NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW
OF
CHETCO FEDERAL CREDIT UNION

Report #OIG-13-10

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ACRONYMS AND ABBREVIATIONS

ALLL	Allowance for Loan and Lease Losses
Board	Board of Directors
Chetco	Chetco Federal Credit Union
Crowe	Crowe Horwath LLP
CLS	Commercial Loan Services
CUSO	Credit Union Service Organization
DTD	Division of Training and Development
DOR	Document of Resolution
EIC	Examiner-in-Charge
FCU	Federal Credit Union
FOM	Field of Membership
Guide	NCUA Examiner's Guide
IRPS	Interpretive Ruling and Policy Statement
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

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Crowe Horwath LLP (Crowe) to conduct a Material Loss Review (MLR) of Chetco Federal Credit Union (Chetco, or Credit Union), a federally regulated and insured credit union. We reviewed Chetco to: (1) determine the cause(s) related to the liquidation of Chetco Federal Credit Union and the resulting $76.5 million[1] loss to the National Credit Union Share Insurance Fund (NCUSIF); (2) assess NCUA's supervision of the credit union; and (3) make appropriate observations/recommendations to prevent future losses. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence; interviewed management and staff from NCUA's Region V; and reviewed NCUA guides, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports.[2]

We determined Chetco failed for the following reasons:

- Inadequate Management and Board Oversight

  The Board of Directors and management exposed the credit union to excessive amounts of credit and liquidity risk due to its failure to set appropriate limits and maintain the appropriate risk management infrastructure to support the growth in the Member Business Loan (MBL) portfolio. Specifically:

  - Management allowed the credit union's MBL portfolio to grow significantly between 2002 and 2008 with MBLs representing over 600 percent of net worth in 2008. Regulations typically limit MBL portfolios to 175 percent of net worth.[3] However, Chetco received an exception[4] from this limit based on its designation as a low-income credit union and its history of making member business loans. Chetco

[1] The final cost to the NCUSIF will not be known until all assets are sold.
[2] Crowe provides additional details in the Objectives, Scope, and Methodology section of the report.
[3] Code of Federal Regulations (CFR) § 723.16 states the aggregate limit on a credit union's net member business loan balances is the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets. Loans that are exempt from the definition of member business loans are not counted for the purpose of the aggregate loan limit.
[4] CFR § 723.17 states there are three circumstances where a credit union qualifies for an exception from the aggregate limit. Loans that are excepted from the definition of member business loans are not counted for the purpose of the exceptions. The three exceptions are: (a) Credit unions that have a low-income designation or participate in the Community Development Financial Institutions program; (b) Credit unions that were chartered for the purpose of making member business loans and can provide documentary evidence (such evidence includes but is not limited to the original charter, original bylaws, original business plan, original field of membership, board minutes and loan portfolio); and (c) Credit unions that have a history of primarily making member business loans, meaning that either member business loans comprise at least 25 percent of the credit union's outstanding loans (as evidenced in any call report filed between January 1995 and September 1998 or any equivalent documentation including financial statements) or member business loans comprise the largest portion of the credit union's loan portfolio (as evidenced in any call report filed between January 1995 and September 1998 or any equivalent documentation including financial statements).

management substantially secured the MBL portfolio through real estate, and experienced financial difficulty when the broader economy and real estate markets declined, starting in 2007. Using loan renewals and modifications, management initially masked loan delinquency. In the face of regulatory restrictions regarding renewal and modifications and a declining economy, the true risk profile of the MBL portfolio emerged, which caused Chetco to recognize significant losses.

- Management failed to develop an adequate liquidity plan to address its rapid loan growth. In addition, with Chetco's deteriorating financial condition, liquidity sources were ultimately restricted.

- Management failed to operate the Commercial Lending Solutions (CLS) Credit Union Service Organization (CUSO) in a safe manner and intertwined its operations with the Credit Union with no clear delineation of employee responsibilities.

In addition, we determined examiners missed the opportunity to reduce the loss to the NCUSIF as follows:

NCUA's Region V raised concerns with Chetco's MBL portfolio during the September 30, 2008 supervision contact (effective) when examiners downgraded the Credit Union to a CAMEL Composite rating of 3. The September 30, 2008 supervision contact resulted in a Document of Resolution (DOR) that cited concerns with MBL limits and the adequacy of the Allowance for Loan and Lease Losses (ALLL) specifically related to the risk in the MBL portfolio. Examiners issued DORs, which placed limits on lending activities and required on-going reductions to the MBL portfolio concentration each quarter. Examiners also performed a second supervision contact effective October 1, 2008 as a result of a member complaint that identified management activities designed to mask a significant delinquent loan relationship.

We believe that red flags were present, which may have indicated the existence of governance issues affecting the management of MBL credit risk. Examiner commentary identified tone at the top[5] issues exhibited by executive management, which we believe can signal more serious problems. Although we cannot conclude that further analysis would have prevented the Credit Union's liquidation, we can reason that these observations might have served as a 'red flag' prompting examiners to expand the scope of the review of the MBL portfolio sooner. We determined that the following contributed to examiners not identifying the increases in MBL credit risk earlier:

[5] Tone at the top is a commonly used phrase to describe an organization's general ethical climate, as established by its board of directors, audit committee, and senior management.

- Limited exam resources and hours devoted to a comprehensive review of MBLs;
- Limited scope of individual MBLs reviewed compared to the complexity of the credits within the MBL portfolio, including construction and development financing;
- Lack of examination focus on MBL renewals and modification processes; and
- Lack of completion of formal training courses by the Examiner-in-Charge (EIC) in complex commercial credit analysis.

As a result of our review, we are making one suggestion and two observations to NCUA management. We appreciate the effort, assistance and cooperation NCUA management and staff provided to us.

BACKGROUND

The National Credit Union Administration (NCUA) Office of the Inspector General (OIG) contracted with Crowe Horwath, LLP (Crowe) to conduct a Material Loss Review (MLR) for Chetco Federal Credit Union (Chetco, or the Credit Union) as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U. S. C. 1790d(j).

History of Chetco Federal Credit Union

NCUA chartered Chetco in November 1957. In 1999, NCUA granted Chetco a community charter to serve those who live, work, and worship in Curry County, Oregon and Del Norte County, California. In January 1999, NCUA granted Chetco an exception to the aggregate MBL limits in NCUA Rules and Regulations Part 723, because the Credit Union had "a history of primarily making MBLs." In 2000, NCUA granted Chetco an expansion of its charter to include the area of Coos County, Oregon, and also granted Chetco a low-income credit union designation. Obtaining the low-income credit union designation allowed Chetco to gain access to alternative funding sources and resources from both the NCUA and outside parties. This designation also allowed Chetco to qualify for exceptions to the aggregate loan limit for MBLs. Table 1 (below) illustrates the MBL exception and waivers NCUA granted to Chetco.

Table 1

MBL Exception / Waivers Granted		
NCUA Rules and Regulations Section	**Date Granted**	**Explanation**
723.17	01/11/1999	Exception to the aggregate MBL limit based upon history of making MBL loans
723.3b	10/30/2001	Approved up to 80 percent LTV for Construction and Development (C&D) Loans
723.8	01/07/2004	Maximum to one borrower: 45 percent of net worth
723.3a	09/01/2005	Maximum C&D portfolio: 100 percent of net worth

In 2001, Chetco's Board of Directors (Board) hired a new CEO. The new CEO focused Chetco on a strategy of growth and expanding the MBL portfolio. The Board supported the focus on growing member business loans and continued overall concentration in loans secured by real estate. The MBL portfolio grew from $33.2 million (21.5 percent of assets) in 2002 to $189.4 million (56 percent of assets) in 2010. In addition, the individual loan size and complexity grew from an average MBL loan amount of $273,353 in 2004 to an average MBL loan amount $444,194 in 2008. MBLs are generally limited to 175 percent of net worth by

regulation. However, Region V granted Chetco an exception from this limit based on its history of making MBLs and low income designation. In addition, management expanded MBL lending out of the local membership area to include loans to entities as far away as New Mexico and North Carolina.

During 2005, Chetco capitalized two CUSO's. The first CUSO, Wild River Financial Services (Wild River), provided fee-based financial planning and wealth management services. Wild River was unprofitable and a drag on Chetco's earnings from 2006 through conservatorship in 2011. The second CUSO, CLS, originated MBLs for client credit unions.

To promote the CU's MBL growth strategy, Chetco management utilized the services of their wholly owned CUSO, CLS, to originate, participate, and service MBLs for client credit unions. Chetco employees often worked on multiple projects related to each entity without properly accounting for their time. In addition, there was no prescribed methodology for recognizing income or allocating expenses between the entities. Chetco management tried, but was unable to obtain, a legal opinion supporting that CLS was organized and operating as a separate and distinct entity. As a result, officials and management were unable to determine the true financial condition of either CLS or Chetco.

In April 2011, Chetco's Board asked its CEO to resign due to the credit union's deteriorating operating performance. Chetco's Board initially sought approval for a replacement CEO, who Region V initially denied based on a lack of demonstrated knowledge, skills, and abilities for a troubled credit union. Region V subsequently approved the replacement CEO on appeal by Chetco's Board. Shortly thereafter, Region V denied the new CEO's spouse for the Credit Union's vacant CFO position. Ultimately, the Chetco Board hired the CEO's spouse as a management consultant.

Economic conditions and regulatory restrictions to curtail the MBL concentrations exposed the risk management weaknesses. The result was high loan losses, increasing non-performing loans, and depletion of reserves. NCUA's Board placed Chetco into conservatorship on September 23, 2011 and liquidated the credit union effective December 31, 2012. The estimated loss to NCUSIF as a result of the involuntary liquidation was $76.5 million. However, the actual cost to the NCUSIF is unknown until all assets are sold.

<u>NCUA Examination Process</u>

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[6], trend analysis[7], reasonableness analysis[8], variable data analysis[9], and qualitative data analysis[10]. 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 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, examiners should identify changes in profile through various means including:

- Review of Call Reports;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union.

[6] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[7] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[8] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[9] 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.
[10] Qualitative data includes information and conditions that are not measurable in dollars and cents, percentage.

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this material loss review to satisfy the requirements of Section 216(j) of the FCU Act, 12 U.S.C. §1790d (j), which requires the OIG to conduct an MLR if the loss to the NCUSIF exceeds $25 million.[11]

Our audit objectives were to: (1) determine the cause(s) related to the conservatorship of Chetco and the resulting loss to the National Credit Union Share Insurance Fund (NCUSIF); (2) assess NCUA's supervision of the credit union; and (3) make appropriate observations/recommendations to prevent future losses.

We conducted this audit from January 2013 to September 2013 in accordance with *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained, as described in the Scope and Methodology sections, provides a reasonable basis for our findings and conclusions based on our audit objectives.

The scope of this audit included an analysis of Chetco Federal Credit Union from 2005 to December 31, 2012, the date of liquidation. Our audit also included an assessment of NCUA regulatory supervision of the institution during the same period.

To achieve the objectives, we performed the following procedures and utilized the following techniques:

- We analyzed NCUA examination and supervision contact reports and related correspondence and work papers contained within the AIRES[12] system.

- We interviewed management and/or staff from NCUA Region V and reviewed NCUA guides, policies and procedures, as well as NCUA Call Reports and NCUA Financial Performance Reports.

- We reviewed Chetco data and correspondence maintained at the NCUA in Tempe, Arizona as provided to Crowe by NCUA.

Crowe relied primarily upon the materials provided by the NCUA OIG and NCUA Region V officials, as well as information and other data collected during interviews. We relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained to support our audit conclusions. We conducted interviews to gain a better understanding of decisions made

[11] 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.
[12] NCUA's Automated Integrated Regulatory Examination Software.

regarding the activities of credit union management and the NCUA's supervisory approach, and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the NCUA and Chetco. Crowe relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

RESULTS IN DETAIL

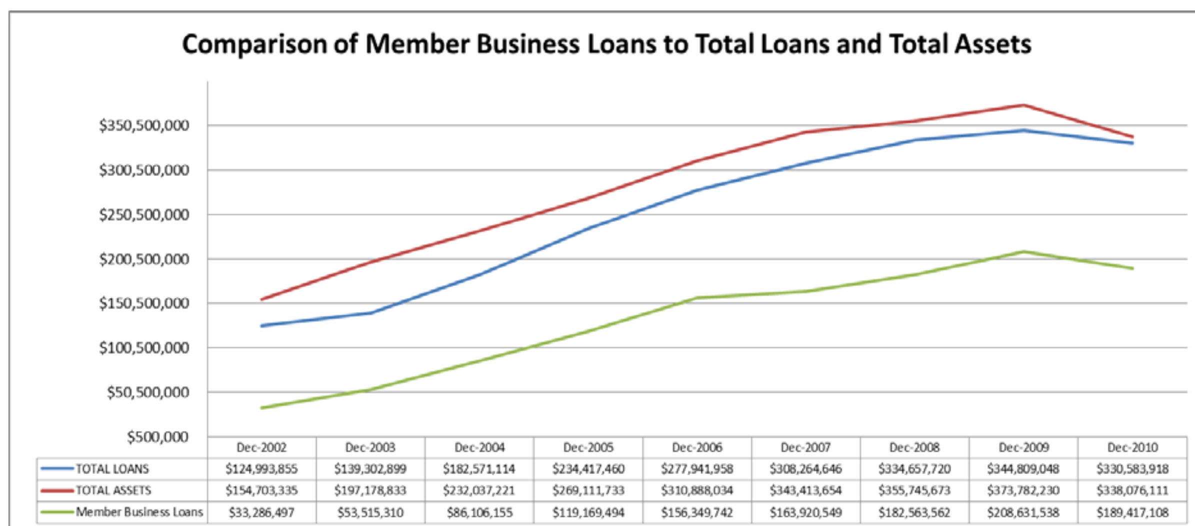
We determined that Chetco Federal Credit Union’s management and Board caused the failure and resulting loss to the NCUSIF. Specifically, Chetco management and Board exposed the credit union to excessive amounts of credit and liquidity risk due to its failure to set appropriate limits and maintain the appropriate risk management infrastructure to support the growth in Chetco’s MBL portfolio. Although not a direct cause of the failure, we also determined management did not adequately operate its CLS CUSO in a fiscally and legally prudent manner, thereby allowing CLS operations to intertwine with the Credit Union’s with no clear delineation of each entity’s respective employee responsibilities. We also determined NCUA could have mitigated the loss to the NCUSIF had they taken a more timely and aggressive supervisory approach regarding Chetco’s concentration risk in its MBL portfolio.

A. Why Chetco Federal Credit Union Failed

Large Loan Concentration in MBLs Led to Chetco’s Failure

Chetco’s Board and management did not adequately manage its loan portfolio, which maintained a large concentration in member business loans, particularly commercial real estate loans. Specifically, Chetco management grew its MBL portfolio from $33.2 million, including unfunded commitments, in December 2002, to a high of $212 million in 2009, eventually lowering to $189.4 million by December 2010. This represented an increase in concentrations in Chetco’s MBL portfolio from less than 26.6 percent of total loans as of 2002 to over 60 percent as of December 2009. Chart 1 (below) illustrates the growth of Chetco’s MBL portfolio compared to total loans and total assets.

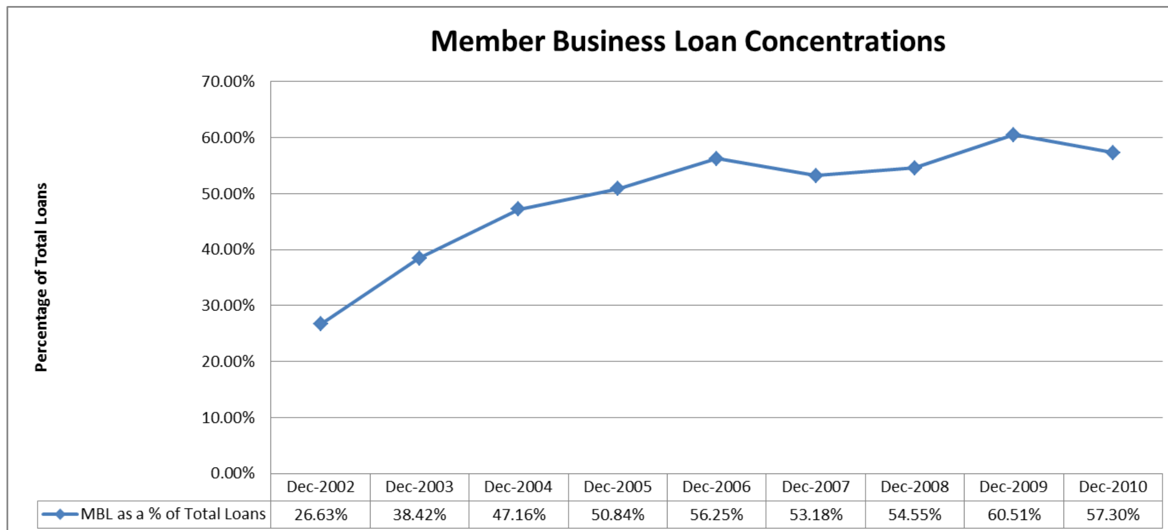
Chart 1



	Dec-2002	Dec-2003	Dec-2004	Dec-2005	Dec-2006	Dec-2007	Dec-2008	Dec-2009	Dec-2010
TOTAL LOANS	$124,993,855	$139,302,899	$182,571,114	$234,417,460	$277,941,958	$308,264,646	$334,657,720	$344,809,048	$330,583,918
TOTAL ASSETS	$154,703,335	$197,178,833	$232,037,221	$269,111,733	$310,888,034	$343,413,654	$355,745,673	$373,782,230	$338,076,111
Member Business Loans	$33,286,497	$53,515,310	$86,106,155	$119,169,494	$156,349,742	$163,920,549	$182,563,562	$208,631,538	$189,417,108

During the decade from 2001 - 2010, management focused on expanding the MBL portfolio and, during much of this period, the portfolio experienced lower delinquencies and losses. Management increased Chetco's concentration levels in MBLs from 26.6 percent of total loans in 2002 to 60 percent of total loans by December 31, 2009, with a slight decline to 57 percent by the end 2010. Chart 2 (below) illustrates Chetco's MBL concentration as a percentage of total loans.

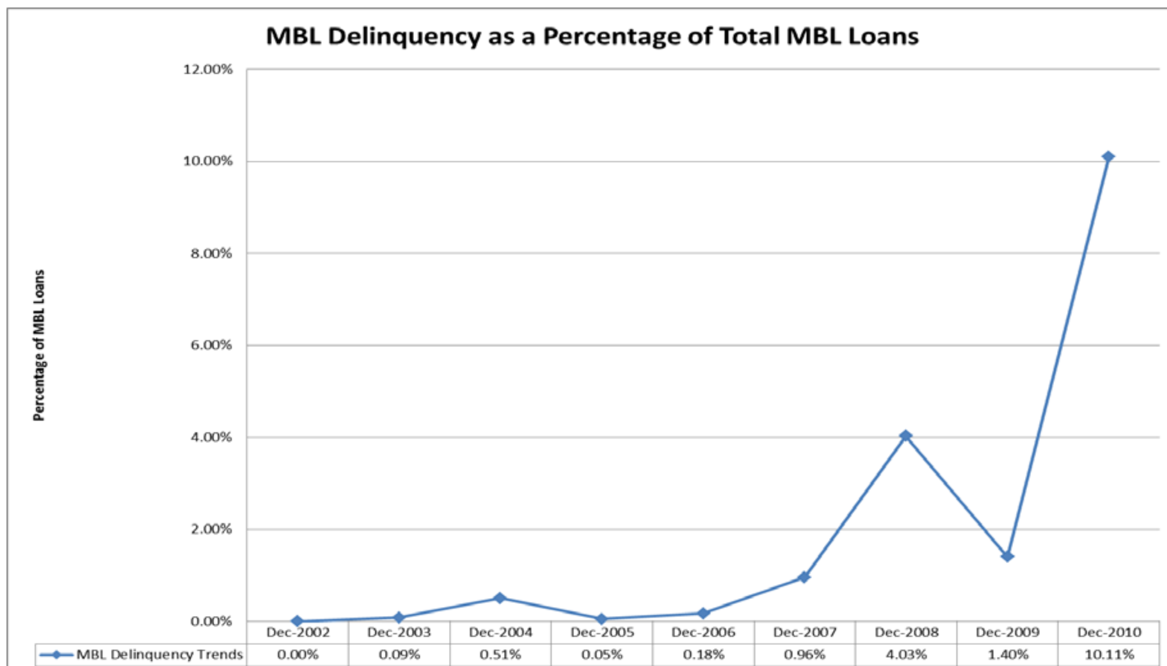
Chart 2



<u>Rising Delinquencies</u>

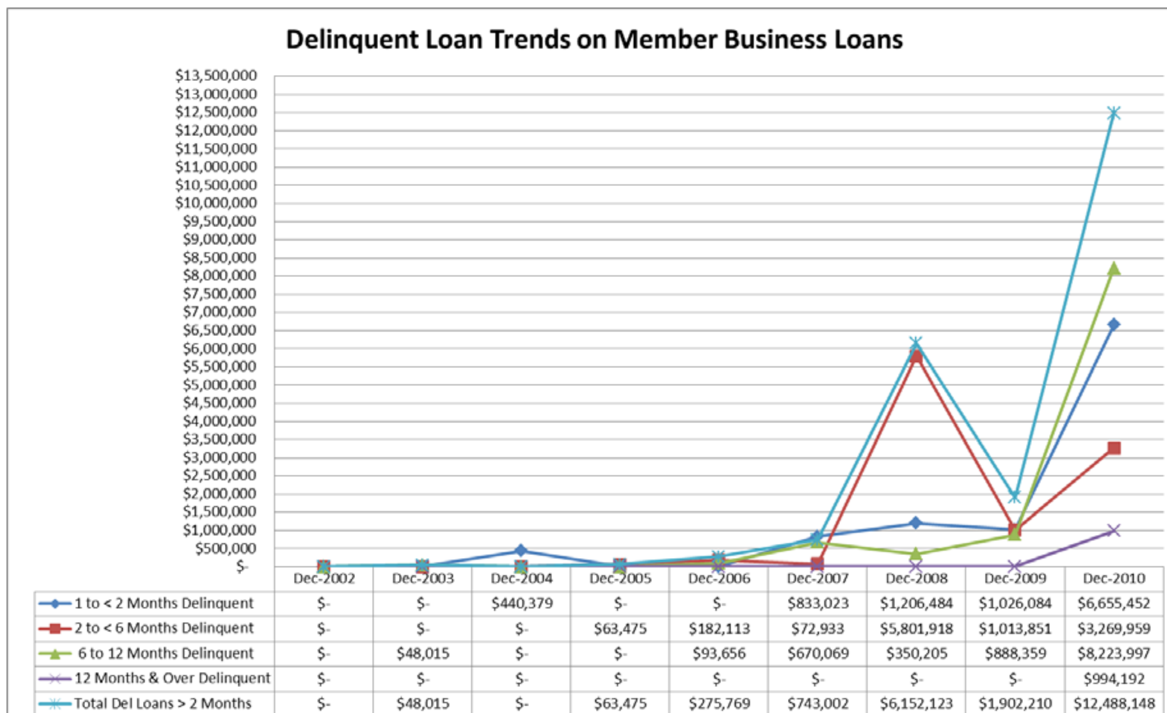
Our analysis of Chetco's financial performance during this period of rapid growth in its MBL portfolio showed the credit union's delinquency rates remained less than 1 percent from 2002 to 2007. Management had secured the majority of Chetco's loan portfolio, including the MBL portfolio, with real estate. In 2007 and 2008 when the broader economy, and particularly the real estate market within Chetco's membership area, began experiencing financial difficulty, Chetco likewise began experiencing an increase in delinquencies. By 2008, MBL delinquencies had reached over 4 percent of total MBL loans and by December 2010 had climbed to over 10 percent. Chart 3 (below) illustrates Chetco's MBL delinquencies as a percentage of total MBL loans.

Chart 3



During the September 30, 2008 supervision contact, the Examiner-In-Charge (EIC) observed rising delinquencies and Region V received a member complaint shortly after the conclusion of this examination, which resulted in a follow-up targeted contact effective October 1, 2008. Region V looked into the complaint, which alleged activities by Chetco management to mask the delinquency of a large MBL relationship. As a result of this targeted follow up, examiners placed restrictions on certain payment and extension transactions in an effort to prevent Chetco management from masking additional delinquencies. As the economy continued to deteriorate in 2007 and 2008, the losses embedded within the portfolio began to show very quickly. By the end of 2008, Chetco's total delinquent MBLs were over $6.1 million, a $5.4 million increase from 2007, and by December 2010, total delinquent MBLs had risen to over $12.4 million. Chart 4 (below) illustrates Chetco's delinquency trends observed between 2002 and 2010.

Chart 4



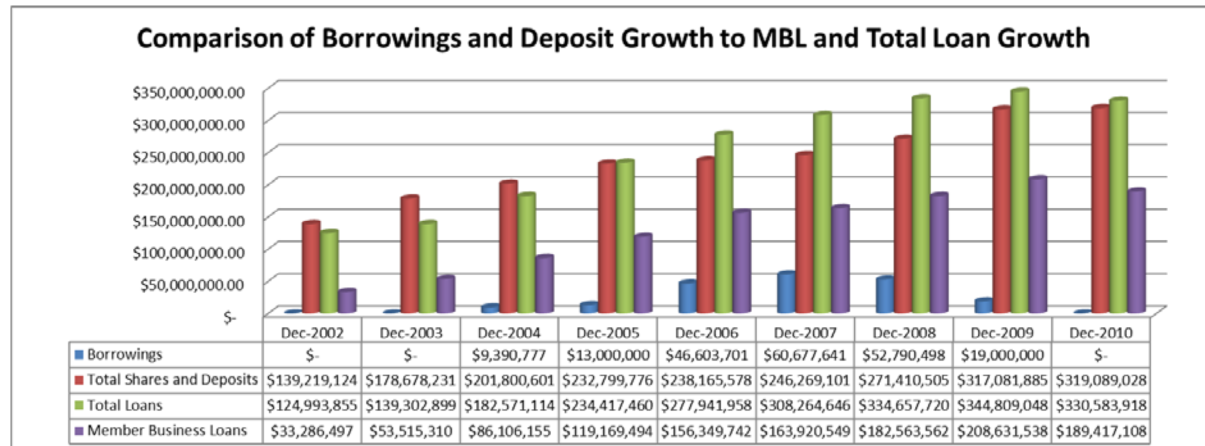
	Dec-2002	Dec-2003	Dec-2004	Dec-2005	Dec-2006	Dec-2007	Dec-2008	Dec-2009	Dec-2010
1 to < 2 Months Delinquent	$-	$-	$440,379	$-	$-	$833,023	$1,206,484	$1,026,084	$6,655,452
2 to < 6 Months Delinquent	$-	$-	$-	$63,475	$182,113	$72,933	$5,801,918	$1,013,851	$3,269,959
6 to 12 Months Delinquent	$-	$48,015	$-	$-	$93,656	$670,069	$350,205	$888,359	$8,223,997
12 Months & Over Delinquent	$-	$-	$-	$-	$-	$-	$-	$-	$994,192
Total Del Loans > 2 Months	$-	$48,015	$-	$63,475	$275,769	$743,002	$6,152,123	$1,902,210	$12,488,148

<u>Liquidity</u>

Our review of examination working papers also showed that Chetco management funded rapid loan growth through a combination of borrowed funds and deposit products with above-market rates. However, in July 2011, due to Chetco's deteriorating financial condition, Southwest Corporate Federal Credit Union reduced Chetco's line of credit from $15 million to $10 million. In addition, the Federal Reserve Bank restricted Chetco to secondary credit and overnight borrowings. Ultimately, Chetco management failed to maintain liquidity at levels required by examiners in their 2010 examination reports as well as a July 2011 Letter of Understanding and Agreement.

Chart 5 (below) illustrates Chetco's increasing reliance on borrowed funds to expand its MBL portfolio.

Chart 5



	Dec-2002	Dec-2003	Dec-2004	Dec-2005	Dec-2006	Dec-2007	Dec-2008	Dec-2009	Dec-2010
Borrowings	$-	$-	$9,390,777	$13,000,000	$46,603,701	$60,677,641	$52,790,498	$19,000,000	$-
Total Shares and Deposits	$139,219,124	$178,678,231	$201,800,601	$232,799,776	$238,165,578	$246,269,101	$271,410,505	$317,081,885	$319,089,028
Total Loans	$124,993,855	$139,302,899	$182,571,114	$234,417,460	$277,941,958	$308,264,646	$334,657,720	$344,809,048	$330,583,918
Member Business Loans	$33,286,497	$53,515,310	$86,106,155	$119,169,494	$156,349,742	$163,920,549	$182,563,562	$208,631,538	$189,417,108

Examiners issued Chetco management three DORs in 2008 citing concerns with MBLs, including a requirement to begin reducing the concentration in MBLs. As previously mentioned, one of the DORs issued effective October 1, 2008, was the result of a supervision contact made as the result of a member complaint. In the complaint, the complainant accused the CEO of asking other members to cover up a delinquent relationship thereby masking the delinquency of the loan relationship. Examiners issued a follow-up DOR that prohibited such activity along with imposing limits on further lending and modifications. By the end of 2008, Chetco's MBL delinquencies had risen to $7.3 million or 4 percent of its MBL portfolio.

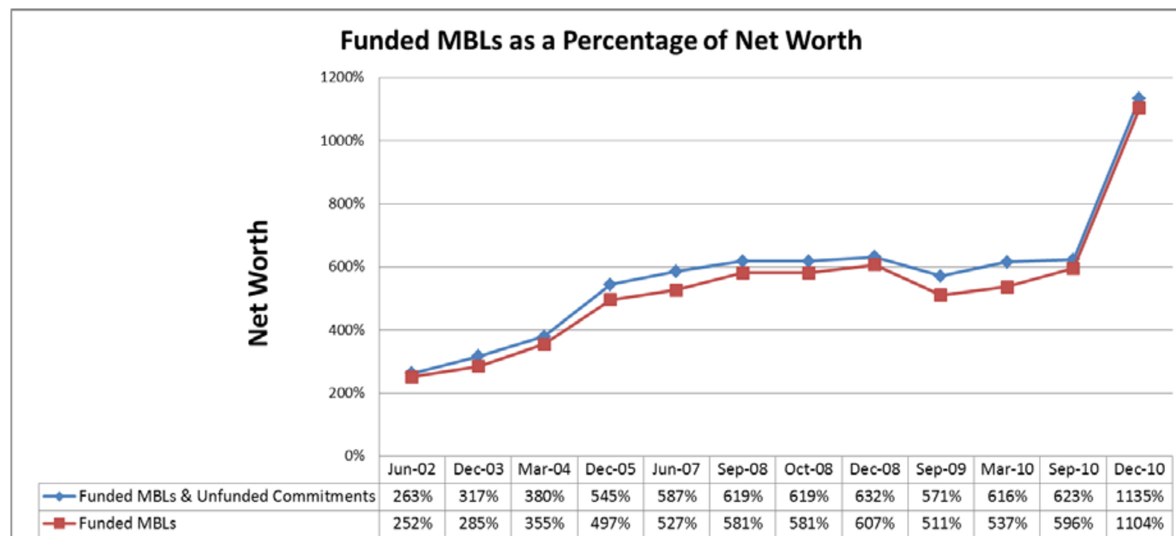
Beginning with the supervision contact effective September 30, 2008, examiners cited concerns related to the declining economy and its potential impact to Chetco's MBL portfolio. Examiners issued a DOR and placed restrictions on further MBL lending. In the DOR, examiners required Chetco management to reduce the MBL portfolio as a percentage of net worth to 500 percent by December 31, 2009. Management appealed the reduction of MBL's, stating that Chetco had approximately $100 million in MBL loan applications in the pipeline prior to the NCUA issuing the DOR. In its appeal, Chetco management requested that the Region:

> *[e]liminate the quarterly Member Business Loan (MBL)/Net Worth ratio targets and increase the December 31, 2009 limits on the MBL/Net Worth ratio from 500 percent to 600 percent.*

In a letter to Chetco management dated March 3, 2009, the Region V Regional Director granted the appeal. However, Chetco management was unable to reduce its concentration of MBL lending fast enough to lessen the impact of the losses in a rapidly declining real estate market. Based on its high concentration of MBL lending as a percentage of capital, the losses quickly caused the Credit Union to become undercapitalized. As previously mentioned, NCUA Rules and Regulations typically limit MBLs to 175 percent of net worth. However, Chetco had obtained an exception to this restriction based on its history of making MBLs and low income designation.

Chart 6 (below) illustrates the relationship between Chetco's MBLs to its total net worth:

Chart 6:



	Jun-02	Dec-03	Mar-04	Dec-05	Jun-07	Sep-08	Oct-08	Dec-08	Sep-09	Mar-10	Sep-10	Dec-10
Funded MBLs & Unfunded Commitments	263%	317%	380%	545%	587%	619%	619%	632%	571%	616%	623%	1135%
Funded MBLs	252%	285%	355%	497%	527%	581%	581%	607%	511%	537%	596%	1104%

Allowance for Loan and Lease Losses

Our analysis of Chetco's ALLL showed that Chetco management was not maintaining the Credit Union's ALLL methodology in compliance with NCUA Interpretive Ruling and Policy Statement (IRPS) 02-3[13] and Accounting Bulletin 06-01.[14] Examiners first determined during the examination effective September 30, 2009, that Chetco's ALLL was underfunded and deemed its methodology deficient because it failed to reflect actual and emerging losses in the loan portfolio. In addition, examiners noted during the examination effective March 31, 2010, that management did not:

- Obtain updated financial statements from borrowers;
- Obtain updated collateral valuations even though commercial real estate values were falling nationwide; and/or
- Update internal risk ratings.

As a result, Chetco management did not have sufficient data to quantify risk in the loan portfolio to determine the impairment of individual large or complex commercial loans. The ALLL did not accurately reflect the declining credit quality and the 5300

[13] The NCUA IRPS 02-03 is the final interpretive rule and policy statement on ALLL Methodology and Documentation for Federally Insured Credit Unions. This IRPS provides guidance for ALLL methodologies and supporting documentation practices.
[14] Accounting Bulletin 06-01 distributes an interagency advisory addressing the ALLL that reiterates key concepts and requirements included in generally accepted accounting principles.

Call Reports did not reflect the anticipated losses and diminishing capital. As a result, the examiner's analysis of the 5300 Call Reports did not alert them to increased risk in the loan portfolio because the information used in the analysis was incorrect.

CUSO Operations – Commercial Lending Solutions

As previously mentioned, Chetco management operated CLS, a wholly owned CUSO established to originate, participate, and service MBLs for client credit unions. Although not a direct cause of the failure, Chetco Management failed to operate CLS in a safe and sound manner by intertwining the operations of the Credit Union and CLS with no clear delineation of each entity's respective employee responsibilities. Employees often worked interchangeably on multiple projects related to each entity without properly accounting for their time. In addition, there was no prescribed methodology for recognizing income or allocating expenses between the two entities. In the DOR issued to Chetco management during the examination effective March 30, 2010, Region V instructed Chetco management to:

> *[c]ease funding the CUSO Commercial Lending Services and obtain a legal opinion until such time as you have submitted and received a favorable legal opinion from a qualified attorney for a plan to address the conflicts of interest and lack of reporting and documentation for participation loan files.*

Examiner working papers showed Chetco management tried, but was unable to obtain, a legal opinion supporting that CLS was organized and operating as a separate and distinct entity.

B. NCUA Supervision of Chetco Federal Credit Union

NCUA Could Have Mitigated the Loss to the NCUSIF

We determined Examiners could have mitigated the loss to the NCUSIF had they taken a more timely and aggressive approach regarding Chetco's concentration risks in its MBL portfolio. Specifically, had examiners: 1) better understood the complexity and magnitude of the concentration risk within the MBL portfolio; 2) expanded the hours allotted to supervise Chetco through additional analysis of the MBL portfolio; and 3) included a review of renewal/modification activities within the scope of examinations prior to September 30, 2008, the lending activities might have been identified earlier, thus potentially reducing the $76.5 million loss to the NCUSIF.

As previously mentioned, Region V initiated a follow-up targeted supervision contact effective October 1, 2008, as the result of a complaint alleging Chetco management masked its delinquent loan activity. The examiner identified inappropriate activity and issued a DOR designed to prohibit management from engaging in certain payment and extension transactions. As a result of this prohibition, Chetco's delinquency rates immediately increased from $743 thousand as of December 31, 2007, to over $6.1 million by December 31, 2008. Prior to this targeted contact, Region V had not identified significant credit quality concerns with the Credit Union's MBL portfolio or concerns with the significant level of concentration risk in the MBL portfolio, which we believe should have required an increased level of attention or supervision. As a result, the NCUSIF incurred a loss of $76.5 million.

Supervisory Background

Chetco consistently received a Composite CAMEL rating of 2 or better up through the examination effective June 30, 2007, an indication of strong performance. Examiners noted the Credit Union's deterioration beginning with the next examination effective September 30, 2008, when they downgraded the Credit Union's CAMEL Composite to 3. Examiners kept the Credit Union's Composite CAMEL rating at 3 until the examination effective March 31, 2010, when they again downgraded it to a Composite Camel rating of 4. The Credit Union remained a Composite CAMEL 4 through the examination effective June 30, 2011, when NCUA downgraded it to a Composite CAMEL 5 where it remained through liquidation in 2012. Table 2 (below) provides Composite and specific CAMEL ratings for the applicable examinations during the scope period of our review.

Table 2:

NCUA Examination Results for Chetco**							
Examination Effective Dates	Exam Type[15]	CAMEL NCUA Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
May 2000	10	2	1	1	2	3	2
August 2001	10	2	2	1	2	2	2
June 2002	10	2	1	1	2	1	2
December 2003	22	2	2	1	2	1	2
March 2004	10	2	1	2	2	1	1
December 2005	10	1	1	1	2	1	2
June 2007	10	2	2	2	2	2	3
September 2008	22	3	3	3	2	2	3
October 2008	22	3	3	3	2	2	3
December 2008	10	3	3	3	2	2	3
September 2009	22	3	3	3	2	2	3
March 2010	10	4	4	4	4	4	4
September 2010	22	4	4	4	4	4	4
December 2010	10	4	4	4	4	5	4
June 2011	22	5	5	5	5	5	5

***Examination information provided by NCUA's Region V.*

We determined that in the examinations where Chetco's Composite CAMEL rating was 3 or greater, the NCUA took appropriate actions and notified Credit Union management of the weaknesses observed and the mandatory actions required under NCUA's Rules and Regulations Manual, which included requiring the Credit Union to reduce its MBL concentrations and revoke its MBL waivers. Specifically, examiners issued three DORs between September 30, 2008, and December 31, 2009, requiring, among other things, that Chetco management reduce its MBL portfolio as a percentage of net worth to 500 percent by December 31, 2009. As previously mentioned, Chetco management appealed the reduction of member business loans and the Region V RD granted the appeal. Examiners issued additional DORs and a Letter of Understanding and Agreement that increased requirements and placed additional prohibitions on management related to the MBL portfolio. Chetco management failed to follow through with required actions, which resulted in Chetco's Board acting to replace the CEO.

Insufficient Resources

Despite examiners utilizing NCUA's risk-focused exam program, which allows for reallocating budgeted hours within examinations to focus more time within any

[15] Work Classification Code (Examination Type) 10 is a regular risk focused examination of a federally chartered credit union, whereas an Examination Type 22 is an on-site risk-focused supervision contact.

particular area, Supervisory Examiners (SE) and EICs involved with examining Chetco from 2005 to 2011 indicated that sufficient resources were not always available and/or allocated to significantly expand the review of Chetco's MBL activities prior to 2009. These individuals indicated that the hours allotted to supervision contacts and examinations included hours focused on a variety of risk factors beyond the concentration risk in the MBL portfolio and included reviewing asset liability management, liquidity, and consumer compliance activities. Additionally, based on discussions with Region V management officials, during 2007 and 2008 Region V experienced an unprecedented influx of troubled credit unions, which required the Region's complete attention and resources. With a finite amount of total resource capacity, Region V management explained they made resource allocation decisions to focus on identified critical situations in other areas of the region, which ultimately limited the total hours allocated to the supervision of Chetco because examiners had not identified the risks related to its MBL credit quality and concentrations at that time.

We learned during one interview with a Region V employee that this resulted in sometimes less than 100 hours devoted to analyzing what had become an increasingly complex MBL portfolio as the concentration grew from 2002 through 2010. Although our review of the examination effective March 31, 2010 reflected a significant increase in the number of hours focused on the MBL portfolio, at that point, significant risk already existed within the portfolio and delinquencies and losses were mounting. In situations where management takes action to mask problems and the credits are complex in nature, we believe a review of a relatively small sample of loans – as was the case during this examination – is less likely to early identify increased risks and credit quality concerns within a portfolio. Table 3 (below) illustrates the relationship between the hours utilized during each contact as compared to MBL growth and changes in CAMEL ratings and net worth comparisons. Specifically, the credit union's MBL portfolio grew from just over $33 million as of June 30, 2002 to $182 million as of December 31, 2008. During the same period, MBLs as a percentage of net worth grew from 263 percent to 632 percent, yet the total number of hours allotted to the examination only increased 20 hours from 241 to 261.

Table 3:

Exam Date	Exam Type	Composite Camel Rating	Total Exam Hours	Total Net Worth	Net Worth	Risk Based Net Worth	Total MBL	Unfunded Commitments	MBLs Net of Unfunded Commitments	MBL as % of Net Worth	Net MBLs as % of Net Worth
6/30/2002	10	2	241	$ 12,655,681	9.26%	6.80%	$ 33,286,479	$ 1,442,560	$ 31,843,919	263%	252%
12/31/2003	22	2	87	$ 16,890,230	8.95%	7.44%	$ 53,515,310	$ 5,301,757	$ 48,213,553	317%	285%
3/31/2004	10	2	248	$ 17,486,005	8.87%	6.40%	$ 66,423,840	$ 4,277,850	$ 62,145,990	380%	355%
12/31/2005	10	1	272	$ 21,882,887	8.64%	7.63%	$ 119,169,494	$ 10,480,124	$ 108,689,370	545%	497%
6/30/2007	10	2	237.9	$ 25,877,926	8.37%	8.01%	$ 151,798,780	$ 15,446,989	$ 136,351,791	587%	527%
9/30/2008	22	3	56	$ 29,702,572	8.63%	8.33%	$ 183,782,781	$ 11,287,235	$ 172,495,546	619%	581%
10/1/2008	22	3	14	$ 29,702,572	8.63%	8.33%	$ 183,782,781	$ 11,287,235	$ 172,495,546	619%	581%
12/31/2008	10	3	261	$ 28,906,729	8.31%	8.18%	$ 182,563,562	$ 6,970,315	$ 175,593,247	632%	607%
9/30/2009	22	3	116.5	$ 33,844,941	9.44%	8.19%	$ 193,366,542	$ 20,437,542	$ 172,929,000	571%	511%
3/31/2010	10	4	381	$ 34,578,646	9.42%	8.18%	$ 212,958,169	$ 27,394,065	$ 185,564,104	616%	537%
9/30/2010	22	4	291	$ 31,137,490	8.48%	6.97%	$ 193,843,315	$ 8,164,269	$ 185,679,046	623%	596%
12/31/2010	10	4	439.5	$ 16,690,328	5.01%	7.18%	$ 189,417,108	$ 5,182,425	$ 184,234,683	1135%	1104%

<u>Lack of Examination Scope Related to MBL Renewals and Modifications</u>

Based on discussions with the SEs and EICs involved with supervising Chetco between 2005 and 2011, we concluded that the scope of the examinations did not focus on MBL renewals and modifications for appropriateness and proper underwriting. Chetco's delinquency rate was less than 1 percent until 2008. Chetco was able to maintain a lower level of delinquencies by renewing and modifying delinquent loans, thus managing the system to make the delinquent loans appear current on system reports. As previously noted, because the examination process did not include robust analysis of renewed and modified loans, Region V did not detect that Chetco management had been asking members to pay interest for an unrelated MBL relationship to mask the delinquent status until NCUA received a member complaint in 2008.

Although this was the first indication of potentially hidden problem credits, subsequent examinations identified that Chetco management appeared to be actively modifying problem credits to mask delinquencies. The examiners later issued a DOR prohibiting management's actions related to modifying and renewing problem loans. We determined examiners did not identify Chetco management's actions through standard ratio analysis. We believe that, had the 2008 or earlier examinations included an in-depth review of Chetco's loan modification practices, the likelihood that examiners would identify this activity earlier would have increased. In addition to a review of its modification practices, other types of analysis might have detected similar behaviors, such as performing a trend analysis on the number of modifications performed on loans without principle reductions.

Lack of Formal Training Revolving Around Complex Commercial Credits and Problem Loan Identification

Based on discussions with SEs and EICs involved with Chetco between 2005 and 2011, we concluded there was a lack of understanding and specialized training for staff regarding the complexity surrounding the origination and monitoring of member business loans. Although it is evident that the EIC had experience with member business credits, we learned much of the training the EIC received he obtained "on the job" and did not involve receiving instruction through a formal NCUA MBL training program. Although "on the job" training and experience is very valuable, we believe in situations where credit union management may be masking problems, there is greater risk examiners may not detect these behaviors or they may rationalize them due to the lack of familiarity with the circumstances.

NCUA's Division of Training and Development (DTD) includes a core curriculum of courses on member business lending that increases in complexity. We learned that DTD officials routinely make changes to these courses based upon changes to the laws, regulations, and industry. We obtained the training records for the EIC involved in supervising Chetco from 2005 to 2011 going as far back as 1999 and observed no training specific to member business lending. We believe had the EIC received the core curriculum of MBL training courses, there would have been a greater likelihood that the credit quality and concentration risk concerns would have likely been identified much sooner. Additionally, in response to industry changes at the time, NCUA created specialized positions (Regional Lending Specialist) in 2010 to help provide more expertise in the lending area.

Based on the lack of formal training identified above, we suggest NCUA management ensure that during the Individual Development Plan process, supervisors perform a review of the training courses completed by examiners to ensure that the courses taken are in connection with their assigned responsibilities and to determine whether examiners have been exposed to the right mixture of course material. The objective of the training review should be to ensure that examiners have sufficient and current knowledge related to the critical risk conditions of the credit union they are examining. When critical changes occur in the industry or in the content of courses previously taken, examiners should consider re-taking those refreshed courses.

OBSERVATIONS

Important observations from our review of Chetco include:

- Identifying and understanding the complexity and risks associated with member business lending is essential to applying the risk-focused exam program procedures effectively. NCUA created specialized positions (Regional Lending Specialist) in 2010 to help provide more expertise in the lending area.

- The examination scope should include procedures over member business loan activities involving renewals, modifications, and extensions in order to validate that these activities are properly documented, underwritten, and approved in accordance with safety and soundness guidelines. As observed with Chetco, credit union management can use these activities to mask loan delinquencies.

  In May 2012, NCUA revised 12 CFR Part 741 and added on Appendix C: "Interpretive Ruling and Policy Statement on Loan Workouts and Non-accrual Policy and Regulatory Reporting of Troubled Debt Restructured Loans," to acknowledge the economic situations impacting the lending function and asset quality of the industry. The requirements outlined in this regulation became effective during the fourth quarter of 2012. The data first became available to field examiners through the 5300 Call Report with the completion of the December 31, 2012 regulatory reports. Subsequently, in April 2013, NCUA issued Supervisory Guidance on TDR[16] to all field staff, which requires federally insured credit unions to incorporate the following into their lending programs:

  - Develop a written loan workout policy;
  - Establish monitoring requirements over loan workouts;
  - Report to regulatory agencies loans in workout status, including past due TDRs;
  - Place loans on non-accrual status when loans are past due 90 days unless the loan is "well secured" and "in the process of collection;" and
  - Return the member business loan to accrual status only after the credit union can document a current credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms.

  The Supervisory Letter also established a uniform examination approach to reviewing loan workouts, nonaccruals, and regulatory reporting of TDR loans. Additionally, it provided specific guidance for evaluating whether credit unions are following applicable regulatory requirements in administering a sound loan workout program.

[16] Supervisory Letter No. 13-02.

Appendix A - Management Response

National Credit Union Administration

E&I/RMB:RMB
SSIC 1920

SENT BY E-MAIL

TO: Inspector General James Hagen

FROM: Executive Director Mark Treichel

SUBJ: Comments on Material Loss Review of Chetco Federal Credit Union #12047

DATE: September 25, 2013

This memorandum responds to your request for official comments on the Office of Inspector General's (OIG) draft report titled Material Loss Review (MLR) of Chetco Federal Credit Union #12047.

The MLR includes one suggestion outlined below with our response:

> *Ensure that during the Individual Development Plan (IDP) process, supervisors perform a review of the training courses completed by examiners to ensure that the courses taken are in connection with their assigned responsibilities and to determine whether examiners have been exposed to the right mixture of course material. When critical changes occur in the industry or in the content of courses previously taken, examiners should consider re-taking those refreshed courses.*
>
> **Management Response:** We agree with this suggestion. We recognize the importance of supervisors reviewing the completion of training courses to identify future training and development needs unique to employees. The Talent Management Council charged a subcommittee to look at the IDP process. We will ensure the subcommittee is aware of this suggestion.

The observations identify improvements NCUA has already made to the exam procedures for identifying and understanding the complexity and risks associated with member business lending and the procedures over member business lending for renewals, modifications, and extensions. In addition, implementation of the National Supervision Policy Manual (NSPM) led to improvements in documenting the review of Member Business Loan (MBL) waivers and revocations when necessary. We noted Region V implemented the periodic waiver review process in 2009, prior to the implementation of the NSPM.

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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.

cc: DED Kutchey
DEI Fazio
DDEI Segerson
DRM Komyathy
RD Whitehead
ARDO Freed
ARDP Dyer
OIG Senior Auditor Bruns
AMAC President Barton
GC McKenna
LRAO Barr