NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF CHESTER UPLAND SCHOOL EMPLOYEES, O P S EMP, ELECTRICAL INSPECTORS, TRIANGLE INTERESTS % SERVICE CENTER, CARDOZO LODGE, AND SERVCO FEDERAL CREDIT UNIONS

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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of Chester Upland School Employees Federal Credit Union (Chester), O P S EMP Federal Credit Union (OPS), Electrical Inspectors Federal Credit Union (Electrical), Triangle Interests % Service Center Federal Credit Union (Triangle), Cardozo Lodge Federal Credit Union (Cardozo) and Servco Federal Credit Union (Servco) (collectively "the Credit Unions"), six federally insured credit unions. We reviewed the Credit Unions to: (1) determine the cause(s) of the Credit Unions' failures and the resulting estimated $3.2 million loss to the National Credit Union Share Insurance Fund (Share Insurance Fund); (2) assess NCUA's supervision of the Credit Unions; and (3) provide appropriate suggestions and/or recommendations to prevent future losses.

To achieve these objectives, we analyzed NCUA examination and supervision reports, as well as related correspondence, for the period January 2014 through April 2016. We interviewed NCUA officials and regional staff, and reviewed NCUA guidance, including regional policies and procedures and NCUA 5300 Call Reports (Call Reports).

We determined the Credit Unions failed due to overstatement of approximately $3.2 million in assets, primarily investments in certificates of deposit (CDs), allegedly due to fraud. According to the Call Reports filed just prior to the discovery of the alleged fraud and information provided by NCUA's Asset Management and Assistance Center (AMAC) from immediately after, the Credit Unions reported total assets and total investments as follows:

Assets and Investments by Credit Union				
	December 31, 2015 Call Report Data		December 31, 2015 AMAC Data	
Credit Union	**Total Assets**	**Total Investments**	**Total Assets**	**Total Investments**
Chester	$827,269	$321,124	$433,343	$0
OPS	$1,182,927	$927,635	$258,279	$0
Electrical	$65,894	$39,149	$23,906	$0
Triangle	$290,098	$247,750	$51,806	$0
Cardozo	$226,485	$163,576	$64,485	$0
Servco	$2,193,229	$1,710,467	$1,009,015	$0
Total	$4,785,902	$3,409,701	$1,840,834	$0

Region II Officials determined the Credit Unions to be insolvent and executed liquidation orders for each Credit Union on April 5, 2016.

The following factors created an environment in which such overstatement could go undetected.

- Questionable Management Integrity and Performance

Management displayed a lack of integrity and did not manage the Credit Unions in the best interest of their members. Examiners identified $2.8 million in discrepancies between the February 29, 2016 investment statements provided by the employee of Service Center for Credit Unions (SCCU), and the confirmations from the related institutions. NCUA examiners later determined that Credit Union management had overstated assets at all six of the Credit Unions by approximately $3.2 million in total.

- Weak Supervisory Committee Oversight

The Supervisory Committees failed to obtain Supervisory Committee Audits that included confirmation of investments, the most material asset of the Credit Unions.

- Weak Board of Directors Oversight

Although the Supervisory Committee is the entity charged with primary responsibility over the records of the Credit Union, the Board of Directors is responsible for the general direction and control of the affairs of the Credit Union. The Board of Directors exhibits control over the Supervisory Committee by providing a forum for receiving the audit report and minutes of the Committee meetings. We believe the Credit Unions' Boards of Directors failed in these responsibilities as evidenced by the Boards' failure to review Supervisory Committee Audits.

We concluded that these factors created an environment in which the overstatement of assets went undetected.

We also determined NCUA may have identified the alleged fraud sooner and mitigated the loss to the Share Insurance Fund had they followed National Supervision policies and identified the Supervisory Committee Audits as unacceptable, confirmed account balances directly with institutions,[1] and addressed risks related to the failures of the Supervisory Committees and Boards of Directors.

As a result of our review, we are making five observations and two recommendations to NCUA management related to strengthening oversight in the Supervisory Committee Audits and clarifying examination procedures related to NCUA's Small Credit Union Examination Program (SCUEP).

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

[1] Examination procedures prior to March 2015 did not require this procedure.

BACKGROUND

The NCUA OIG contracted with Moss Adams to conduct an MLR for the Credit Unions as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). The Credit Unions were federally chartered and located in Bensalem and Chester, Pennsylvania. NCUA's Region II provided supervision over the Credit Unions.

General History of the Credit Unions

All six Credit Unions outsourced the management, recordkeeping, and maintenance of financial records to a third party provider, Service Center for Credit Unions, Inc. (SCCU), in Bensalem, Pennsylvania. SCCU had one location.

SCCU had been servicing credit unions in the Bensalem, Pennsylvania and surrounding areas since 1971. They offered services such as data processing, recordkeeping, financial reporting, management functions, and Board of Directors meeting minutes.

Within this report, all references to the Credit Unions' management are referring to SCCU, and specifically the manager of SCCU.[2]

History of Cardozo Lodge Federal Credit Union

NCUA chartered Cardozo Lodge Federal Credit Union in 1960. Cardozo primarily served regular members of the Cardozo Lodge No. 400, Independent Order Brith Sholom, in Philadelphia and employees of Rovner, Allen, Rovner, Zimmerman, and Nash who work in Feasterville, Pennsylvania. According to its final Call Report, December 31, 2015, Cardozo reported total assets of $226 thousand and membership of 83.

Our review of NCUA examinations during the period from January 2014 to March 2016, identified that Cardozo generally received positive results, usually a CAMEL[3] Composite rating of 2. Based on our review of examiner working papers provided by NCUA Region II and additional files provided by AMAC, an external party completed Supervisory Committee Audits, on behalf of the Supervisory Committee, for the audit period April 2012 through December 2013, and January 2014 through December 2014. Our review of examination working papers determined examiners reviewed these reports.

During the examination, effective June 30, 2014, examiner working papers stated that the Supervisory Committee was inactive. They attended monthly board meetings and participated in discussions, but there was no oversight of file maintenance reports or insider accounts. The examiner in-charge (EIC) noted this was not a major concern because SCCU, who was an

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[2] We learned during the review that SCCU had few employees and only one employee, the manager, who performed almost all of the recordkeeping functions.

[3] The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.

independent third party with no interest in the Credit Union, managed the Credit Union. In the examination effective March 31, 2015, the working papers noted again that the Supervisory Committee was not involved and did not perform any reviews. However, the EIC did not issue an Examiner's Finding (EF).

During the examination, effective June 30, 2014, the EIC issued a DOR for the Supervisory Committee not meeting the requirements of no fewer than three nor more than five members, as required by the Federal Credit Union Act, IX, Section 1. The Supervisory Committee had two members. During the examination effective March 31, 2015, the DOR was noted as resolved.

AMAC provided the Supervisory Committee Audit reports and working papers for the period April 2012 through December 2013, and January 2014 through December 2014. Neither set of working papers contained copies of returned investment confirmations or evidence of the results of the confirmation procedures.

An EF in the examination, effective June 30, 2014, identified a $326 difference between the certificate of deposit (CD) report and general ledger accounts. In addition, neither balance agreed to the safekeeping receipts. During the examination, effective March 31, 2015, the EIC issued a DOR for the investment subsidiary showing a total investment balance of $193,635 for certificates of deposit and the general ledger balance showing $160,000 for certificates of deposit. The $33,635 variance was 15% of total assets as of March 31, 2015.

While on site completing the examination effective December 31, 2015, the EIC attempted to confirm the existence of the investments recorded on the general ledger. The EIC received a response from the correspondent institutions that the Cardozo investments they were attempting to confirm did not exist.

<u>History of Chester Upland School Employees Federal Credit Union</u>

NCUA chartered Chester Upland School Employees Federal Credit Union in 1939. Chester primarily served employees of the Chester Upland School District in Chester City, Chester Township, and Upland Borough in Delaware County, Pennsylvania. According to its final Call Report, December 31, 2015, Chester reported total assets of $827 thousand and membership of 593.

Our review of NCUA examinations during the scope period, January 2014 to March 2016, identified that Chester received CAMEL Composite ratings of 2 and 3. Based on our review of examiner working papers provided by NCUA Region II and additional files provided by AMAC, an external party completed Supervisory Committee Audits, on behalf of the Supervisory Committee, for the audit period January 2013 through December 2013, and January 2014 through December 2014. Our review of examination working papers determined examiners reviewed these reports.

In the examinations effective June 30, 2014, and September 30, 2014, the EIC rated Transaction Risk as high in the Examination Overview section of the Exam Reports. The support for the rating was for an inactive Supervisory Committee and a number of transaction issues that increased other areas of risk. In the examination effective December 31, 2014, the EIC rated Transaction Risk as high due to several recordkeeping concerns identified. In the examination effective September 30, 2015, Transaction Risk was still high due to management not resolving recordkeeping concerns identified in the previous contact.

During the examination effective December 31, 2014, a DOR was issued for various recordkeeping issues. Those recordkeeping issues included a variance between the March 31, 2015 investment subsidiary and general ledger balance for accrued interest. The DOR stated that the investment subsidiary must agree to the general ledger for all accounts. The EIC downgraded Chester from a CAMEL composite rating of 2 to 3 during the examination and issued a Regional Director letter dated July 1, 2015, due, in part, to the recordkeeping concerns.

The next examination, effective September 30, 2015, identified that recordkeeping issues were still a significant concern and the DOR had not been resolved. The Examiner's Findings noted that they could not verify investment balances, as management was not able to provide certificates from the banks where they purchased the CDs or an investment subsidiary ledger. In addition, an EF was included for outside services expense being $73,221 as of November 30, 2015. The comment stated that SCCU intended on reimbursing some of the amount to Chester as represented by the accounts receivable balance recorded in the general ledger. The CAMEL composite rating remained a 3.

AMAC provided the Supervisory Committee Audit reports for the period January 2013 through December 2013, and January 2014 through December 2014. Neither report contained copies of returned investment confirmations or evidence of the results of the confirmation procedures.

<u>History of Electrical Inspectors Federal Credit Union</u>

NCUA chartered Electrical Inspectors Federal Credit Union in 1976. Electrical primarily served active and associate members of the Eastern Pennsylvania Chapter, Eastern Section, International Association of Electrical Inspectors in Philadelphia, and employees of Municipal Inspection Corporation who work in Philadelphia. According to its final Call Report, December 31, 2015, Chester reported total assets of $66 thousand and membership of 44.

Our review of NCUA examinations during the scope period, January 2014 to March 2016, identified that Electrical consistently received a CAMEL Composite rating of 3. Based on our review of examiner working papers provided by NCUA Region II and additional files provided by AMAC, an external party completed Supervisory Committee Audits, on behalf of the Supervisory Committee, for the audit period January 2013 through December 2013, and January 2014 through December 2014. Our review of examination working papers determined examiners reviewed these reports. AMAC was unable to provide either of the reports for our review.

The examinations effective dated March 31, 2014, September 30, 2014, and September 30, 2015, all included EFs and DORs related to continued negative earnings. The September 30, 2015 examination included a finding for a lack of written succession plan related to SCCU.

History of O P S EMP Federal Credit Union

NCUA chartered O P S EMP Federal Credit Union in 1968. OPS primarily served employees of O.P. Schuman & Sons, Inc. who work in Warrington, Pennsylvania. According to its final Call Report, December 31, 2015, OPS reported total assets of $1.2 million and membership of 85.

Our review of NCUA examinations during the scope period, January 2014 to March 2016, identified that OPS received CAMEL Composite ratings of 2. Based on our review of examiner working papers provided by NCUA Region II and additional files provided by AMAC, an external party completed Supervisory Committee Audits, on behalf of the Supervisory Committee, for the audit period January 2013 through December 2013, and January 2014 through December 2014. Our review of examination working papers determined examiners reviewed these reports.

During the examination effective September 30, 2014, the EIC noted in the Exam Scope that the investment subsidiary ledger accrued interest did not agree to the general ledger balance. In addition, OPS management (SCCU) could not locate one of the CD statements to verify the existence and accuracy of that investment. However, the EIC traced the remaining CDs to actual CD purchases. The EIC identified the variances in accrued interest and the missing CD statement as EFs in the report. Again, in the examination, effective September 30, 2015, the EIC issued a DOR for the investment subsidiary ledger not agreeing to the general ledger for accrued interest on investments. In the same exam, there was an EF for OPS not providing an original source document for the $112,511 CD with First Trust Bank that they purchased on November 7, 2012.

AMAC provided the Supervisory Committee Audit reports for the period January 2013 through December 2013, and January 2014 through December 2014. Neither report contained copies of returned investment confirmations or evidence of the results of the confirmation procedures. The lack of investment confirmations was noted by the EIC as an Examiner's Finding in the examination effective September 30, 2015. The EIC noted a few exceptions during the audit work paper review for the December 31, 2014 audit. Specifically, the audit report stated that confirmation letters had been sent to the credit union depository and investment accounts and when they were returned, they would be maintained in the auditor's files. The auditor was not a member of the Supervisory Committee. The EIC stated that OPS should request a copy of the confirmation letters for verification.

In both the examination effective September 30, 2014, and September 30, 2015, the EIC noted that the Supervisory Committee was not involved in the oversight of OPS and that formal minutes were not maintained by the Supervisory Committee.

There was an EF in the examination effective September 30, 2015, for the lack of a written contract with SCCU. Both the examination effective September 30, 2014, and September 30, 2015, noted that a review of internal controls during the examination was not required because SCCU, an independent third party, maintained all of the records of OPS.

History of Servco Federal Credit Union

NCUA chartered Servco Federal Credit Union in 1950. Servco served various groups in Delaware, New Jersey, New York, and Pennsylvania. According to its final Call Report, December 31, 2015, Servco reported total assets of $2.2 million and membership of 795.

Our review of NCUA identified that Servco received CAMEL Composite ratings of 2, 3, and 4. Based on our review of examiner working papers provided by NCUA Region II and additional files provided by AMAC, the Supervisory Committee chairperson completed Supervisory Committee Audits for the period January 2013 through December 2013, and January 2014 through December 2014. Our review of examination working papers determined examiners reviewed these reports.

During the examination effective September 30, 2014, Servco had a CAMEL composite rating of 2. There were no significant recordkeeping issues or management concerns identified in the Examiner's Findings. During the next examination, effective September 30, 2015, the EIC identified significant recordkeeping issues. The EIC originally scheduled the on-site exam procedures for September 8, 2015. The EIC rescheduled the examination three times due to the manager of SCCU having no items ready. In the Examination Overview section of the report, the EIC noted recordkeeping concerns that were severe and ongoing for several months despite keeping the examination open for an extended period. The EIC required Servco to have an agreed-upon procedures audit performed by a certified public accountant (CPA) effective December 31, 2015, and to have all recordkeeping concerns fully corrected as of December 31, 2015. Examiners issued a DOR related to the recordkeeping issues.

The September 30, 2015 examination noted in the Examination Overview that SCCU manages Servco, but that the Board of Directors is ultimately responsible for Servco. It also noted activity in two related party accounts, the personal account of the manager of SCCU and the SCCU account. The manager frequently overdrew these accounts despite Servco not having an overdraft program. As noted in the Supervision Chronology Report, the EIC determined the manager of SCCU was frequently overdrawing her account and SCCU's account with Servco. The EIC noted the manager of SCCU made an adjusting entry to the accounts at month end to bring the accounts current, sometimes by posting transactions to the general ledger.

The examiner initiated a Regional Director Letter (RDL), with a planned follow-up in 60 days. In processing the request, however, the Region II Division of Supervision (DOS) identified numerous red flags of potential fraudulent activities. DOS concerns resulted in field staff conducting on-site contacts at all credit unions managed by SCCU during the first quarter of 2016.

Based on discussions with DOS, because of the review of the RDL and the significant red flags identified, they reviewed the most recent examination for all credit unions managed by SCCU. In January 2016, DOS identified seven credit unions managed by SCCU that had similar recordkeeping concerns in their most recent examinations. Six of the seven credit unions are the subjects of this Material Loss Review.

During the examination effective December 31, 2015, Servco was downgraded to a CAMEL composite rating 4. Significant weaknesses with accounting and recordkeeping were still present. The EIC noted in the Examination Overview that the Board and Supervisory Committee were unaware of these issues until the NCUA's examination. Management did not provide investment statements to verify investment balances. In addition, the EIC identified a non-member deposit for $100,000, which they verified with the correspondent credit union; however, the non-member deposit did not appear on the Automated Integrated Regulatory Examination System (AIRES) download or on the general ledger. The Credit Union maintained a line of credit with Mid-Atlantic Federal Credit Union for liquidity purposes. Servco had fully drawn on the line of credit with Mid-Atlantic Federal Credit Union. The EIC noted in the Examiner's Findings that the Credit Union had fully drawn on the line of credit. Servco had first drawn on the line of credit in June 2015, but they had not reported any borrowings or interest on borrowed funds on the financial statements.

On February 25, 2016, field staff issued a Letter of Understanding and Agreement (LUA) to Servco. The LUA set forth significant recordkeeping weaknesses and concerns regarding insider account activity identified by the NCUA during the December 31, 2015 follow-up examination.

History of Triangle Interests % Service Center Federal Credit Union

NCUA chartered Triangle Interests % Service Center Federal Credit Union in 1995. Triangle primarily served natural person members of Triangle Interests headquartered in Philadelphia. According to its final Call Report, December 31, 2015, Triangle reported total assets of $290 thousand and membership of 99.

Our review of NCUA examinations between January 2014 and March 2016 identified that Triangle received CAMEL Composite ratings of 3. Based on our review of examiner working papers provided by NCUA Region II and additional files provided by AMAC, an external party completed Supervisory Committee Audits, on behalf of the Supervisory Committee, for the audit period from January 2013 through December 2013, and January 2014 through December 2014. Our review of examination working papers determined examiners reviewed these reports.

During the examination, effective September 30, 2014, the EIC noted in the Confidential section that Triangle was downgraded to a composite CAMEL rating of 3. The EIC had originally scheduled the examination for November 26, 2014, but the manager was not prepared and was reported ill. The EIC rescheduled for December 15, 2014, and the manager was still not prepared; however, she performed the examination. The examination identified significant recordkeeping concerns that warranted a DOR. Investment balances in the investment subsidiary, general ledger and Call Report were all different. The general ledger balance was $262,557 and the Call Report was $233,527. The total variance was $29,030, or 12% of total investments reported on the Call Report. During the follow-up examination effective December 31, 2015, all recordkeeping issues had been deemed resolved and transaction risk was decreased from high to moderate.

During the examination effective September 30, 2014, examiners issued a DOR for Triangle accessing their line of credit with Mid-Atlantic Federal Credit Union instead of allowing the investment CDs to mature as a source of liquidity. Triangle maintained the line of credit for liquidity purposes. During the follow-up examination effective December 31, 2014, the EIC determined that management had again renewed the CDs.

AMAC provided the Supervisory Committee Audit reports for the period January 2013 through December 2013, and January 2014 through December 2014. Neither report contained copies of returned investment confirmations or evidence of the results of the confirmation procedures. The EIC noted the lack of investment confirmations as an EF in the examination effective June 30, 2015. The EIC noted that the most recent Supervisory Committee Audit report, as of December 31, 2014, stated that confirmation letters had been sent to the credit union depository and investment accounts and when they were returned, they would be maintained in the auditor's files. The auditor was not a member of the Supervisory Committee. The EIC stated that Triangle should request a copy of the confirmation letters for verification.

Supervisory Committee Audits

During our review, we noted that one individual performed the Supervisory Committee Audits on behalf of the committees for five of the six Credit Unions. The Supervisory Committee chairperson completed Servco's Supervisory Committee Audits. Based on the information provided in the Supervisory Committee Audit reports and working papers, the individual performing the procedures was not a certified public accountant or affiliated with an established company. The examiners' working papers provided limited information regarding the procedures they performed to determine the independence and qualifications of the individual performing the Supervisory Committee Audits.

In addition, the examiners' working papers across the five Credit Unions had conflicting documentation of the type of audit this individual was performing. The Supervisory Committee Audit reports showed that the individual performed the same type of procedures for the five Credit Unions in 2013 and 2014. Examiners inaccurately and inconsistently documented the type of audits that were being performed. Listed below are the five Credit Unions and the audit type as documented by the examiners' in their working papers.

	Audit Type per Examiners' Working papers	
Credit Union	**Audit effective December 31, 2013**	**Audit effective December 31, 2014**
Chester	Agreed upon procedures audit performed by CPA	Non-opinion audit performed by other external auditor
OPS	Non-opinion audit performed by other external auditor	Non-opinion audit performed by supervisory committee or designated staff
Electrical	Non-opinion audit performed by supervisory committee or designated staff	Non-opinion audit performed by other external auditor
Triangle	Agreed upon procedures audit performed by CPA	Non-opinion audit performed by supervisory committee or designated staff
Cardozo	Non-opinion audit performed by supervisory committee or designated staff	Non-opinion audit performed by other external auditor

Identification of Alleged Fraud

During the on-site examination for Cardozo in February 2016, the EIC attempted to confirm investment CDs directly with the correspondent institutions, as required by SCUEP procedures. On March 1, 2016, the EIC received returned investment confirmations from the correspondent institution indicating there were no known CDs for Cardozo at their institution.

On March 21, 2016, the EIC and Supervisory Examiner (SE) went to the correspondent institution to discuss the returned investment confirmation. The EIC brought the CD statement that the SCCU manager had provided as support. The representative at the institution indicated there was no record of deposit for Cardozo, and upon review of the statement the EIC provided, the representative pointed out inconsistencies in the document that indicated the statements were not originals.

The EIC then went to SCCU and requested all CD statements. Based on discussions with examiners, the SCCU employee presented what appeared to be altered CDs and a thumb drive containing CD templates that appeared to be used to create fraudulent CD statements.

Regional management immediately directed all field staff of the Credit Unions managed by SCCU to independently verify all Credit Union investments. After confirming all investments, Region II determined approximately $3.2 million in total overstated assets for all six Credit Unions.

NCUA's Board liquidated the Credit Unions on April 5, 2016. NCUA estimates the loss to the Share Insurance Fund at approximately $3 million. The actual cost of the failures will be known after all assets are sold, potential bond claims paid, and any restitution collected.

NCUA Examination Process

Total Analysis Process

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.

NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the Share Insurance Fund, and for identifying those institutions requiring special supervisory attention or concern. 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. At the conclusion of an examination, examiners assign a CAMEL rating.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[4] trend analysis,[5] reasonableness analysis,[6] variable data analysis,[7] and qualitative data analysis.[8] 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. NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, 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.

[4] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.
[5] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.
[6] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.
[7] 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.
[8] Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the Credit Union's current condition, and its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.

Risk-Focused Examination Program

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic,* and *Reputation*. Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Reports as well as the risks detected in the credit union's operations and in management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

- Review of quarterly Financial Performance, Risk, and Call Reports;
- Communication with credit union staff; and
- Knowledge of current events affecting the credit union.

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the Annual Examination Scheduling Program (AEP).[9] NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the Annual Program would provide more timely, relevant, qualitative, and quantitative data to recognize any sudden turn in a credit union's performance.

In 2009, NCUA developed a new examination policy[10] that resulted in additional minimum required examination procedures based on a national review of risk. The policy directed a periodic national review of risk issues and adjustment to the minimum review procedures. NCUA indicated the intent of the policy was to shape its examination and supervision program to consistently identify and mitigate emerging risks in response to changing environmental factors within the credit union industry. As a result of this policy, E&I, with input from the regions, now updates the minimum scope procedures, as necessary, by focusing on emerging risks, risk monitoring observations, results of quality control reviews, regulatory changes, and lessons learned from NCUA OIG Material Loss Reviews. NCUA reviews and updates the minimum examination scoping steps on an annual basis.

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[9] The AEP requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling availability.

[10] NCUA revised this policy multiple times with Instruction No. 5000.20 (rev. 4), *Risk-Focused Examinations – Minimum Scope Requirements*, on June 25, 2012, Instruction No. 5000.20 (Rev. 5), *Risk-Focused Examination Scope*, on February 5, 2014, Instruction No. 5000.20 (Rev. 6), *Examination Scope*, on January 26, 2015, and Instruction No. 5000.20 (Rev. 7), *Examination Scope*, on January 14, 2016.

Small Credit Union Examination Program

In 2011, NCUA's Region I piloted the SCUEP to determine whether examination resources could be better aligned with industry risks. Essentially, the SCUEP expanded the minimum required examination scope for nationally identified areas of elevated risk and reduced the minimum required examination scope in CAMEL 1, 2, or 3 Federal Credit Unions with less than $10 million in total assets.

Based on the success of the pilot, NCUA established the SCUEP on a national basis in January 2012. NCUA officials indicated that the new scope requirements supplement existing RFE practices and do not replace the examiner's judgment and responsibility to refine and adjust their scope, noting that examiners should continue to follow the concepts of the RFE process outlined in the Examiner's Guide for areas of elevated risk.

In 2015, the NCUA issued instructions that established requirements for defined-scope examination with tiered procedures for SCUEP-eligible federal credit unions. Effective in 2015,[11] SCUEP exams were required to focus resources on the areas that presented the greatest potential risk to the National Credit Union Share Insurance Fund in those institutions: internal controls, recordkeeping, and lending.

[11] NCUA required field staff to complete the small credit union examination training before they could perform a SCUEP defined-scope examination. Based on discussions with Region II, field staff completed training in March 2015.

RESULTS IN DETAIL

We determined that the Credit Unions failed due to alleged fraudulent activities by management of approximately $3.2 million in Credit Union assets, primarily through the creation of fictitious certificates of deposit held as investments. Once NCUA staff uncovered the fraudulent activities, they determined the Credit Unions to be insolvent and liquidated them within two weeks of discovery. NCUA Region II assigned AMAC as liquidating agent per the *Notice of Involuntary Liquidation and Revocation of Charter*.

Contributing factors included issues with management integrity, lack of functioning Supervisory Committees, and failure of the Boards of Directors to perform their duties related to the general direction and control of the affairs of the Credit Unions.

A. Why the Credit Unions Failed

Management's Actions Caused the Credit Unions to Fail

We determined that management's alleged fraudulent activities, primarily related to investments, caused the Credit Unions to fail. Highlighted below are the specific factors that we believe allowed this fraud to remain undetected for an extended period of time.

<u>Management Integrity and Performance Issues</u>

We determined the Credit Unions' management, specifically SCCU, did not conduct the business of the Credit Unions in the best interest of its members. Specifically, examiners discovered assets overstated by approximately $3.2 million, including $3 million of investments in CDs.

NCUA Region II examiners discovered numerous physical items that SCCU management could have used to forge bank statements and records. Examples included various types of bank statement templates that management would not have used in the normal course of the Credit Unions' business in hard copy format and electronically on a thumb drive. Through our review of examination working papers and later corroborated in interviews, we determined NCUA regional management and examiners agreed that the falsified statements SCCU prepared appeared authentic. Several interviewees informed us that the manager of SCCU performed almost all recordkeeping functions at SCCU, including posting of journal entries. They believe it was probable that the manager knew of the alleged fraud. This assertion is supported based on the small size of SCCU and the level of involvement in the recordkeeping functions by the manager.

Weak Supervisory Committees

Examiners documented the Supervisory Committees of several of the Credit Unions as weak and inactive. This is consistent with interviews and our review of minutes of the Board of Directors. There were no Supervisory Committee minutes available for any of the Credit Unions or references to an active Supervisory Committee based on our review of the minutes of the Boards of Directors. The Supervisory Committees performed or obtained Supervisory Committee Audits as required under Part 715 of the NCUA Rules and Regulations for fiscal years ended 2013 and 2014; however, they failed to ensure the procedures completed were appropriate and sufficient.

We reviewed the Supervisory Committee Audit reports for the Credit Unions for the fiscal years ended December 31, 2013, and December 31, 2014, as provided by AMAC. AMAC was unable to provide Supervisory Committee Audit reports for Electrical for 2013 and 2014 and Triangle for 2014. We did note from our review of examination working papers that examiners reviewed those reports.

Based upon our review of the Supervisory Committee Audit reports, audit procedures over material portions of the Credit Unions' assets were not supported in the working papers, nor was there any evidence that the procedures were actually completed. None of the reports for 2013 and 2014 had any returned investment confirmations. The cover page of the reports contained this message, or a message of a nearly identical nature:

> "Confirmation letters have been sent to the credit unions depository and investment accounts. When they are returned and verified I will keep them in my file. Any discrepancies will be reported directly to the chairperson of the Supervisory Committee."

The Supervisory Committee failed in its requirement to confirm investment accounts, or to ensure the third party hired to perform the procedures confirmed the accounts, as required by NCUA Supervisory Committee Guide, Chapter 7.

In addition, the individual who prepared the report did not sign most of the reports we reviewed. For the audits effective December 31, 2013, three of the five reports we reviewed were not signed. For the audits effective December 31, 2014, none of the four reports we reviewed were signed. We saw no mention of the reports being unsigned in the examiners' working papers. During the investigation leading up to the liquidation, examiners found a stamp with the auditor's signature on it at the SCCU offices as well as electronic versions of some audit reports on USB thumb drives.

Weak Board of Directors Oversight

We determined the Credit Unions' Boards of Directors failed in their duties as required under NCUA Rules and Regulations. NCUA Rules and Regulations Part 715.10 require the Supervisory Committee to present the completed audit report to the Board of Directors. Our review of the Board minutes determined the Supervisory Committee of Triangle presented the Supervisory Committee Audit Reports for 2013 and 2014. None of the other five Credit Unions' Board minutes document that the Supervisory Committees presented the audit reports for 2013 or 2014.

During the examination for Triangle effective June 30, 2015, and OPS effective September 30, 2015, examiners issued EFs for lack of returned confirmation letters in the Supervisory Committee Audit report's supporting work papers. The examiners recommended OPS and Triangle obtain copies of the confirmation letters sent and the returned letters. We noted nothing in the Board of Directors minutes to indicate they followed these recommendations.

Our review of the Credit Unions' Board of Directors minutes revealed a lack of detail regarding the Board Members' activities in directing and controlling the affairs of the Credit Unions. Many of the minutes were very similar month over month and lacked detailed financial discussion.[12] The Board minutes also revealed their failure to review and discuss the findings of the NCUA examination reports. During February 2016, the Servco minutes summarized the issuance of the LUA. The Chester minutes had one reference to an exam report that the Board reviewed; however, no detail was included in the minutes as to the nature of the exam findings or DORs, or the Board's plans to address them. Electrical's minutes made one reference to when an examiner was present at the meeting and went over the report. There were no other references to NCUA examination reports in any of the other Credit Union Board minutes.

The Boards of Directors failed to manage the relationship between the Credit Unions and the SCCU. Based on our review of the examinations and Board minutes, there is no evidence that there was a written contract between any of the Credit Unions and SCCU. During the Cardozo examination effective March 31, 2015, the examiner issued an EF related to the lack of a written contract. For the examinations effective September 30, 2015, OPS and Servco both received DORs related to the same issue. Our review of the Board minutes revealed no discussion of a written contract with SCCU.

[12] AMAC furnished the minutes of the Boards of Directors. There were no financial reports or attachments provided with the minutes.

B. NCUA's Supervision of the Credit Unions

NCUA Examiners May Have Mitigated the Loss to the Share Insurance Fund

We believe if examiners had verified investments in accordance with SCUEP procedures, they may have identified the fictitious investments earlier. In addition, we determined that examiners failed to identify Supervisory Committee Audits as unacceptable. The audits lacked support in the working papers for material sections of the audit, specifically investments. Management was able to manipulate investment statements that examiners accepted, allowing the fraudulent investments to go undetected. Finally, we learned that examiners failed to hold the Credit Union responsible for having functioning Supervisory Committees or to address the Boards' failure in their responsibilities over the records of the Credit Unions. As a result, the fraud went undetected for an extended period of time and the Share Insurance Fund incurred a loss of approximately $3.2 million.

<u>Supervisory Background</u>

The Credit Unions received CAMEL Composite ratings of 2 and 3 for most of the period of our review. The NCUA issued a Letter of Understanding and Agreement to Servco on February 25, 2016. The LUA set forth significant recordkeeping weaknesses and insider account activity concerns identified by NCUA because of the follow-up examination of Servco with an effective date of December 31, 2015.

Region II executed a *Notice of Involuntary Liquidation and Revocation of Charter* effective April 5, 2016. The tables below provide Composite and specific CAMEL ratings for the applicable examinations during the scope period of our review.

NCUA Examination Results for Cardozo**							
Examination Effective Date	Exam Type [13]	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
March 2015	10	2	1	3	2	3	2
June 2014	10	2	1	3	2	3	2

[13] Work Classification Code (WCC) Examination Type 10 is a regular examination or insurance review of a federally chartered credit union and Type 22 is an on-site supervision contact of a federally chartered credit union.

NCUA Examination Results for Servco**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2015	22	4	3	3	4	3	4
September 2015	10	3	2	3	3	3	2
September 2014	10	2	1	3	2	2	2

NCUA Examination Results for Chester**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
September 2015	10	3	3	3	3	3	2
December 2014	22	3	2	3	3	3	2
September 2014	10	2	2	3	2	3	2
June 2014	22	2	2	3	2	3	2

NCUA Examination Results for Electrical**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
September 2015	10	3	2	2	2	4	2
September 2014	10	3	2	2	2	4	2
March 2014	22	3	2	2	2	4	2

NCUA Examination Results for Triangle**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
June 2015	10	3	1	2	3	2	3
March 2015	22	3	1	2	3	2	3
December 2014	22	3	1	2	3	2	2
September 2014	10	3	1	2	3	2	2

NCUA Examination Results for OPS**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2015	22	2	1	2	3	3	3
September 2015	10	2	1	2	3	3	3
September 2014	10	2	1	2	2	3	2

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

<u>Failure to Verify Institutional Balances</u>

Based on our review of examination working papers and interviews, examiners failed to verify institutional balances in a timely manner as required under SCUEP procedures.

NCUA Instruction No. 5000.20 (Rev. 6) issued on January 26, 2015, established exam requirements for federally insured credit unions that were SCUEP eligible (asset size of less than $30 million and CAMEL rating 1, 2, and 3). The SCUEP exam procedures were effective in 2015, with the caveat that field staff had to complete the small credit union examination training before they could perform a SCUEP defined-scope examination. Based on discussions with Region II, their examiners received SCUEP training in March 2015. All six of the Credit Unions had a full scope examination with an effective date between March 31, 2015 and September 30, 2015.

The SCUEP procedures require examiners to:

> "…Confirm a sample of investment balances by observing while the credit union manager or staff downloads statements from the Internet; requesting that financial institutions, brokers, or safekeepers fax statements or safekeeping receipts directly to your RightFax number; or confirming the balances by phone."

We noted that if examiners were requesting information directly from financial institutions, brokers, or safekeepers, they would need management's authorization to those third parties for release of information. The procedure does not address this issue. Based on discussions with NCUA management, they intend for credit union management to be involved in the verification of investments noting that these SCUEP procedures are not meant to be independent confirmation procedures. However, NCUA management expects sufficient control such as direct observation or participation by the examiner[14] to provide reasonable assurance of the information source.

Examiners failed to complete the SCUEP procedures of investment verification for all of the Credit Unions during 2015. During the Chester examination effective September 30, 2015, the examiner was unable to complete the verification of investments because the Credit Union was unable to provide certificates from the banks where Chester purchased the CDs nor a subsidiary ledger. This was included as an EF in the September 30, 2015 report. The other five Credit Unions had no documentation of a similar issue in their reports.

Examiners verified investments for the first time, among the six Credit Unions, at Cardozo during February 2016. The verification in February 2016 revealed the fictitious investments at Cardozo and led examiners to discover the fictitious investments at the other five Credit Unions. In this situation, the performance of SCUEP procedures led to the uncovering of the alleged fraud. However, the SCCU manager was not involved in the process when examiners verified the investment balances. As a result, examiners independently verified the investment balances directly with the institutions, which is not a requirement of SCUEP. We believe that independent verifications ensure the highest quality of evidence regarding the existence of investments.

Given the multiple years of unacceptable Supervisory Committee Audits, weak Board of Directors' oversight, and weak Supervisory Committees' oversight, there were pervasive risks present in the Credit Unions. We believe examiners could have performed an independent verification of the most significant portion of the Credit Unions' assets as a means of mitigating that risk. Further, we believe that SCUEP should require independent verification of investments by the examiners in order to ensure the highest quality of evidence regarding the existence of investments. We believe had examiners independently confirmed investments with the correspondent institutions, they would likely have discovered the fictitious investments sooner. Therefore, we are making the following recommendation to management:

We recommend NCUA management:

1. Revise procedures in the Small Credit Union Examination Program to require an independent verification of investment balances when the examiner determines the verification performed during the audit was inadequate or was not performed, and risk factors related to investments are material.

[14] Examples would include requiring management to log into the credit union's online investment account and display the balances or an archived account statement while the examiner observes this online transaction.

Management Response

Management agreed with the recommendation and to address the issue, plans to revise the Small Credit Union Examination Program by December 31, 2017.

OIG Response

We concur with management's planned action.

<u>Failure to Identify Supervisory Committee Audits as Unacceptable</u>

During our review of examination working papers and the Supervisory Committee Audits provided by AMAC, we determined examiners failed to identify the Supervisory Committee Audits as unacceptable.

The NCUA Supervision Manual, chapter 2 section 3, states in part:

> "…examiners will consider an audit or verification unacceptable and develop plans of action when they determine: material parts of the audit or verification were not done, material parts of the audit or verification are not supported by work papers, material areas of credit union operations were not audited and the auditor lacks independence from the credit union."

The manual also lists the steps the examiner should take if they deem a supervisory committee audit unacceptable. It includes denoting it as a major area of concern in the Examination Overview and preparing a DOR, which provides a reasonable time for the Supervisory Committee to correct the deficiencies, among other steps.

For four out of the six Credit Unions, average investments as a percentage of total assets were greater than 70 percent.[15] The other two Credit Unions had average investments as a percentage of total assets of 36 percent and 55 percent. Based on the size of the investment balances compared to total assets of the Credit Unions' – we believe examiners should have identified investments as a material part of the Supervisory Committee audit at all six Credit Unions. Based on our review of the Supervisory Committee Audits for 2013 and 2014, we found no evidence in the working papers that the auditor confirmed investments during any of the audits.

For all of the Credit Unions during our period under review, examiners identified issues with the Supervisory Committee audits in two instances. For the Triangle examination effective June 30,

[15] Data obtained from published Call Reports. We determined the average using quarter-end data for the period January 1, 2013 to December 31, 2015.

2015, the examiner included an EF stating that the Credit Union should request a copy of the confirmation letters returned from Credit Union depository and investment accounts during the Supervisory Committee audit because they weren't included in the audit working papers. A similar EF was included in the OPS examination effective September 30, 2015. The examiners did not identify the Supervisory Committee Audits as unacceptable in either instance, nor were the findings classified as DORs.

In addition, based on the documentation in the examination working papers, examiners failed to determine the independence or qualifications of the individual performing the Supervisory Committee Audits on behalf of the committees. In reference to an audit performed by the supervisory committee or its designee, Appendix 5D of the NCUA Examiners Guide states in part:

> "…Unlike an audit performed by a CPA, professional standards governing competence and independence do not govern this type of audit."

The appendix also states that examiners are required to use similar criteria in reviewing non-CPA audits as evaluating a CPA's work. We determined the examination working papers lacked information regarding the individual that performed the audits and what their relationship was to SCCU and the Supervisory Committees.

Currently, the AIRES "SC Audit Verification Review" questionnaire does not require documentation of the examiner's consideration of the independence and qualifications of the Supervisory Committee or external auditors performing the Supervisory Committee Audit. To improve documentation and consistency, we believe the questionnaire should be expanded to address these considerations.

Smaller credit unions, which may, among other options, fulfill their requirements by performing a supervisory committee audit as described under *NCUA Rules and Regulations Part 715.7*, often have less sophisticated Supervisory Committees, Boards of Directors, and/or management. However, regulations allow the Supervisory Committee to perform the audit per the guidelines in the NCUA Supervisory Committee Guide for Federal Credit Unions.

Some interviewees from Region II informed us that they believe all Supervisory Committee Audits should be performed by a licensed independent auditor. Licensed practitioners, CPAs, are governed by standards requiring independence from management functions and competency when completing attestation engagements, such as agreed-upon procedures. When the person completing the Supervisory Committee Audit is a committee member themselves or a non-CPA designee of the committee, the burden is on the examiner to determine the independence and competency of the individual.

We concluded that NCUA management should determine the appropriateness of having someone other than a licensed independent auditor perform Supervisory Committee Audits. Based on discussions with NCUA management, requiring credit unions to engage a licensed independent auditor to perform Supervisory Committee Audits would be excessively cost prohibitive to smaller credit unions.

We believe that if examiners had identified the Supervisory Committee Audits as unacceptable and followed the protocol in the NCUA's National Supervision Policy Manual, they would have discovered the fictitious investments sooner. We also believe that the examination process lacks sufficient guidance and requirement for consideration and documentation of the independence and qualifications of the individual completing the Supervisory Committee Audit. Therefore, we are making the following recommendation to management:

We recommend NCUA management:

2. Revise examination procedures to include a review of how the Supervisory Committee evaluated the independence and competency of individuals selected to perform the Supervisory Committee Audit.

Management Response

Management agreed with the recommendation and to address the issue, plans to revise examination procedures by December 31, 2017.

OIG Response

We concur with management's planned action.

OBSERVATIONS

During our review, we noted five observations that were not germane to the failure of the Credit Unions, but are sufficiently important to warrant reporting to NCUA management.

<u>Failure to Address Risk with Ineffective Supervisory Committee</u>

During our review of examination working papers, we determined examiners failed to consider the Supervisory Committees to be ineffective and rarely referenced the lack of involvement and oversight of the Supervisory Committees. At times, examiners discounted the role of the Supervisory Committee due to the involvement of a third party vendor, SCCU. This did not relieve the Supervisory Committees of their responsibility for oversight.

The lack of Supervisory Committee minutes was an EF in only one examination for one Credit Union, OPS, effective September 30, 2015. Cardozo had a DOR related to the vacancy on the Supervisory Committee for the examination effective June 30, 2014. During that examination, the EIC documented that the Supervisory Committee was inactive. They attended monthly board meetings and participated in discussions but there was no oversight of file maintenance reports or insider accounts. The EIC noted that it was a not a major concern because Cardozo was managed by SCCU who was an independent third party with no interest in the Credit Union. A vacancy on the Supervisory Committee was an EF for the Triangle examination effective March 31, 2015, and a DOR for the examination effective June 30, 2015. Based on our review of examination working papers, there were no other EFs or DORs related to the Supervisory Committees for any of the Credit Unions.

Examiners failed to hold the Supervisory Committees responsible for ensuring that all required procedures in the Supervisory Committee Audits were completed, including the confirmation of investment balances.

The following table details the Credit Unions' total asset and investment balances as of December 31, 2015, compared to peers.[16]

Total Assets and Investments by Credit Union Compared to Peers as of December 31, 2015

Credit Union	Total Investments as a % of Total Assets	Total Assets	Total Investments
Chester	38.8%	$827,269	$321,124
OPS	78.4%	$1,182,927	$927,635
Electrical	59.4%	$65,894	$39,149
Triangle	85.4%	$290,098	$247,750
Cardozo	72.2%	$226,485	$163,576
Servco	78.0%	$2,193,229	$1,710,467
Peer Group 1	44.2%		

The checks and balances envisioned in the structure of a credit union as put forth by the *NCUA Rules and Regulations* depends on the proper functioning of the Board of Directors, Supervisory Committee, and management.

We believe that examiners failed to identify the Supervisory Committees as ineffective. Examiners should have included recommendations initially as examiner findings, and escalated the administrative remedies to DORs and beyond if management did not timely achieve

[16] NCUA defines peer group 1 as federally insured credit unions with less than $2 million in assets.

compliance. Without an effective Supervisory Committee, examiners cannot be certain that internal controls at a credit union are functioning as intended, placing member funds and the Share Insurance Fund at risk.

Although we only reviewed two years of examinations, we believe the issues identified above including the lack of Supervisory Committees' involvement, lack of meeting minutes, and insufficient Supervisory Committee Audits, coupled with the Boards of Directors' weaknesses, could have been grounds for downgrading the Management component of the CAMEL rating for Electrical and Cardozo. Examiners appropriately downgraded the management component for OPS, Servco, Chester, and Triangle.

Failure to Address Risk with Ineffective Board of Directors

Although the Supervisory Committee is responsible for ensuring the fidelity of the credit union's records, the Board of Directors also plays a role in this monitoring process by providing a forum for receiving the results of the Supervisory Committee Audit. We determined examiners failed to require the Boards of Directors to perform their vendor due diligence and oversight of SCCU, including understanding the internal control environment of SCCU. We determined examiners failed to hold the Boards of Directors responsible for fulfilling these duties. We believe that had examiners taken a more aggressive approach and escalated administrative remedies, it would have been more likely that the Supervisory Committees would have functioned better and potential issues in the SCCU relationship would have been identified. This in turn might have increased the likelihood the fraud would have been discovered earlier by the Supervisory Committee.

Clarification of SCUEP Investment Confirmation Procedures

The AIRES SCUEP workbook requires examiners to confirm a sample of investments. We learned during interviews that examiners feel they would benefit from additional guidance regarding determining the appropriate sample size and the best method for confirmation.

Results of interviews indicated that examiners felt the instruction to select a "sample" of investments to verify was ambiguous. Examiners would like additional guidance and training on how to determine an appropriate sample size and how to determine which investments to select for verification. Results of interviews with NCUA management indicated that the intent of requiring sampling is to provide greater flexibility to staff and to encourage examiner's judgment in determining the appropriate sample size and investments to select. Providing minimum thresholds of required confirmation coverage of the portfolio would potentially supersede examiner's judgment.

Mandatory Joint Conferences

The NCUA Supervision Manual requires examiners to hold a joint conference[17] at the end of every examination and follow-up examination for CAMEL 3, 4 and 5 credit unions. In CAMEL 1 or 2 credit unions a joint conference is not mandatory; however, examiners must make credit unions aware of the option of holding a joint conference by offering a joint conference to the board chair. The purpose of the joint conference is to provide the examiner the opportunity to reach agreements with the board that they will take appropriate action for reducing levels of unwarranted risk in the credit union.

Interviewees indicated that because the joint conferences were not mandatory for the Credit Unions, they could not compel the Boards of Directors to join the conferences. Multiple interviewees noted that they believed the Boards of Directors were not fully aware of the recordkeeping issues at the Credit Unions. Our review of the National Supervision Policy Manual confirms that the joint conference is not mandatory, but also states that an examiner may hold a joint conference in CAMEL 1 and 2 credit unions as a communication forum or if the examination reveals substantive concerns.

Metric Analysis

We analyzed trends in a number of metrics gleaned from Call Reports and Financial Performance Report (FPR) data. Our purpose was to consider the Credit Unions' reported results in light of the results of peers to determine if examiners missed red flags. Results of these procedures revealed several unusual trends, including yield on investments above that of peers.

While we noticed some unusual results, we noted no anomalies that were so strong as to reveal the presence of fictitious investments held for investment.

Based on this review, we conclude that without confirming the existence of the investments directly with a third party, it would have been difficult for examiners to detect the misstatements in assets. As noted above, examiners did not verify investments with third-party institutions, which was required for examinations with an effective date of March 31, 2015, and later. Prior to this date, examiners met minimum examination requirements over this area.

[17] The National Supervision Manual defines a joint conference as a meeting of the examiners and a sufficient number (quorum) of the Board of Directors to conduct official credit union business.

Appendix A: Objective, 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 a material loss review when the Share Insurance Fund has incurred a material loss, or when unusual circumstances exist that warrant an in-depth review of the loss.[18]

The objectives of the MLR were to:

1. Determine the cause(s) of the Credit Unions' failure and the resulting loss to the Share Insurance Fund;

2. Assess the NCUA's supervision of the institutions, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and

3. Make appropriate observations and/or recommendations to prevent future losses.

To accomplish our review, we performed fieldwork at the NCUA's Region II office in Alexandria, Virginia. The scope of this review covered the period from January 2014 through liquidation in April 2016.

To determine the cause(s) of the Credit Unions' failures and assess the adequacy of NCUA's supervision, we:

- Completed a risk assessment, which included a review of the Examination Overviews as well as other risk considerations, including consideration of minimum scope requirements for examiners.

- Prepared a chronology and summary table of regulatory examinations, which include exam date, regulator, CAMEL rating, supervisory actions, and significant examiner comments.

- Reviewed exam files, including exam reports, risk assessments, examination findings, documents of resolution, confidential sections, corrective actions, exam spreadsheet files, correspondence, analysis, and other documentation.

- Reviewed the Credit Unions' Board of Directors minutes and Board packets, as well as Supervisory Committee minutes provided.

[18] 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.

- Reviewed the external reports on audits, agreed-upon procedures and member account verification, including results, findings, and responses, as provided.

- Conducted interviews with Region II management and staff involved with the examination, supervision, and/or liquidation of the Credit Unions.

- Downloaded Call Reports for the scope period and performed analysis of a number of financial indicators, including loans to total shares, cash on hand, cost of funds, yield on investments, net worth, investments to total assets, and other elements of the balance sheet and income statement.

- Considered allegations of fraud as documented in examiner work papers, including means of misappropriation and potential warning signs.

- Developed a timeline and summary of enforcement actions taken by the NCUA from 2014 through liquidation.

- Assessed NCUA supervision and evaluated the timeliness of supervisory actions.

- Assessed the effectiveness of the Credit Unions management, and oversight by the Supervisory Committees and Board of Directors.

We relied upon materials provided by NCUA Region II and AMAC officials, including information and other data collected during interviews.

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

We conducted this review from May 2014 through February 2017, in accordance with Generally Accepted Government Auditing Standards (GAGAS) and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix B: NCUA Management Response

National Credit Union Administration
Office of the Executive Director

TO: Inspector General James Hagen

FROM: Executive Director Mark Treichel

SUBJ: Material Loss Review Management Response

DATE: February 21, 2017

We agree with your material loss review recommendations with regards to Chester Upland School Employees, O P S EMP, Electrical Inspectors, Triangle Interests % Service Center, Cardozo Lodge, and Servco Federal Credit Unions. These credit unions failed as a result of a shared management company's alleged misappropriation of funds and providing fraudulent financial reports to officials.

The report cites internal control weaknesses, supervisory committee audit failures and missed red flags that delayed the discovery of the alleged fraudulent activity. Implementation of small credit union examination procedures during the latest examination cycle helped NCUA identify irregularities leading to the discovery of the alleged fraudulent activity. Adopting the recommendations below will further strengthen the examination program and assist with more timely detection of potential fraudulent activity.

Recommendation: *Revise procedures in the small credit union examination program to require an independent verification of investment balances when the examiner determines the verification performed during the audit was inadequate or was not performed, and risk factors related to investments are material.*

Response: By December 31, 2017, we will revise the small credit union examination procedures to require an independent verification of investment balances, where the audit did not include a verification of investment balances, as required under a supervisory committee audit, or where the verification of investment balances is deemed inadequate.

Recommendation: *Revise examination procedures to include a review of how the supervisory committee evaluated the independence and competency of individuals selected to perform the supervisory committee audit.*

Response: By December 31, 2017, we will revise examination procedures to include a review of the supervisory committee's determination of the auditor's independence and competence to conduct a supervisory committee audit.

Thank you for the opportunity to comment.

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Appendix C: Acronyms and Abbreviations

AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
AMAC	Asset Management Assistance Center
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
Cardozo	Cardozo Lodge Federal Credit Union
CDs	Certificates of Deposit
Chester	Chester Upland School Employees Federal Credit Union
CPA	Certified Public Accountant
The Credit Unions	Chester Upland School Employees Federal Credit Union O P S EMP Federal Credit Union Electrical Inspectors Federal Credit Union Triangle Interests % Service Center Federal Credit Union Cardozo Lodge Federal Credit Union Servco Federal Credit Union
DOR	Document of Resolution
DOS	Division of Supervision
EF	Examiner's Finding
EIC	Examiner In-Charge
Electrical	Electrical Inspectors Federal Credit Union
FCU Act	Federal Credit Union Act
FPR	Financial Performance Report
GAGAS	Generally Accepted Government Auditing Standards
LUA	Letter of Understanding and Agreement
MLR	Material Loss Review
NCUA	National Credit Union Administration
OIG	Office of Inspector General
OPS	O P S EMP Federal Credit Union

Acronyms and Abbreviations (Cont.)

PCA	Prompt Corrective Action
RDL	Regional Director Letter
RFE	Risk-Focused Examination
Servco	Servco Federal Credit Union
SCCU	Service Center for Credit Unions
SCUEP	Small Credit Union Examination Program
SE	Supervisory Examiner
Share Insurance Fund	National Credit Union Share Insurance Fund
Triangle	Triangle Interests % Service Center Federal Credit Union
WCC	Work Classification Code