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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Chairman Of The National Credit Union Administration

Stronger Supervision Of Credit Unions Needed

The National Credit Union Administration (NCUA) insures both Federal credit unions and qualified State credit unions through the National Credit Union Share Insurance Fund. NCUA has full responsibility for supervising Federal credit unions but shares the responsibility with State regulatory authorities for federally insured State credit unions.

Regarding the supervision of Federal credit unions, this report discusses the reluctance of NCUA examiners to take more stringent actions to convince credit union management to correct problems. In the area of State-chartered federally insured credit unions, NCUA lacks a comprehensive evaluation of the adequacy and acceptability of each State's examination program. GAO recommends steps to improve and strengthen supervisory actions taken against Federal credit unions. GAO also recommends that NCUA first determine the acceptability of various State examination programs and then continue to monitor their capabilities.

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GAO/GGD-83-12
OCTOBER 6, 1982

023612

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT DIVISION

B-202789

The Honorable Edgar F. Callahan
Chairman, National Credit Union Administration

Dear Mr. Callahan:

This report summarizes the results of our review of the NCUA's supervisory process for credit unions and recommends specific actions which we believe will enhance the NCUA's ability in this area.

This report contains recommendations to you on pages 23 and 34. As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are providing copies of this report to the Director, Office of Examination and Insurance, and the Director, Office of Internal Audit and Investigation. In addition, we will provide copies to the House and Senate Committees on Appropriations; the House Committee on Government Operations; the House Committee on Banking, Finance and Urban Affairs; the Senate Committee on Governmental Affairs; and the Senate Committee on Banking, Housing and Urban Affairs.

Sincerely yours,

W.J. Anderson

William J. Anderson
Director

GENERAL ACCOUNTING OFFICE
REPORT TO THE CHAIRMAN
OF THE NATIONAL CREDIT
UNION ADMINISTRATION

STRONGER SUPERVISION OF CREDIT
UNIONS NEEDED

DIGEST

Significant growth has occurred recently in the credit union industry's total assets and membership. Along with this growth, however, problems have increased and contributed to the increase in the number of credit unions forced to liquidate and the number experiencing severe financial problems.

GAO's objective was to assess the National Credit Union Administration's (NCUA) efforts to supervise the credit union industry.

SUPERVISORY EFFORTS TO CORRECT CREDIT UNION PROBLEMS SHOULD BE STRENGTHENED

NCUA insures both Federal credit unions and qualified State credit unions through the National Credit Union Share Insurance Fund. It has full responsibility for supervising Federal credit unions but shares the responsibility with State regulatory authorities for federally insured State credit unions.

NCUA can use a series of actions for resolving problems identified during examinations of Federal credit unions. These include preparing plans of action, conducting supervisory contacts, issuing preliminary warning letters, and instituting more formal administrative actions, such as cease-and-desist orders.

The plans of action are prepared by examiners for credit union officials and set out the specific steps needed to correct identified problems. Examiners conduct periodic supervisory contacts to monitor credit unions' efforts to carry out the steps detailed in the plans. The supervisory contacts are made within prescribed periodic intervals and have been made primarily at small Federal credit unions which pose no material threat to the share insurance fund. Guidelines to limit the period of time over which supervisory contacts can be made have not been established. A better use of supervisory resources could be made if the contacts were directed toward those credit unions which present a greater risk to the share insurance fund and are working to resolve their financial problems. (See p. 11.)

Preliminary warning letters are used to inform credit union officials that, unless persistent problems are corrected within an established time frame, NCUA will take stronger action. These letters have not been used extensively and have lost some of their effectiveness because the promised stronger action has not been taken. This has caused NCUA regional personnel to develop their own criteria regarding the use of these letters. Little guidance is available for NCUA regional personnel concerning the use of the preliminary warning letters and the more formal administrative actions. (See p. 13.)

At the completion of each examination, a rating code is assigned which describes the financial condition of the Federal credit union. Judgment of the examiner is an essential ingredient in determining the appropriate code. Workload considerations of the examiners have been allowed to affect the classification of some credit unions, resulting in higher ratings than circumstances warrant. The assignment of an unjustifiably higher rating compromises the integrity of the classification system. (See p. 20.)

RECOMMENDATIONS TO THE NATIONAL CREDIT UNION ADMINISTRATION BOARD

GAO recommends that the National Credit Union Administration Board:

--Clarify for regional personnel the purpose and circumstances for which preliminary warning letters and administrative actions should be used, including guidance as to when mild actions should be replaced by stronger ones.

--Direct that problem credit unions be properly classified and institute periodic reviews to ensure that ratings are properly assigned and reflect the credit unions' conditions. (See p. 23.)

IMPROVEMENTS NEEDED IN CONTINUED INSURABILITY PROGRAM FOR FEDERALLY INSURED STATE CREDIT UNIONS

The Federal Credit Union Act allows NCUA to accept examination reports prepared by State regulatory agencies in lieu of performing examinations directly. NCUA has used these reports to assess the initial and continued insurability of federally insured State credit unions and, until recently, had conducted few direct examinations of State credit unions.

Although it places considerable reliance on State examination programs, NCUA has not fully evaluated their adequacy and acceptability. The evaluations have not realized their full potential because standards were not established by which the programs could be measured. The absence of criteria has hampered a consistent evaluation of the State programs. (See p. 30.)

NCUA insurance analysts review and monitor the condition of federally insured State credit unions. Little guidance is available to assist the analysts in determining the appropriate course of action to be followed in dealing with both the State agencies and State credit unions. Without appropriate guidelines, differences in approaches can occur in dealing with problem cases within each region and from State to State. (See p. 31.)

RECOMMENDATIONS TO THE NATIONAL CREDIT UNION ADMINISTRATION BOARD

GAO recommends that the National Credit Union Administration Board:

--Initiate and complete a comprehensive study of State examination programs which includes standards by which the acceptability of the various State programs can be measured.

--Establish a process whereby the NCUA can monitor future changes in the State examination programs.

--Develop standards and guidelines for regional staff to assess the reliability of State examination data.

--Develop guidelines for regional staff regarding actions which should be taken to monitor problem State credit unions and to determine when Federal intervention is necessary. (See p. 34.)

AGENCY COMMENTS

NCUA agreed with GAO's conclusion that changes can be made to make credit union supervision more effective. NCUA generally concurred with GAO's recommendations to strengthen the supervisory efforts to correct credit union problems. NCUA disagreed, however, with GAO's recommendations regarding a comprehensive study of State examination programs and a subsequent, ongoing monitoring program. NCUA described a number of actions it has intitiated subsequent to GAO's audit to improve the supervisory process. Although the changes will undoubtedly aid the NCUA in supervising credit unions, GAO does not believe that these actions specifically address the problems described in this report.

Specific NCUA comments and GAO's evaluation are included on pages 23 and 34. The full text of NCUA's comments appears in appendix I.

Contents

CHAPTER 1

INTRODUCTION

Credit unions present regulatory agencies with a unique challenge. The challenge arises because the incentives for prompt action on the part of the credit unions to correct problems or prevent failure are often lacking. Most credit unions are operated by volunteer owner/managers whose livelihoods do not depend on the survival of the credit union. Moreover, credit unions are owned by their depositors--persons whose "ownership interests" are insured in the event of failure.

The correction of credit union problems before they cause the credit union to fail is important in order to preserve a source of credit and financial services for the members and in order to reduce the amounts the National Credit Union Share Insurance Fund 1/ has to pay to arrange emergency mergers or pay off insured accounts. This report discusses ways in which the Federal regulator, the National Credit Union Administration (NCUA), can improve its processes for convincing credit unions to correct operational and financial problems.

THE CREDIT UNION INDUSTRY

Credit unions are cooperative ventures owned by their members. The members must have a common bond of occupation, association, or residence. In the early years of the credit union movement, services were concentrated in consumer loans. Although consumer loans are still important today, financial services have been expanded to include mortgage loans, electronic funds transfers, share draft accounts, and money market certificates.

Credit unions may be federally chartered or State-chartered. Federal chartering of credit unions began in 1934 when the Congress passed the Federal Credit Union Act. Since 1934, almost 24,000 Federal charters have been issued; 12,440 Federal credit unions were in operation at the end of 1980. States may also charter credit unions. At the end of 1980, over 9,000 State credit unions were in operation. Credit unions range in size from those with less than $5,000 in assets to those with over $800 million in assets. However, most credit unions are small. Sixty-two percent of the credit unions have assets of less than $1 million and account for only 6 percent of all industry assets.

1/The National Credit Union Share Insurance Fund provides insurance up to a maximum of $100,000 per member account in Federal credit unions and State-chartered credit unions which apply and qualify for insurance.

Number of credit unions has decreased

As shown below, between 1976 and 1980 the number of Federal and State-chartered credit unions decreased by 2.5 percent and 7.7 percent, respectively.

NUMBER OF CREDIT UNIONS

	Number of credit unions in operation at end of 1976	1980	Percent change
Federal credit unions with assets:			
Under $1 million	9,194	7,893	-14.2
$1 million to under $10 million	3,120	3,796	+21.7
$10 million and above	443	751	+69.5
Total	12,757	12,440	- 2.5
State-chartered credit unions with assets:			
Under $1 million	6,898	5,489	-20.4
$1 million to under $5 million (note a)	2,051	2,345	+14.3
$5 million and above (note a)	827	1,191	+44.0
Total	9,776	9,025	- 7.7

a/The asset ranges for State credit unions differ from those for Federal credit unions because the numbers of State-chartered credit unions in the asset ranges of $1 million to under $10 million and $10 million and above were not available for 1976.

CREDIT UNION INDUSTRY PROBLEMS HAVE GROWN

Two phenomena are indicative of the industry's condition by the end of 1980: The number of Federal credit unions liquidated in 1980 was about 35 percent higher than 1979, and the number of "problem" Federal credit unions was proportionately higher than in 1976 when there were more credit unions overall. High and rising interest rates, restrictions of loan rate ceilings, and increased availability of money market certificates were factors contributing to the problems the industry was experiencing.

Liquidations of Federal credit unions have increased

The number of Federal credit unions which liquidated has increased significantly in the past several years. The following table shows the number of credit unions which entered liquidation voluntarily and those which NCUA placed into involuntary liquidation because of insolvency.

	1978	1979	1980
Voluntary liquidations	212	226	254
Involuntary liquidations	106	124	220
Total	318	350	474

Most of the credit unions which were placed into involuntary liquidation by NCUA were relatively small in size and their failure had little impact on the viability of the share insurance fund. In 1980, however, 15 Federal credit unions with assets over $1 million were placed into involuntary liquidation as compared to only 4 in 1979 and 2 in 1978. Involuntary liquidations attributable to conditions beyond the control of credit union management was responsible for 7 of the 15 large involuntary liquidations: the sponsoring plants closed or significant numbers of employees were laid off. Another seven 1/ of the large involuntary liquidations were caused by the credit unions' deteriorating financial condition generally attributable to poor management. Although the NCUA can do little to avoid liquidations stemming from the first category, it can take steps to prevent liquidations occurring because of management problems.

Number of problem credit unions has increased

Between 1976 and 1980, the number of Federal credit unions which were rated as "problems" or potential problems by NCUA increased. These credit unions are the ones which received the lowest NCUA ratings in 1976 and 1980.

The NCUA classifies the Federal credit unions it insures according to a 5-code classification system. Under this system, Federal credit unions are rated as excellent, good, fair, weak, or unsatisfactory. Prior to October 1980, the NCUA used a 4-code classification system wherein Federal credit unions were classified as good, satisfactory, weak, and unsatifactory. When the NCUA changed to the 5-code system, the NCUA reclassified

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1/Because of incomplete file data, the cause of one large credit union's liquidation could not be determined.

only those Federal credit unions rated as unsatisfactory under the 4-code system to unsatisfactory and weak under the 5-code system.

The number of Federal credit unions rated as weak and unsatisfactory has increased significantly in the period from December 31, 1976, to December 31, 1980, as illustrated below.

4 codes 1976	Number of credit unions 12/31/76	12/31/80	5 codes 1980
Good	3,729	2,015	Excellent
Satisfactory	4,957	5,738	Good
Weak	3,499	3,832	Fair
Unsatisfactory	648	650	Weak
--		229	Unsatisfactory
Total	12,833	12,464	Total

The change in rating codes from 1976 to 1980 makes a comparison of those 2 years imprecise. However, the general condition of Federal credit unions appears to have declined from 1976 to 1980. For example, the number of highest rated credit unions (top two categories in each of the 2 years) declined by about 11 percent. This decline exceeds the 3 percent decline in total credit unions during the same period. More credit unions are rated in lower categories (lowest three) in 1980 than were similarly rated (lowest two ratings) in 1976: 4,711 versus 4,147.

NEWLY CHARTERED FEDERAL CREDIT UNIONS REPRESENT A LARGE PORTION OF LIQUIDATIONS AND PROBLEM CREDIT UNIONS

The probability of the termination of a Federal credit union's operations is high during the first years of its operation. Over 50 percent of the credit unions which were involuntarily liquidated in calendar years 1978-80 had been chartered within 10 years of their liquidation and about 30 percent within 5 years. Also, about 35 percent of Federal credit unions which entered voluntary liquidation did so within 10 years of their charter.

Federal credit unions chartered between 1971 and 1980 make up a disproportionate share of the problem Federal credit unions. Although accounting for only 19.5 percent of all credit unions operating as of December 31, 1980, Federal credit unions chartered between 1971 and 1980 accounted for over 37 percent of the credit unions classified as weak or unsatisfactory as of the same date. More specifically, the 1971-80 chartered Federal credit unions comprise 33 percent of the total weak and 47 percent of the total unsatisfactory credit unions.

DIRECT SUPERVISION OF THE CREDIT UNION INDUSTRY DIVIDED BETWEEN STATES AND THE NCUA

The source of supervision received by a federally insured credit union is determined by whether it is federally or State-chartered. In the 47 States which have credit union statutes, State-chartered credit unions are examined and supervised by a supervisory department of the State. Federal credit unions are examined and supervised by the NCUA.

The NCUA is an independent executive branch agency which charters, supervises, and examines Federal credit unions. The NCUA also insures member savings in Federal credit unions and qualified State-chartered credit unions to a maximum amount of $100,000 per account.

The NCUA's chartering, supervising, and examining functions are financed by fees received from Federal credit unions. Insurance functions are financed principally by assessments against insured credit unions and from earnings on investments in U.S. Government securities.

Supervision of Federal credit unions

The NCUA examines Federal credit unions to determine their financial condition, to evaluate their management, and to discover and correct unsafe and unsound practices or violations of laws or regulations. Examination frequency is determined principally by a credit union's asset size and the risk it poses to the share insurance fund. Once problems are found, the NCUA employs a number of techniques and procedures to assure that the credit unions correct them. These techniques and procedures are discussed in chapter 2.

Supervision of State-chartered credit unions

Federally insured State credit unions are usually examined or supervised by State departments. Data developed by the State examiners in their examinations are submitted to the NCUA for evaluation. The State agencies also provide direct supervision and guidance to the federally insured State credit unions to prompt correction of identified problems. The systems and procedures employed by the NCUA to protect the insurance fund's interests with regard to State-chartered credit unions are described in chapter 3.

CREDIT UNIONS PRESENT UNIQUE SUPERVISORY PROBLEMS

Credit unions present the NCUA with special supervisory problems. Federal credit union charter requirements limit membership to groups having an identifiable common bond. Because of a given credit union's limited field of membership and small size, any losses incurred can become more difficult to absorb. The risk of failure is thus increased. The limited field of membership also makes it difficult to expand membership to attract additional resources. A second unique problem created by the limited field of membership is that a Federal credit union may be sponsor dependent. If the sponsor develops financial difficulties or withdraws support from the Federal credit union, the organization is very likely to fail. Field of membership restrictions also make it more cumbersome to merge Federal credit unions.

Supervisory problems are often compounded when the Federal credit union is controlled by volunteer and nonprofessional management. Most small credit unions cannot afford professional help and must rely on volunteer members. The NCUA must often rely heavily on the interests and abilities of the volunteers to take the necessary steps to correct identified problems. The NCUA's experience has demonstrated that, if the officials do not take the needed steps to resolve the credit union's problems, the credit union is very likely to fail. However, since the NCUA provides insurance protection for the member accounts through the share insurance fund, in most cases there is no financial risk to the officials or the members. The incentive for them to take action to solve the credit union's problems is thus reduced.

OBJECTIVES, SCOPE, AND METHODOLOGY

We performed this review to assess the NCUA's current role in providing supervision and direction to credit unions in resolving identified problems. Our review focused on the NCUA's involuntary liquidations and problem credit unions in 1978, 1979, and 1980. The review was conducted in accordance with GAO's current "Standards For Audit Of Governmental Organizations, Programs, Activities, and Functions."

The objectives of our review were to assess:

--the effectiveness of assistance provided to Federal credit unions in resolving identified problems,

--the effectiveness of the NCUA's efforts to monitor the continued insurability of federally insured State credit unions, and

--any limitations or obstacles which might limit effective oversight of federally insured credit unions.

We conducted most of our work at NCUA headquarters in Washington, D.C., and in its field offices located in Toledo, Ohio, and Atlanta, Georgia. We selected the Toledo and Atlanta regions because their regional boundaries included large numbers of Federal credit unions, federally insured State credit unions, and insured credit unions classified as problems by the NCUA.

To identify NCUA's efforts to resolve Federal credit union problems, we obtained and analyzed listings of involuntary liquidations of Federal credit unions occurring in 1978, 1979, and 1980 and of problem Federal credit unions which had been upgraded to a less severe problem status in those same years. On the basis of these listings, we identified a total universe of 164 Federal credit unions which had been placed into involuntary liquidation and 195 Federal credit unions that had been reclassified to a less severe problem status.

The listings of reclassified problem credit unions consisted of Federal credit unions whose problem codes were changed from unsatisfactory to weak under the NCUA's problem classification system used in 1978, 1979, and 1980. Because the NCUA's current data system does not contain a history of status codes for each Federal credit union, we could not identify any Federal credit unions which may have been rated as unsatisfactory and subsequently upgraded to satisfactory. The inability of the NCUA's data system to provide this history limited the universe because the credit union still had to be rated as a weak credit union at the date we compiled the listings. Thus, any Federal credit unions rated as weak in 1978 and 1979 would not have been included in the universe if they subsequently were reclassified to a satisfactory status code.

We selected two samples from the universe of 164 Federal credit unions which had been placed into involuntary liquidation. This was done to ensure that we had a sufficient number of the few large involuntarily liquidated credit unions. We selected 8 of the 11 credit unions which had assets over $1 million when liquidated, and we selected 75 of the 153 which had assets under $1 million.

Similarly, we selected two samples from the 195 Federal credit unions which had been reclassified to a less severe rating. We chose 6 of the 15 credit unions with assets above $1 million and 80 of the 180 with assets under $1 million.

We obtained a listing of liquidated federally insured State credit unions in 1978, 1979, and 1980 and identified 40 which were placed into involuntary liquidation. Because the universe was small, we reviewed all 40 case files and recorded the information from these files on a data collection instrument designed to provide comparable data on all cases. The data collection sheets were used to record information on the problems of the State credit unions identified by the State supervisors, actions taken by the NCUA to monitor the status of State credit unions, and reasons for liquidation.

In order to obtain comparable data on the sample Federal credit unions, we developed a data collection instrument. This was used to record information on problems of Federal credit unions, corrective actions taken, approaches used by NCUA examiners to assist the problem credit unions, and NCUA use of preliminary warning letters and other formal actions.

A major part of our work involved reviewing NCUA credit union case files and recording the information in these files on the data collection instruments. We reviewed the three most recent examination reports in each case file, if available, and reviewed other documents pertaining to the case in each file. We also reviewed legislation, rules, regulations, and administrative and operating policies and procedures pertaining to the NCUA's supervision process. We discussed the NCUA's supervision process and its continued insurability program for State credit unions with officials in Washington, D.C.; Atlanta, Georgia; and Toledo, Ohio. We also discussed the results of our work with NCUA officials and considered their views in preparing the report.

Our audit results reflect the practices of the regions we visited, which may or may not reflect the NCUA's practices as a whole.

CHAPTER 2

SUPERVISORY EFFORTS TO CORRECT CREDIT UNION PROBLEMS SHOULD BE STRENGTHENED

The NCUA's approach to the ultimate resolution of problems identified in Federal credit unions relies primarily on the examiners' efforts to gain the voluntary cooperation of credit union management to take corrective action. Although this is an important aspect of problem resolution, the NCUA has relied extensively on this approach and has not effectively used its other enforcement tools.

The NCUA appears to be reluctant to take more formal or stringent actions to convince credit unions to correct their problems even though such actions hold potential for success. We believe that the NCUA could achieve better results if it established a supervisory approach which made full use of all available methods.

From our review, we believe the NCUA's approach is characterized by

--a lack of guidance as to when one type of action should be discarded in favor of a more forceful one;

--a routine use of supervisory visits in spite of indications that resources might be better spent;

--a limited use of formal supervisory actions when such actions appear to be warranted; and

--a somewhat pessimistic view about the ability of some credit unions to resolve their problems.

THE SUPERVISION PROCESS BEGINS WITH PLANS OF ACTION

In theory, the process for resolving credit union problems can involve a series of steps, with the NCUA increasing the forcefulness of its actions until the target credit union resolves its problems. For credit unions with examination-disclosed problems, these steps begin with plans of action developed by an NCUA examiner and can end with the suspension of the credit union's charter.

Plans of action show how problems are to be corrected

In all NCUA examinations of a Federal credit union, the examiner develops an examination report which identifies major areas of concern. The examination report is given to credit union officials and discussed at conferences held with officials at the end of the examination.

Where the examination identifies areas of concern, the examiner develops a detailed plan of action which sets forth steps the Federal credit union officials need to take in order to correct the problems identified. The plans set forth the specific steps to be followed, identify the person(s) responsible for taking the steps, and establish time frames for correction. The NCUA believes the credit union would not be experiencing severe financial problems if its officials had the ability to correct its problems by themselves. Thus, the NCUA gives these officials specific direction as to the course of action to be followed. The NCUA believes that the plan of action is critical to a credit union's solving its problems.

Supervisory contacts are used to monitor correction efforts

After the plan of action has been developed, the NCUA monitors credit unions' correction efforts. This monitoring usually consists of onsite supervisory contacts made by the NCUA's examiners.

NCUA procedures require that onsite contacts be made with each Federal credit union classified as weak or unsatisfactory. Until October 1981, at least one contact was required every 4 months. In November 1981, the interval was lengthened to at least every 6 months. In addition to the supervisory contact, the examiner can make periodic telephone calls and can request the credit union to submit periodic financial data so that its financial condition can be monitored.

Credit union must be forewarned of more formal action

NCUA procedures require that a Federal credit union with serious problems be forewarned that unless major areas of concern are corrected within a specified period of time, more formal action will be taken. The warning is transmitted through a preliminary warning letter to the Federal credit union's officials. The letter sets forth the areas of concern and establishes target dates for the correction of the identified problems. The issuance of a preliminary warning letter would generally precede the issuance of a cease-and-desist order.

Several types of formal actions are available

The NCUA has several formal administrative remedies available if the informal methods fail. Their use is generally restricted to insolvent Federal credit unions and to those that are classified as weak or unsatisfactory because of serious operational problems. Available administrative remedies include: the establishment of special reserves for losses; suspension and removal of directors, officers, and committee members; cease-and-desist proceedings; and suspension of the Federal credit union charter.

ROUTINE SUPERVISORY CONTACTS MAY NOT BE BEST USE OF RESOURCES

NCUA's examiners are required to make supervisory contacts with those Federal credit unions which are rated as weak or unsatisfactory. However, because there are no limits as to how long such contacts are to continue when problems are not resolved and because most time on supervisory contacts will be spent on credit unions having the smallest amount of assets, the NCUA may be using examiner resources unproductively.

Time spent on supervisory contacts is increasing

Before November 1981, examiners were to make supervisory contacts at 4-month intervals. The interval was then changed to 6 months. Budgetary and staffing constraints appear to have been the reason for the extension. The following chart shows that, while the number of examinations conducted is decreasing, the number of, and time involved in, supervisory contacts is increasing.

Fiscal year	Number of exams	Total exam time (in hours)	Average exam time (in hours)	Number of supervisory contacts	Total EWSA time (note a) (in hours)	Average EWSA time (note a) (in hours)
1978	10,907	409,153	37.5	1,277	19,276	15.09
1979	9,863	427,009	43.3	1,328	24,480	18.43
1980	8,277	420,976	50.9	1,385	30,098	21.73

a/Early Warning System Analysis (EWSA) is an NCUA term used to denote supervisory contacts.

Although the supervisory contact interval has been lengthened, the NCUA will likely continue to spend considerable time and resources on such contacts because credit unions tend to stay in weak or unsatisfactory condition for years. Our analysis of Federal credit unions that were liquidated for reasons other than economic events beyond their control (48 of 79 involuntary liquidations during calendar years 1978, 1979, and 1980), 1/ shows that more than half had been classified as problems for several years as shown below.

Time in problem status	Number
Less than 1 year	7
1 to 1.9 years	4
2 to 2.9 years	12
3 to 3.9 years	7
4 to 4.9 years	4
5 or more years	14
Total	48

The average time these credit unions were classified as problems was about 3-1/2 years.

Supervisory contacts were made for 39 of the 48 credit unions. In the other cases, the credit union entered liquidation before a supervisory contact was made.

Resources for supervisory contacts may be misapplied

We believe the NCUA has taken a positive step by changing the supervisory contact interval. But even with the extended interval, a large number of supervisory contacts will be made. Most will involve small credit unions which would pose no material threat to the share insurance fund should they fail. As illustrated in the chart, as of December 31, 1980, nearly 81 percent of the credit unions which were supposed to receive

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1/Most of the remaining 31 credit unions were liquidated because of plant closings which disrupted their memberships. These credit unions generally were not classified as problem cases prior to their liquidations. The reason for one credit union's liquidation could not be determined.

supervisory contacts had assets under $1 million. As shown below, they control only 8 percent of the assets of all credit unions classified as weak or unsatisfactory. Thus, most supervisory contacts will be made on a rather small amount of credit union assets.

	Number	Percent	Assets (in thousands)	Percent
Assets under $1 million				
Weak	511		$ 124,143	
Unsatisfactory	198		38,339	
	709	80.7	$ 162,482	8.3
Assets $1 million to under $10 million				
Weak	108		$ 341,221	
Unsatisfactory	23		58,109	
	131	14.9	$ 399,330	20.4
Assets over $10 million				
Weak	31		$1,126,179	
Unsatisfactory	8		267,528	
	39	4.4	$1,393,707	71.3
Total	879	100.0	$1,955,519	100.0

PRELIMINARY WARNING LETTERS COULD BE USED MORE EFFECTIVELY

Although the NCUA's experience shows that preliminary warning letters can be an effective method for convincing credit unions to correct their problems, regional staff does not perceive them as such and does not use them extensively for problem cases. Of the 48 liquidations we reviewed, only 20 credit unions had received preliminary warning letters.

Regional staff said that preliminary warning letters implied an intent on the part of the NCUA to initiate stronger action if problems are not resolved. Because such action is often not taken, the letters lose meaning and effectiveness. Also, regional staff pointed out that, once preliminary warning letters have been issued, they are continually extended though the problems remain and more formal actions are not taken.

Preliminary warning letters are potentially effective

Although the regional staff we contacted were critical of preliminary warning letters, analysis of their use shows reasonably good results. The NCUA issued 1,142 preliminary warning letters (an average of 228 per year) from 1975 through 1979. 1/ NCUA analysis showed that about 69 percent of the credit unions receiving them between 1975 and 1977 corrected their problems. For the years 1975, 1976, and 1977, the correction rates were 75 percent, 70 percent, and 55 percent, respectively. Correction rates were not determined for 1978 and 1979 because a large number of the preliminary warning letters were still outstanding when the NCUA made its analysis.

Preliminary letters are not used extensively

Preliminary warning letters have not been used extensively by the NCUA to persuade credit union management to take action to resolve identified problems. From 1975 through 1979, the period for which complete statistics are available, the NCUA issued 1,142 preliminary warning letters. Yet the number of letters issued in 1979 was only about 77 percent of the number issued in 1975. As shown below, the number of weak and unsatisfactory credit unions in 1979 equalled about 96 percent of the number in 1975.

1/Beginning in 1980, the NCUA no longer maintained data regarding the number of preliminary warning letters issued or their results.

PRELIMINARY WARNING LETTERS

AND LOW-RATED CREDIT UNIONS BY YEAR

	1975	1976	1977	1978	1979
Preliminary warning letters	337	195	174	176	260
Problem credit unions:					
Weak	3,611	3,499	3,145	3,373	3,433
Unsatisfactory	796	648	526	674	817
Total	4,407	4,147	3,671	4,047	4,250

Although this is an imperfect measure, if one compares the number of preliminary warning letters issued to the number of credit unions for which these letters might be used, the NCUA's use of the letters appears low. Letters went to about 8 percent of the weak and unsatisfactory credit unions in 1975. By 1977, the percent of such credit unions receiving letters had declined to 5 percent; in 1979, it was 6 percent.

Preliminary warning letters remain outstanding for long periods of time

One reason cited by a regional staff member for not using preliminary warning letters was that they remained outstanding for long periods of time without credit union or NCUA action. According to regional staff, once the preliminary warning letters have been issued, the letters have been extended and remain outstanding against a credit union for several years without either the problems being resolved or administrative action being initiated. Regional supervisory staff believe that continual extension without stronger action causes credit union managements to disregard the preliminary warning letters. Our analysis of 20 liquidated Federal credit unions which had received preliminary warning letters showed that the letters were outstanding for an average of 15 months, were outstanding for periods ranging from 1 month to 41 months, and were not followed up by more formal cease-and-desist proceedings.

The following case was selected from those in which the NCUA's regional offices had recommended the issuance of a cease-and-desist action in 1978, 1979, and 1980. It illustrates the extension of correction dates or preliminary warning letters without timely problem resolution or further administrative action.

May 1975

The NCUA issued a preliminary warning letter to the Federal credit union. The letter cited delinquent loans and excessive expenses as major problems endangering the continued sound operation of the credit union. The letter stated that some of these problems existed as far back as December 31, 1972.

Plans of action had been prepared in the regular examination reports, but agreements reached with credit union officials to resolve the problems were not carried out. June 1975 was the target date for completion of outstanding plans of action and a review of progress. If the problems were not corrected, a cease-and-desist action was to be recommended.

December 1976

The problems identified in the May 1975 preliminary warning letter persisted through December 1976 as disclosed by an examination. Between May 1975 and October 1976, the NCUA made a number of supervisory contacts. As a result of these contacts, the target date for problem resolution or the issuance of a cease-and-desist order was periodically extended to September 1975, December 1975, May 1976, and August 1976 because the credit union problems remained unresolved.

April 1977

The December 1976 examination disclosed a deterioration of financial condition as well as violations of the Federal Credit Union Act. The credit union was informed again that, unless correction was made, a cease-and-desist order would be recommended.

December 1977

A regular examination disclosed that most of the problems remained. The examiner noted that the management of the credit union was unable and unwilling to operate the credit union properly in spite of continued supervision in the form of examinations, supervisory contacts, and telephone calls. The examiner expressed his opinion that the only way to obtain results was by firm administrative action. According to the examiner, the officials no longer took the NCUA seriously since it had not followed through on any threatened action. The regional office had recommended to NCUA headquarters in November 1977 that a cease-and-desist order be issued.

April 1978

The regional office decided to postpone the issuance of the cease-and-desist order due to some progress made by the credit union in resolving problems.

November 1978

On the basis of the examiner's supervisory contact made in September 1978, which showed no progress by the credit union, the NCUA region recommended to NCUA headquarters that a cease-and-desist order be issued. NCUA headquarters agreed to issue the cease-and-desist order in December 1978.

February 1979

The examiner noted that he had no evidence that the cease-and-desist order had been issued. However, the examiner recommended that it not be issued because of progress made by credit union officials.

December 1979

A supervisory contact had been made in October 1979, and some improvement had been noted by the examiner. The NCUA again informed the credit union that the recommendation for a cease-and-desist order would be postponed until January 1980. In November 1979, the region, however, recommended to the NCUA headquarters that the proposed action be withdrawn. The recommendation for the cease-and-desist action was withdrawn at NCUA headquarters.

April 1980

A supervisory contact made in February 1980 revealed progress in certain areas. A letter to the credit union informed them of the results of the contact and stated that the NCUA was still not satisfied with its progress. The letter also stated that the cease-and-desist action would be postponed until June 1980.

The credit union was still classified as a problem (unsatisfactory) at April 1980.

July 1980

The credit union was reclassified to a rating of satisfactory.

Our comments

Although the credit union apparently corrected the problems identified during the examination process, the period involved for the problem resolution spanned over 7 years. The continual extension of the preliminary warning letters, without the promised administrative action being taken, contributed to an extremely lengthy period for problem resolution. The length of time it took for this case to be resolved clearly indicates a need for guidance to be used by regional staff which could be used to determine when stronger action should be taken. With stronger action, the Federal credit union would have had more incentive to correct its prolems. The continued threats of the NCUA, without any follow-through on the promised action, did little to inspire the officials to take action within a reasonable period of time.

GUIDANCE IS NEEDED TO CLARIFY THE USE OF PRELIMINARY WARNING LETTERS

NCUA staff responsible for the issuance and processing of preliminary warning letters have been given little guidance. As a result regional staff have developed different standards for their use and this inconsistency has resulted in a less than effective use of this enforcement tool.

The available guidance for preliminary warning letters states that such letters should be used when the Federal credit union has engaged in an unsafe or unsound practice which has been adequately disclosed in the examination reports' open sections for at least two consecutive examinations. The guidance does not list the unsafe and unsound practices that would precipitate the issuance of a preliminary warning letter. Nor does the guidance specify the length of time a preliminary warning letter should be allowed to be outstanding before more formal administrative action is taken.

In the two regions we visited, preliminary warning letters were used under different conditions, indicating a need for specific guidance regarding their use. In one region, we were informed that use of preliminary warning letters was restricted to those instances where NCUA action would be anticipated if corrective action was not taken by credit union officials. In the other region, preliminary warning letters were issued to inform credit union management of the seriousness of its problems even though it was not necessarily expected that an administrative action would follow. Previously, according to a regional official, this latter practice was followed by the region which now restricts the use of preliminary warning letters to those where administrative action is expected. We could not determine however, if the number of preliminary warning letters issued by these two regions differed significantly because the necessary statistics are no longer maintained.

FORMAL ENFORCEMENT ACTIONS ARE USED INFREQUENTLY

In 1976 through 1980, the NCUA made limited use of the formal enforcement tools available to it, despite increased numbers of problem credit unions and credit unions which needed special financial assistance. In this period, 209 administrative actions were issued or recommended. Of these, the majority 155, were notices of intent to suspend charter or notices of suspension of charter--the most severe types of administrative actions.

NCUA statistics show that in 1976 through 1980, 45 cease-and-desist actions were issued or recommended. The cease-and-desist action is considered the NCUA's first line administrative remedy and a means by which the NCUA can take strong affirmative action against a credit union to compel corrective action and, at the same time, preserve and strengthen the credit union. These actions are intended to correct unsafe or unsound practice or violations of the Federal Credit Union Act or NCUA regulation Cease-and-desist actions were issued or recommended as follows:

1976	1977	1978	1979	1980	Total
11	7	10	13	4	45

Because of the limited number of cease-and-desist actions issued or recommended in these years, we cannot conclude whether increased use of this type of action is an effective tool in solving credit union problems. However, we did note that of the four cease-and-desist actions in 1980, sufficient progress was made by three credit unions to warrant the withdrawal of the action. One action was still pending as of December 4, 1981. In 1979, 13 cease-and-desist actions were issued or recommended. In eight of these actions, the NCUA withdrew the action against the credit union because corrective action was forthcoming according to the NCUA staff. It is not known whether the NCUA also upgraded the problem code status of all of these Federal credit unions because the NCUA's data system does not provide for a history of problem status codes.

PROBLEM CLASSIFICATIONS MAY NOT BE CONSISTENT OR PROPER

Our analysis of 77 case files of Federal credit unions whose problem rating had been upgraded in 1978, 1979, and 1980 showed that in some of these cases the improvements, if any, were outweighed or balanced by the problems that continued. NCUA examiners reclassified these credit unions despite data which showed that major problems, such as lack of share growth, loan delinquency, or expenses, remained unresolved.

Several factors were identified which caused the problem code to be upgraded despite the apparent lack of improvement. An NCUA regional official told us that the examiners would not change a classification unless the condition of the credit union had stabilized and the examiner believed that the credit union's management was committed to addressing and solving the problem. We agree that the judgment of the examiner would play an important role in assessing the status of the credit union. A regional official told us that workload considerations sometimes affect the examiner's decision to reclassify a credit union, as when the required followup visits are no longer justified because of other demands on his or her time. One official also told us that the examiners would classify just enough credit unions as unsatisfactory to accommodate the time available for the required supervisory contacts. The following cases illustrate the inconsistencies noted in upgrading of the problem codes of Federal credit unions.

Case 1

The credit union had been classified as "unsatisfactory" during its September 1978 examination because of problems in the following areas: weak credit committee, supervisory committee, and board of directors, decline of shares, delinquent loans, and decline in liquidity. A supervisory contact was made in April 1979, and the examiner upgraded the credit union's rating to "weak," noting that there had been some short term improvement, but the credit union was not viable in the long run because of a declining field of membership. A June 1980 examination disclosed that the problems of the credit union had not improved. Problems were identified and remained in the following areas: collection procedures, weak credit committee, supervisory committee, and board of directors, adverse economic conditions, decline of shares, delinquent loans, and expenses relative to gross income. The examiner maintained the weak classification despite the credit union's condition because he believed little would be gained by onsite visits. Onsite visits would have been required by NCUA procedures if the credit union was classified as unsatisfactory.

Our comments

Although this credit union was upgraded to a higher classification by the examiner, evidence suggests that one reason the classification was made was to eliminate the need for an onsite visit. It is also apparent that the credit union would probably liquidate or merge in the near future because of the declining field of membership. Because of the future outlook of the credit union, onsite visits were thus not justified. However, upgrading the credit union's rating to a higher classification to avoid an onsite visit degrades the rating system's accuracy and lessens the NCUA's ability to monitor problem credit unions.

Case 2

A Federal credit union was classified as "unsatisfactory" at its May 1978 examination and in January 1979 for the following reasons: weak supervisory committee, high expenses relative to gross income, and incomplete records. In June 1979, the rating was upgraded to "weak" because the credit union had received a subsidy which resolved its expense problem. At the time of this supervisory contact, the examiner reported that all problems had been resolved except for the supervisory committee and the failure to follow up on delinquent borrowers.

The December 1979 examination of the credit union disclosed that the following problems continued: weak supervisory committee, noncompliance with NCUA rules, regulations, and procedures, incomplete records, and delinquent loans. Between the January 1979 examination and the December 1979 examination, the percentage of delinquent loans to total loans had increased from 5 percent to 17 percent. The "weak" classification of the credit union was maintained by the examiner. The examiner indicated that he believed that the credit union's officials were qualified but questioned their dedication. The examiner did not pursue a cease-and-desist action because the officials promised to correct the credit unions problems.

Our comments

We were not able to determine from our review of this case why the examiner maintained the higher rating code despite the adverse trends noted in delinquent loans and the credit union's previous record which had resulted in its earlier classification as unsatisfactory. At the time of our review of this case, the December 1979 examination was the last one performed, so it is not known if the condition of the credit union has improved or worsened since that time.

We agree that the elimination of the perfunctory onsite contacts for failing credit unions with little hope of recovery may be necessary. Changing the problem code of a Federal credit union to a higher rating than warranted to achieve this end and to adjust for examiner workload compromises the integrity and utility of the NCUA's rating code system. If the NCUA is to deal effectively with failing Federal credit unions and develop the necessary plans to cope with these institutions, a rating system which provides accurate and reliable information on the status of problem credit unions is essential.

CONCLUSIONS

In many cases, the NCUA is unable to assist Federal credit unions in overcoming identified problems. To be sure, some of the factors which contribute to this situation are outside NCUA's control. For example, in Federal credit unions where the sponsor experiences adverse economic trends, such as a strike or plant closure, credit unions are also likely to experience troubles and may need to liquidate. In such cases the NCUA can do little to help the credit unions.

Moreover, the NCUA often faces a dilemma in dealing with credit unions whose problems are not totally related to economic or social events beyond their control. In many cases, the credit union cannot correct its problems because of managerial inability or inexperience, or it will not correct them because there is no incentive.

Thus, the NCUA's task is not easy. However, we believe that the NCUA can make better use of its supervisory tools to increase its effectiveness. We recognize that a certain amount of judgment must be exercised by examiners and supervisors when dealing with troubled credit unions, but we believe that the NCUA can provide its regional staff guidance which outlines a reasonable escalation of action if a credit union does not correct its problems. General guidelines as to how available supervisory actions should be used can only enhance the supervisory process. For example, supervisory contacts could be followed by preliminary warning letters and, if needed, by cease-and-desist orders or even stronger actions.

We also believe that the NCUA can improve its effectiveness by ensuring the integrity of its rating system and by ensuring that the supervisory approaches available to achieve corrective action are used to the fullest extent possible.

RECOMMENDATIONS TO THE NATIONAL CREDIT UNION ADMINISTRATION BOARD

We recommend that the National Credit Union Administration Board:

--Clarify for regional personnel the purpose and circumstances for which preliminary warning letters and administrative actions should be used, including guidance as to when mild actions should be replaced by stronger ones.

--Direct that problem credit unions be properly classified and institute periodic reviews to ensure that ratings are properly assigned and reflect the credit unions' conditions.

AGENCY COMMENTS

NCUA was in agreement with our recommendation in this chapter for improving the classification of problem credit unions. NCUA believes that changes made in its policies for onsite supervisory contacts, together with supervisory review on a sample basis of problem credit union classifications, should reduce the misclassification of problem credit unions.

With regard to our recommendation to clarify and provide guidance to regional staff on the use of preliminary warning letters and administrative actions, NCUA stated that its current policy requires NCUA staff to determine the need for supervisory action. We do not dispute this fact, but we continue to believe that specific clarification and guidance is needed to eliminate the varying interpretations made by NCUA staff regarding their use.

NCUA agreed that there may be more instances where formal administrative actions are appropriate but stated that the utilization of such actions is hampered by mandated hearing and notice requirements and limited staff resources. It is our view that limitations of this nature make it even more imperative that clear guidelines exist to enable NCUA to obtain the most effective use of the enforcement tools available to it.

CHAPTER 3

IMPROVEMENTS ARE NEEDED IN THE CONTINUED INSURABILITY PROGRAM FOR FEDERALLY INSURED STATE CREDIT UNIONS

The NCUA, through the National Credit Union Share Insurance Fund, insures qualifying State-chartered credit unions. The vast majority of these State-chartered credit unions are examined and supervised by State regulatory agencies. The NCUA receives copies of State examinations and other information which it uses to monitor the "continued insurability" of State credit unions. The NCUA, however, has not fully evaluated the adequacy and acceptability of State supervision programs and has not provided its own analysts sufficient training and guidance to assure consistent, reliable assessments of continued insurability.

To date, the NCUA has made several attempts to identify State examination programs which may be unreliable. These efforts, however, have not sufficiently evaluated the individual State programs because

--standards were not established to measure the adequacy of State examination program areas, and

--a detailed analysis of State examination program areas was not made.

Because of these factors, the NCUA has not had adequate control over the State credit unions which it insures.

STATES SUPERVISE FEDERALLY INSURED STATE CREDIT UNIONS

Since the approval of share insurance for credit unions in October 1970, State-chartered credit unions could apply and be accepted for Federal share insurance. State credit unions granted Federal insurance pay the same rate for insurance coverage as Federal credit unions.

Although the NCUA insures State credit unions, it generally does not examine them. Their examination is the responsibility of the supervisory authority in each State. Historically, the NCUA has relied on the State authorities to provide the necessary data to determine the initial and continued insurability of federally insured State credit unions.

Administration monitors problem State credit unions but does not take an active problem-resolution role

The NCUA's Continued Insurability Program was established in the early 1970s. Basically, the program consists of the establishment of a working relationship with each State supervisor who agrees to provide the NCUA with examination reports and specific continued insurability information. Until recently, the NCUA has emphasized a policy of noninterference with the State authorities and limited its contacts with State credit unions to those occasions when participation was invited by the States. The NCUA's policy placed the responsibility for correcting deficiencies with the State credit unions' officials and with the various State supervisory authorities to provide the needed supervision and guidance to assure that the credit union officials corrected their problems.

We reviewed the case files and records on 40 federally insured State credit unions which liquidated in 1978, 1979, and 1980 in two NCUA regions. These cases disclosed that the NCUA knew of existing problems in the State credit unions prior to their liquidation but did not take an active onsite role to influence the correction of identified problems.

In these cases, the NCUA's actions consisted primarily of monitoring the activities of the problem State credit unions by written and oral contacts with the State regulatory authorities and/or the credit unions. The records also showed that the NCUA relied completely on the data provided by the State supervisor either directly in the examination report or through supplemental data it requested. The NCUA also relied completely on the State supervisors to correct identified deficiencies.

The NCUA's General Counsel told us that, although formal administrative actions can be used for federally insured State credit unions, the NCUA has never exercised this power. Our case reviews did not disclose any instances where the NCUA used formal administrative actions to prompt corrective action by a State credit union.

MORE STATE CREDIT UNIONS ARE BEING INSURED BY THE NCUA AND MORE ARE BEING CLASSIFIED AS PROBLEMS

State credit unions have been acquiring Federal share insurance in increasing numbers. The following table shows the increases which have occurred in the number of federally insured State credit unions from 1976 to 1980.

Year	Federally insured State credit unions	Percent of all State credit unions
1976	3,519	36.0
1977	3,882	40.5
1978	4,362	46.3
1979	4,769	51.4
1980	4,910	54.4

In addition to an increase in the number of State-chartered credit unions with Federal insurance, a significant increase has occurred in the number and amount of insured savings of State credit unions classified by the NCUA as weak or unsatisfactory. The increases for these two rating categories were greater than the overall increases in federally insured State credit unions and savings insured over the same period.

	1976 (note a)		1980 (note a)	
Condition Code (note b)	Number	Savings (millions)	Number	Savings (millions)
Good	1,813	$4,561	2,011	$8,168
Satisfactory	828	1,461	1,604	4,979
Weak	624	957	1,138	2,259
Unsatisfactory	182	339	210	851
Total	3,447	$7,318	4,963	$16,257

a/The number of federally insured State credit unions shown in these tables for 1976 and 1980 differ from those in the previous table because the NCUA did not compile the statistics from the same data sources.

b/Insured State credit unions are classified under a 4-code system. Implementation of the uniform 5-code system went into effect in 1982.

NCUA HAS CONDUCTED FEW EXAMINATIONS OF STATE-CHARTERED CREDIT UNIONS

In keeping with its policy of relying to the extent possible on the State supervisors to examine and supervise federally insured State credit unions, the NCUA did not examine any State credit unions prior to September 30, 1977. In the period September 30, 1977, to December 31, 1980, the NCUA completed 50 examinations of federally insured State credit unions either jointly with State examiners or with NCUA staff only. The situations under which these examinations were conducted are described below:

Reason for examination	Number of examinations
Request for joint examinations received from the State supervisor.	6
State credit union had serious financial problems and/or needed financial assistance to avoid liquidation (joint examinations).	2
State credit union's continued insurability was in question and the NCUA determined that onsite involvement was needed (joint examination).	7
An experiment to develop examination procedures/techniques interfacing with State supervisor's staff (joint examination).	2
Determination of State credit union's continued or initial insurability (NCUA examiners only).	10

Reason for examination	Number of examinations
Determination of State credit union's qualification as a Central Liquidity Facility (note a) agent.	
NCUA examiners only	16
Joint examination	7
Total	50

a/The Central Liquidity Facility is a mixed-ownership Government corporation, administered by the NCUA and owned by its member credit unions. It provides a source of liquidity to the credit union industry.

Direct examination of State credit unions discloses weaknesses in State examination programs

In 1979 and early 1980, the NCUA performed several reviews of State central credit unions that had requested access to the Central Liquidity Facility through agent membership. State central credit unions are State-chartered credit unions which accept other credit unions, as well as individuals, as members. In a memorandum prepared in April 1980, the NCUA reported the State central reviews showed that

--many of these credit unions had serious operational or financial deficiencies; and

--in many cases, the deficiencies were not fully disclosed in the State supervisory agency's examination report, or when disclosed, the magnitude of the deficiencies was not clear.

Futhermore, in its August 1979 budget request for fiscal year 1981 to the Office of Management and Budget, the NCUA reported that its "efforts to monitor continued insurability of these credit unions (State) are inadequate."

These findings were in direct contrast to a May 1979 memorandum which reported on several experimental joint examinations conducted at the request of State supervisors in two States. According to the NCUA, these joint examinations "failed to disclose major deficiencies in the States' examination procedures in areas affecting continued insurability." The memorandum also reported that State examinations generally provided all required "continued insurability" data.

NCUA expands its examination program to include State credit unions

In April 1980, in response to its findings revealed by the selected reviews of State central credit unions described above, the NCUA expanded its examination program to include other insured State central credit unions which seemed to be experiencing financial difficulties. Twelve State credit unions were identified as potential candidates for examination by the NCUA.

Subsequent to the completion of the NCUA's March 1981 regional assessment of State examination programs (see p. 30), the NCUA expanded its 1981 fiscal year examination program to include 70 additional State credit unions. These State credit unions were included as a result of the NCUA's evaluation of the risk to the share insurance fund arising from credit unions in States which it believed had unreliable examination programs.

Resistance by States to NCUA'S examination of State credit unions

State agencies were notified in early 1981 of the NCUA's intention to conduct examinations of additional State credit unions. Several State supervisors, through the National Association of State Credit Union Supervisors, requested the NCUA to rescind the revised supervision policy of direct examination. The Association cited the NCUA's previous policy of limited direct contact with federally insured State credit unions as a precedent to be followed, the willingness of States to provide their resources in lieu of NCUA resources, their past cooperation, and States rights' as the bases for their request.

After a June 1981 meeting with Association officials, the NCUA revised its policy regarding the examination of State credit unions because of the resistance of certain State supervisors. Essentially, the revised policy restricted NCUA examination of State credit unions to State central credit unions. In those States determined to be deficient in certain areas of examination, the NCUA will conduct insurance reviews of selected asset categories and/or problem classifications. The NCUA will also examine State credit unions when requested to do so by the State super-involved in the examination of about 70 State credit unions in fiscal year 1981 and 180 State credit unions in fiscal year 1982. There were 4,910 federally insured State credit unions as of December 31, 1980.

EVALUATION OF STATE EXAMINATION PROGRAMS HAS BEEN INADEQUATE

Since the beginning of share insurance for State-chartered credit unions in 1971, the NCUA has completed two evaluations of the acceptability of the various State examination programs. It started another in 1981. The completed efforts consisted primarily of opinion polls of NCUA regional personnel to obtain their views regarding the reliability of the various State examination programs. The results of these two surveys were based on the individual judgments of NCUA regional staff, as the NCUA did not provide standard criteria by which to measure or judge the State programs' reliability.

The first such survey was done in 1974. Each regional office was requested to provide its views on various subjects related to the State examination programs. Two of the questions to which NCUA regional staff responded were: (1) "Does the State examiner generally conduct an effective examination?" and (2) "Do the examination reports provide sufficient information to determine insurability status?" The responses to the first question varied from "yes," to "questionable at times," "seems to," "no - some examinations not effective," "unknown - appears weak," and "very questionable." Responses to the second question also varied from "yes," "brief but sufficient," "not always," "generally," and "could be better." The survey report, prepared in June 1974, identified four State examination programs which generally did not conduct effective examinations. Despite the identification of weak examination programs, the NCUA did not perform any examinations of insured State credit unions in those States unless requested by the State regulatory authority.

The second evaluation began late in 1980 and was completed in March 1981. Again, each region was requested to submit an assessment of each State program which addressed: (1) the frequency and quality of examination, identifying strong points and weak points; (2) the frequency and quality of other supervision efforts; and (3) the extent to which the State effort could be relied upon to ensure the safety and soundness of State-chartered credit unions. Standards for the evaluation of the above areas were not provided to the regional office staff. As a result of this evaluation, the NCUA regional staff identified 17 of the 44 State examination programs as not reliable.

LATEST EFFORT TO ASSESS STATE EXAMINATION PROGRAMS NEEDS IMPROVEMENT

In July 1981, the NCUA directed its regional offices to initiate another evaluation of the State examination programs. Unlike previous assessments of the programs, the NCUA provided its regional offices with some standard criteria and guidance for evaluating the programs. However, we do not believe that this evaluation will provide sufficient information needed to adequately assess the quality of the State examination programs because (1) an indepth analysis of State examination program areas is not being made, (2) some areas of evaluation do not have standards by which they can be measured, and (3) the evaluations will be conducted during only a brief visit by NCUA regional staff with the various State supervisors.

According to NCUA officials, the length of the visit with the State supervisors and the depth of their evaluation has been left to the discretion of the individual regional directors. The individual items to be assessed are intended to be guides for discussion and are not planned to be evaluated in depth when the meetings are held. An adequate evaluation would require going into greater detail than can be done during these planned meetings and would involve a study of State examination programs. Minimally, a study of the States' examination guides would be needed; however, there is no requirement to review these guides or to obtain copies for later regional review. The NCUA, at the time of our review, did not maintain copies of each State examination guide in its regional offices. Regional staff advised us that they believe the NCUA should also observe the State examiners performing their work in order to make a proper assessment of the program.

Specific criteria need to be established to measure certain individual areas to be rated in this evaluation. NCUA regional staff are required to evaluate whether the State agencies have a sufficient number of examiner staff, whether staff training is adequate, and whether quality control of the examination programs is present. We were informed by NCUA staff that evaluations of areas such as these will be made based on the regional staff's experience and current knowledge concerning the State examination program.

UNIFORM CRITERIA TO ASSESS STATE EXAMINATION QUALITY HAS NOT BEEN DEVELOPED

In our report to the Congress, "Federal Examinations Of Financial Institutions: Issues That Need To Be Resolved" (GGD-81-12, Jan. 6, 1981), we identified a need for the

Federal Financial Institutions Examination Council 1/ to address issues facing the Federal regulators regarding their reliance on examinations performed by State agencies. Specifically, we recommended that the Council develop criteria for the uniform evaluation of State examinations and monitor the Federal regulators' efforts to determine the acceptability of State examinations programs and reports. We stressed that the Federal regulators should rely only on State examinations that are competently performed.

In July 1982, the Executive Secretary of the Council told us that the Council had decided not to implement our January 6, 1981, recommendation on developing criteria for evaluating State examination programs. Instead, the Council has decided to monitor the divided examination program developed by the Federal Deposit Insurance Corporation. Under the divided examination program, problem banks and other banks of supervisory concern are examinedboth by the State and the regulatory agency at least once a year. Annual examinations of the remaining insured banks are conducted alternately by the State and the regulatory agency. The Council has concluded that the divided examination program is successful and has recommended its adoption by the regulatory agencies.

We believe the Council's inaction on our recommendation makes it even more imperative that NCUA develop criteria for evaluating State examination programs. Unlike most of the other depository institution regulators, NCUA does not routinely examine State depository institutions. As a result, NCUA has little first-hand information available on the adequacy of the State examination program. Given the fact that the Council has decided not to develop evaluation criteria, we believe NCUA should develop such criteria to use in assessing the capabilities of State examination programs.

1/In 1978, the Congress established the Federal Financial Institutions Examination Council to prescribe uniform principles and standards for the Federal examination of financial institutions and to make recommendations to promote uniformity in the supervision of these financial institutions. The Council is composed of officials from the Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and the National Credit Union Administration.

CONTINUED INSURABILITY ANALYSTS NEED STANDARDS AND TRAINING

NCUA personnel responsible for the oversight of federally insured State credit unions have little guidance and receive no formal training to assist them in reviewing and monitoring the conditions of State credit unions. As a result, when problems develop in State credit unions, each NCUA region must deal with the State supervisors and State credit unions individually, which can cause differences in approaches in dealing with problems within each region and from State to State.

Federally insured State credit unions are rated by an NCUA insurance analyst on the basis of his or her review of examination reports prepared by the various State examiners. This process differs from the rating of Federal credit unions which is based on a direct contact or examination by an NCUA examiner.

NCUA review staff principally use State examination reports to determine the condition of an insured State credit union. However, we found in the NCUA regions we visited that copies of the States' examination programs or procedures which produced these reports were not maintained. Furthermore, no formal training is given to the insurance analysts who review and evaluate the State examination reports. Minimum standards of review, followup procedures for resolving serious problems, and contacts with State regulators have not been established.

In July 1981, the NCUA established specific objectives to address the areas noted above. However, the NCUA, as of January 1982, had not acted to develop the guidance needed in these areas.

CONCLUSIONS

The NCUA has been insuring State credit unions since the inception of the share insurance program in 1971. For most of this time, the NCUA has relied primarily on the examination programs of the various State regulatory agencies to assess the continued insurability of federally insured State credit unions. Recent efforts to assess the adequacy of the State examination programs, coupled with a number of direct examinations of State credit unions by the NCUA, have disclosed that many State examination programs may not be reliable. In response to the identification of the unreliable State examination programs, the NCUA has expanded its efforts to directly examine selected State credit unions because of the increased risk to the insurance fund.

We agree with the NCUA that close monitoring of the risk to the fund is needed. And, we generally support the reliance on State supervisors' work in lieu of Federal examination. However, we believe that such reliance must be based on adequate information about State programs and complete assurance that these programs are adequate and reliable. Current efforts made and underway are a positive step toward providing a needed assessment of the acceptability of the State examination programs. However, more needs to be done to assess the examination programs in depth so that the NCUA can safely rely on the information provided by the State supervisors.

The review of State examination reports by NCUA staff in the regional offices is a key step in evaluating the status of federally insured State credit unions. The absence of standards and guidelines to assist the regional review staff in making informed decisions regarding State credit unions weakens the NCUA's ability to effectively monitor problem State credit unions.

RECOMMENDATIONS TO THE NATIONAL CREDIT UNION ADMINISTRATION BOARD

We recommend that the National Credit Union Administration Board:

--Initiate and complete a comprehensive study of State examination programs which includes standards by which the acceptability of the various State programs can be measured.

--Establish a process whereby the NCUA can monitor future changes in the State examination programs.

--Develop standards and guidelines for regional staff to assess the reliability of State examination data.

--Develop guidelines for regional staff regarding actions which should be taken to monitor problem State credit unions and to determine when Federal intervention is necessary.

AGENCY COMMENTS

NCUA generally disagreed with our recommendations regarding the need to perform a comprehensive study of State examination programs, the establishment of a process to monitor future changes in these programs, and the need to develop standards and guidelines for regional staff to assess the reliability of State examination data.

NCUA believes that its current formal review approach is sufficient to assure a proper evaluation of State examination programs. We disagree. In our view, a comprehensive evaluation using established standards is essential to NCUA supervision because of NCUA's almost complete reliance on the State examination programs to monitor the status of federally insured State credit unions. Without such an evaluation the acceptability of the State examination programs and their components continues to be subject to individual interpretations by NCUA regional directors. We believe that the establishment and use of specific criteria would improve NCUA's capability to determine the degree of reliance that it should place on the various programs. Additionally, the evaluation could also be used to identify similar problem areas in the State examination programs enabling NCUA to target its resources more effectively in those areas which warrant greater emphasis.

NCUA suggests that the effectiveness of its informal review process can be monitored by its review of the results achieved by individual credit unions. We agree that the results achieved could be one measure of the success of NCUA's informal review process. However, we believe that such an approach would not be adequate due to the lengthy period of time which could elapse before NCUA could relate credit union problems to weak examination and supervisory practices in the State programs. Unless NCUA establishes a process to systematically assess the State examination programs and future changes, we believe NCUA will not possess the necessary data to adequately measure the acceptability of the programs.

NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

SE/LLB:el
SSIC 5000
September 1, 1982

Mr. William J. Anderson, Director
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

I am writing in response to your letter and enclosed draft report dated July 29, 1982, concerning "Supervision of Credit Unions could be more Effective."

We agree with the observation that changes can be made to make credit union supervision more effective. In fact, subsequent to the time period covered by this audit report the National Credit Union Administration has taken a series of actions which we believe have significantly improved our supervision of federally insured credit unions.

Through an agency-wide reorganization of staff, we have achieved the first increase in the number of financial examiners in a number of years. As an example, at year end 1971 there were 320 financial soundness examiners, at year end 1981 there were 313 financial soundness examiners. Seventy six examiners (an increase of 24%) have been made available to examine and supervise credit unions through a reduction of Central Office and Regional Office staffs and the conversion to financial soundness examiners of a number of former consumer examiners. This was accomplished in spite of a 4% reduction in overall staffing. Through this increase in field staff and the introduction of a variable scope examination we will, for the first time in years, achieve an annual examination program for federal credit unions.

As a part of this reorganization the NCUA Board has delegated to the regional directors greater authority in the area of mergers, liquidations and certain administrative functions. These delegations have resulted in improved and more rapid response to supervisory problems.

An Evaluation Performance System has been implemented. This system utilizes 5 years' of financial data and through ratio and peer group analyses assigns an overall performance code. These financial analyses will be provided to credit unions as well as examiners. We strongly believe that by furnishing such reports to credit union management we are providing them with a tool to assist them in improving their own operations. The use of this objective scoring system coupled with the elimination of mandatory on-site contacts for certain credit unions based upon their EWS code rating, should ensure the proper and consistent classification of all credit unions. To further emphasize the importance of proper classification the EWS rating system is scheduled as a major topic at our National Examiners' Conference in September 1982. This is the first National Examiners' Conference and provides us with a unique opportunity for open discussions not only between NCUA field staff with their

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regional office staff and Washington Office staff, but also between regions, with state supervisory staff, with credit union officials and managers, with trade association representatives, and with representatives of other participants in the financial market place.

To improve the supervision of all federally insured credit unions we have developed examiner specialists for corporate credit unions (those credit unions which serve primarily other credit unions) and electronic data processing (EDP) centers. Through the use of these specialists we have conducted annual examinations of all federally insured corporate credit unions (this includes 14 state chartered federally insured corporates). In addition we have either examined individually or participated in the joint examination of 5 other corporate credit unions which are state chartered and not federally insured. Our EDP examiners have been examining credit unions, credit union service organizations, and independent companies that provide EDP services to credit unions. These EDP examination reports are routinely distributed to state supervisory agents. This sharing of information has done much to improve our relationship with the various states.

It is our intent to develop a working partnership with the state supervisors rather than to duplicate their efforts or unilaterally displace them from their supervisory role. In our effort to forge a strong partnership we have opened our training programs to state examiners. Since January 1981 some 55 state examiners have attended NCUA and FFIEC training programs.

We have instituted quarterly meetings between our regional directors and the state credit union supervisors to identify and address problem areas and to schedule, where appropriate, joint examinations of federally insured state chartered credit unions. To further enhance this cooperative effort we have instituted semiannual meetings between NCUA and state supervisors through the National Association of State Credit Union Supervisors. Within this cooperative framework, since January 1981, NCUA staff have participated in supervision or examination contacts at approximately 100 state chartered credit unions and assisted in mergers involving 381 state chartered credit unions.

We intend to make available to state supervisors Evaluation Performance Reports for federally insured credit unions in their states. We believe that through the use of these objective reports we can further improve our working relationship with state supervisors and forge a mutually beneficial partnership which is compatible with both our supervisory responsibility and the rights and responsibilities of the states.

We share your concern regarding the increasing numbers of problem credit unions and liquidations. However, we believe that the involuntary liquidation statistics cited tend to illustrate recent credit union experiences, which include rapid change in economic conditions and growth in total assets and operations. Based on our analysis, it appears that much of the increase in liquidation activity is in proportion to the total growth which has occurred in the credit union industry. For example, between 1977 and 1980, the total dollar amount of share claims paid by NCUSIF in involuntary liquidations when related to the total dollar amount of insured shares increased by only .076% (.034% for

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12/31/77 to .110% for 12/31/80). The change for the period year-end 1980 to year-end 1981 was an increase of .024%.

On the other hand, the total shares in federally insured problem credit unions equaled 1.4% of total insured shares in 1977 and had increased to 4.4% of total insured shares in 1980. This increase in problem credit union shares reflects that economic problems are impacting large as well as small credit unions and would appear to indicate that the supervisory process is identifying the problems. This increase is cause for concern and has been addressed by a number of actions which are described above.

The desired effects of these changes include more frequent supervisory contact with credit unions by examiner staff and regional staff when necessary, better utilization of call report data as a surveillance tool for NCUA staff and an information tool for credit union management, and more expeditious handling of supervisory matters since the authority to authorize action is closer to the supervised institution.

We find these changes to be consistent with the premise that our most effective supervision tool in a majority of problem cases is the examiner's working relationship with officials in correcting problems. Formal enforcement efforts certainly are appropriate but will vary in severity and duration depending upon number of priorities, amount of resources, and risk to the insurance fund.

The report included the following recommendations on pages 23 and 33 to the National Credit Union Administration (NCUA) Board:

1. "Clarify for regional personnel the purpose and circumstances for which preliminary warning letters and administrative actions should be used, including guidance as to when mild actions should be replaced by stronger ones."

> Current examination and supervision procedures are geared to detection and correction of problems in federally insured credit unions as a means of reducing risk to the NCUSIF. Examiner and regional office staff are directed as a matter of policy to evaluate the need for supervisory action and its form during each examination and supervision contact. As recognized in the report, the volunteer staffing of many smaller credit unions precludes the effective utilization of formal administrative action, such as cease and desist orders. However, we do agree there may be more instances where more formal administrative actions may be appropriate.
>
> The agency's effective utilization of cease and desist actions, while appropriate in certain cases, is hindered by mandated hearings, notice periods, and by limits on staff resources needed to effectively pursue formal administrative procedures.

2. "Direct that problem credit unions be properly classified and institute periodic reviews to ensure that ratings are properly assigned and reflect the credit unions' conditions."

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Current supervision policy provides specific criteria for proper classification of credit unions with problems. These classifications are reviewed at the regional level in conjunction with the review of examination reports and reports on supervision contacts. Current changes in policy will give regional directors the latitude to authorize supervision or follow-up review contacts with problem credit unions on an as needed basis rather than within specified time frames, which has been past practice. This approach should reduce misclassification of problem credit unions as noted in the report. NCUA's Department of Supervision and Examination staff will review on a sample basis the accuracy of problem credit union classification through report review, on-site visits with examiner staff in the field, and surveillance monitoring of semiannual call report data.

3. "Initiate and complete a comprehensive study of state examination programs which includes standards by which the acceptability of the various state programs can be measured."

Regional directors do currently evaluate individual state examination and supervision process by working with state supervisory authorities on issues involving problem resolution. Regional office staff review examination reports of federally insured credit unions submitted by state supervisors within the region. Furthermore, federal examiners participate in selected insurance reviews of federally insured state-chartered credit unions. This approach gives the regional directors the flexibility to judge conditions and to take actions with proper latitude to effectively set priorities and to properly allocate resources. As noted in the report, previous attempts to standardize the evaluation process placed NCUA's positive working relationship with state supervisory authorities in jeopardy. In assessing the benefits of uniform standards in relation to the more informal review process, the effort to achieve an absolute uniform standard does not appear to be cost effective. However, NCUA will continue to monitor the federally insured state credit union program through the central office supervision, examination, and insurance functions.

4. "Establish a process whereby the NCUA can monitor future changes in the state examination programs"

5. "Develop standards and guidelines for regional staff to assess the reliability of state examination data."

As previously indicated, the monitoring of state examination programs is being conducted by ongoing, established working relationships between regional staff and state supervisory authorities. The effectiveness of this process can be monitored by the results achieved by individual credit union operations. One method of reviewing this activity is through analysis of individual and aggregate trends and ratios of call report data gathered semiannually. This capability is being refined, with planned implementation for the December 31, 1982, call report cycle.

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6. "Develop guidelines for regional staff regarding actions which should be taken to monitor problem state credit unions and to determine when Federal intervention is necessary."

> We concur with a need for improvement in the area of guidelines for monitoring state credit unions. Again, regional director discretion will be necessary to properly allocate resources to the review and monitoring of problem credit unions.

We appreciate the opportunity to comment on the report. If you have any questions, please contact me.

Sincerely,

E. F. Callahan

E. F. CALLAHAN
Chairman

(233066)

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