NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF NORLARCO CREDIT UNION

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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review of Norlarco Credit Union (Norlarco). We reviewed Norlarco to (1) determine the cause(s) of Norlarco's failure and the resulting loss to the National Credit Union Share Insurance Fund (NCUSIF), and (2) assess NCUA's supervision of the credit union. To achieve these objectives, we analyzed NCUA and Colorado State Supervisory Authority (SSA) examination and supervision reports and related correspondence; interviewed management and staff from NCUA Region V and the Colorado SSA; and reviewed NCUA and SSA guides, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPRs).

We determined that Norlarco management's actions created credit, liquidity compliance, and strategic risks which directly contributed to the credit union's failure. Specifically, the Board of Directors (Board) and management ignored sound risk management principles by committing a significant portion of the credit union's assets to a risky Residential Construction Lending (RCL) program without adequate controls in place to oversee the program's daily operations.

Significant factors in Norlarco's failure were management's inability to adequately identify, manage, and mitigate the risks within its RCL program. Specifically, management's poor strategic decisions over its lending practices, as well as the inability to find adequate funding sources to meet commitments, created risks that Norlarco management did not, or could not, effectively manage. In addition, the risks and issues plaguing Norlarco were interrelated and inseparable. Eventually, management's inability to effectively manage the risks its own actions had created, led to Norlarco's failure.

Colorado SSA and NCUA examiners determined, and the OIG agrees, that Norlarco management failed to perform due diligence and establish appropriate controls over the RCL program. Specifically, Norlarco management:

- Failed to conduct a due diligence review of its relationship with its third-party vendor, First American Funding, LLC[1] (First American);

- Failed to adequately oversee the RCL program;

- Created a concentration risk by committing to fund $30 million per month in construction loans;

- Failed to develop an adequate Asset-Liability Management (ALM) policy; and

[1] The owner of First American Funding, LLC also owns First American, Inc. For purposes of this report, we will refer to both companies as First American.

- Failed to develop adequate policies and a strategic plan to guide the credit union and the RCL program.

In addition, we determined Norlarco management took undue advantage of its field of membership to grow the RCL program.

We also determined Colorado SSA and NCUA examiners did not adequately evaluate the safety and soundness of Norlarco's loan participation program. As a result, we believe SSA and NCUA examiners missed an opportunity to slow the RCL program's growth, which might have mitigated the loss to the NCUSIF.

Auditor Observations made as a result of our review of Norlarco's failure included:

- Examiners did not view the participation program and the participation agreements as safety and soundness concerns fraught with risk.

- Examiners did not associate the rapid rise of loans sold through participations as a potential safety and soundness concern to Norlarco, or to the NCUSIF, but rather examiners merely viewed participations as a means to manage Norlarco's balance sheet risk.

We also reviewed industry observations regarding the failures of financial institutions, as well as recent NCUA observations regarding credit union failures. We believe the industry's and NCUA's observations apply directly to issues we observed during our review. Our comparative analysis can be found in Section C. of this report.

NCUA management previously established guidance to credit union management and examiners to address the issues that led to Norlarco's failure, such as third-party lending, liability management, balance sheet risk management, etc. However, based on this review, it was clear Norlarco management failed to follow this guidance. Since NCUA officials declared Norlarco insolvent,[2] NCUA has provided additional guidance to credit union management and examiners to address deficiencies in the area of participation lending. Therefore, we are making no formal recommendations to NCUA management at this time.

We appreciate the courtesies and cooperation NCUA and Colorado SSA management and staff provided to us during this review.

[2] NCUA officials determined Norlarco was insolvent as of November 30, 2008.

Background

Norlarco Credit Union

Norlarco, located in Fort Collins, Colorado, was originally chartered as a Federal credit union in 1959 to serve employees of Colorado State University and local school district employees. In 1979, Norlarco converted to a state charter and its field of membership included the residents of Larimer and western Weld counties in north-central Colorado. On November 10, 2005, Kodak Colorado Division Credit Union located in Windsor, Colorado merged into Norlarco.

On May 15, 2007, the Commissioner of the Colorado Division of Financial Services (DFS), a State Supervisory Authority, placed Norlarco into conservatorship and appointed the NCUA as conservator. The NCUA Board approved the Federal conservatorship of Norlarco on July 26, 2007. At the time of conservatorship, Norlarco was a full service, federally insured state credit union (FISCU) servicing over 42,000 members through its more than 180 select employee groups and six branches. Norlarco was located in NCUA's Region V.

In November 2007, the NCUA accepted bids from credit unions interested in acquiring Norlarco. In January 2008, the NCUA selected the bid of Public Service Credit Union (PSCU), a FISCU located in Denver, Colorado.

On February 29, 2008, the NCUA Board placed Norlarco into involuntarily liquidation under section 207(b)(3) of the Credit Union Act[3] and appointed itself as liquidating agent. Also on this date, the NCUA, as liquidating agent, executed a purchase and assumption (P&A) agreement and transferred the assets, liabilities, and shares of Norlarco to PSCU, for a premium of $21.6 million. Norlarco's assets at the time were approximately $275 million. The P&A by PSCU resulted in a loss to the NCUSIF of approximately $10.0 million; however, the final cost to the NCUSIF will not be known until all assets are sold.

NCUA Examination Process

Total Analysis Process

NCUA uses a total analysis process that includes: collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL[4] components, and reviewing qualitative and quantitative measures.

[3] 12 U.S.C. §1787(b)(3(A)

[4] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and Asset/[L]iability Management

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

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[5] trend analysis,[6] reasonableness analysis,[7] variable data analysis,[8] and qualitative data analysis.[9] Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends. Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, NCUA requires examiners to determine whether material negative trends exist; ascertain the action needed to reverse unfavorable trends; and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

Risk-Focused Examination Program

In May 2002, NCUA announced its new Risk-Focused Examination (RFE) Program, for implementation in the fall of 2002. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, a*nd *Reputation.* Examination planning tasks may include (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up; and (b) analyzing Call Report and FPR trends. The extent of supervision plans depends largely on the severity and direction of the risks detected in the credit union's operation and on management's demonstrated ability to manage those risks. A credit union's risk

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[5] Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

[6] Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

[7] As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

[8] Examiners can often analyze an examination area in many different ways. NCUA's total analysis process enables examiners to look beyond the "static" balance sheet figures to assess the financial condition, quality of service, and risk potential.

[9] Qualitative data includes information and conditions that are not measurable in dollars and cents, percentages, numbers, etc., which have an important bearing on the credit union's current condition, and its future. Qualitative data analysis may include assessing lending policies and practices, internal controls, attitude and ability of the officials, risk measurement tools, risk management, and economic conditions.

profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

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

On November 20, 2008, the NCUA Board approved changes to the risk-based examination scheduling policy, creating the 12-Month Program.[10] NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the 12-Month Program will provide more timely relevant qualitative and quantitative data to recognize any sudden turn in a credit union's performance.

Supervision of FISCUs

NCUA's statutory authority and its guidelines indicate the agency has the legal and fiduciary responsibility to ensure the safety of the NCUSIF. FISCUs receive the same account insurance coverage under the NCUSIF as federally chartered credit unions. Therefore, FISCUs are subject to the same review of risks as other credit unions. The two most common types of onsite FISCU reviews are an independent insurance review and a joint examination/insurance review. During both reviews, NCUA limits its scope to risk issues negatively affecting the NCUSIF. However, during an independent insurance review, NCUA examiners limit their role to the review and analysis of risks to the NCUSIF only, rather than to complete an examination of the FISCU. In joint examinations/insurance reviews, both NCUA and the SSA examiners focus on risk issues, while the state examiner also focuses on regulatory concerns.

NCUA examiners primarily monitor the financial condition and progress of FISCUs by reviewing SSA examination reports, Call Reports (5300 Reports), and FPRs. In reviewing SSA reports, NCUA's concerns include whether:

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

[10] The 12-month program requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling eligibility.

The Federal Credit Union Act (FCU Act) requires that, because SSAs are primarily responsible for the supervision of insured state credit unions, NCUA should use the SSA examination reports to the maximum extent feasible.[11] However, NCUA reserves the right to conduct an insurance review of any FISCU as it deems necessary to determine its condition for insurance purposes.[12]

Objective, Scope and Methodology

The FCU Act requires the NCUA Office of Inspector General to conduct a material loss review if the loss to the NCUSIF exceeds $10 million.[13] NCUA notified the OIG of a loss reserve for Norlarco of $12 million. Consequently, in accordance with the FCU Act and Chapter 3 of the NCUA Special Assistance Manual, we initiated a material loss review.

The objectives of our review were to (1) determine the cause(s) of Norlarco's failure and the resulting loss to the NCUSIF, and (2) assess NCUA's supervision of the credit union. To accomplish our review, we conducted fieldwork at NCUA's headquarters in Alexandria, VA, and its regional office in Tempe, AZ.

To determine the cause of Norlarco's failure and assess the adequacy of NCUA's supervision we:

- Analyzed NCUA and Colorado SSA examination and supervision reports and related correspondence;

- Interviewed management and staff from NCUA Region V and the Colorado SSA; and

- Reviewed NCUA and state policies and procedures, NCUA Call Reports (5300 Reports), and NCUA FPRs.

Our review covered the period from August 1998 to February 2008, Norlarco's liquidation date. We conducted our fieldwork from November 2008 through May 2009. We conducted our review in accordance with generally accepted government auditing standards.

[11] The FCU Act, 12 U.S.C., Chapter 14, § 1781(b)(1).
[12] The FCU Act, 12 U.S.C., Chapter 14, § 1784(a).
[13] The FCU Act, 12 U.S.C. § 1790d, §216(j) requires that the OIG conduct a review when the NCUSIF has incurred a material loss with respect to a credit union. A material loss is defined as (1) exceeding the sum of $10 million and (2) an amount equal to 10 percent of the total assets of the credit union at the time at which the Board initiated assistance or was appointed liquidating agent.

RESULTS IN DETAIL

We determined Norlarco management's actions contributed directly to the credit union's failure. In addition, we determined NCUA examiners may have been able to mitigate the loss to the NCUSIF had they fully recognized Norlarco's loan participation program represented a potential safety and soundness concern.

A. Why Norlarco Credit Union Failed

Management's Actions Led to Norlarco's Failure

We determined Norlarco management's actions created credit,[14] liquidity,[15] compliance,[16] and strategic risks[17] which directly contributed to the credit union's failure. Specifically, Norlarco's Board and management ignored sound risk management principles by committing a significant portion of the credit union's assets to a risky residential construction lending program without adequate controls in place to oversee the program's daily operations.

Significant factors in Norlarco's failure were management's inability to adequately identify, manage, and mitigate the risks within its RCL program. Specifically, management's poor strategic decisions over its lending practices, as well as the inability to find adequate funding sources to meet commitments, created risks that Norlarco management did not, or could not, effectively manage. In addition, the risks and issues plaguing Norlarco were interrelated and inseparable. Eventually, management's inability to effectively manage the risks their own actions had created, led to Norlarco's failure. Although some may view the downturn in the real estate market[18] as the cause of Norlarco's failure, management's actions clearly left the credit union overexposed to unfavorable economic conditions.

Colorado SSA and NCUA examiners determined, and the OIG agrees, that Norlarco management failed to perform due diligence and establish appropriate controls over the RCL program. Specifically, Norlarco management:

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[14] Credit Risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet terms of any contract with the credit union or otherwise fail to perform as agreed. Credit risk exists in all activities where the credit union invests or loans funds with the expectation of repayment.
[15] Liquidity Risk is the current and prospective risk to earnings or capital arising from a credit union's inability to meet its obligations when they come due, without incurring material costs or unacceptable losses. Liquidity risk includes the inability to manage funding sources.
[16] Compliance Risk includes the current and prospective risk to earnings or capital arising from violations of, or nonconformance with rules, regulations, prescribed practices, internal policies and procedures, or ethical standards.
[17] Strategic Risk is the current and prospective risk to earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.
[18] A Business Week article published in April 2005 indicated that extremely cheap mortgage rates had fueled a record-setting level of home sales since 2001. Demand had caused home prices to jump at rates not seen since the 1980s. Another article published in Barron's in August 2006 indicated the housing market boom appeared to have ended abruptly for many parts of the U.S. in late summer of 2005, and as of summer 2006, several markets were facing increasing inventories, falling prices, and sharply reduced sales volumes.

- Failed to conduct a due diligence review of its relationship with its third-party vendor, First American;

- Failed to adequately oversee the RCL program;

- Created a concentration risk by committing to fund $30 million per month in construction loans;

- Failed to develop an adequate Asset-Liability Management[19] (ALM) policy; and

- Failed to develop adequate policies and a strategic plan to guide the credit union and the RCL program.

In addition, we determined Norlarco management took undue advantage of its field of membership to grow the RCL program.

<u>Summary of Norlarco's CAMEL Ratings History and RCL Program</u>

From 1993 through 2002, Norlarco consistently received composite code 1 or 2 CAMEL ratings based on a business plan that concentrated on routine financial services.

In late 2001, the Board approved the creation of the RCL program. The RCL program allowed Norlarco to finance and service construction loans through a third-party broker/servicer, First American. First American is a Colorado-based company that originates, closes, services and administers residential home construction loans. In addition, First American obtains permanent financing for borrowers upon maturity of the construction loans.

In August 2003, Norlarco management entered into a Funding and Services Agreement with First American to fund $30 million per month in construction loans under the RCL program. NCUA examiners indicated Norlarco management expanded the RCL program because of flat loan demand in auto financing and home equity lines of credit. Norlarco management indicated they wanted to allow for improved yield and earnings. Examiners indicated the RCL program had shown excellent yield and profitability levels. Examiners also indicated the program had generated a million dollar profit with no losses. The Funding and Services Agreement included:

- A requirement that First American would obtain permanent financing for the borrower upon the maturity of the construction loan.

[19] ALM is the process of evaluating balance sheet risk (interest rate and liquidity risk) and making prudent decisions, which enables a credit union to remain financially viable as economic conditions change.

- A guarantee by First American to buy back all residential construction loans from Norlarco if First American or the borrower was not able to obtain permanent financing.[20]

- A guarantee by First American to make any interest payments on construction loans that were more than 45-days past due.

In December 2003, First American entered into a construction loan agreement with Palm Harbor Homes, Inc. (Palm Harbor), a builder of manufactured homes. Initially, First American worked with Palm Harbor to fund construction loans through Norlarco and 55 other construction lenders for properties located in Texas. The agreement guaranteed Palm Harbor would buy back all construction loans from First American for which borrowers did not obtain permanent financing.

In October 2004, First American and Norlarco shifted the focus of the RCL program to fund construction loans for properties located primarily in Lee County Florida. Also, in October 2004, First American entered into a construction loan agreement with First Home Builders of Florida (FHBF). The agreement included a guarantee by FHBF to First American (and Norlarco) that FHBF would pay all debts and liabilities owed by buyers pursuant to construction loans until permanent financing satisfied the construction loans.

From 2003 to 2007, Norlarco's Composite CAMEL rating slowly eroded from a code 2 in March 2003 to a code 4 at its last joint examination conducted in April 2007. In November 2007, NCUA determined Norlarco's Probable Asset/Share (PAS)[21] ratio was 99.19 percent, and concluded that the eroded Florida real estate market would further drop Norlarco's PAS to approximately 90 percent. Ultimately, NCUA concluded Norlarco was insolvent[22] due to the potential losses resulting from the Florida RCL program. Appendix A provides details regarding the examination history of Norlarco and the CAMEL ratings.

<u>Summary of Management's Actions</u>

The following summarizes Norlarco management's actions contributing to the credit union's failure:

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[20] First American would purchase the construction loan no later than 7-months following the original maturity date of the construction loan.

[21] NCUA defines the Probable Asset/Share ratio as the relative worth of each one dollar in shares using an ongoing concern concept.

[22] A credit union is determined to be insolvent when the total amount of shares exceeds the present cash value of its assets after providing for liabilities unless: (a) it is determined by the NCUA Board that the facts that caused the deficient share-asset ratio no longer exist; (b) the likelihood of further depreciation of the share-asset ratio is not probable; (c) the return of the share-asset ratio to its normal limits within a reasonable time for the credit union concerned is probable; and (d) the probability of a further potential loss to the insurance fund is negligible.

Norlarco management failed to conduct a due diligence review of its relationship with its third-party vendor, First American

An NCUA examiner determined Norlarco management failed to perform a due diligence review before entering into a third-party relationship with First American. More significantly, we found no evidence Norlarco management ever assessed First American's financial ability to fulfill its buyback commitment to Norlarco on defaulted construction loans. We believe this was a crucial oversight considering the magnitude of Norlarco's $30 million per month commitment to fund construction loans underwritten by First American.

NCUA guidelines indicate credit union officials should require a due diligence review prior to entering into any arrangement with a third-party. This should include a review of the company's financial statements to determine the strength of the institution. The guidelines indicate a weakly capitalized third-party vendor could lead to potential losses.

We learned that as of December 2003, First American's assets totaled approximately $5.8 million, which included approximately one hundred thousand in cash. We also learned First American worked with 55 other financial institutions to fund construction loans. Although we were unable to determine whether First American had entered into similar Funding and Service Agreements with any of the other 55 financial institutions, even one additional agreement with similar guarantees could have created a significant financial burden on First American's assets.

First American's questionable financial means to fulfill its buyback guarantee was highlighted when examiners learned, during the September 30, 2005 examination, that Norlarco management provided First American a $2.5 million line of credit, which First American used to buy back loans that were past due or were in the process of litigation or foreclosure. We believe that if Norlarco management had conducted a third-party due diligence review before entering its relationship with First American, management may have questioned First American's financial standing, considering the terms of the agreement.

After the Colorado SSA placed Norlarco in federal conservatorship in May 2007, NCUA officials concluded First American did not have the financial capability to guarantee payment on the RCL program loans, which at the time were over $230 million.

Norlarco management failed to adequately oversee the RCL program

Colorado SSA and NCUA examiners determined Norlarco management had allowed First American complete control in making and overseeing Norlarco's construction loans in the RCL program. Specifically, First American provided the entire servicing function for Norlarco, which included conducting the underwriting

of the borrower, qualifying the borrower as a potential member of Norlarco, arranging for the contractor to build the home, conducting the inspections, forwarding to Norlarco draw requests and interest payments based on its own inspections and schedule, qualifying the borrower for take-out financing, and forwarding extensions of matured loans and interest payments on those loans to Norlarco.

NCUA guidelines indicate that inadequately managed and controlled third-party relationships can result in unanticipated costs, legal disputes, and financial loss. NCUA has issued guidance to remind credit union officials that, when working with third-parties, credit union officials are still responsible for planning, directing, and controlling the credit union's affairs.

Norlarco management's lack of oversight of the RCL program resulted in:

- Overreliance on guarantees in the RCL program,
- Underreported delinquencies in the RCL portfolio,
- Misclassification of loans in the RCL program, and
- Declining borrower credit quality.

Overreliance on Guarantees in the RCL Program

We determined Norlarco management relied on guarantees that either were not financially sound or did not exist. NCUA officials indicated Norlarco management had a multitude of contracts and agreements associated with the RCL program, but had not conducted a legal review of these documents. As a result, NCUA officials indicated Norlarco management did not have a sufficient grasp of its contractual rights and responsibilities.

Norlarco management indicated the RCL program's purported multi-tier guarantee structure minimized the credit risk to Norlarco. Specifically, Norlarco management indicated:

- The first tier was traditional real estate security provided by Norlarco which held the first deed of trust on each loan.
- The second tier was contingent upon First American's financial ability to meet its contractual obligations. This included a guarantee by FHBF to First American (and Norlarco) that FHBF would pay all debts and liabilities owed by buyers pursuant to construction loans until permanent financing satisfied the construction loans.

We determined the foundation of the second tier was tenuous. As previously discussed, NCUA officials stated, and we agree, that First American did not have the financial capability to fulfill its guarantee to Norlarco. Furthermore, the guarantee Norlarco management believed First American had with FHBF may not have existed after June 2005 because First American and FHBF had removed the guarantee from the original agreement. The following is the chronology associated with First American's Construction Loan Agreement with FHBF:

- In October 2004, First American entered into a Construction Loan Agreement with FHBF. The agreement indicated First American was a servicing and loan disbursement company for Construction Lenders.[23] The intent of the agreement was that neither FHBF nor First American (or the Construction Lenders) would realize a loss on a construction loan as the result of a breach, default or failure by a buyer. The agreement included a guarantee to First American and the Construction Lenders that FHBF would pay all debts and liabilities owed by a buyer until the permanent financing satisfied the construction loan.

- On June 7, 2005, FHBF and First American modified their original agreement to (1) remove the guarantee, and (2) indicate that the construction loans were the obligations of the borrowers and were not guaranteed obligations of FHBF.

- On July 28, 2005, Hovnanian Enterprises, Inc. (Hovnanian, Inc.) contacted First American due to its pending purchase of FHBF's assets.[24] Hovnanian, Inc. requested First American provide them confirmation of First American's lending relationship with FHBF.

- On August 1, 2005, First American formally confirmed to K. Hovnanian First Homes, LLC[25] (KHov) that there were no written, verbal, direct or indirect agreements that required a guaranteed buyback of mortgage loans by FHBF.

- On August 2, 2005, First American formally communicated to KHov that it understood KHov would not provide any form of financial guarantees on the loans.

NCUA officials indicated there was no evidence Norlarco management had approved and waived their vested interest as a beneficiary to the agreement. NCUA officials also indicated, and we agree, it was not clear whether Norlarco

[23] The Construction Lenders were a network of licensed construction mortgage lenders (including Norlarco) who were third-party beneficiaries of the agreement, having the same rights and remedies as First American.
[24] Hovnanian Enterprises, Inc., designs, constructs and markets a variety of for-sale housing in 284 residential communities in 18 states.
[25] K. Hovnanian First Homes, LLC is a wholly-owned subsidiary of Hovnanian Enterprises.

management knew about the elimination of this guarantee because, subsequent to the modification:

- Norlarco management had represented the existence of the guarantee to several participants.

- Norlarco's Chief Executive Officer (CEO) indicated the builder's guarantee justified Norlarco management's risk in participating in the RCL program. The CEO indicated the burden of defaults and delinquencies would have fallen first on the builders, secondly on First American, and lastly on Norlarco.

NCUA officials indicated Norlarco management should have had independent legal counsel review the agreements related to the RCL program to ensure management understood each party's rights and responsibilities under the terms of the agreements prior to meeting with the RCL program's new builder in 2007. We agree with NCUA officials' assessment. In addition, we believe Norlarco management should have conducted independent legal reviews before each of the agreements and revisions were executed, starting with the initial Funding and Services Agreement entered into with First American in August 2003.

Underreported Delinquencies in the RCL Portfolio

NCUA officials determined Norlarco management permitted First American to comprehensively and unilaterally extend residential construction loans in the RCL program. Norlarco officials admitted First American extended these loans to maintain the borrowers' interest payments and avoid delinquency reporting. We also believe First American extended the loans to avoid having to fulfill its buyback guarantee.

NCUA guidelines indicate credit unions should not use extension agreements to cover up delinquency problems. First American's extensions of Norlarco-funded construction loans ultimately led to Norlarco underreporting its delinquencies to NCUA. For example, from June 2006 through December 2006, Norlarco's overall delinquency ratio was reported at less than one percent. NCUA and SSA examiners determined extensions in the RCL program were approximately 48 percent as of July 31, 2006. When NCUA and SSA examiners required the credit union to cease all extensions on properties with Certificates of Occupancy, Norlarco's reported delinquencies increased from 2.14 percent as of March 2007 to over 20 percent in June 2007.

By November 2007, NCUA officials determined that 87 percent of the RCL program loans had been extended once, 51 percent had been extended twice, and six percent had been extended three times. In addition, NCUA officials

determined that 97 percent of the RCL program loans were more than 180 days delinquent and Norlarco's overall delinquency ratio was over 25 percent.[26]

Examiners stated the integrity of financial reporting and disclosure to the Colorado DFS and NCUA was compromised due to the extensions. Therefore, it was impossible for NCUA and SSA examiners to gain an accurate assessment of Norlarco's delinquencies. As a result, examiners did not have accurate information, during examinations and offsite monitoring, to determine the potential losses in Norlarco's RCL program.

Misclassified Loans in the RCL portfolio

NCUA officials determined Norlarco management's internal controls over the RCL program were so lax that the Board and management failed to recognize the vast majority of the loans in the RCL portfolio were for investment purposes. NCUA officials determined the borrower's intent was often misrepresented on the loan applications underwritten by First American. In fact, NCUA officials indicated some borrowers owned multiple properties - some on the same street, which were not being reported as member business loans (MBLs). As a result, NCUA officials required Norlarco management to reclassify every RCL portfolio loan as a MBL until each borrower could be contacted to verify the intent of their loan.

NCUA's statutory limit on MBLs requires a credit union's aggregate net MBL balance to be the lesser of 1.75 times its net worth or 12.25 percent of its total assets. As of December 2006, Norlarco presented its MBL balance at approximately $39 million, 1.15 times Norlarco's net worth and 10.9 percent of its total assets, which was within NCUA's statutory limits. After Norlarco management reclassified the loans, Norlarco's MBL balance as of March 2007 was $86.7 million, nearly three times Norlarco's $30.5 million net worth, and the ratio of MBLs to assets ($353.8 million) was more than 24 percent. Based on the statutory limits, Norlarco's MBL balance should not have exceeded approximately $43 million.[27]

As a result of Norlarco's ongoing misclassification of its RCL portfolio loans, NCUA and SSA examiners did not have accurate information to properly supervise the credit union.

Declining Borrower Credit Quality[28]

NCUA and SSA examiners determined, and we agree, the credit quality of borrowers declined steeply as the RCL program progressed. During an

[26] The peer delinquency ratio was 1.01 percent as of December 31, 2007.
[27] Forty-three million dollars represents 12.25 percent of Norlarco's assets of $353.8.
[28] The borrowers' credit quality refers to a borrower's capacity to repay a loan as represented by their credit score and proof of income.

examination completed in April 2007, NCUA and SSA examiners reviewed 350 credit scores from a sample of 360 RCL program loans and determined (1) borrowers' credit scores declined[29] and (2) proof of income to support the borrowers' ability to repay the construction loans became more limited as the RCL program progressed. In addition, we reviewed the credit scores of 1,240 borrowers of Florida RCL program loans financed by Norlarco valued at more than $308 million and also determined the credit quality of borrowers declined between 2005 and 2006.[30] As a result of this declining credit quality, Norlarco was exposed to higher credit risk.

Credit scores provide the best guide to future risk when only considering credit report data.[31] The higher the credit score a borrower has, the lower the risk for the lender.[32] Table 1 illustrates the system we used to group the borrowers' credit scores:

Group	Credit Score Range
1	720 and over
2	700-719
3	680-699
4[33]	660-679
5	640-659
6	620-639
7	600-619
8	Below 600

Table 1: Credit Score Rating Categories

Based on our review of the borrowers' credit scores, we determined the number of borrowers with credit scores below 680 increased from approximately 30 percent in 2005 to more than 41 percent in 2006. Although borrowers with credit scores between 680 and 699 increased just slightly over one percent from 2005 and 2006, borrowers with credit scores from 700 and above declined from approximately 56 percent to 43 percent. Chart A (below) summarizes the credit scores of the 1,240 borrowers we reviewed:

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[29] The median credit score of all loans examiners reviewed was 687. However, the median credit score for the 153 loans reviewed that were granted in 2006 was 665, and the credit scores on 36 percent of the loans reviewed that were granted in 2006 were less than 639.
[30] In 2005, 651 of the loans were financed for approximately $157 million. From January 1, 2006 through August 21, 2006, 589 of the loans were financed for approximately $151 million.
[31] According to MyFICO.com, a division of Fair Isaac Corporation (FICO).
[32] Credit scores can range between a low score of 300 and a high of 850. There is no single cutoff score used by all lenders.
[33] A borrower with a credit score in this group would be considered as having "Ok" credit.

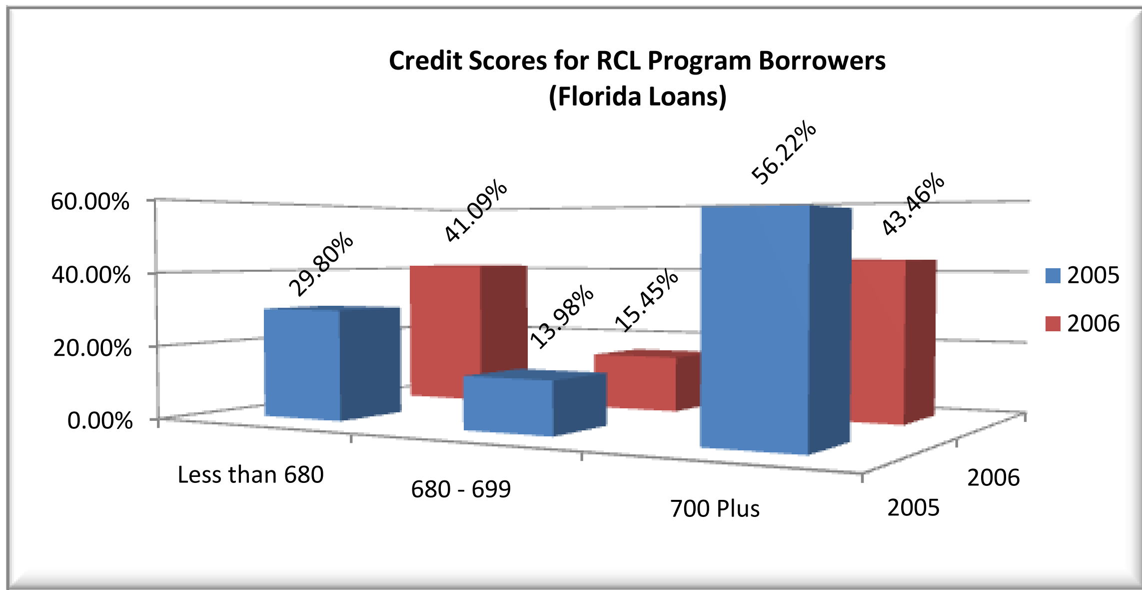

Chart A: Summary of Borrower Credit Scores Reviewed by OIG

In addition, of the sample of 350 RCL program loans NCUA and SSA examiners reviewed, examiners indicated the majority of RCL program borrowers stated the intent of the construction loans was for first and second residences. However, not only did the examiners indicate the characteristics of the loans[34] did not support this intent, but they also indicated that borrowers' credit scores did not support a second residence.

Furthermore, the examiners determined that of the 350 loans they reviewed, proof of income to support the borrowers' ability to repay the loans became more limited as the RCL program progressed. Specifically, the examiners determined:

- Approximately 14 percent (47) of the loans included limited documentation to support the borrower's capacity to repay;
- 55 percent (193) of the loans were "stated-income" loans where borrowers are not required to provide documentation to support the income included on the application; and
- 31 percent (109) of the loans, approved during the latter portion of the RCL program,[35] were No Income No Asset (NINA) loans, which do not require the borrower to disclose income or provide bank statements.[36]

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[34] Examiners indicated that without income verification or stated income on many of the loans, it was impossible to adequately determine if the borrowers had the capacity for a primary or secondary residence.
[35] From the end of 2005 through the end of the RCL program
[36] Generally, NINA loans represent a higher risk to the lender, requiring a higher credit score.

The examiners determined the NINA loans would have represented approximately $23 million (31 percent) of the $73 million in Norlarco RCL wholly/partially owned loans as of February 20, 2007. In addition, the NINA loans would have represented 68 percent of Norlarco's December 31, 2006 net worth of $33.6 million, which created significant credit and concentration risks. Although "stated income" and NINA loans have been an accepted practice for qualifying borrowers, we believe the results of the loan review, which determined 86 percent of the loans required no supporting documentation for borrowers' income, clearly demonstrate that Norlarco management's actions created significant credit and concentration risks in its RCL portfolio.

Norlarco management created a concentration risk by committing to fund $30 million per month in construction loans

We determined Norlarco management's $30 million monthly commitment resulted in an excessive concentration of the credit union's assets in a residential construction lending program operated by a single third-party servicer. However, NCUA officials indicated that First American and Norlarco did not have the expertise necessary to handle a mortgage broker/servicing arrangement with such a high monthly loan volume. In addition, Norlarco management also concentrated a significant portion of the credit union's assets in one geographic location - Lee County, Florida.

Concentration in a Single Residential Construction Lending Program

Examiners indicated Norlarco management's policy[37] was to limit the loans in the RCL portfolio to five percent of total assets, with an additional two percent allowance for participations.[38] However, we determined that as a result of its monthly commitment,[39] Norlarco's RCL portfolio increased to more than 35 percent of its total assets as of September 2005[40] - from just over $13 million in Norlarco-owned commitments as of February 2003 to more than $123 million in outstanding loans as of September 2005. In addition, Norlarco's unfunded commitments for residential property loans increased from $47 million as of March 2003[41] to $165 million as of September 2005. The value of Norlarco's outstanding RCL program loans and unfunded commitments - $288 million - was more than 83 percent of Norlarco's total assets.

Examiners indicated that initially, Norlarco management used non-member deposits and borrowings to fund the $30 million monthly loan commitment.

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[37] Examiners determined this was Norlarco's policy as of March 2003.

[38] Federal credit unions may participate with others in loans to credit union members, subject to the provisions of *NCUA Rules and Regulations*. Loan participation represents another potential source of liquidity for credit unions. Typically, participation involves an agreement between two or more credit unions or other types of financial institutions, and includes a pool of loans.

[39] Norlarco management entered into the $30 million per month agreement with First American in August 2003.

[40] The value of Norlarco's total assets as of September 30, 2005 was $347,612,542.

[41] At the time, this data was referred to as 'Unused Commitments'.

Examiners also indicated that when Norlarco reached its borrowing limits, management began selling construction loan participations. From August 2003 to August 2006,[42] Norlarco had funded and sold participations and whole loans to 18 financial institutions. However, examiners indicated during the September 2005 examination that the rate of participations had decreased significantly, with no agreements in place for other institutions to purchase a sufficient number of loans to restore Norlarco to a balanced level of liquidity. The lack of funding sources resulted in Norlarco's increasingly leveraged and illiquid position.

Geographic Concentration in Lee County, Florida

Examiners determined that 97 percent of the properties Norlarco management funded under the RCL program were located in Florida. Specifically, the properties were located in Lee County in the cities, towns or neighborhoods of Alva, Cape Coral, Fort Myers and LeHigh Acres, where a report indicated, based on market conditions,[43] home values in 2005 may have been overvalued by 35 percent.[44] NCUA officials indicated the homes built during Florida's rapid price appreciation through early 2005, enticed a number of borrowers to purchase homes to be constructed. In April 2008, a National Public Radio article about Lee County, Florida real estate indicated that, although just a few years ago there was a rush to buy property in Lee County, Florida, there was now a glut of unsold homes in the county. The article also indicated that, as of February 2008, the county had the highest foreclosure rate in the nation. We believe that when the Lee County Florida real estate market collapsed, Norlarco was unable to absorb the losses from the significant concentration of properties on which buyers did not fulfill their loan obligations.

Auditor's Note: Examiners noted that as of the September 30, 2005 examination completed on November 30, 2005, Norlarco's RCL portfolio was 41 percent of its *total loans*. Interestingly, Norlarco's Financial Planning Committee approved a measure to increase the RCL program loan limit from five percent of *assets* to 40 percent of *total loans* on November 2, 2005.

Norlarco management failed to develop an adequate ALM policy

NCUA officials determined Norlarco management did not have an adequate ALM program in place to monitor its liquidity position. Consequently, NCUA officials determined Norlarco management was unable to forecast the potential liquidity

[42] As a result of the June 2006 examination, the Commissioner, Colorado Division of Financial Services, examiners required Norlarco to cease funding new loans with First American or any wholesale loan program until certain requirements were met, thereby prohibiting the credit union from making any additional loans through the RCL program.
[43] Market conditions are based on historic price data, area income, mortgage rates, and population density.
[44] An article in the August 31, 2005 edition of the *Credit Union Times -Economist says Home Prices Have Risen to "Extremely Overvalued" Levels in 53 Cities* - indicated 53 cities were "at high risk of price declines. One of the cities was Cape Coral, FL where the author indicated home prices may have been overvalued by 35 percent.

problems that would occur due to significant loan growth generated by the RCL program.

NCUA guidelines indicate that credit union boards have responsibility for overseeing the ALM process. As a result of the joint SSA and NCUA examination conducted in November 2005,[45] NCUA and SSA examiners determined the Board's liquidity management policies were not commensurate with the complexity of its funding sources. The examiners determined Norlarco management: (1) extensively used non-member deposits, overnight corporate borrowing, and term borrowings from the Federal Home Loan Bank; and (2) pursued loan participation sales to fund the $30 million per month in loan commitments for the RCL program in Florida. However, NCUA and SSA examiners indicated they could not find any policy that required reporting asset sales, borrowing activity, or use of non-member deposits. In fact, the examiners indicated Norlarco's ALM reporting was not sufficient, and the Board and the Asset Liability Committee were not discussing liquidity management. The examiners considered this an unsafe and unsound practice; therefore, they rated Norlarco's liquidity risk as "high".

Norlarco management failed to develop adequate policies and a strategic plan to guide the credit union and the RCL program

Colorado SSA and NCUA examiners determined that approximately two years after Norlarco management entered into the $30 million per month Funding and Services Agreement with First American,[46] and approximately 11 months after Norlarco began funding RCL program loans in Florida,[47] Norlarco management's policies and strategic plan were not adequate to guide the RCL program.

Specifically, examiners indicated:

- Norlarco management did not have sufficient and adequate guidance at the policy level to outline operating goals, targets, ranges, concentrations, and limits, or measurements of progress toward those goals and targets.

- The Board's policy did not include guidance or direction regarding participation in the RCL program other than to allow the purchase of third-party loans subject to portfolio limits set by the Financial Planning Committee.[48]

[45] This was approximately 13 months after Norlarco began funding its RCL program in Florida in October 2004.
[46] Norlarco entered into the Agreement with First American in August 2003.
[47] Examiners indicated Norlarco began funding RCL program loans in October 2004.
[48] The only quantitative mention of the RCL program was in a December 2004 presentation to the Financial Planning Committee, which indicated Norlarco management's plan was to aggressively maintain the program and sell off loans as needed to keep [Norlarco's] aggregate total at 'around $65 million'.

- There was no policy that set parameters to limit risk or that required management to report asset sales, borrowing activity, or use of non-member deposits to help fund the $30 million per month loan commitment for the RCL program.

- Norlarco's Strategic Plan for 2005 did not address the RCL program in terms of concentration by percentage, return on investment for purchases, pool sales, or participations.

Examiners determined, and we agree, that as a result of Norlarco management's failure to develop policies and parameters to manage risk in pursuing loan growth, as well as the lack of an adequate strategic plan, Norlarco had escalating levels of liquidity, strategic, and credit risk that required corrective action and monitoring.

Norlarco management took undue advantage of its field of membership

We believe Norlarco management took undue advantage of its field of membership in order to not only help Norlarco fulfill its $30 million per month funding commitment, but also to financially benefit from what economists believe was the largest real estate boom in U.S. history. As a result, management concentrated a significant portion of its loan portfolio in a distant and unfamiliar geographic location. In addition, the RCL program in Florida grew in a rapid and uncontrolled manner and created significant credit and concentration risks.

Colorado DFS provisions allow credit unions to serve fields of membership with a common bond of employment or association or groups residing within a well-defined geographic area. Norlarco used the following Colorado-based associational groups to qualify the Florida RCL program borrowers for Norlarco's field of membership.

- Rocky Mountain Bird Observatory, which addresses bird conservation in the western United States.

- Boys & Girls Clubs of Larimer County, which provides activities for children in three locales in Larimer County Colorado.

- Legacy Land Trust, which protects resources in northern Colorado.

Due to limitations in available data, we were not able to fully determine the geographic location of all RCL program borrowers. However, examiners sampled the Florida RCL loans and determined over 43 percent of the borrowers resided in the Miami-Dade County area of Florida. We learned Norlarco management sent letters to the borrowers/new members that included a statement indicating Norlarco would close their accounts at the completion of their construction loans. We believe this statement clearly indicated Norlarco

qualified the borrowers for membership to help Norlarco fulfill its $30 million per month commitment and take advantage of the ongoing real estate boom. In fact, NCUA and SSA examiners determined that borrowers in the RCL program did not represent opportunities for cross-selling credit union services because the borrowers would not have a relationship with Norlarco beyond the duration of the construction loan. In addition:

- A Colorado DFS official indicated SSA staff were surprised when they learned where the RCL program borrowers were located, and

- An NCUA official indicated Norlarco staff obviously took advantage of its field of membership.

Furthermore, another NCUA official stated, and we agree, Norlarco management made a mistake by establishing a significant loan business in a geographically distant location. The official added that this decision required Norlarco management to rely solely on third-party vendors for information about the local Florida real estate market and the status and progress of the RCL properties.

The RCL program loans increased 293 percent between December 2004 and December 2005. Ultimately, by the end of June 2006, the overall Florida RCL portfolio totaled over $330 million.

Auditor Observations: NCUA management previously established guidance to credit union management and examiners addressing the issues that led to Norlarco's failure. In addition, since declaring Norlarco insolvent, NCUA has provided additional guidance to credit union management and examiners to address deficiencies in the area of participations. The following are *Letters to Credit Unions* and *Risk Alerts* issued to FISCUs between 1991 and 2008 that provide guidance on due diligence over real estate lending, outsourced lending, and loan participations:

Year	Reference	Title
1991	Letter No. 124	Real Estate Secured by Credit Union Members
1995	Letter No. 174	Risk-Based Loans
1999	Letter No. 99-CU-05	Risk-Based Lending
2001	Letter No. 01-CU-20	Due Diligence Over Third Party Service Providers
2003	Letter No. 03-CU-11	Non-Maturity Shares and Balance Sheet Risk
	Letter No. 03-CU-15	Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios
	Letter No. 03-CU-17	Independent Appraisal Evaluation Functions for Real-Estate Transactions
2004	Letter No. 04-CU-13	Specialized Lending Activities
2005	Risk Alert No. 05-Risk-01	Specialized Lending Activities – Third Party Subprime Indirect Lending and Participations
	Letter No. 05-CU-07	Managing Risks Associated with Home Equity

		Lending
2007	Letter No. 07-CU-13	Evaluating Third-Party Relationships
2008	Letter No. 08-CU-09	Evaluating Third-Party Relationships Questionnaire
	Letter No. 08-CU-26	Evaluating Loan Participation Programs

Furthermore, NCUA issued a series of *Letters to Credit Unions* between 1999 and 2008, providing guidance on balance sheet risk management and asset-liability management:

Year	Reference	Title
1999	Letter No. 99-CU-12	Real Estate and Balance Sheet Risk Management
2000	Letter No. 00-CU-10	Asset Liability Management Examination Procedures
2000	Letter No. 00-CU-13	Liquidity and Balance Sheet Risk Management
2001	Letter No. 01-CU-08	Liability Management – Highly Rate-Sensitive & Volatile Funding Sources
2008	Letter No. 08-CU-20	Supervisory Letter – Evaluating Current Risks to Credit Unions

We believe NCUA has provided credit unions with sufficient guidance on (1) due diligence over third parties providing lending activities, (2) balance sheet risk management, asset liability management, and liquidity management, and (3) loan participation programs. Therefore, we are not making any recommendations to NCUA management regarding these issues.

B. Colorado State Supervisory Authority and NCUA Supervision of Norlarco Credit Union

Examiners May Have Been Able to Mitigate the Loss to the NCUSIF

We determined Colorado SSA and NCUA examiners did not adequately evaluate Norlarco's loan participation program. As a result, we believe examiners missed an opportunity to slow the RCL program's growth, which might have mitigated the loss to the NCUSIF.

Starting in 2002, SSA and NCUA examiners took actions to work with Norlarco management to get control of its RCL program.[49] However, SSA and NCUA examiners did not fully recognize Norlarco's loan participation program represented a potential safety and soundness concern.

Colorado SSA and NCUA supervision efforts over Norlarco's RCL program

The following are highlights of events and actions surrounding the SSA's and NCUA's supervision of Norlarco's overall RCL program (Appendix A includes specific details of the examination history):

December 2002	**Joint Examination completed March 2003**

• Examiners noted Norlarco had established a new construction loan program.[50]
• Examiners included in the Document of Resolution (DOR), requirements for Norlarco management to:
  o Develop and adopt written construction loan policies and procedures.
  o Revise liquidity polices to a level commensurate with the size and complexity of the credit union.
  o On an ongoing basis, determine and make appropriate adjustments to tighten underwriting standards.	

June 2004	**Joint Examination completed October 2004**
Examiners determined Norlarco's partial compliance with the revision of its liquidity policy. The examiners noted the policy was incomplete.	
In October 2004, Norlarco began funding RCL program loans for properties located primarily in Lee County, Florida.	
August 2005	**NCUA officials discovered Norlarco was funding loans for Florida properties.**

[49] As discussed in the Background section of this report, SSAs are primarily responsible for the supervision of insured state credit unions. NCUA conducted examinations jointly with the SSA.
[50] We noted that at the time, this program was primarily in Texas. (Discussed in Section A of this report)

<table>
<tr><th>September 2005</th><th>Joint Examination completed November 2005</th></tr>
<tr><td colspan="2">NCUA and SSA examiners determined Norlarco had a serious liquidity issue and noted the underlying problem was Norlarco management’s $30 million monthly funding commitment.
NCUA management officials agreed to include specific language in the DOR to require Norlarco management to limit new construction loan commitments. However, the DOR the Colorado SSA issued allowed Norlarco management to consider one of three methods for calculating and limiting credit concentration and liquidity risk.[51]
The SSA and NCUA also included requirements in the DOR to address loan target limits and concentration risk. In addition, the examiners required Norlarco management to provide monthly reports to the SSA that included liquidity and cash flow information.</td></tr>
<tr><td colspan="2">Subsequent to the September 2005 examination, NCUA and the SSA completed several frequent joint contacts during 2006.</td></tr>
<tr><td>March 2006</td><td>Joint Contact completed May 2006</td></tr>
<tr><td colspan="2">NCUA and SSA examiners noted:
Norlarco management had taken several steps to try to improve the monitoring and risk assessment of the First American portfolio.
Norlarco’s liquidity levels had improved substantially.
There was a substantial reduction in the level of Norlarco’s borrowed funds.</td></tr>
<tr><td>June 2006</td><td>Joint Contact completed August 2006</td></tr>
<tr><td colspan="2">As a result of this contact, the examiners required Norlarco management and the Board to:
Cease funding of new loans with First American or any wholesale program until Norlarco fulfilled certain requirements.
Provide to the SSA and NCUA a report on the status of the First American portfolio and the status of completion of all DOR items.
The examiners also indicated that despite the cooperation NCUA had received from Norlarco, it was likely that NCUA would not wait for further reporting to place Norlarco in Special Actions.</td></tr>
<tr><td>August 2006</td><td>Norlarco was placed in NCUA Special Actions with the first contact conducted in November 2006.</td></tr>
</table>

[51] SSA officials informed us they made the change on the advice of their counsel because there was not sufficient evidence to support the restrictive DOR language NCUA wanted in the DOR.

Colorado SSA and NCUA Examiners did not fully recognize Norlarco's loan participation program represented a potential safety and soundness concern

We determined SSA and NCUA examiners did not adequately evaluate Norlarco's loan participation program to determine whether safety and soundness concerns existed. Specifically, we found no evidence examiners conducted a thorough review of Norlarco's participation program to document the adequacy of Norlarco's risk analysis, strategic planning, or due diligence.[52] As a result, examiners did not identify the potential liability, or risks the loan participation program represented to Norlarco, or ultimately, to the NCUSIF.

Under the risk-focused examination approach, NCUA guidance:

- Encourages examiners to focus on activities of increased or higher risk and to determine that credit unions are completing proper due diligence reviews prior to engaging in new or expanded activities; and

- Indicates examiners should ensure that credit unions continue to monitor higher risk activities on an on-going basis.

In addition, NCUA guidance indicates:

- Loan participations expose a credit union to a full range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation.[53]

- Credit unions buying and selling loan participations must fully understand the terms of the loan participation agreement and underlying loan transaction(s) and be able to explain them to all interested parties, including regulators.

We determined Norlarco began its loan participation program during the first quarter of 2002. In a joint examination conducted with the Colorado SSA in March 2003,[54] examiners documented that Norlarco was participating First American construction loans to other financial institutions. The examiners noted Norlarco's external auditors raised concerns[55] regarding the participation program. The external auditors indicated the participation agreement did not clarify the notion that (1) Norlarco would not have to purchase back the participation loans at any given time; and (2) the participations could be considered a potential liability rather than an asset. However, there is no

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[52] Risk assessment, strategic planning, and due diligence assure that officials are fully informed about the program and provide the opportunity to design and implement procedures and controls to mitigate the risks.
[53] The degree of risk varies depending on factors such as whether the credit union is the seller or buyer, the sale is with or without recourse, and the complexity of the individual loans.
[54] Effective date was December 31, 2002.
[55] Examiners noted this concern in a workpaper that was not part of the official examination report.

indication the examiners raised the external auditors' concerns to Norlarco management, or to NCUA or SSA management, much less as a potential safety and soundness concern. The only official discussion we found of Norlarco's participation program was in the NCUA examiner's memorandum to their supervisory examiner and in the examination Contact Report, which indicated Norlarco had begun a participation program. Neither the Scope Workbook nor the Examiner Findings document addressed the loan participation program.

During the September 2005 joint examination, examiners reviewed the RCL program loan participation *agreements* and determined Norlarco's standard participation agreement was without recourse or guarantee on the part of Norlarco. Examiners also determined:

- The Senior Vice President of Operations seemed to be the only one who knew anything about participation loan sales.

- It was a serious control deficiency for a $347 million dollar credit union to have only one individual knowledgeable about this critical function.

- The loan participation sales process should have been monitored and overseen by the same committee that managed liquidity or interest rate risk.

However, we found no evidence in this or other examinations or contacts that examiners evaluated the safety and soundness of Norlarco's overall participation *program*. In fact, in the September 2005 DOR, examiners included a requirement for the Board and management to consider obtaining additional written agreements with participation partners to purchase loans in an amount sufficient to restore Norlarco's liquidity level to those established in its business plans.

NCUA officials stated during Norlarco's conservatorship period that the $30 million per month agreement entered into in August 2003 between Norlarco and First American ensured Norlarco would experience liquidity problems. To help fulfill this monthly commitment and try to maintain adequate liquidity, Norlarco management had sold construction loan participations in addition to funding non-member loans and borrowing funds. From August 2003 to August 2006, Norlarco pooled together and sold participations and whole construction loans to 18 financial institutions. NCUA officials determined that at its peak, the balance of RCL program loans Norlarco sold to participating financial institutions was nearly $250 million.[56]

We reviewed the loan participation agreements and learned that while the agreements were without recourse, the recourse clause included language that the seller (Norlarco) was obligated to repurchase a loan only if the participant(s)

[56] As of December 2006.

could prove there was a material misrepresentation of fact within 12 months from the date of purchase.

One participant alleged Norlarco materially misrepresented the loans it purchased. The participant indicated Norlarco allegedly:

- Emphasized a guarantee by the builder effective October 2004 to buy back construction loans under certain conditions. However, the participant alleged that it was not made aware until February 2007 that this guarantee was removed from the builder's agreement, effective June 2005.

- Sold a pool of participation loans held out by Norlarco as "Owner-Occupied" when in fact approximately 40 percent of the loans were later determined to be held for investment purposes.

The participant demanded Norlarco repurchase over $12 million in participated loans.

We found no evidence that examiners verified whether Norlarco management had obtained legal guidance as to the recourse provisions of the participation agreements/circulars, and explicit and implied representations and warranties made by Norlarco to investors of RCL program loans in Florida. It was not until April 2007 that NCUA officials required Norlarco to obtain legal reviews of its contracts. As a result, we believe Norlarco management was not fully aware of the impact of all the terms and conditions of the participation agreements until much too late. We also believe that had examiners first addressed the safety and soundness concerns through a risk-focused examination, when the program was first identified by external auditors, Norlarco management would have been better informed about the agreement's clauses and warranties when working with potential buyers of loan participations.

The external auditors' determination regarding the potential liability of the loan participations was foretelling. NCUA officials told the OIG that in their opinion, had examiners viewed Norlarco's participation program as a potential safety and soundness concern, the loss to the NCUSIF may have been mitigated.

Auditor Observations: Examiners did not view the participation program and the participation agreements as safety and soundness concerns fraught with risk. Specifically, Norlarco entered into a participation program too quickly without conducting proper due diligence and slowly gaining the necessary experience over time to effectively operate such a program. In addition, examiners did not associate the rapid rise of loans sold through participations as a potential safety and soundness concern to Norlarco, or to the NCUSIF, but rather examiners merely viewed participations as a means to manage Norlarco's balance sheet risk.

Lesson Learned: NCUA officials advised the OIG that the inadequacies we found in NCUA's supervision efforts related to participations were more systemic in nature due to not having a formal program in place to review participations, versus inadequacies of the individual examiners who supervised Norlarco. Accordingly, in November 2008, NCUA issued a supervisory letter (08-CU-26) to NCUA field staff indicating that loan participation credit and concentration risks were increasing more rapidly than credit unions' overall loan portfolio risk. The letter included guidance and a questionnaire for examiners to use in evaluating loan participation programs.

In addition, NCUA issued Letter to Credit Unions, No. 08-CU-26 titled: Evaluating Loan Participation Programs, advising credit union management that despite the benefits of loan participation programs, there are potential risks. NCUA indicated that credit unions should perform a comprehensive risk assessment before beginning loan participation activities, and that due diligence is a key factor in assuring risks are identified and mitigated.

Because NCUA management provided additional guidance to credit union management and examiners to address deficiencies in the area of participation lending, we are making no formal recommendations to NCUA management at this time.

C. OBSERVATIONS AND LESSONS LEARNED

This section addresses observations and lessons learned regarding credit union operations and management actions.

Credit Union Operations and Management Actions

We reviewed industry[57] observations regarding the failures of financial institutions. We also reviewed recent NCUA observations regarding credit union failures. We believe the industry's and NCUA's observations apply to issues we observed during our review of Norlarco's failure.

The following table lists the industry observations regarding failed financial institutions and how they compare to our observations about Norlarco's failure:

Industry Observations of Failed Financial Institutions	NCUA OIG Observations of Norlarco's Failure
Failed institutions often exhibit warning signs when they appear financially strong. The financial condition of the institution is no guarantee of future performance.	Norlarco's net worth ratio was 9.49 percent at its last examination in April 2007 (12/31/06 Effective Date) when examiners indicated Norlarco needed to "take hold" of the RCL program because it was negatively impacting all areas of risk – Credit, Interest Rate, Liquidity, Transaction, Compliance, Management, and Reputation, contributing to a downgrade of the CAMEL rating to an overall 4. Based on NCUA guidance, Norlarco had been well capitalized since at least December 2002.
Managers of failed institutions frequently assume more risk than they are able to handle.	Norlarco management's decision to shift their business model to construction loan financing, particularly with a third-party vendor with whom complete control was given to run the construction loan financing program, resulted in a significant amount of credit union assets involved in a risky, speculative real estate venture with little or no controls in place to oversee daily operations.
An inattentive or passive Board is a precursor to problems.	The Norlarco Board delegated authority to First American to originate, underwrite, approve, and perform all servicing and collection functions for the RCL program.

[57] We reviewed a 2004 report issued by the FDIC OIG - *Observations from FDIC OIG Material Loss Reviews Conducted 1993 through 2004 (Report No. 04-004, January 22, 2004)* - that summarized observations from material loss reviews of 10 failed FDIC-supervised institutions.

The Institution may reach a point at which problems become intractable and supervisory actions are of limited value.	At the conclusion of the April 2007 examination (Effective date 12/31/2006), the Colorado DFS determined Norlarco management's serious errors and omissions in their management of the outsourced third-party lending arrangement, and failure to discharge their duty to provide effective oversight of the credit union, warranted issuance of a Cease and Desist Order. On April 18, 2007, Norlarco management was served with a Cease and Desist Order due to engaging in unsafe and unsound business practices. The Colorado DFS placed Norlarco into state conservatorship on May 15, 2007 and appointed the NCUA Board as conservator. The NCUA Board approved the Federal conservatorship of Norlarco on July 26, 2007.

Industry officials observed other issues regarding failed financial institutions similar to those we observed during our review of the Norlarco failure. They observed:

- The institutions' management[58] took risks that were not mitigated by systems to adequately identify, measure, monitor, and control the risks.

- Economic conditions contributed to, but were not the sole cause of, the failure and the resulting material loss.

Although, we believe the economic decline of the Florida real estate market contributed to Norlarco's failure, management's risk taking and decision to involve the credit union in the Florida construction loan program without adequate controls in place were the main causes of Norlarco's failure.

We also reviewed recent observations by NCUA regarding credit union failures. NCUA indicated that overly aggressive management activity is a reason credit unions fail. This observation is consistent with the industry's observation that management often assumes more risk than it can handle. The following table compares the overly aggressive management activities NCUA identified at Norlarco with our observations in the course of this review:

[58] Management includes the Boards of Directors and executive officers.

NCUA Observations	NCUA OIG Observations of Norlarco
Liberal lending policies.	A loan review determined 86 percent of the RCL program loans required no supporting documentation for borrowers' income.
Excessive loan growth compared with abilities or funding sources.	Norlarco management used non-member deposits and borrowings to fund the $30 million monthly loan commitment. Examiners also indicated that when Norlarco reached its borrowing limits, management began selling construction loan participations.
Inadequate liquid assets/secondary source of liquidity.	
Undue reliance on volatile liabilities.[59]	Norlarco borrowed funds from a Federal Home Loan Bank.
Collateral based lending/loan concentration.[60]	Norlarco had a high concentration of loans secured by real estate in Florida.

Furthermore, the financial industry and NCUA identified four stages of an institution's failure:

- I – Strategy
- II – Growth
- III – Deterioration
- IV – Failing

Finally, we believe a significant industry observation is that one of the more difficult challenges facing regulators is limiting risk assumed by institutions even though their capital ratios make them appear financially strong. A critical component in limiting an institution's risk is early corrective action by regulators in response to examinations that identify potential problems and effects on the institution's condition.

[59] Volatile liabilities generally include funding from institutions/brokers. These tend to be interest rate sensitive and are funds that are likely to be withdrawn at a moment's notice.
[60] A collateral loan is a loan obtained from a financial institution where, in exchange for the loan, the creditor may sell the collateral if the loan is unpaid. A collateral loan is often offered at a lower interest rate than an unsecured loan, because there is a guarantee of repayment should the borrower default on the loan.

Appendix A: Examination History

This appendix provides a summary of the Colorado SSA and NCUA joint examinations and onsite contacts through the April 2007 contact during which the Colorado Division of Financial Services (DFS) placed Norlarco under conservatorship. Since at least 1993, the Colorado SSA rated Norlarco a CAMEL 1 or 2. NCUA did not conduct an onsite supervision of Norlarco until March 2003 (effective date December 31, 2002). The Colorado SSA and NCUA examiners downgraded Norlarco to a 3 as of the June 2004 examination because of high loan losses and charge-offs in their indirect auto lending program. NCUA and the SSA further downgraded Norlarco to a 4 as of the December 2006 joint examination because Norlarco management was not in control of the Residential Construction Lending (RCL) program.

Table 2 below provides a summary of the Colorado SSA's and NCUA's examinations and contacts of Norlarco effective between December 2002 and March 2007. The table also identifies Norlarco's key ratios as of the effective dates of the examinations and onsite contacts.

Table 2: Examinations, Contacts and Key Ratios									
Exam or Contact Date	**12/31/02**	**6/30/04**	**3/31/05**	**9/30/05**	**3/31/06**	**6/30/06**	**9/30/06**	**12/31/06**	**3/31/07**
Work Classification Code[61]	**11**	**11**	**23**	**11**	**23**	**23**	**23**	**11/23**	**23**
CAMEL	**2**	**3**	**3**	**3**	**3**	**3**	**3**	**3**	**4**
Net Worth	9.28%	8.86%	8.67%	8.03%	8.42%	8.74%	9.33%	9.49%	8.63%
Delinquency	1.89%	2.41%	1.06%	1.19%	.76%	.96%	.95%	.83%	2.14%
Net Charge-Offs*	.28%	2.07%	1.26	1.27%	.77%	.75%	.80%	1.21%	1.21%
ROAA[62]*****	1.36%	0%	.87%	1.24%	.55%	.74%	.81%	.75%	-3.40%
Operating Expense/Avg Assets*	4.45%	3.84%	3.84%	3.65%	3.25%	3.26%	3.35%	3.38%	3.54%
Borrowings / Ttl Shares & NW*	0%	0%	0%	6.15%	4.24%	6.73%	0%	0%	0%
Asset Growth*	13.49%	-2.80%	8.18%	25.51%	-5.19%	-4.55%	-8.06%	-6.12%	.32
Loan Growth*	8.28%	-15%	15.89%	46.39%	74.36%	38.3%	15.29%	11.69%	-6.69

**** Indicates Annualized Ratios***

[61] Work Classification Code "11" denotes a regular joint examination or insurance review of any FISCU. Work Classification Code "23" denotes on-site supervision of any FISCU.
[62] Return On Average Assets.

December 31, 2002

Code 11 Joint Examination

The Colorado SSA and NCUA completed a joint examination of Norlarco in March 2003 using credit union data effective December 31, 2002. The regulatory agencies rated the Asset Quality, Management and Asset/Liability Management CAMEL components a 2. The overall composite rating was 2. The examiners conducted the examination because of:

- The asset size of the credit union,
- Declining net worth,
- Increasing delinquency,
- Increasing loan growth, and
- Increasing real estate lending.

The areas the examiners reviewed included real estate/construction loans. The examination resulted in a Credit Risk rating of Moderate; minor findings in the area of collections and loan policies (particularly real estate/construction); and minor underwriting concerns in the state's loan exception report regarding the real estate/construction loans and other recent consumer loans.

Examiners noted Norlarco's net worth increased 20 basis points for 2002. Examiners also noted that while Norlarco's operating expenses steadily increased over the previous three years, the return on assets was a "healthy" 1.36 percent, which contributed to the net worth growth. In addition, the examiners indicated Norlarco management modified their lending and demonstrated a reduced loan growth ratio of over 24 percent from the previous year to an 8.28 percent ratio. Furthermore, examiners indicated Norlarco management began a participation program with other credit unions through First American and Centennial Lending.

There was an informal workpaper in the AIRES download files that included the following assessments regarding Norlarco's RCL program. However, these assessments were not included in the Examiner Findings or the NCUA Region V Memo:

> The workpaper indicated the Board had approved a new loan program approximately sometime in late 2001. The program allowed the credit union to finance modular home construction projects up to nine months through First American. Norlarco's policy limited this loan type to five percent of assets, but allowed an extra two percent for the creation of participation pools. Norlarco had in fact participated out a portion of the loans.

The workpaper also indicated:

- Norlarco was performing due diligence at the front end of the loan to help mitigate credit risk.

- The earnings on this program for Norlarco and the participants had outweighed the potential losses.

While the workpaper noted Norlarco was performing certain underwriting procedures, it also noted that Norlarco had not incorporated the following procedures into the program in writing:

- Guidelines addressing loan extensions and the maximum a loan was allowed to extend, and under what circumstances, prior to taking possession of the property.

- Establishing a stop loss parameter. For example, if delinquency in relation to Total Loans outstanding became greater than a specific percentage, Norlarco management would halt this type of lending and revise underwriting procedures.

- Resolving problems with borrowers moving in to the residence prior to closing the construction loan.

- Guidelines providing strict third party requirements for experience and expertise to handle draws and inspections.

- Guidelines indicating First American followed underwriting parameters set by Norlarco FISCU.

- The guidelines should have noted the credit union only allowed a 90 percent loan-to-value and maximum 55 percent debt ratio.

- Guidelines indicating Norlarco would have researched the location of the property in comparison to where the individual worked.

- Guidelines indicating Norlarco would not have financed “stick built” homes under the program.

Furthermore, the workpaper:

- Recommended monitoring the program in approximately nine months to review delinquency, ensure loans continued to turn over, etc.

- Indicated there was an audit that questioned the participation agreement. The audit indicated the participation agreement did not clarify whether Norlarco would not have to buy back the participation loans at any given time. Thus, these participations could have been considered a potential liability rather than an asset.

- Indicated Norlarco needed to establish a written liquidity policy and guidelines.

Document of Resolution

The Colorado SSA examiners required Norlarco management and the Board to:

- Develop and adopt written construction loan policies and procedures by July 31, 2003.

- Continue to develop and adopt written real estate loan foreclosure policies and procedures by July 31, 2003.

- Revise the liquidity polices to a level that was commensurate with the size and complexity of the credit union by July 31, 2003.

- On an ongoing basis, determine and, if necessary, make appropriate adjustments to tighten underwriting standards if current loan underwriting policies and procedures were too heavily weighted towards minimal approval time/member convenience, volume, and profitability at the expense of prudent credit and collateral risk analysis.

Code 26 Review of Examination

NCUA completed a code 26 review in May 2003. The examiner noted a weak real estate construction policy. There was no AIRES download.

June 30, 2004

Code 11 Joint Examination

The Colorado SSA and NCUA completed a joint examination of Norlarco in October 2004 using credit union data effective June 30, 2004. The regulatory agencies rated the Asset Quality component a 4, the Management component a 3, and the Earnings component a 5. The overall composite rating was 3. The examiners downgraded Norlarco because of high loan losses and charge-offs in an indirect auto lending program.

The examiners indicated profitability had been declining since December of 2002 when the Return on Average Assets (ROAA) ratio was 1.36 percent. As of June of 2004, this ratio had declined to break even. The Operating Expenses to Average Assets ratio as of June 30 2004 was 4.84 percent, which was 108 basis points above the peer average and had been steadily increasing since 2001. The examiners also indicated Norlarco's delinquencies and charge offs were a major area of concern:

Examiners believed an ongoing advisory was warranted because of significant economic uncertainties created by high unemployment, a weakened economy, and rising bankruptcy filings nationally and in Colorado. Examiners also advised management to:

- Remain cautiously alert to the possibility of additional loan problems and ensure that the allowance for loan loss remained fully funded each month.

- Beware of taking on excessive credit risk and be prepared to adjust underwriting standards if necessary.

Furthermore, examiners determined Norlarco's liquidity policy was incomplete. The policy did not clearly establish the purpose, objectives, and goals of liquidity management. The examiners advised Norlarco management the policy should have, among other things, addressed what courses of action would have been taken in response to liquidity needs under normal business conditions, deteriorating liquidity scenarios, and emergencies.

Status of DOR Items from the December 31, 2002 Examination

- Develop and adopt written construction loan policies and procedures by July 31, 2003.

  The examiners noted Norlarco's compliance - the Board approved a construction loan policy.

- Continue to develop and adopt written real estate loan foreclosure policies and procedures by July 31, 2003.

  *The examiners noted Norlarco's compliance – Norlarco management **indicated** that procedures had been developed for real estate loan foreclosures.*

- Revise the liquidity polices to a level that was commensurate with the size and complexity of the credit union by July 31, 2003.

  The examiners noted partial compliance by Norlarco.

- On an ongoing basis, determine and, if necessary, make appropriate adjustments to tighten underwriting standards if loan underwriting policies and procedures were too heavily weighted towards minimal approval time/member convenience, volume, and profitability at the expense of prudent credit and collateral risk analysis.

  The examiners noted Norlarco's compliance – Norlarco management had made some adjustments to underwriting standards, although they continued to be lenient as compared to the industry standards.

Document of Resolution

The Colorado SSA examiners required Norlarco management and the Board to:

Improve Profitability

Board of Directors and Executive Management December 31, 2004	Establish a strategic goal to reduce the Operating Expense to Average Assets ratio so that earnings would have improved.

Asset Quality

Board of Directors and Executive Management Immediately	Continue efforts to improve loan credit quality and underwriting decisions, thereby reducing the likelihood of loan charge offs and decreasing the need for loan loss expense. Efforts should have been concentrated in those areas that management had deemed the primary areas of losses – unsecured loans and indirect auto loans.
Board of Directors and Executive Management By November 30, 2004	Establish alternate plans to be implemented if CU Direct Connect did not implement the changes recommended by the panel made up of participating indirect lending credit unions.

Board of Directors and the VP of Lending By December 31, 2004	Review and make revisions to the procedures regarding the guaranteed credit files from First American. Essential documentation for these files should have been easily found on the CD/ROMs. A recommendation to correct this problem was to create a spreadsheet documenting each loan and what date essential documents were obtained in order to easily locate them.
Board of Directors and the VP of Lending By December 31, 2004	Formalize the "after funding checklist" process to include specific underwriting criteria, which loan types and what percentage of loans funded would have been reviewed, and which loan officers would have been required to complete the checklist.
	Loan Policy
Board of Directors and Executive Management By December 31, 2004	Review and revise the loan policy to adequately reflect lending practices for unsecured loans.
Board of Directors and the VP of Lending By November 30, 2004	Include in the lending policies and procedures specific criteria that needed to be met without additional approval for refinances, extensions, and workout loans. This would have provided guidelines and some consistency for the loan officers.
	Allowance for Loan and Lease Loss Policy
Board of Directors By December 31, 2004	Establish and approve a policy for the Allowance for Loan and Lease Loss Account.
	Dual Controls
Executive Management Immediately	Implement an effective system of dual controls for all applicable branches to adequately safeguard cash and cash items and to help protect the employees from unfair or false accusations.
Board of Directors and Executive Management By February 15, 2005	Mail to the Colorado DFS the Board-approved 2005 Strategic Business plan and corresponding pro forma balance sheet and income statement budgets.

Code 26 Review of Examination

NCUA completed a code 26 review in December 2004. The examiner noted: high operating expenses; high, but improving delinquencies; high charge-offs in indirect lending; and declining capital. There was no AIRES download.

March 31, 2005

Code 23 Joint Contact

The Colorado SSA and NCUA completed a three hour joint onsite contact of Norlarco in July 2005 using credit union data effective March 31, 2005. The examination addressed delinquencies and loan quality identified during the June 2004 examination. The contact concluded delinquencies were high, but improving, and charge-offs were high. The regulatory agencies rated the Capital and the Earnings components a 2, and the Asset Quality and the Management components a 3. The overall composite rating was 3.

September 30, 2005

Code 11 Joint Examination

The Colorado SSA and NCUA completed a joint examination of Norlarco in November 2005 using credit union data effective September 30, 2005. The regulatory agencies rated the Asset Quality, Management, and Earnings components a 3 and the Asset/Liability Management component a 4. The overall composite rating was 3.

The examiners determined Norlarco management lacked policy, planning, and limit-setting, oversight of the credit union, and failed to recognize problems and deficiencies and to develop effective remedial plans to alleviate those problems when identified by others.

In addition, the examiners indicated:

- Norlarco's reported ROAA of 1.24 percent was a "picture of profitable operation". The strong ROAA was achieved in part by Norlarco management's aggressive and successful cutting of its operational costs, highlighted by its rapid asset growth in the first nine months of the year.

- The largest factor after the reduced operating expense was the lowered ratio of Provision for Loan Losses (PLL) as a percentage of Average Assets. Norlarco's PLL decreased for the first nine months of 2005 as a result of Norlarco's increased concentration of First American construction loans, for which management had not established an allowance for loss. The

Allowance for Loan Loss (ALL) decreased from 2004. However, if Norlarco management had established an appropriate ALL, Norlarco's PLL expense would have increased commensurately and earnings and ROAA would have decreased to well below one percent.

- Norlarco Credit Union's loans increased at an annual rate of 33.93 percent, and Total Real Estate Loans increased by 51.47 percent (annualized). The examiners indicated the increase in assets had been supported by a significant shift in Norlarco's liability structure. Norlarco's Regular Shares decreased by approximately $12 million, while non-member shares increased by approximately $13 million. The remaining growth was supported by $20 million in borrowings, which resulted in a strongly leveraged position.

- Delinquent Loans as a percentage of outstanding loans, and Net Charge Offs in the prior twelve months as a percentage of average loans outstanding in the nine month period of the current year showed an improvement since the end of 2004. However, the examiners indicated they and Norlarco's internal auditors raised questions regarding the reporting of delinquencies in the First American construction loan portfolio.

The examiners indicated key aspects of third party vendor lending functions that warranted sound business practices included, at a minimum:

- Regularly analyze the program's impact on net worth, profitability, delinquency, charge-offs, liquidity, and interest rate risk.

- Properly evaluate and oversee all underwriting criteria to ensure all data was accurate and meets the credit union's standards. This included verification of creditworthiness, debt to income, lien perfection, and insurance coverage.

- Evaluate the payment process to ensure accurate reporting of delinquency and maturity of loans.

- Test the accuracy of any third-party vendor reports.

- Include an exit clause in any third-party vendors servicing agreement.

The examiners noted two concerns with the First American RCL program:

1. The program had grown to become over 40 percent of Norlarco's loan portfolio as of September 30, 2005.

   Norlarco's loan policy indicated third party construction loans with committed permanent financing may have been subject to portfolio limits set by the Financial Planning Committee. However, there was no limitation set for the

guaranteed residential construction loans. There had been no formal quantitative risk analysis dealing with the high concentration level of residential construction loans in the Florida area and other possible locations within the United States. The examiners indicated Norlarco management should have conducted a risk analysis to determine an acceptable level of risk.

2. First American's RCL program carried with it the risks of any third-party lending arrangement.

   First American conducted the underwriting of the borrower, qualified the borrower as a potential member of Norlarco in order to place the loan, arranged for the contractor to build the project, conducted the inspections, forwarded draw requests and interest payments to Norlarco based on its own inspections and schedule, and qualified the borrower for a take-out loan by a lender all without any approvals by Norlarco management. First American also forwarded extensions of matured loans and interest payments on those loans to Norlarco, which resulted in Norlarco management's dependence on First American for the entire conduct of the loan, from start to finish, without Norlarco conducting any due diligence on any borrower. The examiners indicated the primary source of repayment for the loan was the take-out arranged by First American, and the secondary source of repayment was First American's guaranty. The borrower did not represent a repayment source or a potential member of Norlarco in terms of relationship, cross-sell opportunities, or membership beyond the duration of the loan.

In addition, NCUA examiners noted:

- First American reviewed all appraisals and documentation. There was no internal process by Norlarco to validate this process.

- First American was allowed to make a "service advance" to the credit union for the amount past due on borrower loans due up to the amount of the interest reserve that were more than forty-five days past due on interest.

Furthermore, examiners learned Norlarco management approved a $2.5 million line of credit (LOC) to First American that allowed First American to exercise its buy-back agreement for seven loans that were seven months past due and eleven loans that were in the process of litigation or foreclosure. As a result, Norlarco management did not consider the loans as delinquent. In addition, the examiners indicated it was not clear if the loans were previously included as delinquent for Asset Quality calculations.

Examiners also indicated:

- The contracts and agreements between First American and Norlarco appeared to always be an ongoing work in progress. Many agreements were made informally. Examiners noted that, considering the size of the portfolio, it would have been imperative that all agreements be formalized and completely understood by all parties. Formal agreements should have been in place for the protection of the credit union. Exit clauses and the ability to adjust levels to market should have been paramount in protecting the credit union.

- The Norlarco Board was deficient in its capacity as policy makers and in establishing specific operating goals and the strategies to achieve those goals. The Financial Planning Committee was deficient in carrying out its duties within a defined and disciplined approach to managing the specific risk areas within its delegated charge – credit risk, interest rate risk, liquidity risk, and strategic risk.

- On-site management was operating in a position of limited effectiveness due to the announced retirement of the CEO and the resignation of the Chief Financial Officer (CFO). In the absence of strong leadership, Norlarco had exceeded previously established limitations and guidelines for safeguarding concentrations of credit, the measurement and monitoring of interest rate risk, and had incurred excessive liquidity risk, which in turn created heightened strategic risk. Both the Financial Planning Committee and management failed to adequately and completely report, to the Board, Norlarco's increasingly leveraged and illiquid position.

- Although the Supervisory Committee, with the assistance of Norlarco's internal auditor, identified some of the increased risks and raised concerns with the measurement and monitoring of those risks, those concerns did not attract the attention or generate any action on the part of the Board.

- Norlarco had a serious liquidity issue. The underlying problem and cause was that Norlarco management had agreed to fund $35 million [*sic*] in First American loans per month. Examiners noted Norlarco had credit facilities in place to stave off a liquidity crisis in the short term. In addition, examiners indicated the influx of construction loans was offset through a participation program; however, the rate of outflow by participation had abated significantly in recent months, with no agreements in place to purchase the large amounts required to restore liquidity equilibrium. Norlarco had to resort to borrowings to fund the incoming loans it was obligated to buy, resulting in an increasingly leveraged and illiquid position. Two target liquidity ratios Norlarco management established for 2005 were (1) Total Loans (as a percent of Total Assets) of less than 80 percent, and (2) Cash plus Short-Term Investments

(as a percentage of assets) greater than 15 percent. As of September 30, 2005, the first ratio was 88.54 percent[63], and the second ratio was 4.85 percent[64].

NCUA examiners summarized Norlarco's inadequacies with its involvement in the RCL program as follows:

- The Board policy didn't assign responsibility [for the program]; therefore, there was no accountability.

- Norlarco management had not done an Interest Rate Risk measurement review in five quarters.

- The Financial Planning Committee was essentially inactive.

- Norlarco's liquidity management was unacceptable.

    - Norlarco did not have a highly leveraged liquidity position.
    - Norlarco management did not have a formal process for liquidity management.
    - Neither the Board minutes nor the minutes contained discussion regarding liquidity in the last twelve months.

- Norlarco management's cash flow forecasts indicated funding difficulties in the last three months of 2005.

- Norlarco's Senior Vice President for Operations seemed to be the only one who knew anything regarding participation loan sales and management of this secondary marketing function. It is unacceptable to place this critical function in hands of one person.

- Within the ALM policy and process, there was no reporting process that demonstrated compliance with policy limits. The policy was also silent in terms of who was responsible for its implementation.

Regarding loan participation sales, examiners indicated Norlarco management should have had listings of potential buyers on hand, the balance of past purchases, estimated future commitments, and a knowledge of their legal purchase limits if applicable. The examiners added that the same committee that managed liquidity or interest rate risk should have monitored and overseen the loan participation sales process. The existing loan participation sale process was being managed by one

[63] The peer ratio as of June 30, 2005 was 66.86 percent.
[64] The peer ratio as of June 30, 2005 was 12.85 percent.

individual, which examiners indicated was a serious control deficiency for a $347 million dollar credit union.

NCUA's Plan for Corrective Action

In working with the Colorado SSA, NCUA expected to have the following DOR items included in the examination report with discussion, approval, and compliance anticipated on all issues from management.

Liquidity Management

Board of Directors	Limit new construction loan commitments to 80 percent of paid off loans until such time as the credit [*sic*] was able to operate without borrowed funds for 60 consecutive days, and non-member deposits were less than 15 percent of member deposits. The examiner noted that the SSA and management may not have agreed with this process, but it was on the table and would only be removed if an acceptable alternative could have been developed.
Board of Directors	Perform a liquidity management self assessment after reviewing.
Board of Directors	Create a Liquidity Review committee and assign responsibility for liquidity management to the Financial Planning Committee.
Liquidity Review Committee	Meet no less than monthly to review the liquidity position, develop liquidity management strategies, insure sufficient operating liquidity, and ensure that Norlarco had sufficient contingent liquidity sources available. This committee should have managed all assets sales, participation sales, non-member deposit funding, and borrowing activity.
Board of Directors & Liquidity Review Committee	Develop or incorporate within existing policies specific liquidity management requirements, including limits on the use of assets [*sic*] specific funding sources

Asset Liability Management

Financial Planning Committee December 31, 2005	Insure that Norlarco developed a process to actively measure interest rate risk according to existing credit union policies.

Concentrations

Board of Directors	A risk analysis on the Residential Construction portfolio should have been fully evaluated to determine an acceptable risk appetite.

Third party reporting systems

Board of Directors & Management	Overall [*sic*] management needed to embrace the importance that the First American program needed to establish and realize that control measures increase in importance by using a third-party vendor to perform loan underwriting activities (underwriting, servicing, inspections, collection, and foreclosure processes) as well as effective monitoring and review systems.

Contracts and Agreements

Board of Directors & Management	Management should have reviewed all agreements with First American to ensure that all aspects of understood agreement [*sic*] informal or formal [*sic*] were formalized. Formal agreements should have been in place for the protection of the credit union. Acceptable limits, exit clauses, and ability to adjust levels to market should have always been paramount in protecting the credit union.

Document of Resolution

The Colorado SSA examiners required Norlarco management and the Board to:

Management

Board of Directors Immediately and Ongoing	Establish, at the policy level, target limits of the amounts of different loan types in which Management may have invested. The policy should be reflective of the goals established in the Strategic Plan for Norlarco Credit Union, and should have integrated guidelines and ratio considerations contained in the Credit Union's Loan Policy, Asset/Liability Management Policy, and its Liquidity Policy.
Board of Directors Immediately and Ongoing	Review for revision the Policy and Methodology for establishing and maintaining an adequate Allowance for Loan and Lease Loss that would have addressed the risk represented by the current excessive concentration in the loan portfolio.

Board of Directors, On-site Management

Consider any of the following methods for calculating and limiting credit concentration and liquidity risk:

- By recognizing First American's guaranty as the secondary source of repayment for the First American construction loans, limit the Credit Union's portfolio of those loans, funded and unfunded, [*sic*] less participated amounts, to Member Business Lending limits of 15 percent of the Credit Union's Net Worth, or about $4.2 million, less the $2.5 million line of credit granted to First American in August. Any amount beyond those limits might have been subject to reserve in the Allowance for Loan Loss based on historic portfolio levels of net charge off.

- Limit the commitment for funding of First American construction loans in any month to 80 percent of paid or participated loans already in the portfolio until such time as the credit union was able to operate without borrowed funds for 60 consecutive days and non-member deposits were less than 15% of member deposits.

- Obtain written agreements with participation partners to purchase loans in an amount sufficient to restore the Credit Union's liquidity level to those established in its business plans. Restrict new purchases and commitments until those agreements were in place.

Communication

Board of Directors, On-site Management Monthly

Before the twenty-fifth day following the close of each calendar month, mail a complete Board information packet to the Examiner that included the following items, at a minimum:

- Board minutes

- Committee minutes, as applicable

- Balance sheet and income statement

- Delinquency report

- Cash flow or liquidity reports

- Allowance for loan loss adequacy report

Other Examination Areas

Board of Directors, On-site Management Upon Receipt of Report	Correct the Examiner Findings and Loan Exceptions contained in this report, where possible, and take corrective action to prevent their recurrence in the future.

Code 26 Review of Examination

NCUA completed a code 26 review in February 2006. The Code 26 resulted in NCUA raising the Earnings CAMEL component from a 3 to a 1. The examiner rated the following risks as High: Credit Risk, Interest Rate Risk, and Liquidity. The examiner noted there were five key risks resulting from the large growth of the First American portfolio:

1. Liquidity Risk – unfunded loan commitments and growth of the First American loans resulted in tight liquidity levels. Management reached into expanded markets of brokered deposits, borrowed funds, and loan participation sales.

   Management's original plan for the RCL program was to generate a large volume and hold it on Norlarco's books, selling off a sizeable portion by the end of 2005 to reduce the outstanding loans to $65 million. This change in plans resulted in serious liquidity problems. As of September 2005, the outstanding balance of loans in the First American portfolio was $142 million. The SunCorp and FHLB lines of credit were fully funded. There was very little formalized analysis to evaluate the impact of allowing the construction loan portfolio to grow to this size. Norlarco management should have considered the following risks:

   - Liquidity
   - Concentration Levels
   - Economic Impact
   - Availability of markets to sell the loans.

2. Loan Concentrations – geographic, industry, economic, and single guarantor. A major percentage of the construction loans were located in Florida. There was no formalized analysis or quantification of risk factors in assessing acceptable risk levels.

3. Third-party control and reporting systems needed improvement

4. Commitments and agreements lacked formalized policies, limits, and procedures.

5. Changing management structure.

March 31, 2006

Code 23 Joint Contact

The Colorado SSA and NCUA completed a 24 hour joint onsite contact at Norlarco in May 2006 using credit union data effective March 31, 2006. The regulatory agencies rated the Asset Quality, Management, and Earnings components a 3 and the Asset/Liability Management component a 4. The overall composite rating was 3. The purpose of the contact included reviewing the following areas:

- Liquidity status and management planning and reporting processes

- The First American Portfolio

- Any new agreements between Norlarco and First American

- Strategic Plan and Budget for 2006

Liquidity

Examiners indicated Norlarco's liquidity levels had improved substantially since the last contact. In addition, the examiners indicated the reduction in the level of Norlarco's borrowed funds had been substantial since the end of 2005.

First American

Examiners indicated Norlarco management had taken several steps to try to improve the monitoring and risk assessment of the First American portfolio:

- A third party completed a risk assessment in April 2006. However, the examiners' opinion of the assessment was that it was weak in terms of identifying and quantifying risk.

- Norlarco management had indicated they were only buying construction loans from two builders – 12-month stick built homes from FHBF in Florida, and six-month modular construction loans from Palm Harbor Builders in Texas. Examiners indicated this reduced some areas of risk, but may have increased risks in other areas.

- Norlarco management no longer had a monthly purchase commitment agreement with First American. Examiners indicated management was monitoring [the portfolio] closely and planned for funding not to exceed pay downs in the portfolio.

- Examiners identified other areas of risk that needed to be monitored and controlled closely, including:

  - Smaller builder and broker loans that provided much higher performance risk. Norlarco management indicated Norlarco had not purchased any of these loans since August 2005. Examiners indicated the $38 million in outstanding loans in this category would have been almost completely paid out by September 2006.

  - There were still a high number of loans that were classified as business loans because the individuals were purchasing multiple homes in the same area. Examiners indicated Norlarco did not classify these homes as Member Business Loans (MBLs). The examiners had two concerns with these loans:

    1. In the event of an economic downturn, the examiners expected that a large number of these loans would have defaulted, resulting in a high number of foreclosures. The examiners noted the Florida and Texas markets remained strong.

    2. The examiners found the income levels of some of the loans in question. The examiners indicated they believed income verification should have been required in many of the cases. Examiners indicated they discussed this with Norlarco management and with the internal auditor at Norlarco and asked them to review this area and adjust loan policies and procedures if necessary.

  - There was some concern that Norlarco may have been purchasing some construction loans from New Horizons. Examiners indicated Norlarco management said they had not knowingly done so and had only purchased loans from First Home and Palm Harbor since August 2005.

New Agreements with Norlarco and First American

Examiners indicated Norlarco management had neither entered into nor planned to enter into any new agreements with First American in terms of commitments to purchase any loans. Examiners also indicated Norlarco management allowed up to a 40 percent mix of the loan portfolio to be in First American. Examiners noted Norlarco's mix was slightly above that limit. However, the examiner indicated if

maturity and payoffs correlated, there would have been substantial declines in May, June, and July.

June 30, 2006

Code 23 Joint Contact

The Colorado SSA and NCUA completed a 139 hour joint onsite contact at Norlarco in August 2006 using credit union data effective June 30, 2006. The regulatory agencies rated the Asset Quality, Management, and Asset/Liability Management CAMEL components a 3 and the Earnings component a 4. The overall composite CAMEL rating was a 3. The examiners focused on:

- An extensive review of the First American portfolio to assess risk, specifically on the high number of extensions and to determine if any adjustment to the ALL was needed.
- The management of Liquidity.
- The profitability of Norlarco's wholesale (First American) program.
- The core credit union consumer lending portfolio to assess why delinquencies and charge-offs were so high.
- The management team.

The examiners indicated ratio analysis reflected Norlarco's declining profitability in 2006 from 2005 due to lower loan yields and higher cost of funds to support the loans. The examiners indicated the yield on average loans had declined nearly 80 basis points, while the cost of funds had increased by more than 50 basis points. Examiners indicated Norlarco's Net Worth had increased to 8.74 percent due in part to a decrease in Total Assets along with positive earnings. However, the examiners indicated the composition of assets continued to be a concern because real estate lending, primarily in the wholesale RCL program, continued to dominate the loan portfolio. NCUA determined:

- Norlarco did not have any formal analysis for determining the profitability of its RCL program.
- Norlarco's servicing income for the first six months of 2006 was $379,823.[65] In addition, Norlarco received $195,400 in extension fees.[66] Norlarco's total

[65] Income was from the 0.375 percent servicing fee on each loan.
[66] The fee was $200 per loan per extension.

income from interest income, servicing fees, and extension fees from the RCL program totaled 59.49 percent of total operating income as of June 30, 2006.

The examiners determined that non-member funds and borrowings would not have been necessary if Norlarco had not been in the RCL program. In addition, examiners determined the yield from the RCL program was lower than the remainder of the asset structure when allocating the cost of debt and non-member deposits directly to the RCL program. However, the examiners determined the program remained profitable when considering the servicing income. On the other hand, the trend showed a declining yield. The examiners indicated this was unexpected because the RCL program loans were a short term loan product. The examiners had concerns with the stability of the profitability of the wholesale program as the rate charged on the portfolio was tied to the prime rate.

Examiners indicated Norlarco's involvement in the RCL program, and the funding the program necessitated, had created an ongoing liquidity issue for Norlarco. However, since the last examination, the Cash plus Short-Term Investments divided by Assets increased from 4.85 percent as of September 30, 2005 to 9.42 percent as of June 30, 2006, reflecting a significant improvement in liquidity. On the other hand, based on the peer average of 16.99 percent as of March 31, 2006, there was room for Norlarco to improve. The ongoing need for expensive funds for liquidity purposes continued to depress the earnings potential of the RCL program. Examiners indicated Norlarco management had not developed what they would have deemed a reliable outlet for participating the RCL program loans. This is another issue that should have been addressed long ago by policy and plan. The examiners concluded Norlarco's liquidity issues would likely continue given the potential for slowing and stagnation in the market and extensions of the maturities of the RCLs.

NCUA officials indicated:

- Norlarco management needed to establish an approved, validated and quantified vehicle or conduit to ensure that funding lines were pre-approved and in place before any approval or funding of RCL loans.

- RCL program loans outstanding should never exceed the internal limit established by Board policy.

- There were signs of improvement on Norlarco management's part. However:

    - Liquidity risk showed moderate improvement since the September 30, 2005 examination. Norlarco management had utilized non-member deposits along with the FHLB line of credit. Projections for the remainder of the year indicated that borrowed funds would peak at $23 million and would reduce to $8 million by October, when no further debt

would be needed. The uncertainty of the projections came from the fact that the levels of First American payoffs in relation to the funding of the construction draws had been erratic, but management indicated the condition was stabilizing and they hoped to have more accurate projections going forward.

- o There were no commitments or contractual agreements with First American or any of the borrowers for commitments to purchase. Norlarco management indicated they could shut down any further purchases of new loans at their discretion.

Examiners determined the RCL program was a factor in assessing Norlarco's asset quality. The examiners indicated First American underwrote and originated the loans, and qualified the borrower for membership in Norlarco and for the loan. First American also arranged the permanent financing, conducted the inspections, and issued draw requests based on its oversight of the process. Examiners determined Norlarco's delinquency was unknown because First American had the ability to approve extensions within its own judgment, with no input from Norlarco. However, the examiners indicated Norlarco management recently began to report extensions and to monitor the progress of those extended loans.

Examiners determined that, regarding the RCL program, gaps appeared between planning and policy, the responsibility of the Board, and execution and procedures. Oversight and control had lagged program involvement.

In addition, the examiners indicated the real estate lending and the RCL created a concentration risk that seemed readily apparent to the regulators, but not to Norlarco management. Norlarco management maintained that the loss history and the layered guarantees it had received from the builder, FHBF and the third-party originator, First American, averted any risk to Norlarco's capital. Based on that premise, Norlarco management continued to purchase RCLs through First American even though (1) Florida, the primary market for the RCLs, had experienced a slowdown, (2) hurricane-related contingencies had slowed the progress of construction to completion on the homes, and (3) higher mortgage loan rates had affected demand. As a result, NCUA examiners determined:

- Management should have addressed the absence of risk diversification within the asset structure of the credit union and specifically the wholesale program.

- Norlarco should have established concentration limits dealing with geographic distribution, market area, builders, and portfolio mix.

- Norlarco's level of exposure and risk was deemed unsafe and unsound without adequate risk control and mitigation.

The examiners determined that beginning in the first quarter of 2006, the risk level of loan concentrations had increased substantially, resulting in the extension of 38 percent of the outstanding RCL program loans. The percentage of extensions had increased to almost 48 percent of the RCL portfolio by July 31, 2006.

The examiners also determined that as part of the due diligence process, Norlarco management and First American should have conducted an analysis to determine if the production ability and capacity could have maintained a twelve month schedule of completion in relation to the level of sales. Furthermore, examiners determined that as a result of the concentration risk, the potential for other risk areas (i.e., market, interest rate increases, take-out cancellations, and buyer dissatisfaction) existed that might have resulted in further delays, foreclosures, or possible financial trouble with the builder.

The examiners indicated they conducted an extensive loan review, focusing on:

- Loan underwriting;
- Appraisal valuation;
- Extension considerations;
- Any indication of deterioration in the take-out agreements;
- Any indication of borrower dissatisfaction with builder;
- The miscellaneous loan portfolio, how it was performing and whether there were problems developing;
- Validation that the delays and need for extensions were a result of the production capacity of the builder and not extensive cancellations or walk-aways; and
- Any indication of property taxes not being paid.

The examiners noted the following concerns:

- Extensions: There was no indication that the buyers had signed or agreed with the extensions or that the interest could be capitalized on their construction loans even though the interest was apparently being paid by the builder. The examiners indicated that without signed extension agreements by the buyers, Norlarco management may have been required to classify the loans as delinquent.

- Home completions: Examiners indicated Norlarco management had reported there were close to 900 homes that had received their Certificate of Occupancy, which equated to $175 million. The examiners indicated that per Norlarco management, the delays in getting these homes closed and paid off were due to:

    - FHBF's title company could not handle the large number of closings;
    - Delays in satisfying the "punch list" of the borrower; and
    - Some delays by the borrowers.

NCUA's Planned Corrective Action

NCUA examiners indicated that, working with the Colorado SSA, they expected to have the following DOR items added to the DOR approved during the last examination. The examiners indicated they wanted no new funding of any First American construction loans until the following items had been resolved and approval issued by the Colorado DFS and NCUA.

Concentrations

Board of Directors and Management	Cease further funding of new loans with First American or any wholesale program until a Strategic plan was developed and approved that established concentration limits dealing with geographic distribution, market area, builders, single guarantors and portfolio mix. The existing parameters and levels were deemed unsafe and unsound.

Reporting systems and Due Diligence

Board of Directors & Management	Address the issue of fully funded homes: o A plan needed to be developed and put into action to accelerate the closings of homes that had obtained their Certificate of Occupancy. o There were a high number of members who had more than one home. [*sic*]There were some classified as MBLs [*sic*] and could have been tracked. There were others classified as second homes, but not classified as a [*sic*] business loan. With the declining sales market, the level of risk for "walk away" increased for these members. Norlarco needed to identify these loans and develop a tracking system to monitor their performance. Norlarco needed to determine if there was a correlation between homes fully funded and MBLs or second homes.

- FHBF had indicated there were between 35 and 40 homes that were considered problems with no resolution. Norlarco needed to identify these loans and put in place a specific plan of action to resolve them.

- Cease any further extensions without specific well-defined parameters and special circumstances for each individual loan that had been approved by the Colorado DFS.

- Contract with an independent third party (approved by the Colorado DFS) to validate the status of the FHBF loans outstanding. The wholesale program had a high number of extensions and high number of homes that had received the C/O, but which had not closed.

Profitability

Board of Directors and Management	Develop and monitor a program separating the functions of the credit union into profit centers.

Liquidity Management

Board of Directors and Management	Provide and report the Financial Planning Committee's Cash Flow analysis and Liquidity review to the regulatory authorities monthly.

Monthly Reporting

Board of Directors and Management	Provide and report each month on the status of the RCL portfolio.

NCUA recommended a monthly onsite contact be maintained at least through the end of 2006. NCUA recommended a RCMS during a full examination planned by the Colorado SSA for October 2006. .

Document of Resolution

The examiners required Norlarco management and the Board to:

Board of Directors and Management Immediately and Ongoing	1. Cease new loans with First American or any wholesale program until a Strategic plan was developed and approved that established concentration limits dealing with geographic distribution, market area, builders, single guarantors and portfolio mix.

Board of Directors and Management Immediately and Ongoing with initial Completion by October 31, 2006	2. a. Cease funding of new loans with First American or any wholesale program until a plan was developed and implemented to ensure timely closings of homes that had obtained their C/O. 2. b. Obtain the details on each of the loans with a C/O to determine if serious problems were developing. 2. c. Identify and track the large number of multiple loans to one borrower to monitor performance. Determine if there was a correlation between homes fully funded and MBLs or second homes. 2. d. Identify and implement a specific plan of action to resolve the 35 and 40 homes that FHBF considered problems with no resolution. Determine the reasons for the problems and assess the remainder of the portfolio to determine if any of these problems were chronic. 2. e. Engage an independent third-party to assist in the review, classification, and development of needed actions to ensure that the items required in [*sic*] items a. thru [*sic*] d. were completed and implemented no later than October 31, 2006. 2. f. Foreclose any loans that were classified as problems and not performing to contract.
Board of Directors and Management by September 30, 2006	3. Obtain a legal opinion to determine the effect of the large number of extensions in the First American borrowers' contracted obligations.
Board of Directors, Supervisory Committee and Management by September 30, 2006	4. Expand the focus of the internal audit of the wholesale portfolio.
Board of Directors and Management by November 30, 2006 and ongoing	5. Develop and monitor a program separating the functions of the credit union as separate profit centers. Complete analysis that could have effectively determined the profitability and trend attributes of both the wholesale program and on [*sic*] the core credit union operations.

Board of Directors and Management by September 20, 2006 and monthly thereafter	6. a. Provide to the Colorado DFS and NCUA the Financial Planning Committee's Cash Flow analysis and Liquidity review. 6. b. Provide to the Colorado DFS and NCUA a report on the status of the First American portfolio and the status of completion of all DOR items.

The examiners indicated that in spite of excellent cooperation in obtaining the types of reporting that NCUA had required from Norlarco, it was likely that NCUA would not wait for further reporting to place Norlarco in Special Actions. The examiners indicated that much of the reporting requirements in the DOR was retroactive to the type of due diligence that should have been done before Norlarco entered into the RCL program. The examiners anticipated that there was going to be a required on-site contact prior to the next examination, which was scheduled for February 2007.

September 30, 2006

Code 23 Joint Contact

The Colorado SSA and NCUA completed a 77 hour onsite contact of Norlarco in November 2006 using credit union data effective September 30, 2006. The regulatory agencies rated the Asset Quality, Management, and Earnings CAMEL components a 3 and the Asset/Liability Management component a 4. The overall composite CAMEL rating was 3.

The examiners indicated that Norlarco management decreased its goal of RCL loans to Assets from 40 percent to 10 percent. The examiners also indicated blanket extensions were still being performed up to six months. Furthermore, the examiners indicated Norlarco management had not adjusted its ALLL account for potential losses in the RCL program.

The examiners indicated that, since Norlarco recently hired a new CEO in August 2006, there was a willingness and ability to correct poor decision making by previous management. Examiners perceived a noticeable change in management's attitude toward the RCL program. During this contact, conversations with the individuals of the Executive Management Team,[67] the Internal Auditor, and the Associate Vice President of Wholesale Operations, showed there was a noted willingness to comply with the DOR. Their comments also reflected management's recognition of the potential risks in the RCL program.

NCUA examiners determined that Norlarco's MBLs represented 12.92 percent of total assets as of June 30, 2006. This level of MBLs exceeded the requirement that

[67] The CEO, Interim CFO/Vice President Lending/Finance/Information Technology, and the Senior Vice President of Operations

MBLs be no greater than the lesser of 1.75 times net worth or 12.25 percent of total assets.

December 31, 2006

Code 23 Joint Contact

The Colorado SSA and NCUA completed a 45 hour onsite contact of Norlarco in February 2007 using credit union data effective December 31, 2006. NCUA rated the Asset Quality, Management, and Asset/Liability Management components a 3 and the Earnings component a 4. The overall composite CAMEL rating was 3.

Examiners indicated:

- Norlarco continued to struggle to get control of the RCL program. They noted the dollar amount of RCL program commitments versus funded loans was as follows:

Total Sum of Investor[68] Commitment	$298,410,973
Total Sum of Norlarco Commitment	$ 86,701,840
Total Sum of Commitments	**$385,112,813**
Total Sum of Investor funded	$249,418,838
Total Sum of Norlarco funded	$ 74,633,995
Total Sum of Funded	**$324,052,833**

- Ninety-seven percent of the RCL portfolio properties were located in Florida, one percent was located in Colorado and two percent were located in 39 other states.

- When they were last on site, the credit union stated they would not perform any more blanket extensions. However, the assistant vice president of Wholesale Operations/Project Manager, said extensions up to three would continue in blanketed form.

In addition, examiners indicated that although Norlarco was performing a plethora of reporting for RCL, there continued to be a disconnection between who was doing what (Norlarco, FAM, FHBF/KHov). Norlarco had yet to take control of the program and stood by its belief the loans were performing assets. However, as of February 5, 2007, examiners learned Norlarco had not received interest payments since December 2006, which changed the definition for performing assets. Norlarco was

[68] 100 percent owned portfolios by Banco Poplar; Principal Bank; and First American.

awaiting the decision by KHov as to whether an agreement could be reached to receive interest payments. KHov wanted all RCL loans fully funded by Norlarco and its investors.

December 31, 2006

Code 11 Joint Examination

The Colorado SSA and NCUA completed a 328 hour examination of Norlarco in April 2007 using credit union data effective December 31, 2006. NCUA rated the Capital component a 2, the Asset Quality and Earnings components a 5, the Management component a 4 and the Asset/Liability Management CAMEL components a 3.[69] The examiners downgraded the overall composite CAMEL rating to a 4, indicating Norlarco was not in control of the RCL program that was negatively impacting its financials. The examiners reviewed the RCL program during this examination.

The examiners' primary concerns were that the Norlarco Board and management needed to concentrate their efforts and attention on the following areas, each of which came from the ongoing, dominant concern with the wholesale RCL program:

- Risk exposure posed by the uncertainties of the retail construction loan program. The program presented heightened Credit Risk, Interest Rate Risk, Liquidity Risk, Strategic Risk, and Reputation Risk.
- The previous lack of inclusion of the RCL program in planning for liquid resources created a dependence on non-member funds and borrowing to fund on-going operations.
- The lack of inclusion of the RCL program in the Strategic Plan and Budget.

The examiners determined that many of the problems and challenges which had surfaced and dominated the present and future of Norlarco came from the failure of the Board of the credit union to establish, review, and revise the policies that guided the credit union. The following findings and subsequent required actions reflected the common denominator of deficient policy, planning, direction, due diligence and oversight, specifically in the RCL program. The findings included:

- There was no formal documentation indicating a legal review was performed on the contracts for the RCL program.

[69] The SSA rated Norlaro as follows: Capital component a 2, the Asset Quality and Earnings components a 5,and the Management Asset/Liability Management CAMEL components a 3.

- The credit union had not yet received the interest payments for March and continued to negotiate with KHov for interest payments moving forward.

- In a meeting between Norlarco's CEO and representatives from First American and K Hovnanian First Homes, LLC/KHov Enterprises, nothing was resolved in the CEO's efforts to ensure interest would continue to come from KHov. KHov representatives wanted to negotiate the interest by having Norlarco take some Deeds in Lieu.

- Review of participation agreements indicated the Principal Bank documentation was with recourse after holding the loan for 18 months from initial commitment date. The Banco Poplar contract stated a repurchase must take place if there was a material misrepresentation within twelve (12) months of purchase. Also, there was an addendum agreement added to the participation agreement for Capital Community Credit Union: "Seller is obligated to repurchase the loan from Participant in the event that Seller commits a breach or default under this Agreement or Seller's conduct constitutes a negligent act or omission. The seller must pay within 5 days following Participant's demand for recourse payment." It did not appear the other participants had recourse in their agreements.

- Regarding the characteristics of the RCL portfolio – over 400 RCL loans were reviewed during the examination addressing Credit Quality and Borrowers Capacity. Of the loans underwritten in 2006, 25 percent reflected a credit score less than 620. Additionally, although income was identified in the loans underwritten in 2005, the income was not verified. For the loans underwritten in 2006, the applications no longer included income figures. Overall, the borrower's capacity was indeterminate and the low credit scores indicated increasing credit risk.

- Regarding, the borrowers' location, 40 to 50 percent of Norlarco wholly-owned loans were from borrowers established in the Miami area. This indicated a move to Lehigh Acres or Cape Coral unlikely. Permanent Residential Aliens living in Miami were identified in 50 of the loans reviewed. These borrowers were predominantly renters and employed in trucking and delivery, making relocation to a rural area for a first or second residence highly unlikely.

- Regarding the borrowers' intent (Speculative vs. Residential) – a majority of loans were first and second residences. Characteristics of the loans did not support this intent. Credit scores did not support a second residence and without stated income, examiners were unable to determine if borrowers had the capacity to support a second residence.

- Regarding inconsistencies in reporting – there was conflicting documentation. The loan documentation listed properties were for investment, while credit union documentation indicated the properties were first and second residences.

- Regarding Member Business Loans –the credit union was unable to determine that the first and second homes financed by the borrowers were not investor loans. The credit union was to review all loans and reclassify them appropriately.

- Regarding appraisal reasonableness – the original appraisal was performed in an upward trending market. When the market showed signs of slowing, no accommodation was made in the appraised value.

- There were potential losses considering:

    - [Property] values had fallen while the loan amount was based on appraisals performed in a hot market on a steep upward trend;
    - The number of days since the issue of C/O, it was clear the borrower did not plan to occupy the property;
    - Legal action expenses to get possession of property;
    - Expenses for upkeep/maintenance until the property is sold;
    - Vacant homes increase risk of vandalism and squatters; and
    - Extensions granted to avoid delinquency and maintain interest payments – violating the integrity of financial reporting and disclosures.

- Troubled loan and impaired credits required disclosure for potential loss risk for the loans in the Allowance for Loan Loss. The potential allowance for the RCL program would have been $1.8 million and ramping up as loans remained on the books and the number of days increased from issuance of C/O creating a provision of another $700,000 creating a loss potential of $2.5 million. The credit union showed a negative ROA [*sic*] for January 2007 because of funding the PLLL expense for the RCL program and writing off over $250,000 for in house HELOC loans. The increased provision amount would have also created a negative impact on the ROA [*sic*] for February 2007.

- Regarding potential legal risks – Inconsistencies in loan documentation. For example, the notes and truth in Lending disclosure indicated the member was responsible for the monthly interest payments to be made to the lender (Norlarco). The Agreement to Purchase Home indicated the Builder/Seller was to pay costs and interest during construction. The revised funding procedures indicated interest was drawn from the construction loan on a monthly basis as long as there were remaining funds available. However, there was no disclosure of this to member. The sales disclosure indicated the

funds were for purchasing property, construction of home, and improvement of site – there was nothing about an Interest Reserve amount. In addition, the loan documentation showed the member paying a non-refundable Earnest Money Deposit that was to be used to pay for the appraisal and credit report. However there was nothing to verify if money was collected, and it was not disclosed in the HUD settlement Form.

- The RCL program was not addressed in the budget for 2007 and the strategic plan reflected growth of 20 percent in assets and 60 percent in the retail loan program with monies from the RCL program moved into investment.

Required Board Actions

The Required Board Actions contained guidance and directives regarding the expectations of the Colorado DFS and NCUA for Norlarco Credit Union to proceed in the matters as they pertained to the RCL program, First American, and K. Hovnanian First Home Builders, LLC, and other examination outcomes. The Required Board Actions included:

Residential Construction Loan Program

Board of Directors In Progress	1. Cease funding of new loans with First American or any wholesale program.
Board of Directors Immediately	2. Retain an independent attorney with contract litigation expertise, who was not already associated with the RCL program, to review the contracts/addendums/letters for the RCL program.
Board of Directors Immediately	3. Attain legal guidance as to the recourse provisions of the participation agreements/circulars, and explicit and implied representations and warranties made by the credit union to investors including Banco Popular of North America and Principal Bank. An independent attorney not involved in the drafting of the agreements was to perform the review.
Board of Directors Immediately	4. Attain legal guidance as to the exposure from paying monthly interest payments from the funds drawn from the construction loan amount.
Board of Directors Immediately	5. Attain legal guidance regarding the HUD-1 Settlement Statements not including the earnest money paid by the member.
Board of Directors March 31, 2007	6. Reclassify all RCL loans as member business loans providing full and fair disclosure for the RCL loans no later than the March 2007 reporting period.

Board of Directors April 10, 2007	7. Inform First American about enforcement of Article 2, §2.2, of the Funding and Servicing Agreement.
Board of Directors April 10, 2007	8. Require First American to repurchase all loans that were seven months past the original maturity date, as was required by Article 2, §2.2, of the Funding and Servicing Agreement.
Board of Directors April 10, 2007	9. Seek legal action against First American for any violation of the Funding and Servicing Agreement.
Board of Directors Immediately	10. Cease granting any further extensions of maturity date for RCL loans that have an issued C/O.
Board of Directors Immediately	11. Cease granting any further extension of maturity date for those loans where construction was in process and a C/O had not been granted without first: a. Investigating the reasons for extension for each individual loan on which an extension of maturity date was requested; and, b. Only grant an extension when your investigation finds the supporting reason was due to construction delays caused by material and labor shortages, weather and other acts of God, and/or governmental permitting issues.
Board of Directors Immediately	12. Notify First American, FHBF and K Hovnanian immediately that Norlarco would have only permitted extensions to maturity according to the terms of these Required Board Actions.
Board of Directors April 10, 2007	13. Order follow-up appraisals on a minimum of 10 properties in each of the Lehigh Acres and Cape Coral areas, for a total of 20 loans. An independent firm not associated with any of the initial appraisals performed for the RCL loans was to perform the appraisals. Additionally, Norlarco was required to be the party ordering the appraisals.
Board of Directors Immediately	14. Modify the Allowance for Loan Loss methodology so that it would have provided for full and fair disclosure of the potential loss in the RCL loans.

Board of Directors Immediately	15. Implement a plan to ensure closings of homes that had obtained their Certificate of Occupancy coordinating this plan with First American, FHBF/KHov, and Norlarco with details and timeframes for completion.
Board of Directors March 31, 2007	16. Develop a watch list of troubled loans.
Board of Directors March 31, 2007	17. Monitor and take appropriate action for loans on the watch list.
Board of Directors April 10, 2007	18. Modify the 2007 Budget to include the RCL program and costs associated with the program.
Board of Directors April 10, 2007	19. Update the Strategic/Business Plan addressing the RCL program and the credit union's strategy to tackle the potential problems and foreclosures of homes associated with this program.

Policies

Board of Directors During 2007 and Ongoing	On a calendar-based agenda or other schedule adopted by the Board, review and revise as needed the policies of the Board. Assure that the policies reflected the direction and intent of the Board and the mission statement, strategic plan, and business plan of the Credit Union. Confirm that each policy reflected the most recent date of review.

Status of DOR items from the June 30, 2006 Examination

Board of Directors and Management Immediately and Ongoing	1. Cease new loans with First American or any wholesale program until a Strategic plan was developed and approved that established concentration limits dealing with geographic distribution, market area, builders, single guarantors and portfolio mix. *The credit union had implemented a 10% limit on the RCL program.*
Board of Directors and Management Immediately and Ongoing with initial Completion by October 31, 2006	2. a. Cease funding of new loans with First American or any wholesale program until a plan was developed and implemented to ensure timely closings of homes that had obtained their C/O. *Non-compliance.*

2. b. Obtain the details on each of the loans with a C/O to determine if serious problems were developing.

The credit union contacted the borrowers on loans that had been fully-funded while First American contacted the borrowers with Certificates of Occupancy. However, no formal documentation reporting was performed to the Board.

2. c. Identify and track the large number of multiple loans to one borrower to monitor performance. Determine if there was a correlation between homes fully funded and MBLs or second homes.

The credit union had identified Investor (MBL) loans by multiple loans to one borrower. However [*sic*] *no formal reporting regarding the performance of these loans. Additionally, it was recognized that there were more loans that were identified as second homes, but the borrower had either skipped or was non-cooperative indicated the intent of the borrower was initially an investment home. The RBA required credit unions to classify all of their RCL loans as MBLs until tangible proof, other than loan documentation, could be produced.*

2. d. Identify and implement a specific plan of action to resolve the 35 and 40 homes that FHBF considered problem loans with no resolution. Determine the reasons for the problems and assess the remainder of the portfolio to determine if any of the problems were chronic.

Per the response to the "Abandonment Letter" sent by First American, the number of these homes had increased [*sic*] *however there was not a specific plan of action leading to resolution.*

2. e. Engage an independent third-party to assist in the review, classification, and development of needed actions to ensure that the items required in items a. thru d. were completed and implemented no later than October 31, 2006.

Norlarco retained Orth, Chakler, and Murnane, [*sic*] *however* [*sic*] *no formal reporting had taken place.*

2. f. Foreclose any loans that were classified as problems and not performing to contract.

The credit union was in non-compliance – no foreclosures had taken place.

Board of Directors and Management by September 30, 2006

3. Obtain a legal opinion to determine the effect of the large number of extensions in the First American portfolio on the borrowers' contracted obligations.

A legal opinion was attained and extensions might have been performed between the builder and the borrower. However, there was nothing regarding blanket extensions. The credit union should have only granted the extension after performing an investigation to find that the supporting reason was due to construction delays caused by material and labor shortages, weather and other acts of God, and/or governmental permitting issues.

Board of Directors, Supervisory Committee and Management by September 30, 2006

4. Expand the focus on the internal audit of the wholesale program.

The credit union was in compliance.

Board of Directors and Management by November 30, 2006 and ongoing

5. Develop and monitor a program separating the functions of the credit union as separate profit centers. Complete analysis that could have effectively determined the profitability and trend attributes of both the wholesale program and on the core credit union operations.

The credit union was in partial compliance and implemented a program for capturing the costs associated with the RCL program.

Board of Directors and Management by September 20, 2006 and monthly thereafter

6. a. Provide the Cash Flow analysis and Liquidity review done by the Financial Planning Committee to the Division of Financial Services and the National Credit Union Administration by the 20th day following the end of each calendar month.

6. b. Provide to the Colorado DFS and NCUA a report on the status of the First American portfolio and the status of completion of all DOR items.

The credit union was in compliance.

March 31, 2007

Code 23 Joint Contact

The Colorado SSA and NCUA completed a 144 hour onsite contact of Norlarco in September 2007 using credit union data effective March 31, 2007.

The Colorado DFS had issued Norlarco a Cease and Desist on April 18, 2007, because the credit union was not in compliance with the items from the examination effective December 31, 2006. The main purpose of the contact was to monitor the credit union's compliance with the Cease and Desist, monitor the conservatorship action, and evaluate the viability of the credit union.

Auditor's Note: NCUA and the SSA conducted this examination in September 2007 after the April 30, 2007 examination presented below, which was conducted in June 2007. During the April 2007 examination, the Colorado DFS placed Norlarco into conservatorship; therefore, we did not include the details of this March 2007 examination.

April 30, 2007

Code 23 Joint Contact

The Colorado SSA and NCUA completed a 318 hour onsite contact of Norlarco in June 2007 using credit union data effective April 30, 2007. NCUA rated the Asset Quality and Earnings CAMEL components a 5, the Capital and Asset/Liability Management components a 3, and the Management component a 4. The overall composite CAMEL rating was 4.[70]

First American ceased performing the servicing for the RCL program as of May 4, 2007. Norlarco took over the servicing and transacted directly with FHBF/KHov regarding payoffs, interest payments, draw requests, and sending reports and draw requests to investors.

The Colorado DFS placed Norlarco into conservatorship on May 15, 2007, to protect the interests of Norlarco's members from acts or omissions of the existing Board. The Colorado DFS Commissioner placed Norlarco into conservatorship because the Commissioner:

- Preferred to have the RCL program "controlled" by NCUA to ensure well thought-out decisions;

[70] The SSA rated Norlarco as follows: The Capital CAMEL component a 2, the Asset Quality and Earnings components a 5, the Management and Asset/Liability Management components a 3. The overall composite CAMEL rating was 4.

- Had reasonable cause to believe that the credit union Board did not see a significant sense of urgency; and

- Believed Norlarco management engaged in unsafe and unsound business practices, which included Norlarco management's actions to negotiate an agreement with FHBF/KHov, legal communications with First American, and negotiations with an outside vendor to move servicing from First American.

The Colorado DFS Commissioner appointed the NCUA Board as Conservator for the action.

Appendix B: NCUA Management Comments

VIA E-Mail

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

FROM: Executive Director David M. Marquis
Office of Executive Director

SUBJ: Comments on Material Loss Review of Norlarco Credit Union

DATE: April 30, 2009

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review of Norlarco Credit Union (MLR)*.

I agree with the MLR's assessment that the inability of Norlarco's management to adequately identify, manage, and mitigate the risks within the residential construction lending (RCL) program was a significant factor in this credit union's failure. Specifically, Norlarco's management failed to:

- Conduct a due diligence review of third-parties;
- Provide appropriate oversight and control over the RCL program;
- Limit concentration risk in a given business line; and
- Develop and implement safe and sound Asset-Liability Management policies and practices.

As discussed in the MLR, NCUA has long provided guidance to credit unions regarding the importance of due diligence when beginning a new program, especially in cases involving third-parties. Since this case, NCUA issued additional guidance to credit unions and examiner staff addressing such issues as evaluating third-party relationships and in particular, loan participation programs.

Thank you for the opportunity to comment on the MLR of Norlarco Credit Union.