU. The sample reflects 29 percent of total insured shares and deposits or \$56.3 billion from the review regions universe of \$192.8 billion, and 20 percent of the total FCU insured shares and deposits of \$285.3 billion (please refer to information in the following table).

Region	Universe		Sample		Percent of Sample compared to universe	
	# FCU	Ins Shares/Dep	# FCU	Ins Shares/Dep	#	\$
2	1262	\$ 66,773,538,741	30	\$ 29,482,135,489	2%	44%
3	1148	\$ 56,962,152,582	30	\$ 11,905,113,139	3%	21%
5	<u>896</u>	<u>\$ 69,105,009,037</u>	<u>30</u>	<u>\$ 14,903,111,854</u>	<u>3%</u>	<u>22%</u>
2 + 3 + 5	3306	\$ 192,840,700,360	90	\$ 56,290,360,482	3%	29%
All	5405	\$ 285,267,966,983			2%	20%

## Examinations at Federal Credit Unions

We held discussions with NCUA staff to determine how examiners were carrying out the RFE process. Specifically, we looked primarily at whether examiners were complying with examination policies and NCUA guidance. In this regard, we focused on whether examiners were reasonably identifying and discussing risk and resolving problems identified and documented in certain examination report forms. We also evaluated key issues and internal controls in the RFE process. Overall, we found good compliance with agency guidance, identification of risks, and either resolution of identified problems associated with risks or plans for their resolution by the review regions' staff.

We selected a random sample of the most recent examinations completed in the time frame 2003 through September 2005. The review regions were Region II (Capital), Region III (Atlanta) and Region V (Tempe). Our review did not attempt to identify how long identified risks and issues had been in existence at the credit union, or whether agreements reached with credit union officials were ultimately successful in correcting noted problems in a timely manner. We plan to perform a separate review to evaluate these issues.

We reviewed the following examination forms for each of the credit unions in our sample:

- Scope Workbook
  1. Tab A – preliminary risk assessment
  2. Tab B – examination scope
  3. Tab C – final risk assessment, and
  4. Tab F – plans and budget)
- Form 110 – exam report information
- Document of Resolution
- Division of Supervision Quality Control Review form
- Supervisory Examiner formal appraisal forms

For all 90 FCU examinations we downloaded an examination inquiry. In addition, all 90 examinations had an information form (Form 110) and 89 of the 90 examinations had an examiner-prepared Scope Workbook. The one missing Scope Workbook in our sample was noted by the Supervisory Examiner. He had commented in the SE evaluation form to the examiner about the missing Scope Workbook and had requested it from the examiner. We found that examiners had prepared Documents of Resolution (DOR) documenting agreements reached with officials to reduce areas of unacceptable risks in 61 of the 90 examinations including 12 of the 36 CAMEL 1 credit unions. Division of Supervision analysts had prepared 34 of the 36 required Quality Control Reviews (QCR) for our sample. In addition, Supervisory Examiners had prepared formal evaluation forms for 37 examinations in our sample.

Overall, we found that examiners, Supervisory Examiners and Division of Supervision analysts are preparing the examination and monitoring forms in accordance with guidance. However, we did find a few instances where guidance appeared not to be followed such as the issuance of DOR for CAMEL 1 credit unions when guidance does not support that action (please refer to the Recommendation section of this report). NCUA staff told us that DOR are not normally prepared for CAMEL 1 credit unions. Also, in a few instances examination scheduling did not coincide with guidance. During our examination sample review we noted the following anomalies:

- DOR prepared for 33 percent of CAMEL 1 credit unions
- 94 percent of required QCR were prepared, when follow-up was made with the regions DOS an additional QCR was prepared 15 months after the effective date of the examination, raising the ratio to 97 percent

## SECTION II

### **NCUA is Identifying and Addressing High Risk Areas in Federal Credit Unions**

The purpose of this part of our review was to determine whether, and how well, the agency is identifying high risk areas. We found, during our discussion with NCUA staff and verified by our review of a sample of 90 examinations completed during the period of January 2003 through September 2005 in Regions II, III, and V, that examiners are identifying and addressing high risks in their reports. Supporting this effort, we found that regional DOS, QCRs, and SE formal appraisals placed special emphasis on examiner identification of the high risk areas and the development of DOR to address risks. Overall, we found through our sample review that examiners are identifying high and moderate risks in the Scope Workbook and, for the most part are also addressing them in the DOR.

The examination documentation provided the following information:

#### Scope Workbook:

- Examiners must prepare/update the Scope Workbook for each examination. We found that the Scope Workbook was prepared for 89 out of 90 samples.
- The highest risk identified was compliance risk followed by strategic risk (please refer to following review information table).
- Scope Workbook Preliminary Risk Assessment (Tab A) identified the seven risks – Credit, Interest Rate, Liquidity, Transaction, Compliance (Regulatory), Strategic, and Reputation were identified as Low, Moderate, or High risk based on preliminary financial and other information.
- Scope Workbook Examination Scope (Tab B) discussed each of the seven risks and examiner plans to review during the examination.
- Scope Workbook Final Risk Assessment (Tab C) contained examiner input regarding final risk assigned by the examiner, anticipated direction of risk, and problem risk summary, as well as a section for the examiner supervision plans and comments. In a few instances, some high or moderate risks did not match headings for DOR.
- Scope Workbook Plans and Budget (Tab F) contained examiner input regarding hours spent on the contact, recommended hours for the next examination, recommended hours for supervision, and supervision plans and comments.

### DOS QCR:

- QCR must be prepared in certain instances or at the request of the Regional Director. QCR was prepared in 34 of 36 required sample instances at commencement of review, for a total of 34 QCR for the sample of 90 examinations. Subsequently, one additional QCR was prepared. The two regions that missed the two required QCR have since modified their tracking systems to avoid a recurrence.
- QCR is prepared to address how the examiner, during the examination, addressed the following: Risk Identification; Scope Development; Proper Solutions; and Continuing Supervision/Examination Plans.
- In the sample, the DOS reviewer addressed all critical questions positively, providing a few constructive comments to the examiner.

### SE formal examination evaluations

- NCUA staff informed us that SEs review all examination reports for their group of examiners and formally review a sample of each examiner's reports during the year. The evaluations are used by the SE to evaluate examiner performance and recommend performance improvements.
- SE formal evaluations address the following: Risk Identification; Scope Development/Resource Allocation; Proper Solutions; and Continuing Supervision/Examination Plans.
- In most instances, the SE evaluated the key questions positively and provided constructive suggestions for improvement to the examiner.
- SE formal evaluations were performed for 37 of the 90 review sample.

### DOR

- NCUA staff informed us that DOR are generally not prepared for CAMEL 1 credit unions.
- Examiner prepares DOR to outline plans and agreements reached with officials to reduce areas of unacceptable risk. Examiners are instructed not to address minor issues in the DOR. Rather, examiners should discuss these issues with management.
- Examiners prepared DOR for 68 percent (61 of 90) of our review sample.
- Pursuant to NCUA guidance, when a credit union is rated a composite CAMEL 1, any weaknesses detected are considered minor and, consequently, the examiner advises the board of directors and management to handle them in a routine manner.
- As noted in the previous section of this report, DOR were prepared for 33 percent of our review sample (12 DOR for 36 CAMEL 1 credit unions – please refer to page 15 of this report for additional information).

In summary, we found that the Scope Workbook identified High, Moderate, and Low Risks for the credit unions in our sample of 90 examinations in the three review regions. We found that the highest rated risk was compliance risk at 28 percent (25 of 90), followed by strategic risk at 14 percent (13 of 90). DOR were prepared in 93 percent (64 out of 69) of high risk instances. To a lesser extent DOR were prepared for the moderate risks (please refer to the following tables for additional information).

### Sample of 90 Credit Unions in Regions II, III, & V

Identified Risks:	Risks						DOR		
	High	Mod	Low	Totals			High	Mod	Totals
Credit	12	32	46	90		Credit	12	18	30
Interest Rate	5	42	43	90		Interest Rate	4	12	16
Liquidity	2	21	67	90		Liquidity	2	8	10
Transaction	6	28	56	90		Transact	5	19	24
Compliance	<b>25</b>	31	34	90		Compliance	<b>24</b>	18	42
Strategic	<b>13</b>	40	37	90		Strategic	<b>12</b>	20	32
Reputation	6	18	66	90		Reputation	5	10	15
	<b>69</b>	<b>212</b>	<b>349</b>	<b>630</b>			<b>64</b>	<b>105</b>	<b>169</b>
	69/630	212/630	349/630	630/630			64/69	105/212	169/281
	<b>11%</b>	<b>34%</b>	<b>55%</b>	<b>100%</b>			<b>93%</b>	<b>50%</b>	<b>60%</b>

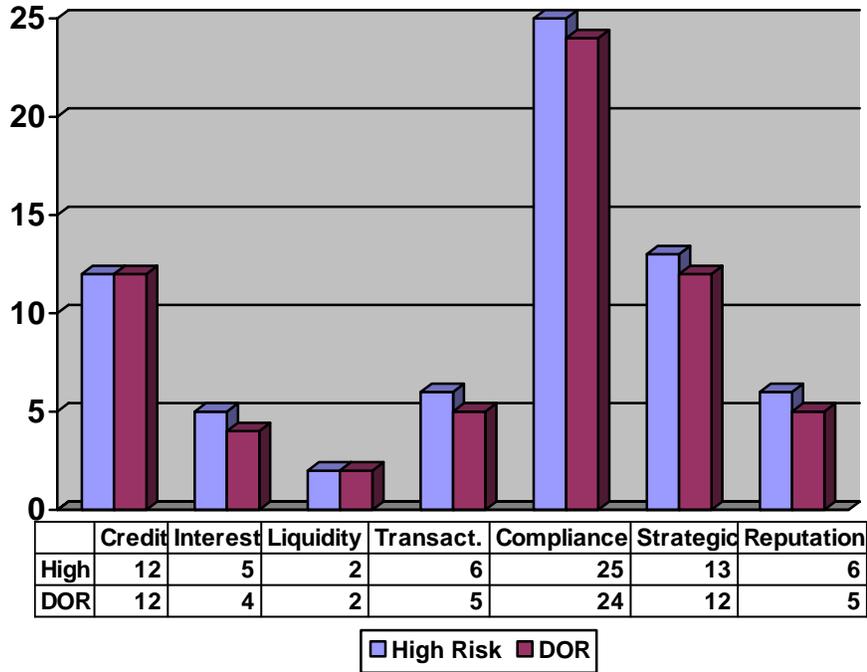
### NCUA Process of Monitoring and Follow-up of Federal Credit Union High Risk Areas Appears Reasonable

Monitoring and follow-up of high risk areas at FCUs begins with the district examiner and is detailed in the Scope Workbook and other examination work papers for each assigned credit union. The SE and the regional DOS monitor, respectively, examiner plans through evaluations (formal and informal) and QCRs of examination documentation. The SE and DOS conduct discussions with the examiner, and review management reports keyed to examination scheduling and other criteria to ensure that the RFE process is accomplished in a timely manner. The purpose of our review in this area was to identify and evaluate key issues and internal controls in the RFE process, and to quantify the most common high risk areas identified by the examiners. Our discussions with staff, followed by our testing of examination reports provided evidence that the agency has a reasonable process of monitoring and follow-up of FCU high risk areas.

Our sample reviews indicated high levels of documented plans of action (DOR) for high and moderate risk areas identified during the examinations. Our review sample indicated that 93 percent of high risk and 50 percent of moderate risk areas had DOR with planned follow-up by examiners.

The following graph indicates a high correlation between identified high risk areas and DOR for our review sample of 90 examinations completed in 2003 through 2005:

**High Risk Areas in the DOR for Sample of 90 Examinations completed in 2003-2005**



## RECOMMENDATION

NCUA should clarify examiner guidance regarding the assignment of CAMEL 1 composite ratings in relation to the development of Documents of Resolution for Federal Credit Unions.

**Management Response:** Management agreed with the recommendation and the Office of Examination and Insurance (E&I) is currently drafting a revision to the CAMEL Rating System Letter to Credit Unions that significantly updates the process.

**OIG Response:** Concur with agency response.

### Background

DOR are generally not developed for CAMEL 1 credit unions. By definition, a CAMEL 1 credit union “Indicates strong performance and risk management practices that consistently provide for safe and sound operations.” (NCUA Letter to Credit Unions, 03-CU-04, March 2003). Further, with regard to CAMEL 1 credit unions, “Any weaknesses are minor and can be handled in a routine manner by the board of directors and management.” (NCUA Letter to Credit Unions, 03-CU-04, March 2003). Finally, “Examiners use the Document Of Resolution to outline plans and agreements reached with officials to reduce areas of unacceptable risk. Examiners should not address minor issues in the DOR.” (NCUA Examiner’s Guide, p. 20-4).

During our Risk-Focused Examination review, we found that in a significant number of cases DOR were developed for CAMEL 1 rated FCUs. Our sample of 90 credit unions included 36 CAMEL 1 credit unions. Of the 36 CAMEL 1 credit unions, 12 (33 percent) had DOR. The breakdown of the DOR were as follows for CAMEL composite 1 FCU:

Effective Date	Complete Date	DOR were prepared for the following Issues
6/30/05	11/30/05	Bank Secrecy Act (BSA)
3/31/05	6/17/05	BSA, Extension Agree, Bankruptcy Loans, Loan C/O Policy
3/31/05	8/11/05	Information Technology weaknesses
12/31/04	4/28/05	BSA
9/30/05	12/16/05	BSA and Anti-Money Laundering
3/31/04	10/27/04	Information Systems & Technology
3/31/05	7/27/05	Investment Conflict of Interest
12/31/04	3/29/05	BSA, Interest Rate Risk/Asset Liability Management
12/31/04	5/5/05	BSA, Supervisory Examiner Evaluation comments: "I have to question either your risk ratings or your CAMEL ratings. How can a CU have one H, four M, and two L-rated risks, and be a CAMEL 1" "Either your risk ratings were excessive or your M, and maybe L, CAMEL ratings were too low (generous)"
12/21/04	4/22/05	BSA
9/30/05	12/12/05	BSA
6/30/05	11/28/05	BSA, Office of Foreign Assets Control

Note: NCUA Instruction 5001.06 (Rev. 1) effective 5/1/05, requires DOR be prepared in certain violation instances.

## NCUA COMMENTS

EI/AVH:ah  
SSIC 5000

### VIA E-Mail

**TO:** William DeSarno, Inspector General  
Office of Inspector General

**FROM:** Executive Director J. Leonard Skiles  
Office of the Executive Director

**SUBJ:** Comments on Draft OIG Report  
NCUA's Risk-Focused Examination Process for Federal Credit Unions

**DATE:** October 5, 2006

This memorandum responds to your request for comments on the draft OIG report titled *NCUA's Risk-Focused Examination Process for Federal Credit Unions* (Report #OIG-06-08). I appreciate your review of this important area. I am pleased to read you determined the process to be working adequately and that your audit found good compliance with agency guidance, identification of risk, and plans to resolve identified problems.

I agree with your recommendation and below are my comments:

### OIG Report Recommendation

*NCUA should clarify examiner guidance regarding the assignment of CAMEL 1 composite ratings in relation to the development of Documents of Resolution (DOR) for Federal Credit Unions (FCUs).*

Your recap of agency issuances regarding the use of a Document of Resolution (DOR) and the assignment of a composite CAMEL 1 rating gives the impression that the two should never occur in the same examination report. Although true in the majority of cases, there are circumstances where it is appropriate. The Office of Examination and Insurance (E&I) is currently drafting a revision to the CAMEL Rating System Letter to Credit Unions that significantly updates the process. As part of the rollout of these changes, E&I will provide examiners guidance on the appropriate use of DORs for CAMEL 1 credit unions. These changes are planned for the first half of 2007.

Page Two

As clarification, your background information supporting the above recommendation provides a listing of 12 CAMEL 1 examination reports where a DOR was used by the examiner. Your audit fell during a period of renewed focus by the agency on Bank Secrecy Act (BSA) compliance which led to examiners developing numerous DORs on the subject. The agency's efforts included the issuance of NCUA Instruction 5001.06 (Rev. 1) which required the use of a DOR for certain BSA violations. Your audit covering this time period appears to have been affected by the heightened level of BSA work as 9 of the 12 DORs included BSA and 4 were issued solely for that reason.

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

cc: Director David M. Marquis  
Office of Examination and Insurance

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## APPENDIX A

### OIG ANALYSIS OF LEGAL AUTHORITY FOR RISK-FOCUSED EXAMINATIONS

#### Background

In July of 2001, NCUA implemented a risk-based examination program that eliminated the requirement to perform annual examinations in low risk credit unions (See Letter to Credit Unions 01-FCU-05, issued in August 2001). Rather, credit unions posing minimal or no risk to the National Credit Union Share Insurance Fund (NCUSIF) could receive an examination twice every three years. The credit union system had undergone a variety of changes that prompted NCUA to move from an examination and supervision approach that was primarily focused on reviewing transactions, to an approach that focused NCUA resources on high-risk areas within a credit union. The Agency implemented the concept by issuing NCUA Instruction 5000.15 with an effective date of January 1, 2002.

#### Federal Credit Union Act

The primary statute granting NCUA its supervisory and regulatory authority is the Federal Credit Union Act (the “FCU Act”) (codified as amended in 12 U.S.C. 1751 *et seq.*) The FCU Act, which passed the 73<sup>rd</sup> Congress on June 16, 1934, descended from legislation already enacted in some 36 states and the District of Columbia over the preceding 25 years. Sections 1756 and 1784 of the Act address the examination of insured credit unions.

#### Section 1756

Section 1756 generally provides that:

[F]ederal credit unions shall be . . . subject to examination by, and for this purpose shall make its books and records accessible to, any person designated by the Board.

As originally enacted, section 1756 provided for a special exemption from the requirements of this section when the credit union had less than \$25,000 in total assets. Such credit union could substitute a certified public accountant’s examination in lieu of an examination by agents of the supervising agency. When Congress amended the FCU Act in 1937 it did away with the substitute provision, but still gave special consideration to the small credit union, *i.e.*, the supervising agency was to take into account the ability to pay in determining the examination fees.

The current text of this section, created in 1978 by Public Law 95-360, section 508, deleted the reference to the duty of the supervisory body to fix a scale of examination fees.

#### Section 1784

The current section 1784 was enacted in 1970 as part of the new Title II of the FCU Act, Public Law 91-468. In pertinent part, section 1784(a) provides as follows:

- (a) The Board shall appoint examiners who shall have power, on its behalf, to examine any credit union making application for insurance of its member accounts, or any closed insured credit union whenever in the judgment of the Board an examination is necessary to determine the condition of any such credit union for insurance purposes. Each examiner shall have power to make a thorough examination of all of the affairs of the credit union and shall make a full and detailed report of the condition of the credit union to the Board. . . .

In connection with examinations of insured credit unions, the House Banking and Currency Committee, in its Report of September 21, 1970, further authorized the Board to subpoena any documents and apply to the United States district courts for the enforcement of such subpoenas.

Neither the language of the sections cited above, nor the legislative history of the FCU Act, specifically addresses whether credit union examinations should focus on calendar year examination cycles or, alternatively, risk to the NCUSIF. Consequently, it is within the NCUA's jurisdiction, as the regulatory authority, to interpret the statute as it sees fit. The Supreme Court has held that if an implementing agency's construction of a statute is reasonable, then a federal court is required to accept the agency's construction.<sup>1</sup> NCUA has not interpreted sections 1756 and 1784 as requiring the examination of all credit unions each calendar year. Rather, the Agency's position is that the examination cycle for credit unions should be determined by risk to the NCUSIF, economic trends, and staff and resource availability. (See Instruction 5000.15, dated September 13, 2001). To date, this interpretation has not been challenged.

#### NCUA Instructions

As mentioned above, NCUA implemented the use of risk-focused examinations by issuing NCUA Instruction 5000.15 with an effective date of January 1, 2002. Instruction 5000.15 was revised recently on August 23, 2005.

#### Instruction 5000.15 (Original)

Instruction 5000.15 (September 13, 2001) established guidelines for the risk-based examination program and outlined the policy for risk-based examination scheduling. A preceding *NCUA Letter to Federal Credit Unions*, Letter No. 01-FCU-05, dated August

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<sup>1</sup> *Chevron v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

2001, explained that the NCUA Board approved this new program to allow the Agency more flexibility in balancing numerous risk factors and priorities with available resources without compromising the safety and soundness of credit unions. The instruction provided that credit unions determined to be low risk could receive two exams in a three year period, although additional supervision and monitoring of such credit unions would be required.

#### Instruction 5000.15 (Rev. 1)

NCUA Instruction 5000.15 was recently revised (See NCUA Instruction 5000.15 (Rev. 1), dated August 23, 2005, with an effective date of January 1, 2006)) based on the Agency's recognition that "the process [of risk based examination scheduling] would be dynamic and change over time." The revised instruction went on to explain that "[n]ow that agency staff is experienced in risk-based scheduling and systems are in place for monitoring, changes to streamline the program can be made."

The general policy change set forth in revised Instruction 5000.15 is that eligible FCUs, as defined by the instruction, "will have an examination completed every 12 to 24 months with a target completion frequency of 18 months. All other FCUs will have an examination completed once every calendar year." The instruction further sets forth the respective responsibilities of examiners, supervisory examiners, Associate Regional Directors-Program, Regional Directors, and the Office of Examination and Insurance in carrying out the Agency's risk-based exam program, as revised.

#### NCUA Examiner's Guide

The Examiner's Guide sets out guidance for NCUA examiners on the examination and supervision of credit unions. The primary goal of the information in the Guide is to ensure the overall safety and soundness of the credit union system. Toward that goal, Chapter 1 of the Guide covers the "Risk Focused Program." A key change made to this chapter, to account for the shift to a risk-based program, is that examiners must exercise more judgment in assessing what activities pose the highest risk to a credit union. Chapter 1 provides guidance to examiners for reviewing areas containing the most risk for an individual credit union. Chapter 1 further provides instruction about how to conduct an examination using the risk-based method.

The Examiner's Guide, as well as regional office instruction guides and bulletins that supplement the Guide,<sup>2</sup> provide dependable guidance for NCUA examiners and supervisors, but are not necessarily the best or final approach in every situation. Rather, the risk-focused approach requires that examiners exercise their professional judgment to assess the risk inherent in a given credit union operation and determine the scope of the examination, taking into consideration the many variables presented by the individual credit union.

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<sup>2</sup> See, e.g., Region III Regional Guide No. III-5001.4 (January 18, 2005) (supplement to the national Examiner's Guide and national instructions pertaining to risk-based examinations) and NCUA Bulletin 5010.06B (May 5, 2003), "OE&I Quality Control Program."

## Conclusion

While the broad statutory authority underlying the Agency's examination authority does not specify a risk-based approach, NCUA, in exercising that broad authority, has issued the guidance discussed above to implement and conduct a risk-focused program. Because the risk-based examination process is a dynamic one, additional changes to the program can be anticipated as the credit union system itself continues to evolve.

## SCOPE AND METHODOLOGY

Prior to the survey and review work<sup>3</sup>, the Office of Inspector General had not reviewed the NCUA Risk Focused Examination (RFE) process. During the survey phase we interviewed and held discussions with National Credit Union Administration (NCUA) staff in the Office of Examination and Insurance; and staff in Region III (Atlanta, GA). In addition, we reviewed certain documentation for a judgmentally selected sample of 13 Federal Credit Union examinations. During the review phase we reviewed certain documentation for 90 additional Federal Credit Union examinations, plus available regional Division of Supervision Quality Control Reviews (DOS QCR) and formal Supervisory Examiner examination evaluations. The 90 credit unions were selected from three regions (Alexandria, VA, Atlanta, GA, and Tempe, AZ). Our review of internal controls was limited to information we received during our discussion with NCUA staff, and documentation available during our review. We performed our work in accordance with government auditing standards with the exception of verifying computer data information supplied from NCUA data systems.

### *Survey Objective*

Our survey objective was to evaluate the NCUA process for identifying and addressing risk factors through the examination process for CAMEL 3 Federal Credit Unions in NCUA Region III.

### *Survey Scope*

Our survey scope included:

- Reviewing the legal requirement and guidance for RFE process in effect since 2001
- Obtaining staff input from the Office of Examination and Insurance (E&I), and Region III
- Reviewing a sample of examinations performed in Region III for years 2004-2005

### *Survey Procedures and Methodology*

Our survey work included the following procedures and methodology:

#### *Reviewed Legal Requirements*

- Identified and reviewed relevant laws and regulations to determine legal requirements for the NCUA RFE program
- Compared requirements with program to determine compliance and use consistency

#### *Obtained staff input from E&I and Region III*

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<sup>3</sup> The survey work included gathering preliminary audit information, preliminary interviews, and limited testing in one NCUA region to determine whether to continue with an audit. Review work included more extensive succeeding work to the survey and involving sample review and testing for three of the five NCUA regions.

- Contacted and held discussions with NCUA Office of Examination and Insurance (E&I) to identify and evaluate key issues of program risks and internal controls in the RFE process
- Contacted and held discussions with NCUA Regional III staff (Atlanta, GA) to identify and evaluate key issues of program risks, and internal controls in the RFE process

*Reviewed a sample of composite CAMEL 3 examinations*

- Identified universe of Region III 2004-05 Federal Credit Union risk-focused examinations
- Judgmentally selected a survey sample of 13 small, medium sized, and large Region III CAMEL 3 Federal Credit Union examinations
- Reviewed selected sample for:
  1. Key issues of program risks and internal controls in the RFE process
  2. Adequacy of RFE policy and procedures in practice
  3. Examination compliance and consistency with guidance
  4. Effectiveness of the RFE program in identifying and addressing high risk areas
  5. Quantification of most common high risk areas
- Examination documentation reviewed for the selected sample included:
  1. Division of Supervision Quality Control Review forms
  2. Supervisory Examiner formal evaluation and forms
  3. Scope Work Book
  4. 110 Form

*Survey Conclusions*

Our survey work indicated:

- The agency followed available authorization in developing agency guidance and implementing the Risk-Focused Examination (RFE) program.
- NCUA staff in general at the E&I and Atlanta regional office are knowledgeable about and following agency RFE program guidance.
- Examination documentation prepared by the examiners in our sample review identified and addressed the seven risk areas, and there were the required actions taken by regional Division Of Supervision (DOS) analysts and Supervisory Examiners (SE) in the preparation respectively of Quality Control Reviews (QCR) and formal appraisals.
- In general, the DOS QCRs, and the SE formal appraisals for the sample examinations indicated adequate action taken by Atlanta regional office analysts and field supervisor staff.

### *Review Objective*

While our survey work concluded that the RFE program appeared to be working well for CAMEL 3 credit unions in Region III, we decided to expand our work in order to draw conclusions across CAMEL codes 1 through 4, and in multiple regions.

The review objective was:

Does NCUA have a process in place to provide assurance that high risk areas are identified and addressed through the risk focused examination process.

### *Review Scope*

- Reviewing Risk-Focused Examination process in effect since 2001-2002
- Reviewing a sample of most recent Risk-Focused Examinations completed during years 2004-2005 in Regions II, III, V
- 30 examinations for Regions II, III, and V, a total of 90 examinations in Federal Credit Unions, CAMEL coded 1, 2, 3, and 4.

### *Review Procedures and Methodology*

Our review work was performed to determine compliance with examination policies and guidance, and the reasonableness of risk identification and resolution of identified problems during the examination as identified in available examination report forms Scope Workbook, Form 110, Document of Resolution, regional Division of Supervision (DOS) Quality Control Reviews (QCR) and Supervisory Examiner appraisal (SEA) forms.

### *Review Procedures and Methodology*

Procedures and methodology for selection of the sample and sample review included:

- identification of all composite CAMEL 1, 2, 3, and 4 FCUs where an examination was completed during 2004 or 2005 in Regions II, III, and V
- sorting into “buckets” FCUs having exams in size of <\$100 million in insured shares; those \$100 million to <\$1 billion in insured shares, and those >\$1 billion in insured shares
- random selection of a sample for evaluation of 90 FCUs (30 per Regions II, III, and V)
- testing for compliance with guidance during review of examination samples of available report forms (Scope Workbook, Form 110 and DOR), available DOS QCR and SE appraisals
- identify and compare weaknesses in internal controls with policy, procedures, and guidance with Region II, III, and V practice during the review of procedures, policies, interviews, and sample examination review
- gain an understanding through discussion, as needed, with regional staff and during sample review, regarding efforts to ensure examiners are identifying and addressing risks as appropriate during the RFE process
- test identification and documentation in addressing various levels of the seven risks
- describe how risks are identified and addressed in RFE process.
- quantify the most common high risk areas identified by examiner