

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW
OF
CAL STATE 9 CREDIT UNION

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Abbreviations

ALLL	Allowance for loan and lease losses
Broker	Local third-party mortgage broker
Cal State 9	Cal State 9 Credit Union
California SSA	California State Supervisory Authority
C&D	Cease and Desist [order]
CUDL	Credit Union Direct Lending [program]
CUSO	Credit Union Owned Service Organization
CLTV	Combined loan-to-value [ratio]
DOR	Document of Resolution
FISCU	Federally insured state-chartered credit union
FCU Act	Federal Credit Union Act
FPR	Financial Performance Reports
HELOC	Home Equity Line of Credit
LTV	Loan-to-value [ratios]
Management	Cal State 9 Board and management
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
P&A	Purchase and Assumption
RFE	Risk-Focused Examination [program]

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review of Cal State 9 Credit Union (Cal State 9). We reviewed Cal State 9 to: (1) determine the cause(s) of Cal State 9'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 California SSA examination and supervision reports and related correspondence; interviewed management and staff from NCUA Region V and the California SSA; and reviewed NCUA policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPRs).

We determined Cal State 9 failed because its Board and management (management) did not implement adequate risk management practices to address credit, concentration, and liquidity risks. Specifically, management committed an exorbitant percentage of the credit union's assets in an indirect Home Equity Line of Credit (HELOC) program without adequate controls in place to oversee and manage the risks in the program's operations.

A significant factor in Cal State 9's failure was management's strategic decision to fund an excessive amount of indirect HELOCs rife with risky loan elements despite examiners' concerns in the years preceding the institution's failure. California SSA and NCUA examiners determined, and the OIG agrees, that Cal State 9 management:

- Created credit risk through weak underwriting standards.
- Created concentration risks by: (1) allowing the indirect HELOC portfolio to account for a significant percentage of the credit union's total assets, and (2) funding most of the indirect HELOC portfolio with subprime loans.
- Created liquidity risk through their rapid and excessive funding of high risk subprime indirect HELOCs.

We determined that despite examiners' concerns and recommendations for improvement, management's inability to effectively manage the risks their own actions had created eventually led to Cal State 9's failure.

A contributing factor in Cal State 9's failure was NCUA and California SSA examiners' inadequate response to the increasing credit risk identified in the credit union's indirect HELOC program and the credit union's liquidity risk, as Cal State 9 increasingly committed more of its assets to fund the indirect HELOC portfolio. Specifically, we determined examiners did not respond adequately or timely to the risks facing Cal State 9, considering: (1) the rate and level of growth of the HELOC portfolio; (2) the excessive concentration of HELOCs, nearly all of which contained subprime elements; and (3) the continuing changes in the California real estate market environment. In addition, we

determined examiners did not adequately monitor the credit union's liquidity position. As a result, we believe examiners missed opportunities to slow or stop the growth of the indirect HELOC program, which would have likely mitigated the loss to the NCUSIF.

This report does not make recommendations but provides observations and suggestions. As major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted.

Auditor observations made as a result of our review of Cal State 9's failure include:

- Cal State 9 management's poor strategic decisions, aggressive appetite for asset growth, and excessive concentrations of sub-prime loans, combined with the declining California real estate market, and lax internal controls, created a financial situation where institutional failure was all but assured.
- Cal State 9 management did not take the time to gain the necessary experience needed to understand and manage all of the related risks with their newly initiated HELOC program before aggressively pursuing the program.
- NCUA has provided an abundance of guidance to credit union management [and examiners] prior to and throughout the residential mortgage market meltdown. However, guidance alone does not protect against failure if management or examiners do not proactively recognize the risks and take corrective actions.
- NCUA's examination processes provide examiners with the tools and guidance with which to assess the safety and soundness of credit union operations and any risk to the NCUSIF. NCUA also has the appropriate means with which to address serious credit union problems. NCUA officials should ensure examiners fully employ and rely on the examination processes in order to avoid increased safety and soundness issues, failures, and losses to the NCUSIF. In addition, although SSA's are primarily responsible for supervision of federally insured state-chartered credit unions and their regulatory issues, NCUA must put its legal and fiduciary responsibility to ensure the safety of the NCUSIF ahead of all other issues and challenges.
- Examiners did not view Cal State 9's participation program as a safety and soundness concern to the credit union, other financial institutions, or to the NCUSIF. Examiners merely viewed participations as a means for Cal State 9 to manage its balance sheet risk.

NCUA previously established guidance to credit union management and examiners to address the issues that led to Cal State 9's failure, such as specialized lending

activities, third-party relationships, HELOCs, and loan participations. However, based on this review, it was clear Cal State 9 management failed to follow this guidance. Since NCUA officials declared Cal State 9 insolvent,¹ NCUA has provided additional guidance to credit union management and examiners to address deficiencies in the areas of third-party relationships.

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

¹ NCUA officials determined Cal State 9 was insolvent as of May 2008.

BACKGROUND

Cal State 9 was a federally insured state-chartered credit union (FISCU) located in Concord, California. Originally established in 1948 to serve employees of California State University, Cal State 9 grew to serve the residents of five counties in the San Francisco Bay area. Cal State 9 also served other groups and associations including state employees, and Regents, employees, and students in the University of California system.

In July 2007, the National Credit Union Administration (NCUA) and the California SSA transferred primary supervision of Cal State 9 to NCUA's Division of Special Actions.² In September 2007, the California SSA issued a Final Order³ placing restrictions on Cal State 9's lending activities, as well as requirements for monitoring liquidity.

On November 2, 2007, the California DFI placed Cal State 9 into conservatorship and appointed the NCUA as conservator. The NCUA Board placed Cal State 9 into Federal conservatorship on November 15, 2007. At the time of conservatorship, Cal State 9 was a full service FISCU with five branches and approximately 27,000 members. Cal State 9 was located in NCUA's Region V.

In April 2008, the NCUA accepted bids from credit unions interested in acquiring Cal State 9. In May 2008, the NCUA Board delegated authority to liquidate Cal State 9 and consummate a Purchase and Assumption (P&A) with Patelco Credit Union under the Federal Credit Union Act (FCU Act).⁴

On June 30, 2008, the NCUA Board involuntarily liquidated Cal State 9 and appointed itself Liquidating Agent.⁵ Also on this date, the NCUA, as liquidating agent, executed a P&A agreement and transferred the assets, liabilities, and shares of Cal State 9 to Patelco. As of July 2008, the estimated loss to the National Credit Union Share Insurance Fund (NCUSIF) was approximately \$206 million; however, the final cost to the NCUSIF will not be known until all assets are sold.

² Special Actions identifies, controls, and corrects serious problems to maintain the integrity and soundness of the NCUSIF.

³ The California DFI's Final Order is equivalent to NCUA's Cease and Desist (C&D) Order.

⁴ Pursuant to Sections 207(a)(3), 207(a)(3)(A)(ii) and 207(a)(3)(B) of the FCU Act.

⁵ The liquidating agent is authorized under Section 107(14), 205(h), 207(b)(2)(A), 207(b)(2)(B), 207(b)(2)(E), 207(b)(2)(J), and 209 of the FCU Act, to transfer the assets, liabilities, and insured shares of the liquidating credit union to another insured credit union.

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 CAMEL⁶ components, and reviewing qualitative and quantitative measures.

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,⁷ trend analysis,⁸ reasonableness analysis,⁹ variable data analysis,¹⁰ and qualitative data analysis.¹¹ 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 2002, NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The RFE process

⁶ The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.

⁷ Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

⁸ Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

⁹ As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

¹⁰ 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.

¹¹ 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.

includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation*. Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up, and (b) analyzing Call 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 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.¹² 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 on-site FISCU reviews are an independent insurance review and a joint examination/insurance review. In joint examinations/insurance reviews, both NCUA and the SSA focus on risk issues (including safety and soundness issues), while the state examiner focuses additionally on regulatory concerns. However, during an independent insurance review, NCUA examiners limit their role to the review and analysis of risks to the NCUSIF only, rather than a complete examination of the FISCU.

NCUA examiners primarily monitor the financial condition and progress of FISCUs by reviewing SSA examination reports, Call 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

¹² 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.

- An agreement or plan exists for resolving unacceptable risks in a timely manner.

NCUA recognizes that SSA's are primarily responsible for the supervision of federally insured state-chartered credit unions. The FCU Act requires that NCUA should use the SSA examination reports to the maximum extent feasible.¹³ However, NCUA reserves the right to conduct an insurance review of any FISCO as it deems necessary to determine its condition for insurance purposes.

OBJECTIVES, SCOPE, AND METHODOLOGY

The FCU Act requires the NCUA Office of Inspector General to conduct a material loss review of an insured credit union if the loss to the NCUSIF exceeds \$10 million and 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. NCUA notified the OIG of a loss reserve for Cal State 9 of \$206 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 Cal State 9'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. The scope of our review covered the period from June 2002 to June 2008, Cal State 9's liquidation and subsequent P&A date.

To determine the cause of Cal State 9's failure and assess the adequacy of NCUA's supervision we:

- Analyzed NCUA and California SSA examination and supervision reports and related correspondence;
- Interviewed management and staff from NCUA Region V and the California SSA; and
- Reviewed NCUA policies and procedures, NCUA Call Reports, and NCUA FPRs.

We used computer-processed data from NCUA's Automated Integrated Regulatory Examination Software and NCUA online systems. We did not test the controls over these systems. However, we relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained from these systems to support our audit conclusions.

¹³ The FCU Act, 12 U.S.C., Chapter 14, § 1781(b)(1).

This report does not make recommendations but provides observations and suggestions. As major causes, trends, and common characteristics of financial institution failures are identified in our reviews, we will communicate those to management for its consideration. As resources allow, we may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted.

We conducted this audit from March 2009 through April 2010 in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Management reviewed a discussion draft of this report. We incorporated their suggested changes where appropriate.

RESULTS IN DETAIL

We determined Cal State 9 management's actions contributed directly to the credit union's failure. In addition, we determined California SSA and NCUA examiners may have been able to mitigate the loss to the NCUSIF had they fully recognized the safety and soundness concerns looming in Cal State 9's indirect Home Equity Line of Credit (HELOC) program and took more aggressive actions to address those concerns.

A. Why Cal State 9 Credit Union Failed

Management's Actions Led to Cal State 9's Failure

Cal State 9 failed because its Board and management (management) did not implement adequate risk management practices to address credit,¹⁴ concentration,¹⁵ and liquidity risks.¹⁶ Specifically, Cal State 9's management committed an exorbitant percentage of the credit union's assets in an indirect HELOC program without adequate controls in place to oversee and manage the risks in the program's operations.

A significant factor in Cal State 9's failure was management's strategic decision to fund an excessive amount of indirect HELOCs rife with risky loan elements, a decision we believe was rooted in the unprecedented appreciation in the California housing market. Although examiners expressed concern about Cal State 9's risk management practices in the years preceding the institution's failure and made a number of recommendations for improvement, management's inability to effectively manage the risks their own actions had created eventually led to Cal State 9's failure. Although the downturn in the California real estate market¹⁷ may be viewed by some as the cause of Cal State 9's failure, management's actions clearly left the credit union overexposed to unfavorable economic conditions.

California SSA and NCUA examiners determined, and the OIG agrees, that Cal State 9 management:

- Created credit risk through weak underwriting standards.

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 Concentration risk results when a credit union does not properly address diversification in the portfolio.

¹⁶ 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.

¹⁷ 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.

- Created concentration risks by: (1) allowing the indirect HELOC portfolio to account for a significant percentage of the credit union's total assets, and (2) funding most of the indirect HELOC portfolio with subprime loans.
- Created liquidity risk through their rapid and excessive funding of high risk subprime indirect HELOCs.

Summary of Cal State 9's CAMEL Ratings History and indirect HELOC Program

Historically, Cal State 9 was considered a well-run credit union, consistently receiving composite code 1 or 2 CAMEL ratings from the California SSA and NCUA through December 2005.

In May 2003, Cal State 9 began an indirect HELOC program with a local third-party mortgage broker (broker) to offer HELOCs to individuals. The indirect HELOC program allowed Cal State 9 to finance and service HELOCs originated by the broker.

Substantially all of the HELOCs Cal State 9 funded had subprime elements that included:

- Stated income;¹⁸
- High Combined Loan to Value (CLTV¹⁹) ratios;
- Borrowers with low credit scores; and
- Being in a junior position behind negative amortization first mortgages.

The broker presented each loan to Cal State 9 management, who had first right of refusal to decide whether or not to fund each HELOC presented.

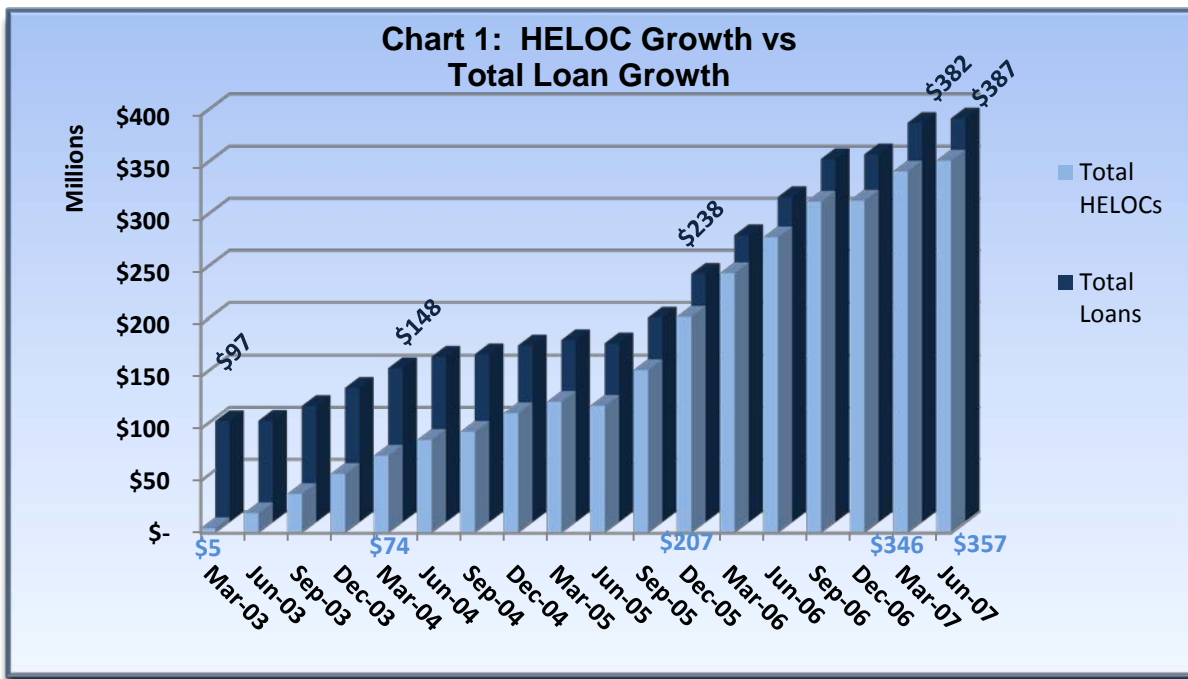
In addition, NCUA officials determined that Cal State 9 performed very little due diligence over the HELOCs. The CFO of Cal State 9 was the sole person responsible for the creation and daily operations of the indirect HELOC program and received bonuses based on additional net income generated by the program. NCUA officials surmised that this individual had no incentive to ensure the credit union had an effective quality control system in place because any loan turned down from the broker would, in effect, take money directly from his bonus.

Cal State 9's lack of adequate risk management practices enabled the HELOC program to grow excessively and at an extremely rapid pace. The HELOC portfolio grew from

¹⁸ Stated income is a loan feature where an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

¹⁹ Combined Loan-to-Value (ratio) is the aggregate principal balance(s) of all mortgages on a property divided by its appraised value or purchase price, whichever is less.

\$4.6 million in March 2003²⁰ to \$357 million in June 2007 (7,661 percent) when the credit union was placed under NCUA’s Special Actions. Chart 1 (below) illustrates the rapid growth and concentration of Cal State 9’s HELOC portfolio in relation to its total loans.



From 2004 to 2007, Cal State 9’s Composite CAMEL rating eroded from a code 2 in December 2005 to a code 5 during the June 2007 contact when Cal State 9 was placed under NCUA Special Actions. In May 2008, NCUA concluded Cal State 9 was insolvent²¹ due to potential and known losses resulting from the indirect HELOC program. Specifically, NCUA determined the Allowance for Loan and Lease Losses²² (ALLL) adjustments needed by Cal State 9 would result in a net worth ratio of negative 135.79 percent, a ratio considered critically undercapitalized under Prompt Corrective Action. Appendix A provides details regarding the examination history of Cal State 9. Table 1 (below) summarizes selected financial information for Cal State 9.

²⁰ We used data as of March 2003 because it was the most recent quarterly data available just prior to inception of the indirect HELOC program in May 2003.

²¹ 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.

²² The ALLL provides a credit union’s estimate of probable but unconfirmed losses in the loan portfolio as of the financial statement date.

Table 1

Financial Measure(\$000)	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07
Total Assets	\$245,643	\$264,546	\$320,617	\$435,207	\$339,037
Total Shares and Deposits	\$194,489	\$201,750	\$251,961	\$391,740	\$285,439
Total Loans & Leases	\$128,869	\$169,581	\$237,663	\$352,349	\$341,584
Net Income (Loss)	\$428	\$3,196	\$6,048	\$9,458	(\$61,643)

Summary of Management's Actions

The following summarizes Cal State 9 management's actions contributing to the credit union's failure:

Credit Risk in the HELOC Program

Cal State 9 management created credit risk in the indirect HELOC portfolio through weak underwriting standards, which enabled credit union management to concentrate a significant percentage of its assets in indirect HELOCs. In addition, substantially all of the HELOCs contained elements of subprime lending such as stated income, high CLTVs, low credit scores, and being in a junior position behind negative amortization first mortgages. Ultimately, the credit union experienced high delinquencies and loan losses, which led to its failure.

NCUA guidelines indicate that credit union officials are responsible for planning, directing, and controlling the credit union's affairs, including the proper and profitable conduct of credit union operations and the safety of credit union assets. In addition, NCUA risk management guidelines state credit unions should have in place a risk management program that includes a strategic plan with implementing policies, procedures, and internal controls necessary to manage the risks inherent in their operations. NCUA guidelines further state that successful risk management programs rely on credit union management to identify, measure, monitor, and control existing and potential risks.

Weak Underwriting Standards

California SSA and NCUA examiners determined, and we agree, that Cal State 9 had weak underwriting standards. Examiners informed management that nearly all of the HELOCs had elements of subprime lending²³ and most had multiple elements. Specifically, examiners determined that:

²³ Subprime elements examiners referred to included stated income, negative amortization, and high CLTV features.

- During the December 2005 examination, stated income loans comprised 82 percent of the HELOC portfolio. Examiners warned management that these types of loans have a greater chance that some of the income reported to the credit union may have been inflated. By July 2006, the level of stated income loans had increased to 88 percent. Although examiners had warned management of the potential for overstated incomes, we found no indication in any examination workpapers that management ever addressed the issue. In fact, examiners later indicated during the March 2007 joint contact that it did not appear that management had evaluated the high percentage of stated income [HELOC] loans for reasonableness.
- In December 2005, credit tier C paper (credit scores between 600-639) made up 27 percent of the HELOC portfolio and an additional 12 percent had credit scores below 600.²⁴ By July 2006, although credit tier C paper increased only slightly to 28 percent, loans to borrowers with credit scores below 600 had significantly increased to 18 percent.
- During the June 2006 joint contact, 61 percent of the HELOCs were in a junior position behind negative amortization first mortgages.

In addition, NCUA officials determined that at inception, nearly 70 percent of the HELOCs had CLTVs between 85 percent and 124 percent. Examiners indicated the credit union should have categorized loans with CLTVs of 89 percent [and higher] as high risk.

Examiners warned management during the December 2005 examination that loan products with liberalized features and liberal underwriting standards carry higher levels of credit risk and that Cal State 9's stated income loans, coupled with the indirect HELOC portfolio's high concentration risk, could potentially result in higher losses. However, we found no indication that management ever addressed the program's underwriting standards. In fact, examiners warned management again during the March 2007 examination (approximately one year later) of the risks posed by the HELOC's subprime elements.

Concentration Risks Created by the Indirect HELOC Program

Cal State 9 management created two interrelated and inseparable concentration risks within the credit union. First, management funded a significant number of indirect HELOCs within the credit union's overall loan portfolio. Second, examiners determined substantially all of the indirect HELOCs contained subprime elements. As a result, when interest rates increased and property values declined significantly during the U.S. residential mortgage market meltdown, Cal State 9 management was unable to

²⁴ NCUA guidance indicates that while there is no industry standard range of credit scores that describe subprime borrowers, those borrowers with credit scores below 620 generally have a higher loan default rate.

successfully manage the high delinquencies and resulting loan losses. Ultimately, Cal State 9 became insolvent as a result of the indirect HELOC program.

We believe two factors contributed significantly to Cal State 9's excessive concentration of its assets in indirect HELOCs:

- A desire to attain goals of fiscal stability and profitability after a failed auto lending program; and
- An incentive compensation program that paid nearly \$400,000 in bonuses to the credit union's CFO between 2006 and 2007 based on additional net income generated by the HELOC program.

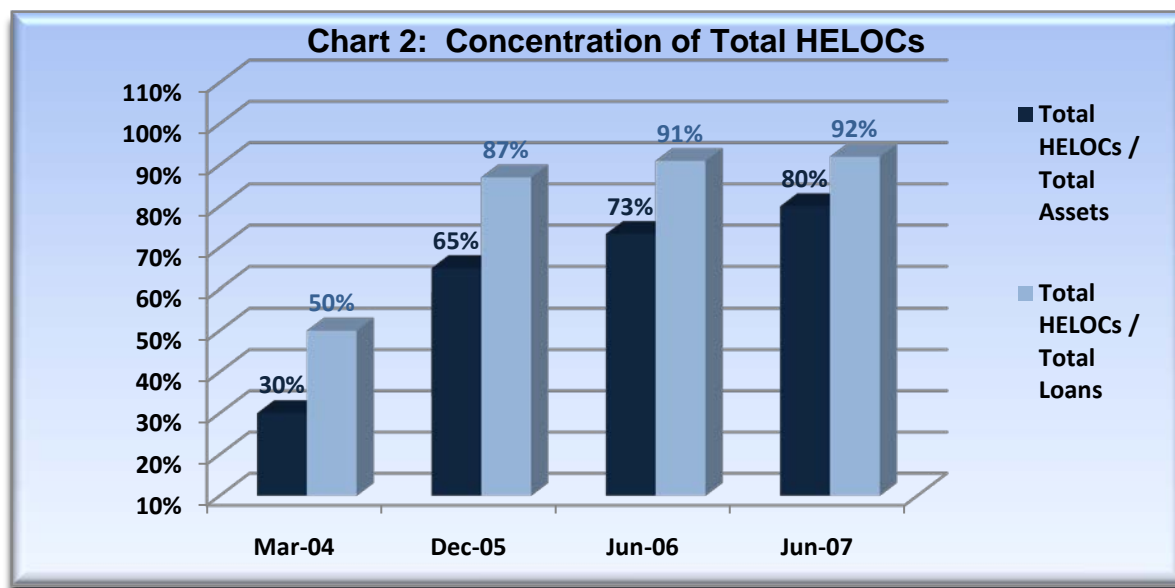
NCUA guidelines indicate, in part, that sound risk management practices include employing proper diversification strategies in order to avoid excessive concentrations in, or reliance on, any asset, liability, or share category.

Eventually, examiners' warnings of the risks associated with concentrations of subprime loans in the portfolio materialized when the combination of rising interest rates and declining California property values caused Cal State 9's delinquencies to increase dramatically. From December 2004, delinquencies grew from \$696 thousand to \$41.8 million by June 2007, a 5,907 percent increase. Further, due to the significant increase in delinquencies, Cal State 9's losses grew from \$481 thousand in September 2006, to \$28.7 million by December 2007, a 5,867 percent increase.

Concentration of HELOCs

Cal State 9 management's aggressive appetite for risk resulted in an excessive concentration of the credit union's assets in high risk HELOCs. Specifically, Cal State 9 management allowed the credit union's indirect HELOC portfolio to grow to 80 percent of the credit union's total assets and 92 percent of the credit union's total loans by June 2007.

Chart 2 (below) illustrates the concentration of Cal State 9's HELOC portfolio as compared to total assets and total loans from the first examination in March 2004 through the last contact in June 2007, when the credit union was assigned to NCUA's Special Actions.



Concentration of subprime HELOCs

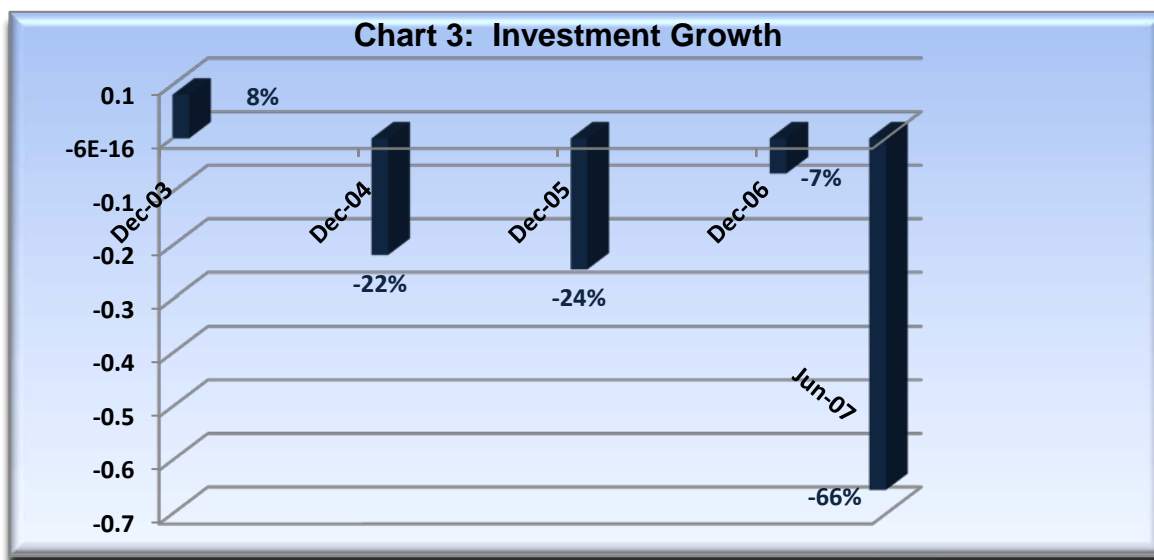
Cal State 9 management also created credit risk by funding an extremely high percentage of HELOCs having subprime elements. As previously noted, examiners had determined that substantially all of the HELOCs had elements of subprime lending with most having multiple elements. Throughout the examinations conducted from March 2004 through June 2007, examiners warned Cal State 9 management of increasing credit risk due to the subprime elements in the indirect HELOC portfolio.

As previously noted, we found no indication that management improved the HELOC program's underwriting standards. In addition, we found no indication that management made any effort to reduce its concentration of subprime loans, despite examiners warnings. Although examiners finally recommended during the June 2006 examination that management reduce its concentration of indirect HELOCs, examiners determined during the next contact (March 2007) that management had in fact not reduced the concentration of HELOCs.

Liquidity Risk within the HELOC Program

During the March 2007 examination, California SSA and NCUA examiners determined Cal State 9 management did not adequately manage its liquidity. In addition, examiners rated the credit union's liquidity risk as high and expected its liquidity problems to increase. Examiners indicated management had sold participations, liquidated investments, borrowed funds, and increased dividend rates to attract shares in order to meet liquidity needs. Specifically, Cal State 9 management:

- Sold non-recourse²⁵ participations valued at nearly \$190 million to three other credit unions and one bank between March 2003 and June 2007.
- Liquidated investments. Total investments declined by 65 percent during the period from December 2003 to June 2007. Chart 3 (below) illustrates Cal State 9's annualized investment growth/decline during this period.



- Borrowed funds regularly and established lines of credit. Cal State 9 borrowed as much as \$61.1 million, and established a line of credit of up to \$90 million during the course of the indirect HELOC program.
- Increased the dividend rate from 2.47 percent to 4.89 percent between December 2004 and March 2007, which resulted in share certificates increasing from \$43 million to approximately \$212 million, a 393 percent increase.

In addition, other liquidity trends indicated Cal State 9's liquidity was tightening significantly. Specifically, as of March 2004, Cal State 9's ratio of cash plus short-term investments to assets²⁶ was 9.21percent (Peer 17.01), and the ratio of total loans to total shares was 75.13 (Peer 70.95). By June 2007, when NCUA placed Cal State 9 under Special Actions, the ratio of cash plus short-term investments to assets was 2.63 percent (Peer 16.58), and the ratio of total loans to total shares was 101.79 percent (Peer 79.00). See Appendix B for other liquidity ratios and trends.

²⁵ With [loan] recourse agreements, there are three types of recourse: full recourse, limited recourse and no recourse. Under full recourse, the dealer [i.e., seller] must purchase the loan at the credit union's demand. Limited recourse requires the dealer to buy back the loan or repossess the goods if the credit union fulfills certain obligations. With no recourse, the dealer has no obligation on the loan unless fraud or misrepresentation was involved.

²⁶ See Appendix B for an explanation of cash plus short-term investments.

NCUA guidelines indicate that to control liquidity risk, management must understand the interrelationships of interest rates, mortgage cash flows, prepayment risk, extension risk, and the effect on the fair value of its assets. Cal State 9 management failed to maintain the proper perspective of the interrelationships between its high concentration of variable-rate subprime loans, interest rates, and the California real estate market environment.

Auditor Observations

Cal State 9 management’s poor strategic decisions, aggressive appetite for asset growth, and excessive concentrations of sub-prime loans, combined with the declining California real estate market, and lax internal controls, created a financial situation where institutional failure was all but assured.

Cal State 9 management initiated a new HELOC program on the heels of a failed auto lending program and made the material flaw of not moving slowly to limit the credit union’s exposure. By growing the HELOC program so aggressively, management did not gain the experience needed to understand and manage the related risks in the program, which is vitally important when offering any new product or service.

In addition, NCUA has provided guidance to credit union management [and examiners] addressing the issues that led to Cal State 9’s failure. Table 2 (below) summarizes the *Letters to Credit Unions* and *Risk Alerts* issued to FISCUs between 1991 and 2009 that provide guidance on issues related to Cal State 9’s failure, such as specialized lending activities, third-party relationships with brokers, and loan participations:

Table 2

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-19	Third-Party Relationships: Mortgage Brokers and Correspondents
	Letter No. 08-CU-26	Evaluating Loan Participation Programs
2009	Regulatory Alert No. 09-RA-09	Interagency Fair Lending Examination Procedures

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. Table 3 (below) summarizes the letters issued to credit union management.

Table 3

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) managing risks associated with home equity lending, (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 regarding these issues at this time.

B. California Department of Financial Institutions and NCUA Supervision of Cal State 9 Credit Union

Examiners Could Have Mitigated the Loss to the NCUSIF

We determined examiners did not adequately assess Cal State 9's new indirect HELOC program during the March 2004 examination,²⁷ or monitor the credit union's liquidity position.²⁸ In addition, we determined examiners did not respond aggressively or timely enough to Cal State 9's increasing credit and liquidity risks. As a result, examiners missed opportunities to slow or stop the growth of the indirect HELOC program, which would have likely mitigated the loss to the NCUSIF. We also determined examiners did not assess the impact of Cal State 9's loan participations on other financial institutions or the NCUSIF.

California SSA and NCUA Examiners' Supervision Efforts over Cal State 9 and its Indirect HELOC Program were not Adequate

We determined examiners did not adequately assess Cal State 9's indirect HELOC program and did not respond adequately or timely to the risks facing Cal State 9, considering: (1) the rate and level of growth of the portfolio; (2) the excessive concentration of HELOCs, nearly all of which contained subprime elements; and (3) the continuing changes in the California real estate market environment. Specifically, we determined examiners did not:

- Adequately assess the overall terms and characteristics of the indirect HELOC program early on.
- Adequately monitor Cal State 9's liquidity position and did not respond aggressively or timely enough to the credit union's liquidity risk as Cal State 9 increasingly committed more of its assets to fund the indirect HELOC portfolio.
- Respond aggressively or timely enough to Cal State 9's increasing credit risk especially considering the changing real estate market environment.

As a result, we believe examiners' less than aggressive actions allowed Cal State 9 management to build an excessive concentration of risky HELOCs in an increasingly adverse real estate market environment. Specifically, we believe examiners should have required management to establish controls during the early stages of the indirect HELOC program²⁹ to monitor and slow the growth of the program. In addition, we believe examiners should have required management to stop funding HELOCs well

²⁷ The March 2004 contact was the first examination of Cal State 9 after the credit union had established the indirect HELOC program in May 2003.

²⁸ In the supervision of Cal State 9 during the operation of the credit union's indirect HELOC program, the California SSA conducted examinations and contacts jointly with the NCUA. NCUA guidance indicates that during joint examinations, both SSA and NCUA examiners focus on risk issues, while SSA examiners also focus on regulatory concerns.

²⁹ Cal State 9 implemented the program in May 2003.

before the credit union was placed under NCUA Special Actions³⁰, which could have mitigated the loss to the NCUSIF.

California SSA and NCUA representatives provided several factors that influenced their lack of actions regarding risks associated with the indirect HELOC program. Specifically:

- California SSA representatives explained that a lack of sufficient staff impacted their ability to adequately examine Cal State 9.
- A former California SSA representative informed us it would have been difficult to get Cal State 9 management to stop or slow the HELOC program because the credit union's position was that they were not breaking or violating any laws or regulations. The representative added that credit union management was adamant with the SSA about this issue.
- A California SSA senior examiner told us that because of the lack of losses early on in the program, examiners believed that they did not have any leverage to be more forceful with the credit union. The examiner added that management did not take the risks in the program seriously.
- A California SSA representative explained that Cal State 9 management was not truthful with examiners. Specifically, the representative stated that during joint conferences, Cal State 9 management would make verbal promises, but never included what they had promised in their response to the examination reports.
- An NCUA official indicated they probably relied too much on the examiners in not acting sooner - despite the official's instincts to the contrary.

NCUA guidance defines risk as the potential that events, expected or unanticipated, may have an adverse effect on a credit union's net worth and earnings. 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. As defined in Section A of this report, two of the seven risk areas examiners review are credit risk and liquidity risk, which address the current and prospective risks to a credit union's earnings and capital.

In addition, NCUA guidance indicates that:

- Although examiners have discretion in determining areas requiring the most attention, examiners' emphasis should focus on successfully managing future risks for credit unions exhibiting existing or potential weaknesses or adverse trends.

³⁰ Cal State 9 was transferred under NCUA Special Actions during the June 2007 contact.

- Off-site supervision and timely identification of risk trends is a critical component of the overall supervision process.
- Examiners will consider a credit union's failure to recognize or properly address the risks involved with residential real estate lending as an unsafe and unsound lending practice.
- Examiners should review new programs that may expose a credit union to higher or increased risks. Specifically, examiners should review subprime lending, indirect lending, and outsourced lending programs to assess the magnitude of risk posed by such programs.
- Identifying a potential problem early provides credit union management and NCUA with the best chance of resolution without requiring assistance from the NCUSIF.

Furthermore, NCUA guidance indicates that when combined with a potentially overpriced real estate market, the impact of exotic adjustable rate mortgages³¹ on credit risk increases tremendously, especially if interest rates rise and the rate of home appreciation flattens or declines.

Indirect HELOC Program Not Adequately Assessed

We determined examiners did not adequately assess the new indirect HELOC program during the March 2004 examination in order to determine the complete terms and characteristics of the program. Examiners advised Cal State 9 management during the March 2004 examination that they needed to approach new programs with caution as the credit union transitioned from its failed participation in an indirect auto lending program. However, although examiners determined during this examination that the HELOCs were variable rate mortgages in junior positions with high CLTVs, we found that it was not until later that examiners learned the full extent of the subprime elements. Specifically, examiners did not know that:

- At inception of the program, nearly 70 percent of the indirect HELOC portfolio had CLTVs between 85 percent and 124 percent.
- At inception of the program, 39 percent of borrowers' credit scores were below 640, which included 15 percent below 600.³²

³¹ NCUA guidance indicates that exotic adjustable rate mortgages include such products as interest only, hybrid, and payment option adjustable rate mortgages.

³² NCUA guidance indicates that while there is no industry standard range of credit scores that describe subprime borrowers, those borrowers with credit scores below 620 generally have a higher loan default rate.

- Most of the HELOCs were stated income loans. In fact, when examiners analyzed the portfolio during the December 2005 examination, they learned that stated income loans comprised 82 percent of the HELOC portfolio.
- Many of the HELOCs were behind negative amortization first mortgages. In fact, when examiners analyzed the portfolio during the June 2006 examination, they learned that 61 percent of the HELOCs were behind negative amortization first mortgages.
- The HELOCs had an interest only payment feature, which examiners determined during the December 2005 examination.

Furthermore, we found no indication until the March 2007 contact that examiners recognized that nearly every indirect HELOC included one or more subprime elements.

We believe that if examiners had learned the full extent of the subprime elements within the HELOC program during the March 2004 examination, they: (1) would have had a better understanding of the potential magnitude of Cal State 9's credit risk as the program grew; and (2) should have required management to establish controls to monitor the overall growth of this new program and monitor and track its performance, e.g., slow payers, mortgage rate/payment increases, delinquencies, collateral/CLTV revaluations, etc.

Liquidity Risk Not Adequately Monitored and Addressed

Although we determined examiners adequately assessed Cal State 9's liquidity issues during each supervision contact, we also determined examiners did not adequately monitor and did not respond aggressively or timely to the credit union's increasing liquidity risk.

During the March 2004 examination, examiners determined that Cal State 9 had adequate liquidity to meet its needs. However, examiners also:

- Described the growth of the indirect HELOC program as "explosive".
- Described the credit union's 26.50 percent total loan growth for the year ending December 2003 as "considerable".
- Determined that the credit union's total loans had a significant growth of 59 percent (annualized) during the first quarter of 2004.

- Discovered that Cal State 9's goal for its HELOC portfolio was to reach 60 percent of total assets by the end of 2006 with a total limit for the portfolio of 75 percent of total assets.³³

Considering examiners' observations about the rapidly growing indirect HELOC program, we reviewed the credit union's financial data as of March 2004 to assess how the program was impacting Cal State 9's liquidity position. We determined the credit union's liquidity was tightening after less than a year of operating the indirect HELOC program as demonstrated by the following ratio and trends (Appendix B describes the relationships between specific ratios and trends, and liquidity). Specifically:

- HELOCs had increased 1,520 percent since March 31, 2003 to \$74.2 million, comprising 50 percent of total loans.
- Annualized loan growth significantly exceeded share growth – 58.88 percent to 4.72 percent respectively.
- The ratio of Total Loans to Total Shares was 75.13 percent (peer was 70.95 percent).³⁴
- The ratio of Cash plus Short-Term Investments to Assets was 9.21 percent (peer was 17.01 percent).³⁵
- Cal State 9 had borrowed \$31.5 million in short-term funds.

Considering the explosive and considerable growth of the indirect HELOC program and the liquidity ratios and trends as of March 2004 that illustrated tightening liquidity, we believe examiners should have closely monitored the growth of the program and its impact on the credit union's liquidity leading up to the December 2005 examination. However, we found no indication that examiners monitored the credit union's liquidity ratios and trends between examinations.

We reviewed the credit union's financial data between examinations (from June 2004 through September 2005) and determined that ratios and trends demonstrated the credit union's worsening liquidity position and its increasing liquidity risk. For example:

³³ We found no indication until the June 2006 joint contact that examiners considered the impact of Cal State 9's unfunded HELOC commitments in the growth of the program. However, any reference we make to HELOC growth includes funded HELOCs and unfunded HELOC commitments.

³⁴ NCUA guidelines indicate that a high loan to share ratio is a key indicator of tightening liquidity.

³⁵ This liquidity ratio is an indicator of how much available cash the credit union has to meet share withdrawals or additional loan demand. A low or rapidly declining ratio may indicate the credit union will be unable to meet its current obligations.

As of December 2004:

- HELOCs increased an additional 55 percent from March 2004 to \$115 million, comprising 68 percent of total loans.
- Loan growth exceeded share growth considerably – 31.6 percent to 3.73 percent respectively.
- The ratio of Total Loans to Total Shares was 84.1 percent (peer was 75.4 percent).
- The ratio of Cash plus Short-Term Investments to Assets was 7.1 percent (peer was 14.4 percent).
- As of September 2005:
 - HELOCs increased 36 percent from December 2004 to \$156.3 million, representing 80 percent of total loans.
 - The ratio of Total Loans to Total Shares was 82.38 percent (peer was 78.48 percent).
 - The ratio of Total Loans to Total Assets was 68.60 percent (peer was 67.20 percent).
 - Total Investments³⁶ declined 12.65 percent (annualized).
 - The ratio of Cash plus Short-Term Investments to Assets was 7.01 percent (peer 14.29 percent).
 - Cal State 9 had borrowed \$15.3 million in short-term funds, with a \$52 million line of credit (LOC).
 - Cal State 9 had sold 956 non-recourse participation loans year-to-date, valued at \$55 million.³⁷
 - Share certificates had increased 83 percent since December 2004 from \$43 million to \$78.6 million.³⁸

³⁶ NCUA guidelines indicate that declining investments are a key indicator of tightening liquidity.

³⁷ NCUA guidance indicates loan participation sales may provide selling credit unions with a means to manage liquidity risk.

³⁸ NCUA guidance indicates that a credit union attracting shares by paying above market rates may provide an indication of liquidity concerns.

An NCUA examiner indicated during their review of the December 2005 joint examination that the HELOC program presented potential red flags, and that trends should be monitored and assessed quarterly with credit union management. Although we noted that between December 2005 and March 2007, examiners adequately identified Cal State 9's increasing liquidity needs and management's efforts and shortfalls in managing these needs, we found no indication during this period that examiners conducted a trend analysis to better assess Cal State 9's liquidity risk. In addition, although Cal State 9's liquidity position was worsening, examiners did not require management to slow the growth of the program early on or to stop funding indirect HELOC loans prior to being placed under Special Actions during the June 2007 contact. Specifically:

- During the December 2005 examination, examiners asked management to respond to their DOR comment regarding placing a limit on the growth of the portfolio as a percentage of loans. However, examiners did not recommend what that limit should be, but more importantly, they did not place any requirements on management to establish more stringent controls over the program.
- During the June 2006 joint contact, although examiners required management to develop a plan to reduce the concentration of HELOCs, they did not require the credit union to: (1) implement the plan; or (2) slow the growth of or stop future funding of the HELOC portfolio.
- During the March 2007 joint contact, although examiners required management to implement specific plans to reduce the excessive concentration of HELOCs, examiners allowed management to decide whether to "reduce or halt" future funding of HELOCs. Despite the critical liquidity risk, examiners did not require management to stop the program.

Within weeks of completing the March 2007 contact, SSA and NCUA officials conducted a June 2007 supervision contact to evaluate Cal State 9 as it was being transferred under NCUA Special Actions.³⁹ During the contact, SSA and NCUA officials determined that Cal State 9's liquidity risk was high and the risk to the NCUSIF was extensive, indicating the HELOCs were in severe distress and illiquid and determining Cal State 9's solvency was questionable at best. Further aggravating Cal State 9's liquidity issues, during the June 2007 contact, Western Corporate (WesCorp) required Cal State 9 management to liquidate the credit union's investment portfolio to pay down its LOC and significantly reduced the credit union's available LOC from \$90 million to \$25 million. In an attempt to maintain liquidity, management began offering high [dividend] rate share certificates. However, when management eventually reduced the share certificate rate to market, depositors began withdrawing their funds from the credit union. Ultimately, NCUA officials determined during the September 2007 contact

³⁹ The March 2007 contact was conducted between April and June 2007 and the June 2007 contact was conducted between July and August 2007.

that Cal State 9's problems were so pervasive and severe; the only resolution would be a P&A.

We believe that as a result of examiners' lack of adequate monitoring and not taking aggressive supervisory actions, examiners missed numerous opportunities during or between contacts to slow or stop the funding of indirect HELOCs. Ultimately, we believe if examiners had taken more aggressive actions sooner, they would have likely mitigated the loss to the NCUSIF.

Credit Risk Not Adequately Addressed

Although we determined examiners adequately assessed Cal State 9's increasing credit risk during each supervision contact, we also determined examiners did not respond aggressively or timely to that risk. Specifically, we determined examiners did not require Cal State 9 management to: (1) improve its underwriting standards for the indirect HELOC program; or (2) limit or reduce its concentration of risky HELOCs, especially considering the declining California real estate market environment.

To determine whether: (1) examiners were aware of changes in the California real estate market environment; and (2) Cal State 9's indirect HELOC portfolio was potentially being impacted by these changes, we reviewed examination reports, real estate industry information, and credit union financial data.

We determined that between June 2003 and December 2005, the Federal Reserve had increased the prime interest rate 13 times from 4 percent to 7.25 percent, and four more times to 8.25 percent by June 2006. In addition, we obtained data regarding the status of the California real estate market during the period Cal State 9 funded HELOCs. (See Appendix C for specific details about changes in the California real estate market during the period surrounding Cal State 9's indirect HELOC program.) Specifically, in August 2005, the *Credit Union Times* published an article indicating that 25 cities in California were overvalued and were at "high risk of price declines".⁴⁰ The article indicated that the overvaluations ranged from 30 percent to 69 percent. Also, NCUA issued guidance in September 2005 indicating that from 2001 through 2005, home prices in California had doubled.⁴¹ Furthermore, The Consumer Federation of America⁴² reported that in certain California markets with high concentrations of non-traditional mortgages, foreclosure rates in the fourth quarter of 2005 were much higher than in the previous year.⁴³

We determined that examiners: (1) appropriately advised Cal State 9 management of their concerns regarding the credit risk created by the high concentration of subprime

⁴⁰ The article was entitled: *Economist says Home Prices Have Risen to "Extremely Overvalued" Levels in 53 Cities.*

⁴¹ This data is according to the National Association of Realtors.

⁴² Consumer Federation of America is an advocacy, research, education, and service organization that has been in existence since 1968 and has a membership of approximately 300 nonprofit organizations.

⁴³ *Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders* (Allen J. Fishbein, Patrick Woodall), May 2006.

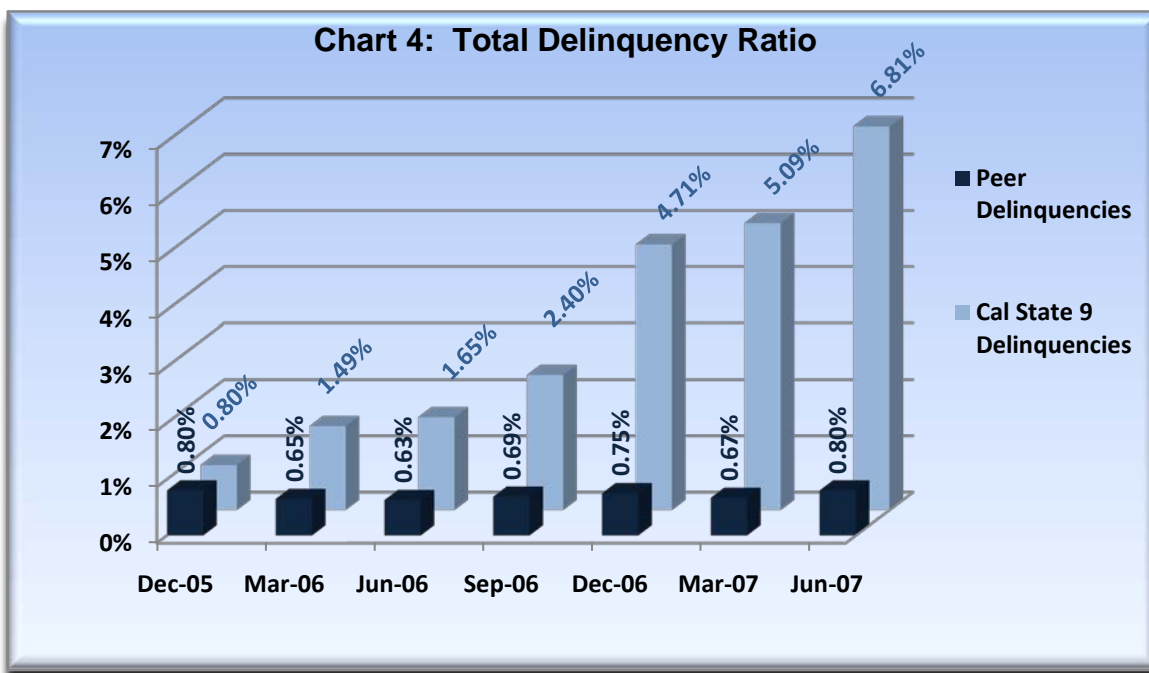
indirect HELOCs (as discussed in section A); and (2) were generally aware of changes in the California real estate market and the potential impact on Cal State 9's credit risk. For example:

- During the March 2004 examination, examiners determined that the indirect HELOC portfolio had increased Cal State 9's credit risk.
- During the December 2005 examination, examiners determined that Cal State 9 had assumed more credit risk from its HELOC portfolio. In addition, examiners indicated that although the credit union had not experienced significant losses in the portfolio to date, the program had only been in place since the beginning of 2003, when interest rates were at their lowest point in years. Examiners advised management: (1) that loan products with liberalized features and underwriting standards carry higher levels of credit risk and that the [subprime] stated income feature of the HELOCs and the high concentration risk meant the credit union could potentially have higher losses; (2) that given the credit union's high credit risk exposure from the HELOC portfolio, they needed to re-evaluate the validity of their stress tests to assure they made informed decisions; and (3) to monitor the performance of the HELOC portfolio closely.
- During NCUA's review of the December 2005 examination, NCUA indicated that (1) seasoning of the HELOC portfolio would take some time, (2) delinquency trends could emerge if local market conditions declined, and (3) the credit union's stress testing showed the ability [of the portfolio] to withstand up to 20 percent declines in local markets without any adverse impacts.
- During the June 2006 contact, examiners indicated that if market values declined and interest rates rose, the risk associated with Cal State 9's high concentration of indirect HELOCs would materialize. The examiners' concern was that there was a risk of much higher loan losses in the long-term as interest rates rose and reached levels beyond which a percentage of the borrowers could afford to make the monthly payments, while market values declined below the initial appraisal values, thereby increasing the CLTV. Examiners noted that market values had in fact been softening and interest rates had been rising.
- By the March 2007 contact, examiners had determined that most of the HELOC loans had multiple elements of subprime lending, and that the credit risk in the rapidly expanding HELOC program was starting to surface. In addition, examiners indicated there was a significant potential credit risk because of optimistic appraised [home] values, unreasonable stated incomes, and negatively amortizing first mortgages.

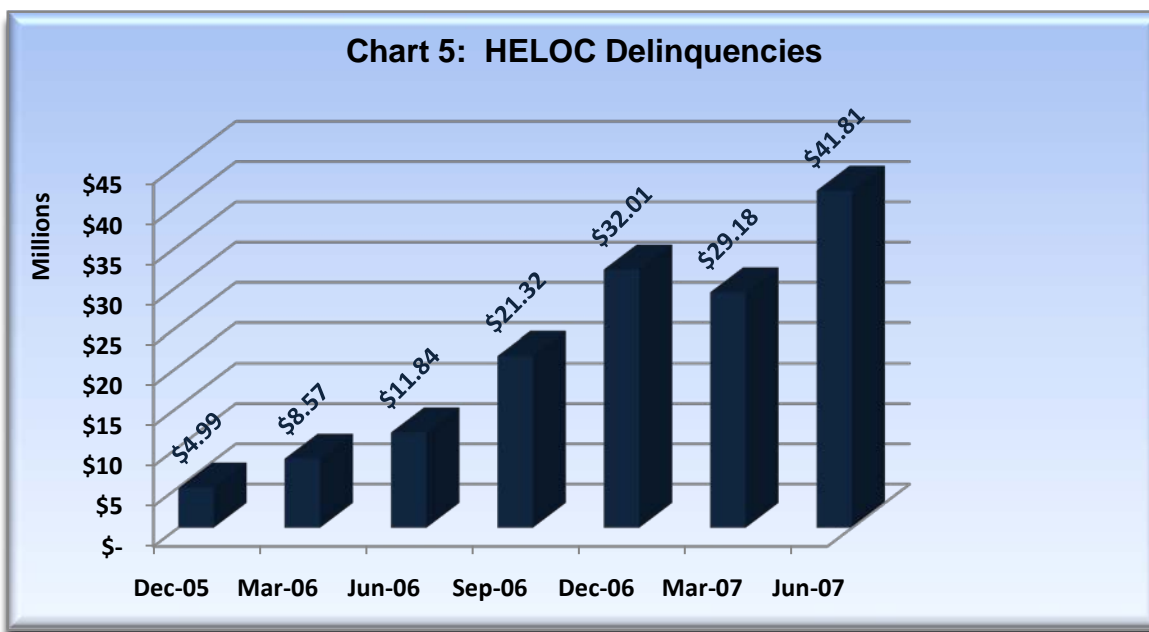
NCUA guidance indicates a drop in real estate property values coupled with the unanticipated burden of increased payments as interest rates rise will likely result in hardship for borrowers and could cause default rates to increase. In addition, NCUA

examiners explained that if borrowers paid only minimum payments until their loans reached negative amortization limits, borrowers could be forced into significantly higher payments in as little as two years.⁴⁴

We reviewed Cal State 9's delinquencies and noted that the credit union's default rates began increasing early on. Specifically, during the December 2005 examination, examiners determined that although total delinquencies were 0.80 percent (peer was 0.80 percent), delinquencies for indirect HELOCs had increased over 300 percent since December 31, 2004. We determined that nearly \$5 million (78 percent) of the total delinquent loans at this time were HELOCs. By the June 2006 supervision contact, total delinquencies had more than doubled to 1.65 percent (peer was 0.63 percent). We determined that by this time delinquent HELOC loans had increased to \$11.8 million over the six month period and were 92 percent of the total delinquent loans. The following two charts illustrate Cal State 9's total loan delinquency rates and the HELOC portfolio's delinquency totals between December 2005 and June 2007:



⁴⁴ Officials indicated the loans in the Cal State 9 portfolio allowed negative amortization of between 110 percent and 125 percent of the original first mortgage amount. Once members reached the maximum permitted negative amortization, the first mortgagee amortized the full balance over the remaining term of the loan.



We analyzed Cal State 9's delinquency data as of July 2007 and believe increasing borrower mortgage payments over time had a role in Cal State 9's increasing delinquencies.⁴⁵ For example, NCUA officials determined that 318 HELOCs delinquent at least 30 days were originated between August 2003 and June 2006. One hundred eighty one of those HELOCs were also delinquent at least 60 days.

We determined that despite: (1) examiners' warnings regarding the risk of weak underwriting standards and the credit risk Cal State 9 faced as a result of the indirect HELOC program; (2) trends in the California real estate market environment impacting Cal State 9's credit risk; and (3) the rapidly increasing rate of HELOC delinquencies, examiners did not require management to strengthen the program's underwriting standards, and either reduce the credit union's extremely high concentration of risky HELOCs or stop funding risky HELOCs in a timely manner. Specifically:

- Despite examiners: (1) indicating during the December 2005 examination that the indirect HELOC portfolio had a high percentage of stated income loans, and that changes to underwriting standards⁴⁶ combined with the HELOC's interest only payment feature and high levels of high appreciation in California home prices increased Cal State 9's potential credit risk; and (2) recommending that Cal State 9 management establish maximum acceptable limits on the percentage of stated income loans to the total portfolio, examiners did not require management to strengthen its underwriting standards.

⁴⁵ As previously discussed, examiners indicated there was a risk of much higher loan losses in the long-term as interest rates rose and reached levels beyond which a percentage of the borrowers could afford to make the monthly payments. Also as previously addressed, the Federal Reserve had increased the prime interest rate 13 times from 4 percent to 7.25 percent between June 2003 and December 2005, and four more times to 8.25 percent by June 2006.

⁴⁶ We were unable to determine from examination workpapers what these changes were.

- Despite observations and their recommendation regarding Cal State 9's underwriting standards in the December 2005 examination, examiners only noted during the June 2006 contact that the credit union's underwriting guidelines were fairly comprehensive and detailed. In addition, although delinquencies had increased more than 137 percent⁴⁷ to nearly \$12 million in the six months between December 2005 and June 2006, examiners did not require management to reduce the credit union's excessive concentration of HELOCs.⁴⁸ As a result of this contact, examiners required management to develop and provide the SSA and NCUA a plan to reduce the concentration of HELOCs. However, they did not *require* management to implement the plan.
- During the March 2007 contact, examiners determined Cal State 9 management was still using the February 2005 underwriting guidelines. Examiners advised management that if any future loan funding was permitted, underwriting standards must be more stringent to mitigate ongoing risk. In addition, examiners determined that management had not reduced the credit union's high concentration of indirect HELOCs even though NCUA officials believed Cal State 9 management had agreed to do so.⁴⁹ Examiners also determined the credit union's delinquencies, loan losses, and foreclosure activity had increased sharply since the last contact and that potentially falling real estate prices made these conditions worse.⁵⁰ Furthermore, examiners indicated that they expected delinquencies and foreclosures to increase as the residential real estate market softened. As a result of this contact, examiners finally took definitive action, requiring Cal State 9 management to reduce its concentration of HELOCs.⁵¹ Examiners' action during the March 2007 contact was much too late as confirmed during the next contact (June 2007) when officials from NCUA Special Actions determined that the HELOCs were already in severe distress and illiquid and Cal State 9's solvency was questionable at best.
- During the June 2007 contact, Cal State 9 was assigned to the responsible NCUA Region's Division of Special Actions due to the credit union's deteriorating financial condition. NCUA officials from Special Actions drafted a Temporary Cease and Desist (C&D) Order. In addition, at the conclusion of the contact, NCUA officials provided the credit union with the lowest CAMEL rating even though SSA officials chose not to lower Cal State 9's CAMEL score from the prior

⁴⁷ This was an annualized rate of 274 percent.

⁴⁸ As of June 2006, Cal State 9's HELOC portfolio represented 91 percent of the credit union's total loans.

⁴⁹ Examiners indicated that at the conclusion of the June 2006 contact, Cal State 9 management had verbally agreed to reduce the concentration in the HELOC portfolio from 65 percent to 50 percent or less of assets within the next six months.

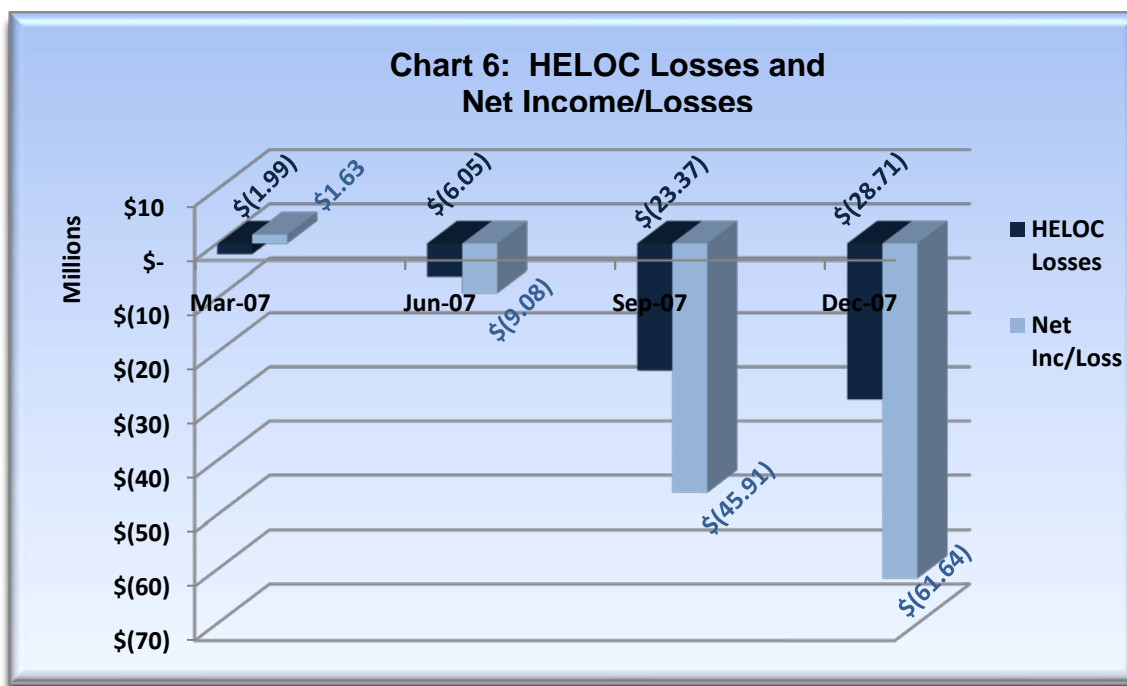
⁵⁰ We reviewed the credit union's financial data and determined that as of March 2007: (1) delinquencies had increased significantly from the June 2006 contact to \$29 million, and (2) losses from the HELOC portfolio had skyrocketed 1,225 percent to approximately \$2 million since the December 2005 examination.

⁵¹ NCUA regional officials told the OIG that they instructed examiners to require Cal State 9 management to stop funding new HELOCs and to sell existing HELOCs.

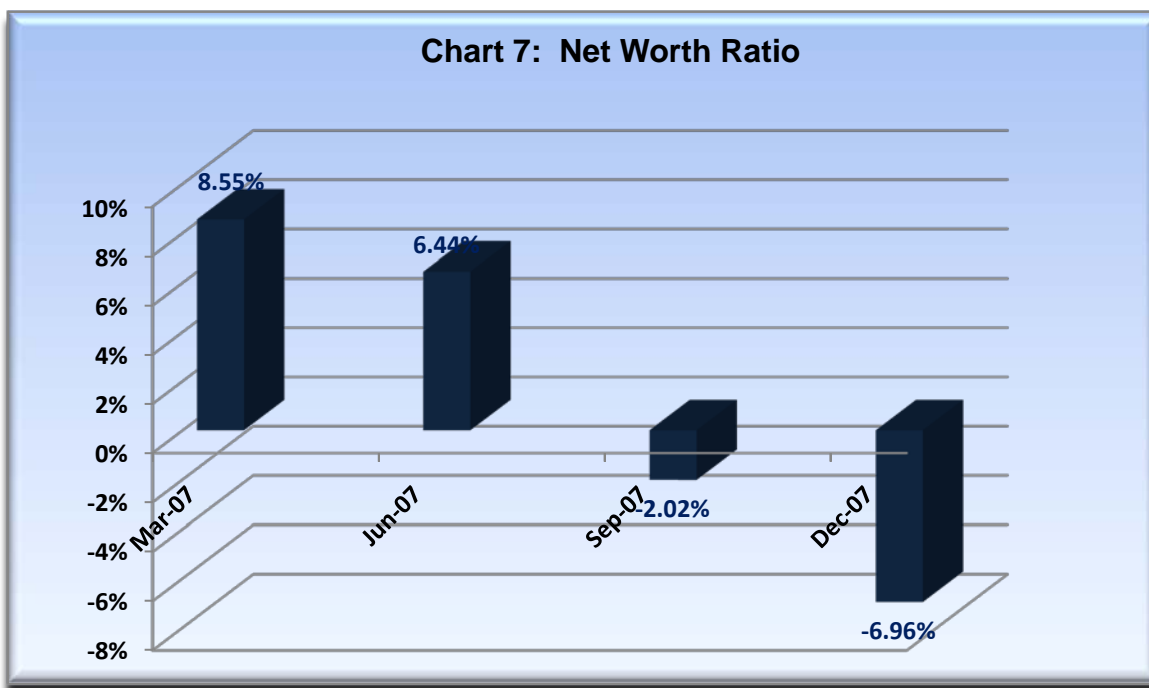
contact. Furthermore, an NCUA official told the OIG that in July 2007, SSA officials were not convinced a C&D was necessary at that time.⁵²

Again, NCUA and SSA officials' efforts during the June 2007 contact were much too late to protect the NCUSIF. NCUA officials indicated during the September 2007 contact - three months after the June 2007 contact - that Cal State 9 represented a significant risk to the NCUSIF, with problems so pervasive and severe that even conservatorship of the credit union would not restore the safe and sound operations.

The following charts illustrate Cal State 9's rapidly increasing HELOC losses and Net Income/Loss, and its significantly declining Net Worth ratio, respectively, between March 2007 and December 2007.



⁵² The SSA issued a Final Order (C&D equivalent) in early September 2007.



We asked a former senior SSA official why the SSA did not take actions to slow or stop Cal State 9's indirect HELOC program as its credit risk and concentrations were increasing. The official told the OIG there were two factors that they believed influenced the SSA's supervisory oversight surrounding the period in which Cal State 9 operated its indirect HELOC program. Specifically, the official indicated:

- The Administration in the White House at the time was pushing for less regulation [of the mortgage lending industry]; and
- NCUA was pushing for lower regulatory net worth requirements, which would encourage credit unions to make more loans.

We agree there were factors during the real estate boom that encouraged increased mortgage lending. However, we found nothing to suggest these factors: (1) encouraged credit unions to concentrate a majority of their assets in poor quality loans; or (2) absolved regulators of their responsibility to not only recognize, but also take appropriate and timely actions to address risks to a credit union's net worth and earnings.

Based on the rapid rate of growth and the increasing concentration of risky HELOCs, we believe that not only should examiners have required management to monitor the performance of the HELOCs early on, they should have also required management to strengthen the program's underwriting standards. Furthermore, we believe examiners should have ultimately required management to either reduce the credit union's concentration of risky HELOCs sooner or stop the indirect HELOC program in light of

the changing California real estate market. We believe these actions would have likely mitigated the loss to the NCUSIF.

Loan Participations Not Addressed

We determined examiners did not evaluate Cal State 9's loan participation program until after Cal State 9 was placed under NCUA Special Actions to determine whether safety and soundness concerns existed. We determined Cal State 9 sold non-recourse participations⁵³ to other financial institutions over the period they operated the indirect HELOC program. However, we found no evidence examiners conducted a review to assess the adequacy of Cal State 9's risk analysis, strategic planning, or due diligence over Cal State 9's participation program.⁵⁴ As a result, examiners did not identify the potential liability, or risks that loan participations represented to Cal State 9, other financial institutions, or ultimately, to the NCUSIF.

NCUA recently issued guidance⁵⁵ indicating that despite the benefits of loan participation programs, there are potential risks. Specifically, the guidance indicates loan participations expose a credit union to credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risks.⁵⁶

We determined Cal State 9's management sold nearly \$190 million in non-recourse participations from 2003 through 2007. The following chart illustrates Cal State 9's year-to-date participation sales as of December of each year.⁵⁷

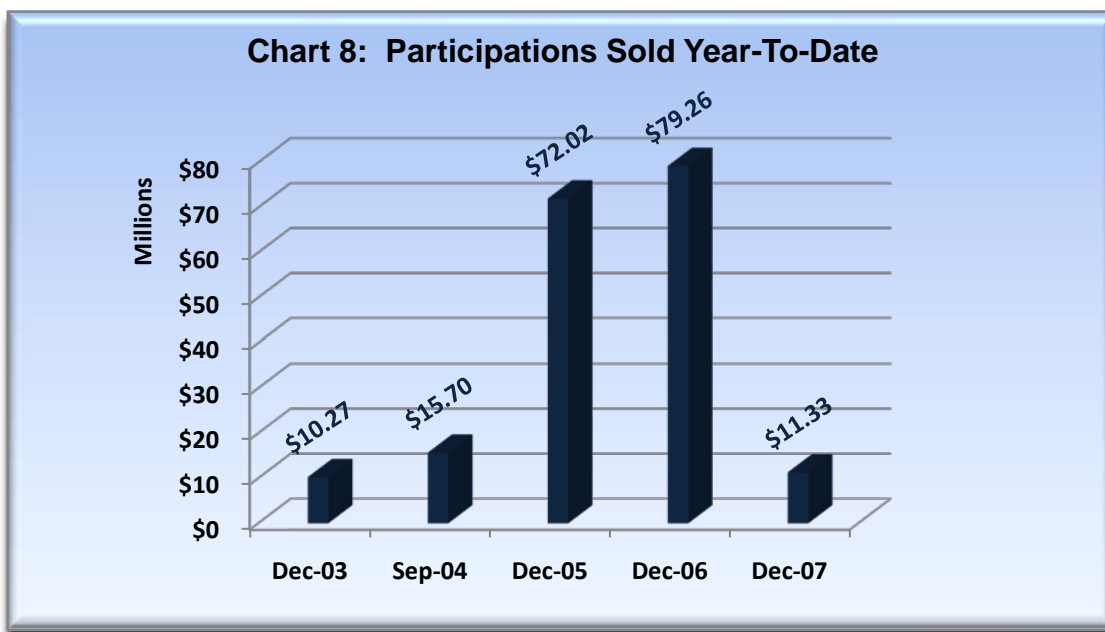
⁵³ Cal State 9 sold non-recourse participations to three credit unions and one bank.

⁵⁴ 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.

⁵⁵ NCUA issued Letter No. 08-CU-26, *Evaluating Loan Participation Programs*, November 2008,

⁵⁶ 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.

⁵⁷ Cal State 9's financial data for 2004 indicated the value of participation loans sold year-to-date dropped from \$15.7 million to \$2.5 million between September and December 2004 while the number of loans sold increased. We found no explanation for this decrease. Therefore, for 2004 we used the participation loans year-to-date as of September 2004.



Despite these participations sold, the only discussions we found in examiners' workpapers regarding Cal State 9's participation program were general comments that Cal State 9 management was selling participations to help meet its liquidity needs.

Auditor Observations: NCUA's total analysis process and risk-focused examination process guide examiner judgment by providing the requisite and appropriate tools and guidance with which to assess the safety and soundness of credit union operations and any risk to the NCUSIF. Examiners used these processes to adequately identify the increasing credit risk created by Cal State 9's indirect HELOC program and used their judgment to identify the impact a changing real estate market could have on the risky portfolio. However, despite what the examination processes revealed early on, examiners and officials indicated they believed they did not have the leverage to be more forceful with management in order to limit the indirect HELOC program.

We believe examiners relied too heavily on management's statements and presentations regarding the credit union's risk management program rather than focusing on the magnitude of the credit risk the examination processes revealed. We also believe examiners did not use available mechanisms to timely and adequately test and monitor the portfolio to validate or dispute management's asserted ability to manage the risks through monitoring reports. For example, during the June 2006 limited high-level review of the indirect HELOC program, examiners indicated management was proactive and had good risk management systems in place. However, examiners also noted that management had not implemented reviewing/tracking procedures to determine the impact of negatively amortizing first deeds of trust.

Despite their observations and recognizing the significant credit risk created by the concentration of sub-prime HELOCs in a softening real estate market, examiners rated Cal State 9's credit risk as moderate as a result of the June 2006 contact. However, during the March 2007 contact, almost four years into the program, the examination process led examiners to affirm that although management generated an impressive amount of monitoring for risk management purposes, some critical elements were not being captured and such reporting does not mitigate risk. Examiners also indicated the impact of making high CLTV loans behind negatively amortizing first mortgages was starting to have an effect and the softening real estate market would drive losses up. Consequently, examiners increased Cal State 9's credit risk to high. However, this change in judgment based on sound examination processes was too little too late as NCUA officials determined shortly thereafter - during the June 2007 contact - that the HELOCs were already in severe distress and illiquid and Cal State 9's solvency was questionable at best.

Examiners should have relied more heavily on the NCUA's examination processes, which more than adequately revealed the prospective risk the indirect HELOC program represented to the safety and soundness of the credit union. Examiners should not have put as much confidence in management's asserted ability to adequately monitor and make adjustments to the portfolio as delinquencies within the portfolio began to surface as early as December 2004 and increased dramatically as management continued to fund these poor quality loans. More significantly, examiners should not have waited for the actual losses that their analysis indicated would occur under a changing market environment. We believe had examiners relied on the processes throughout the supervision of the credit union, maybe they would have realized sooner that management's risk management program would not and could not stem the inevitable losses in this sub-prime portfolio, which was worsened by the changing real estate market.

NCUA also has the appropriate means with which to address serious credit union problems. Although SSA's are primarily responsible for supervision of federally insured state-chartered credit unions and their regulatory issues, NCUA must put its legal and fiduciary responsibility to ensure the safety of the NCUSIF ahead of all other issues and challenges – whether from credit union management or SSA officials. NCUA should ensure examiners fully employ and rely on the examination processes and trust the current and prospective risks to a credit union these processes reveal in order to avoid increased safety and soundness issues, failures and losses to the NCUSIF.

Regarding Cal State 9's participation program, we believe examiners merely viewed Cal State 9's participation sales as a means to manage the credit union's balance sheet risk. We also believe Cal State 9 management entered into their participation program too quickly without conducting proper due diligence to slowly gain the necessary experience over time to effectively operate such a program. We believe examiners should have (1) assessed whether Cal State 9 conducted proper due diligence before entering into the participation arrangements, and (2) evaluated during each supervision

whether the participations presented any risks to Cal State 9, other credit unions, and the NCUSIF.

Appendix A – Examination History

The following table provides California SSA and NCUA supervision contacts conducted from when Cal State 9 implemented the indirect HELOC program in May 2003 through the September 2007 joint contact when Cal State 9 was conserved. The information provided is limited to key findings and Document of Resolution (DOR) items associated with the indirect HELOC program.

March 31, 2004 Effective Date	Code 11 Joint Examination Completed August 2004
<ul style="list-style-type: none"> • Examiners indicated Cal State 9 had begun to transition from a failed CUDL program (which had saturated the credit union’s loan portfolio with a large number of poor quality loans) to a variable rate HELOC program operated indirectly through a third-party. • Examiners recognized the “explosive” growth of the HELOC portfolio since inception of the program and indicated that the HELOC portfolio had increased Cal State 9’s credit risk. • Examiners described Cal State 9’s total loan growth as considerable at 26.50 percent for the year ending December 2003 and an even larger growth of 59 percent (annualized) for the first quarter of 2004. The examiners indicated this was due primarily to the proliferation of the indirect HELOCs. • Examiners learned the indirect HELOCs were all variable rate mortgage loans in junior positions,⁵⁸ usually with high loan-to-value (LTV) ratios. • Examiners determined Cal State 9 had adequate liquidity to meet its needs. 	
<p>DOR - Examiners <u>required</u> the credit union to:</p> <ul style="list-style-type: none"> • Implement a revised loan policy that included limits on the dollar amount outstanding on each loan in risk tier⁵⁹ of grade “C”⁶⁰ and below for all risk-based priced loans as a percentage of loans and a percentage of net worth. 	

⁵⁸ A junior mortgage is one for which a claim against the property will be satisfied only after prior mortgages have been repaid.

⁵⁹ Cal State 9 HELOCs were segregated by risk tier based on borrower credit scores from high to low in six tiers from A+ (730 – 900) through E (less than 550) and by combined loan-to-value (CLTV) ratios (80 or less, 80+ to 90, 90+ to 100) within each tier.

⁶⁰ Tier “C” loans include loans for borrowers with credit scores of 639 and below.

Examiners also **recommended** to the credit union that:

- When management observed an adverse trend or was not attaining the desired goals, perform in-depth analysis to isolate the cause.
- When the cause had been determined, carefully study the situation to determine if something could have been done to improve the situation.
- As each change was implemented, closely monitor the changes to ensure that the changes were positive and helping management to attain their desired goals. If not, try a different strategy.

December 2005 Effective Date	Code 11 Joint Examination Started January 2006 Completed March 2006
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Examiners concluded that Cal State 9 was in satisfactory condition.

- Examiners indicated:
 - The HELOC portfolio was “fast growing”, indicating the portfolio⁶¹ had grown 74 percent in the previous twelve months, with approximately 30 percent of the growth occurring in the last quarter of 2005.
 - Cal State 9 management had to borrow to fund its HELOCs and meet liquidity needs.
 - Cal State 9 management had increased dividend rates to attract shares, had liquidated investments and sold participations in order to meet the credit union’s liquidity needs.
 - The credit union’s goal was for the HELOC portfolio to reach 60 percent of total assets by the end of 2006 with a total policy limit of 75 percent of assets.
- Regarding CREDIT RISK, examiners determined:
 - The credit union had assumed more credit risk from its fast growing indirect home equity line of credit (HELOC) loan portfolio.
 - The indirect HELOC loans were in a junior position and had an interest only payment feature, adding that this payment feature combined with changes to

⁶¹ Net of HELOC loans sold through participations.

underwriting standards and high levels of home price appreciation in California increased potential credit risk.

- The HELOC loans carried a higher potential level of credit risk than the standard 80 percent LTV, 30 year fixed rate first mortgage even without considering loans with negative amortizations.
- Eighty-two percent of the indirect HELOC portfolio was stated income loans and represented a greater chance that some of the income reported to Cal State 9 may have been inflated.
- Stated income loans coupled with the high concentration risk meant the credit union could potentially have higher losses. They recognized that if home prices stayed flat or declined, borrowers could owe more than the property was worth.
- While Cal State 9 management developed a stress test during the examination, the test contained flaws. The test did not appear to take into consideration that the credit union was in a junior position and stood to lose potentially more than the test results showed.⁶²
- Although the credit union had not experienced significant losses in the portfolio to date, the program had only been in place since April 2003 [*sic*], when interest rates were at their lowest in years. They added that there had not been sufficient time for real estate to go through an entire cycle of up and down markets in real estate values.
- Examiners indicated Cal State 9's high policy limit for the HELOC loan concentration was not supported by an analysis that assessed the potential effect on the credit union's overall risk profile.
- Delinquent indirect HELOC loans increased from \$344,000 at 12/31/04 to \$1,389,800 as of 12/31/05.
- Examiners noted that the prime rate had adjusted upward eight times during 2005.
- The HELOC portfolio was segmented reasonably well so the various tiers and combined loan-to-values (CLTVs) were not concentrated in riskier loans.
- Regarding LIQUIDITY RISK, examiners determined Cal State 9's liquidity was "inadequate".

⁶² The stress test segmented the portfolio by combined loan-to-value, negative amortizing loans, and stated income loans for each tier.

DOR - Examiners **required** Cal State 9 to respond to the following items and report on the corrective actions taken:

- Regarding Indirect HELOC Policy & Procedures:
 - Add a percentage of total loans limitation.
 - For monitoring HELOC delinquency, develop a list of chronic and habitual slow payers and perform added risk analyses on this group, e.g. current credit check, current collateral valuation, and current debt analysis.
 - The credit union does not prepare cash flow analyses, which can help the credit union plan when to increase or decrease liquidity cost-effectively.
 - Other procedures as described in the Examination Overview. NOTE: In the Examination Overview, because of the credit union's high concentration of indirect HELOC loans and the potential credit risk in the portfolio, examiners **recommended** that Cal State 9:
 - ✓ Perform a stress test at least quarterly.
 - ✓ Support future loan concentration changes with a stress test.
 - ✓ Establish a floor limitation using the results of the stress test.
 - ✓ Consider developing contingency strategies for scenarios and outcomes that exceed established floor limitations. Contingency plans might include increased monitoring, limiting growth, and selling loans or portfolio segments.
 - ✓ Establish limits on tiers and combined loan-to-value ratios especially in the lower tiers.
 - ✓ Develop a list of chronic and habitual slow payers and perform added risk analysis on these borrowers such as running a current credit check, reviewing current collateral valuation, and performing a current debt analysis, paying particular attention to borrowers who become delinquent on their loan due to capacity issues.
 - ✓ Establish maximum acceptable limits on the percentage of "stated income" loans to the total portfolio of indirect HELOCs by tier.

June 2006 Effective date	Code 23 Contact. Started August 2006 Completed October 2006
<p>Examiners concluded that the credit union had a sound risk management program in place and was monitoring specific items related to the HELOC program. However, examiners also determined the program needed to be strengthened in various areas including liquidity management and concentration risk management.</p> <ul style="list-style-type: none">• Examiners described the credit union's concentration risk as high.• Regarding CREDIT RISK, examiners:<ul style="list-style-type: none">▪ Noted that as of July 31, 2006, 88 percent of the \$242.3 million HELOC portfolio (\$213 million) was stated income loans and \$147.6 million of the portfolio (61 percent) was behind negative amortization first deeds of trust.▪ Noted that while the lowest credit grades (D and E paper⁶³) did not have CLTVs above 90 percent, B, C, and D graded paper⁶⁴ had high delinquency rates and E graded paper⁶⁵ had an extremely high delinquency rate.▪ Indicated that the risk of such a high concentration of indirect HELOCs would materialize if there was a steep decline in the market values while the interest rates rose to levels above the borrower's ability to make full monthly payments.▪ Noted that market values had been softening and interest rates had been creeping up, adding that while charge-offs had been low, Cal State 9 had only started this program in April 2003 when interest rates had been at their lowest in years.▪ Expressed concern that the risk of much higher loan losses could be anticipated in the long-term as interest rates rose and reached levels beyond which a percentage of the borrowers could afford to make the monthly payments, while the market values declined below the initial appraisal values, thereby increasing the CLTV.• Regarding LIQUIDITY RISK, examiners:<ul style="list-style-type: none">▪ Determined the credit union had low liquidity.	

⁶³ Credit scores below 600.

⁶⁴ Credit scores between 550 and 679.

⁶⁵ Credit scores below 550.

- Determined Cal State 9 had not formalized its liquidity program with established parameters and report requirements.
- Indicated that management must develop and document specific liquidity limits and include liquidity projections and analysis in the monthly Assess/Liability Committee (ALCO) package.
- Noted that management had increased its dividend rate to attract more shares or borrowed funds to maintain sufficient liquidity for its loan demand.

DOR: Examiners required (by January 2, 2006):

- Cal State 9 to develop a plan to address the concentration risk of the indirect HELOC lending program, with an emphasis on reducing exposure on the balance sheet. Incorporate plans to reduce high concentration through any combination of increased loan sales, reduced loan originations, loan amortizations, etc., with a target to reach established goals within 120 days.
- Submit their plan for reducing concentration to the Department and NCUA for review and approval.
- Formalize the credit union's liquidity management procedures into written policies and incorporate into the ALCO's oversight. Establish and incorporate liquidity parameters and reporting requirements. Include off-balance sheet elements of the liquidity management program (i.e. borrowings, unfunded contingencies of HELOC loans, real estate loan sales, etc) and contingency plans in the event liquidity sources were impacted.
- Respond to items in the Examiner's Findings section of the report. In the Examiner's Findings, examiners requested Cal State 9 to comment on the following items and report the corrective actions taken:
 - Management and the board have not developed a definition for "high-risk" indirect loans. The board has not set a limit of "high-risk" indirect loans as percentage of net worth (the limit should not exceed 100% of net worth).
 - The credit union does track current combined loan-to-value (CLTVs) for individual loans on an on-going basis. It is recommended that management use credit bureau data periodically to monitor and manage CLTVs.
 - Management has not implemented review and tracking procedures to determine the impact to the HELOC loan portfolio due to negatively amortizing first deeds of trust. Incorporate appropriate credit bureau data to track CLTV on an ongoing basis to detect any potentially adverse impacts.

- The credit union started reviewing and tracking these loans during fieldwork. These procedures should be performed on an ongoing basis.
- Prepare and submit results of CLTV analysis to the board.

March 2007 Effective Date	Code 23 Contact Started April 2007 Completed June 2007
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Examiners determined:

- The board of directors had not reduced the high concentration of indirect HELOCs **as recommended**.
- The high concentration of HELOCs combined with multiple layering of sub-prime risk elements presented a level of risk that was not acceptable.

Regarding CREDIT RISK, examiners:

- Indicated credit risk in the rapidly expanding HELOC program was starting to surface.
- Indicated the impact of making high CLTV loans behind negatively amortizing first mortgages was starting to have an adverse effect on the credit union.
- Delinquency, loan losses and foreclosure activity had increased sharply since the last exam, conditions that were made worse by potentially falling real estate prices. Examiners noted delinquencies had grown from 0.80 percent as of December 2005 to 4.71 percent as of December 2006. They added that delinquencies would likely remain high for the coming months due to problems with subprime elements of the portfolio.
- Explained that although the credit union did not grant loans exclusively to subprime borrowers, nearly all of the HELOC loans had elements of sub-prime lending and most had multiple elements, including high CLTV, low credit scores, stated income, and negative amortizing first deeds of trust. Examiners added that these risk elements were made worse by potentially falling real estate prices.
- Indicated there was a significant potential credit risk because of optimistic appraised values, unreasonable stated incomes, and negatively amortizing first mortgages up to 110 percent.

- The high percentage of stated income loans still did not appear to have been evaluated for reasonableness.
- Indicated that the number of loans with a CLTV of 89 percent was very high, but the credit union did not include them as high risk.

Regarding LIQUIDITY RISK, examiners:

- Determined Cal State 9 had not been able to manage its liquidity problems.
- Noted that the credit union had borrowed \$61.1 million as of April 2007.
- Indicated that they expected the credit union's liquidity problems to increase.

DOR: Examiners placed 20 specific requirements on Cal State 9 management including (by August 13, 2007) to:

- ***Implement immediate action*** to reduce the HELOC loan portfolio by a minimum of \$30 million per quarter until such time as appropriate concentration levels were reached (a percentage of total assets or as a multiple of net worth). Reduce ***or*** halt future funding until established goals are reached.
- Establish minimal interim benchmarks for reduced HELOC concentration levels to the greater of the following:
 - June 2007 – 55 percent of total assets, or 6.4 times net worth dollars⁶⁶
 - September 2007 – 50 percent of total assets, or 5.6 times net worth dollars
 - December 2007 - 45 percent of total assets, or 4.8 times net worth dollars
 - March 2008 – 40 percent of total assets, or 4 times net worth dollars
- Obtain current market values of your HELOC loan portfolio.
- Verify a representative sample of stated income loans to determine the margin of error on members' income levels.
- Place additional limits on use of stated income loans based on the results of this analysis by limiting credit scores, adjusting debt ratio limits, etc.
- Complete a loan profile of delinquent and charged off loans to identify common characteristics of higher risk loans. Update the profile quarterly and amend lending policies accordingly to account for these identified risk elements.

⁶⁶ Examiners provided the credit union a quarterly schedule from June 2007 through March 2008 with maximum ratios for each parameter.

- For risk management purposes, monitor, track or analyze various aspects of the indirect HELOC portfolio.
- Address concerns and issues regarding the Allowance for Loan and Lease Losses.
- Strengthen the underwriting requirements in the HELOC lending policies.
- Submit monthly reports to the California SSA and NCUA.

**June 2007
Effective Date**

Code 23
Started July 2007
Completed August 2007

- This purpose of the contact included reviewing Cal State 9's problems with their line of credit, their liquidity, earnings, delinquencies and losses.
- Cal State 9 was transferred to NCUA Special Actions at the start of this contact.
- Examiners determined Cal State 9 management discontinued the indirect HELOC program in June 2007 with the last funding July 31, 2007.
- Examiners determined that as of July 31, 2007, there were 318 loans valued at more than \$30 million that were delinquent thirty plus days. This included 181 loans valued at more than \$18 million that were 60 plus day delinquent.
- The credit union's net worth was approximately 3.30 percent as of July 31, 2007.
- Examiners indicated charge-offs were accelerating due to the rapidly increasing delinquencies.
- Examiners determined that as of August 2007:
 - WesCorp reduced their \$90 million LOC to \$25 million.
 - The credit union is offering a 6 percent, seven month certificate of deposit with a limit of \$50,000 (for new members only).
 - The credit union almost exclusively charged off loans instead of attempting to buy out the first mortgages because there was little to no equity, and property values were falling in the San Francisco Bay Area.

- Regarding CREDIT RISK, examiners:
 - Described the quality of the loans as atrocious, indicating there is no controlling the portfolio at this point.
 - Determined the HELOC portfolio is so bad the credit union is charging off almost all loans; there is no equity to access.
 - Determined there were excessive amounts of stated income/Alt-A⁶⁷ loans ahead of the HELOCs or as the HELOCs themselves. Property values are declining in the Bay Area.
- Regarding LIQUIDITY RISK, examiners:
 - Described the risk to the NCUSIF as extensive.
 - Determined that while WesCorp reduced Cal State 9's LOC to \$26 million; the credit union had more than 900 accounts (total value more than \$150 million) with total account balances of at least \$100,000.

August 2007 Effective Date	Code 23 Contact Started August 2007 Completed October 2007
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- The primary purpose of the contact was to put together the bidder's package and to facilitate the AMAC review of the portfolio.
- AMAC estimates that approximately 80% of the CAL9 – non prime HELOC portfolio has a combined loan to value (CLTV) equal to or greater than 90% based on our estimate of current market values.
- Approximately, 60 % [sic] of the underlying first variable rate mortgages, which were originated by World Savings and others, were underwritten on a stated income basis and contain a negative amortization feature that allows the loan balance to accrue to 125% of the original loan amount before the payment adjusts again to be fully amortizing. To date the holders of these first mortgages have elected to foreclose on their collateral rather than modify the payment and accrual terms.

⁶⁷ A category of mortgages which have a risk potential that is greater than prime but less than subprime. The reason for the increased risk is usually not the borrower's credit history, but rather something specific about the mortgage.

- The HELOC loans are typically high yield variable interest rate loans with a twenty-five year term; open for the first ten years and are interest only during this period. The loans are expect [sic] to amortize on a principal and interest basis between years eleven and twenty-five
- The value of the HELOC portfolio is also materially affected by the current decline and instability of the California real estate market. In the majority of instances, there is negative equity in the property. In the event that the first mortgage loan becomes delinquent and foreclosure is initiated by the superior lien holder, there is insufficient equity in the property to warrant CAL9 paying off the first mortgage or even keeping the first current. The recovery value of the HELOC under these circumstances scenario approaches zero.

<p>September 2007 Effective Date</p>	<p>Code 23 Contact</p> <p>Started November 2007</p> <p>Completed February 2008</p>
<ul style="list-style-type: none"> • The contact was performed with an effective date of September 30, 2007, and its main purpose was to conduct the conservatorship action and to evaluate the condition of the credit union. • The California Department of Financial Institutions (DFI) issued an order to conserve Cal State 9 Credit Union (CS9) on November 2, 2007. The DFI appointed the NCUA as receiver and RD Love accepted the appointment. The CEO was terminated in conjunction with issuance of the conservatorship order; the CFO resigned in September 2007. • The CU represents significant risk to the NCUSIF. The problems are so pervasive and severe the conservatorship will not result in the restoration of safe and sound operations. The ultimate resolution of the case will be a P&A to be completed in the second quarter of 2008. 	

Appendix B – Liquidity Ratios and Trends (Glossary and Charts)

NCUA guidance indicates for purposes of quantitative analysis, ratios can assist in assessing the level of liquidity risk at a credit union. We reviewed the following financial data and ratios to illustrate trends of Cal State 9's increasing liquidity risk during the operation of Cal State 9's indirect HELOC program:

- Total Loans to Total Shares – NCUA guidance indicates a high loan to share ratio is a key indicator of tightening liquidity. In addition, when loan demand exceeds normal share growth, management must rely on access to borrowed money or the sale of securities to raise needed cash.
- Total Loans to Total Assets - NCUA guidance indicates a high loan to asset ratio may indicate that a credit union cannot meet its member loan demands and other liquidity needs. A high loan to asset ratio (e.g., in excess of 80 percent) may stress liquidity, which is especially true if (1) the credit union has limited other funding sources; (2) existing funding depends on volatile sources; or (3) the credit union has minimal short-term investments.
- Investment Growth versus Loan Growth and Share Growth - NCUA guidance indicates when loan demand exceeds normal share growth, management must rely on the sale of securities⁶⁸ or access to borrowed money to raise needed cash. NCUA guidance also indicates that declining investments are a key indicator of tightening liquidity.
- Cash plus Short Term Investments to Assets – NCUA guidance indicates this ratio is an indicator of how much available cash the credit union has to meet share withdrawals or additional loan demand. A low or rapidly declining ratio may indicate the credit union will be unable to meet its current obligations.
- Unused (Unfunded) Commitments / Cash plus Short Term Investments – NCUA guidance indicates that an indicator of potential future illiquidity is the ratio of unused commitments to cash and short-term investments. This ratio represents the amount of additional member loans that the credit union has committed to fund in the future. If the ratio exceeds 100 percent, this means that the total amount of unused commitments exceeds credit unions' total available funds on-hand.
- Borrowings – NCUA guidance indicates borrowings may indicate a credit union cannot meet its cash needs through member shares. Also, while borrowing is a source of liquidity, it does not provide a continuous basis for funding loan demand or share withdrawals. In addition, NCUA guidance indicates examiners should consider short-term borrowings⁶⁹ as highly volatile sources of funds.

⁶⁸ Investments that can be readily sold are one of the main sources for credit unions to raise needed cash.

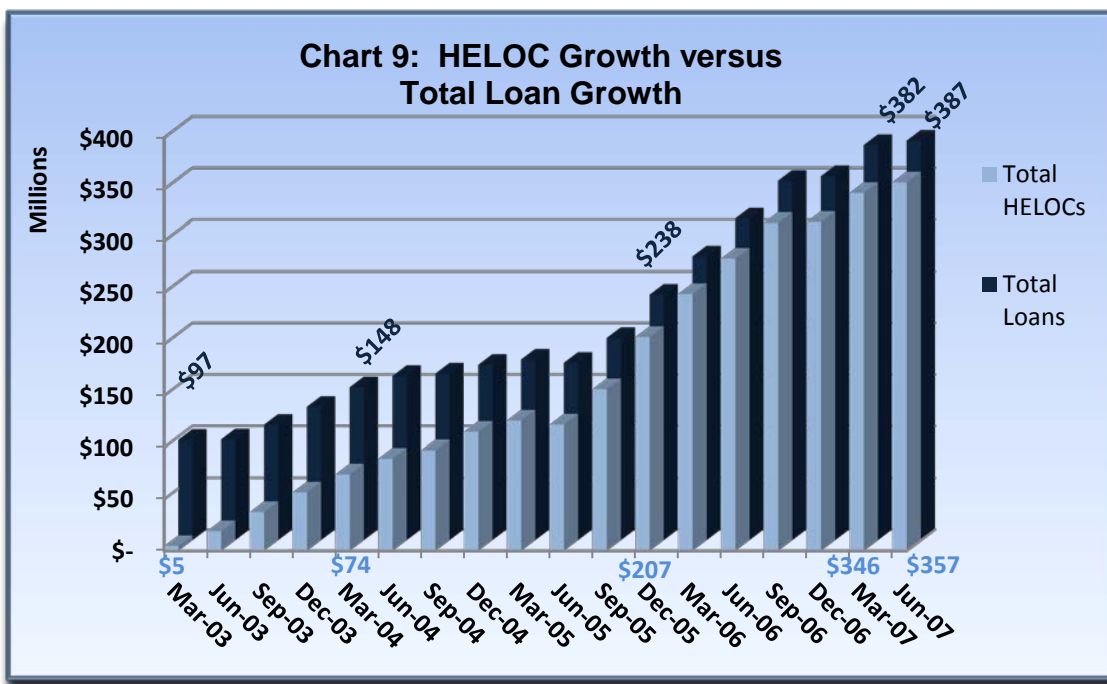
⁶⁹ Short-term borrowings are borrowings of less than one year.

Concentrations of these funds could subject the credit union to liquidity demands in uncertain economic times, or if the credit union’s credit standing deteriorates. Longer-term borrowings generally provide a stable source of funding.

- Share Certificates – NCUA guidance indicates that a credit union attracting shares by paying above market rates may provide an indication of liquidity concerns. NCUA guidance also indicates liquidity risk is increased when management relies on short-term certificates rather than long-term certificates.

Total HELOC⁷⁰ Growth (Chart 9)

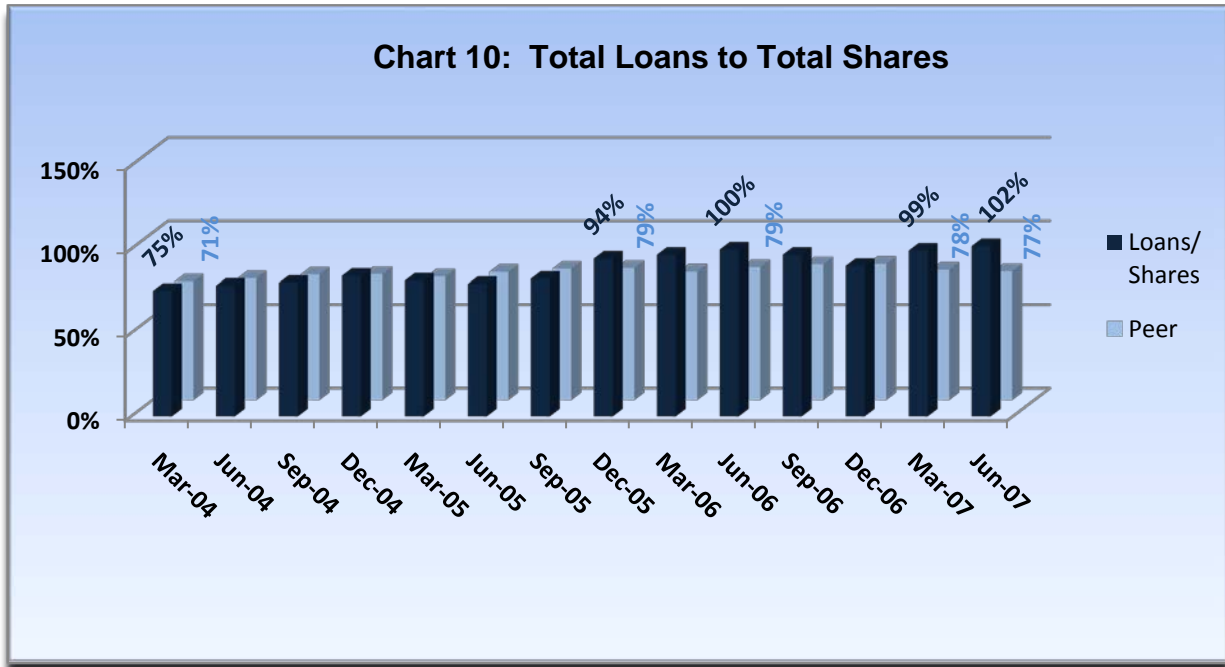
Chart 9 illustrates the growth of Cal State 9’s HELOC loans and unfunded HELOC commitments compared to total loan growth during the period March 31, 2003⁷¹ through June 30, 2007⁷². The portfolio grew from just under \$5 million to nearly \$357 million during this period. Between March 2003 and the December 2005 examination, Cal State 9’s total indirect HELOC portfolio grew 4,419 percent and comprised nearly 88 percent of the credit union’s total loans. Between March 2006 and the June 2007 contact, the portfolio remained at between 90 and 92 percent of the credit union’s total loans.



⁷⁰ For this report, the indirect HELOC portfolio includes funded HELOCs and unfunded HELOC commitments.
⁷¹ The last quarterly reporting period before Cal State 9 implemented the indirect HELOC program in May 2003.
⁷² The effective date of the joint contact when Cal State 9 was placed under NCUA Special Actions and was determined to be illiquid.

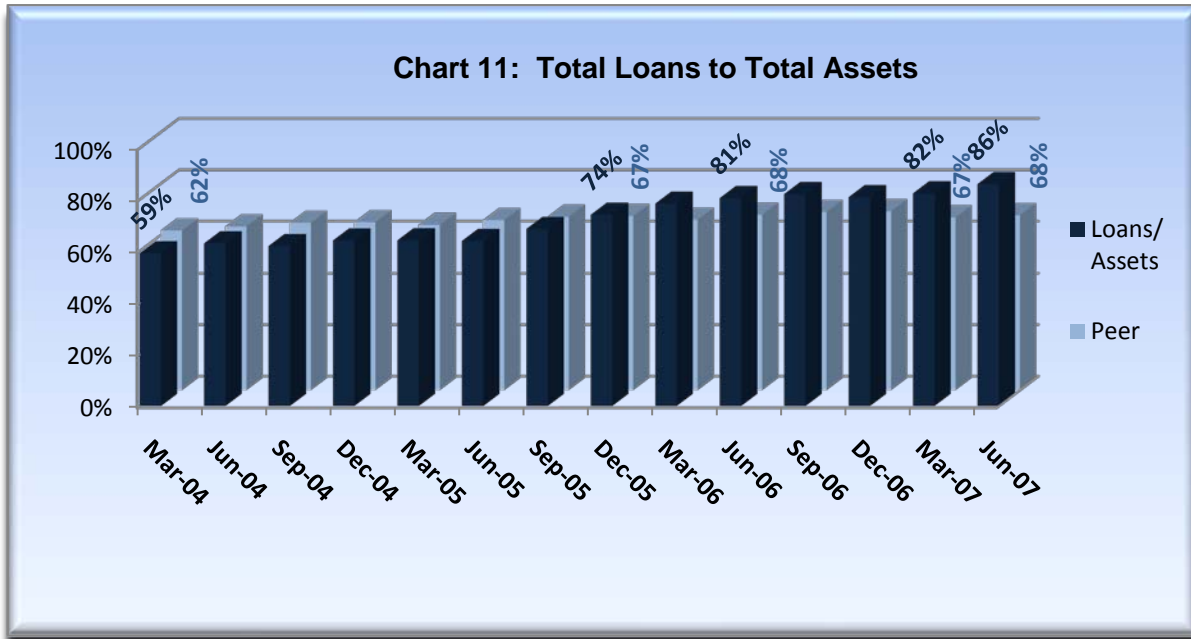
Total Loans to Total Shares (Chart 10)

Cal State 9's Loan to Share ratio increased steadily from 75 percent to nearly 102 percent between the first examination, effective March 2004 and the June 2007 contact when Cal State 9 was placed under NCUA Special Actions. The ratio had remained consistently at 90 percent or higher from the December 2005 examination even though the credit union was participating a significant number of HELOCs and attracting additional share certificates by offering higher than market dividend rates.



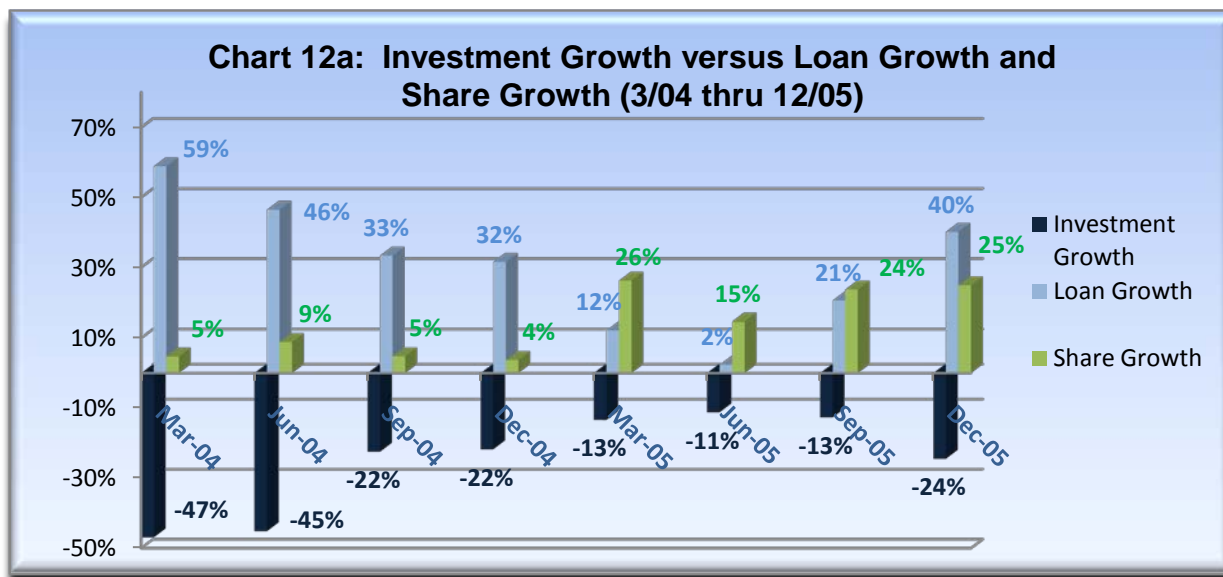
Total Loans to Total Assets (Chart 11)

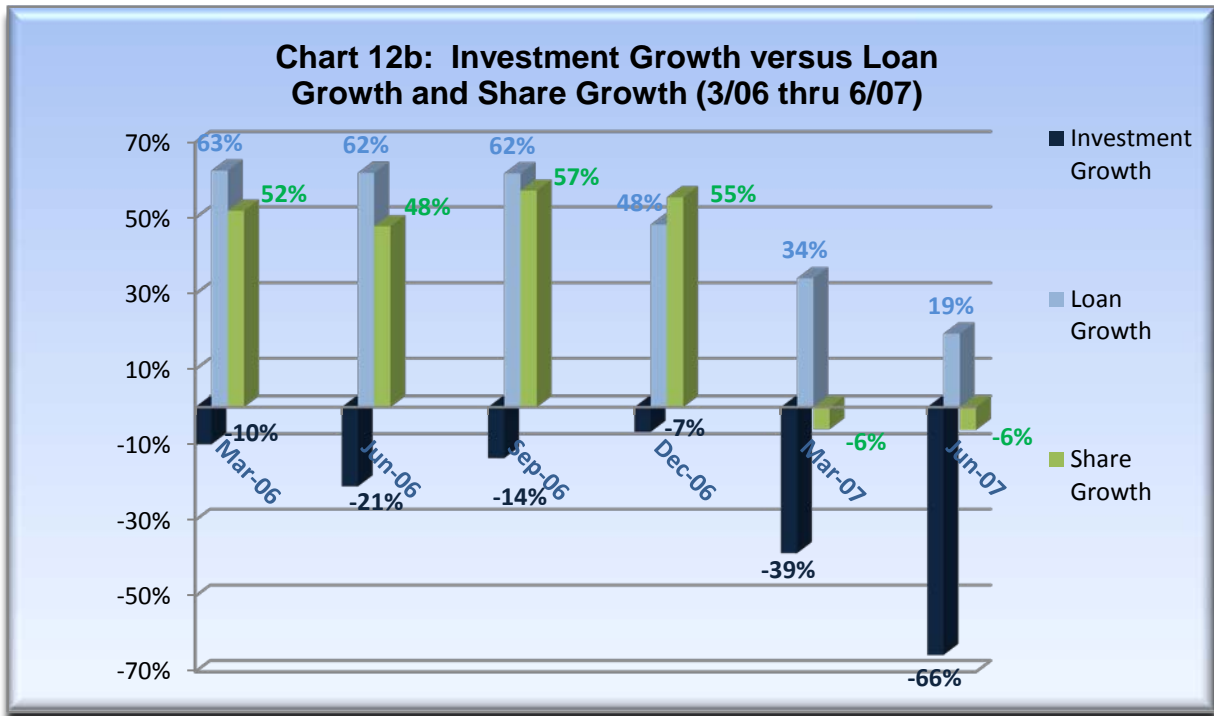
Cal State 9's Loan to Asset ratio increased from nearly 60 percent to 86 percent between the March 2004 examination and the June 2007 joint contact. The credit union's ratio remained steadily at 80 percent or higher from the June 2006 joint contact even though the credit union was participating a significant number of HELOCs. Even more significant was that to fund its loans, Cal State 9 was already liquidating its investments, borrowing short-term funds, had obtained a line-of-credit and sought additional shares by paying higher than market dividend rates.



Investment Growth versus Loan Growth and Share Growth (Charts 12a & 12b))

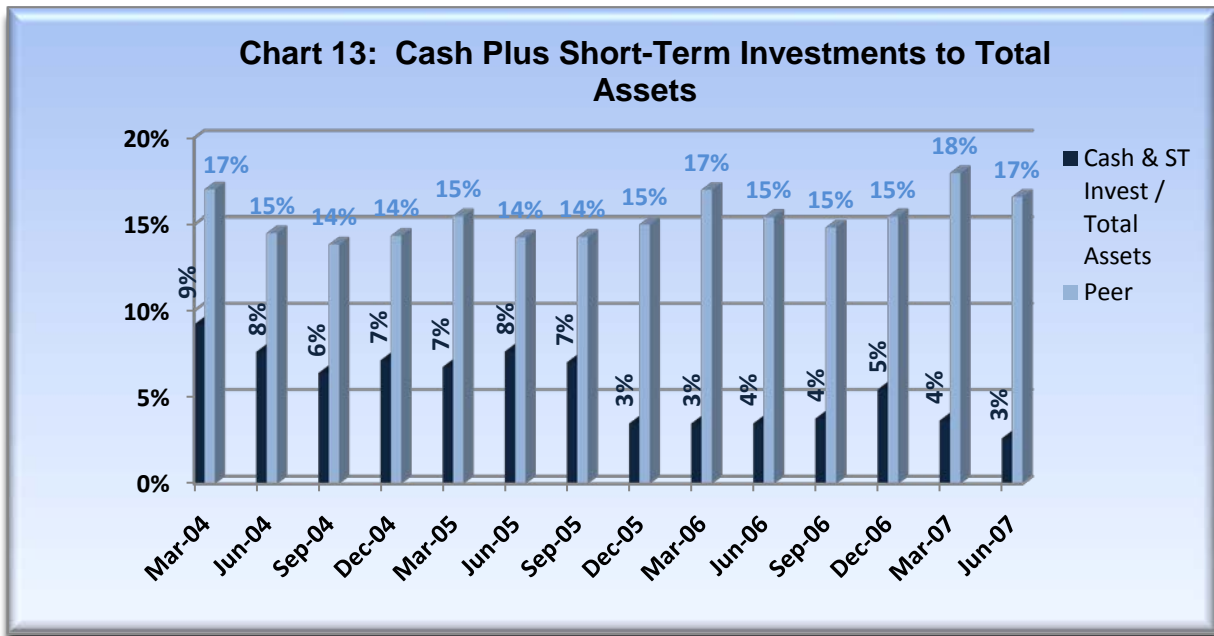
Between March 2004 and June 2007, Cal State 9's total loans grew nearly 162 percent, significantly, exceeding the credit union's total share/deposit growth of 93 percent. This is more notable considering, as examiners noted during the December 2005 examination, Cal State 9 management had been offering increased dividend rates to attract shares to meet the credit union's liquidity needs. As examiners also noted, Cal State 9 management had been liquidating investments to meet the credit union's liquidity needs. Cal State 9's total investments declined every quarter even as Cal State 9 management increased deposits and borrowed short-term money to fund a significant growth and concentration in indirect HELOCs.





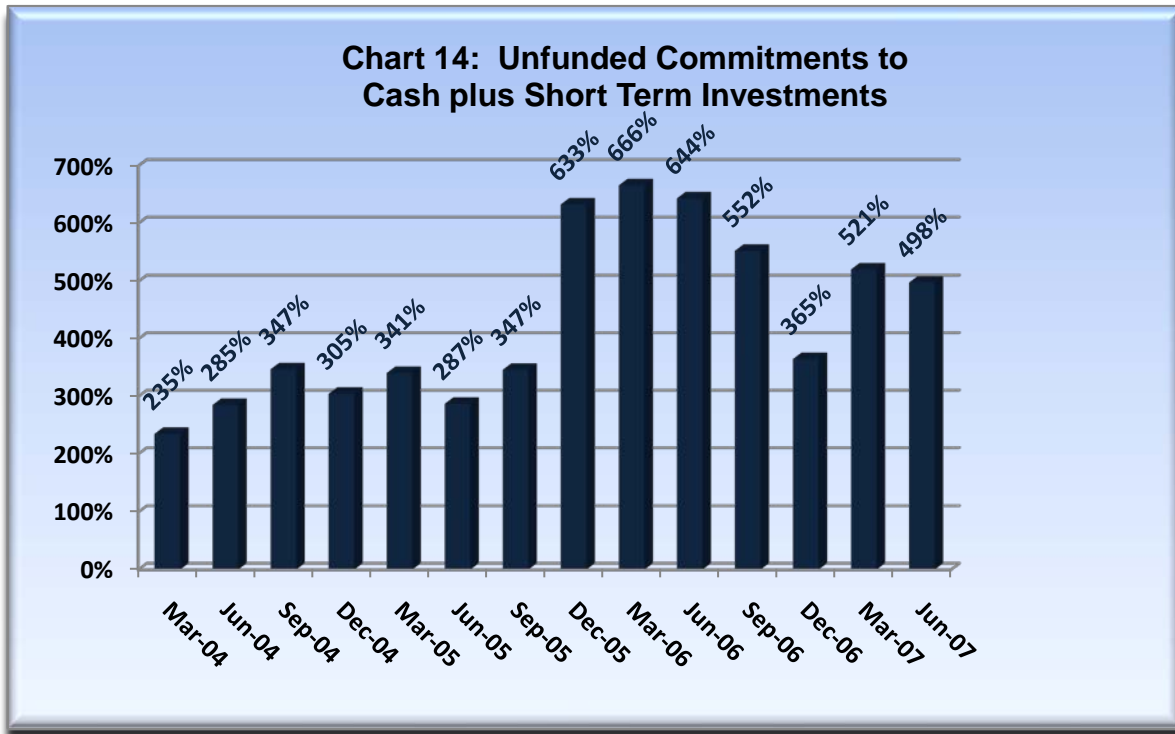
Cash plus Short Term Investments to Assets (Chart 13)

Cal State 9's ratio remained significantly below peer during the operation of the indirect HELOC program. The ratio had been approximately half the peer ratio from March 2004 through September 2005 and dropped significantly during the next quarter (December 2005).



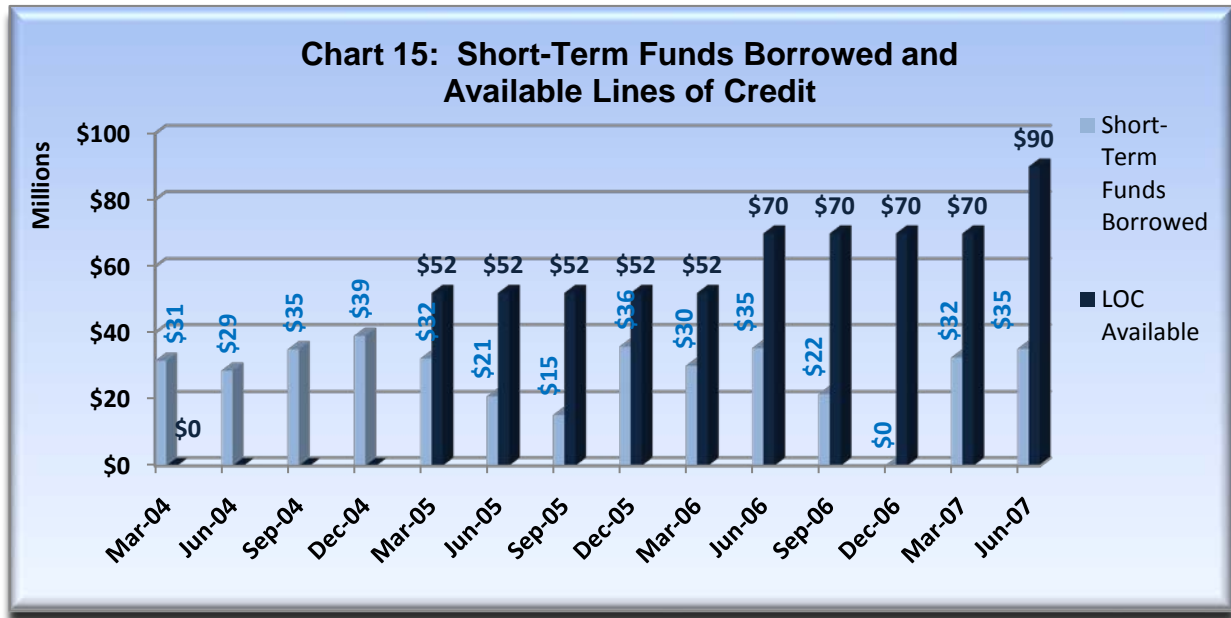
Unused (Unfunded) Commitments / Cash plus Short Term Investments (Chart 14)

Despite Cal State 9's increased borrowing and increased loan participations, this ratio clearly demonstrates that Cal State 9's liquidity position was distressed throughout the period the credit union operated the indirect HELOC portfolio.



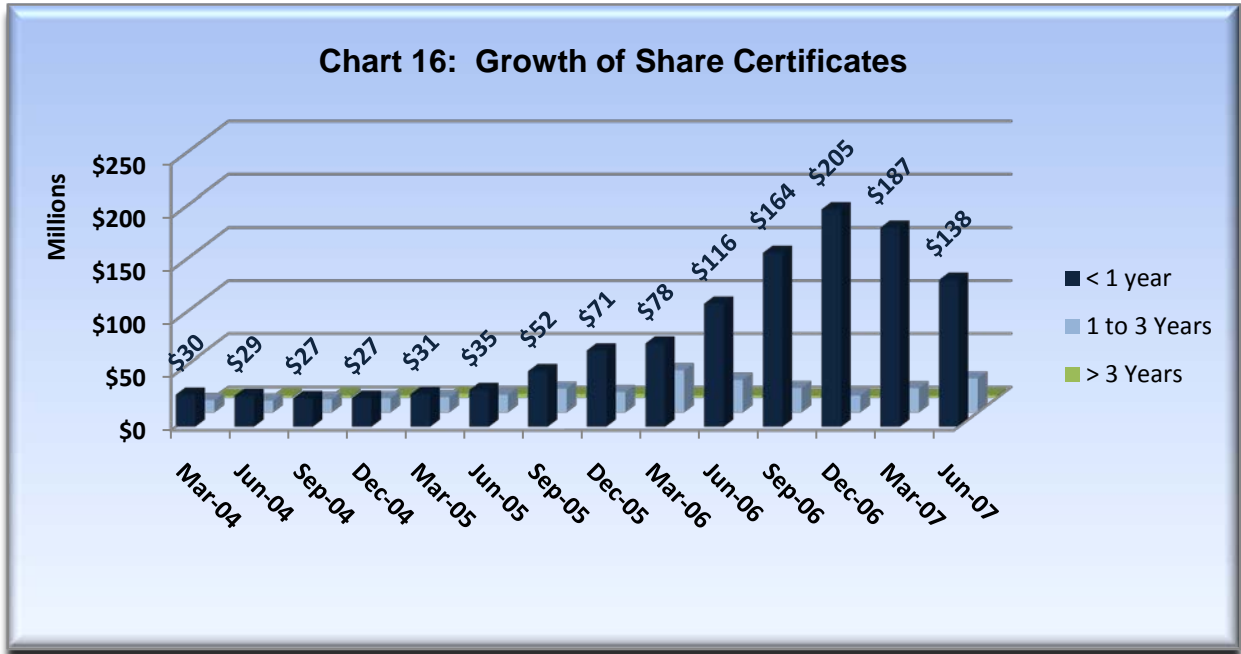
Short-Term Borrowings (Chart 15)

As examiners indicated during the December 2005 contact, Cal State 9 management was borrowing funds to meet its liquidity needs. WesCorp reduced the credit union's LOC from \$90 million to \$25 million during the June 2007 contact.



Share Certificates (Chart 16)

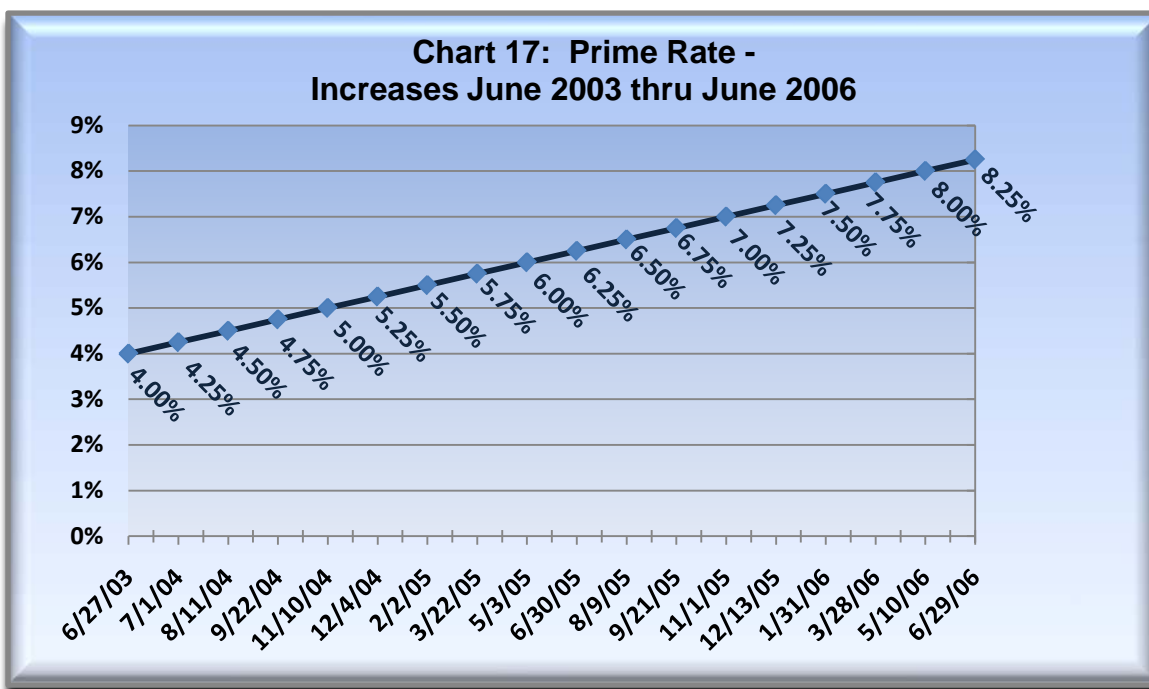
Cal State 9's Total Share Certificates increased from approximately \$43 million as of March 2003 to a high of more than \$222 million by December 2006 (414 percent growth). As the chart illustrates, the most significant growth was in the more volatile short-term certificates.



Appendix C – Changes in the Real Estate Market Environment during the Operation of the Indirect HELOC Program

Rising Interest Rates

NCUA indicated in guidance to examiners that in 2003, interest rates had declined to their lowest point in 45 years.⁷³ From there, interest rates had shown a steadily increasing trend. On June 27, 2003, the prime rate was 4 percent and was raised five times in 2004 to 5.25 percent. As examiners indicated during the December 2005 examination, the prime rate had been adjusted upwards eight times during 2005 (to 7.25 percent on December 13, 2005). Chart 17 illustrates the increasing prime rate between June 2003 (4 percent - its lowest point in at least 45 years) and June 2006 (8.25 percent – its high point before beginning a decline in late 2007).



Furthermore, examiners indicated that the risk of such a high concentration of indirect HELOCs would materialize if there was a steep decline in the market values while the interest rates rose to levels above the borrower's ability to make full monthly payments.

Overvalued Home Prices

On August 31, 2005, the Credit Union Times published an article regarding overvalued home prices. The article indicated 53 cities were at "high risk of price declines," including 25 cities in California where the author indicated the overvaluations ranged from 30 percent to 69 percent. These cities included San Jose (36 percent overvalued),

⁷³ Examiners indicated that the HELOCs were adjustable rate loans tied to the prime rate.

Oakland (39 percent), Los Angeles (48 percent), San Diego (53 percent), Sacramento (54 percent), Stockton (58 percent), and Santa Barbara (69 percent).

Regarding home values and affordability, NCUA guidance issued in September 2005 indicated that during 2001 through 2003, the west coast had experienced significant levels of price appreciation. In addition, NCUA officials indicated that the median sales price of existing homes in the United States increased by 8.5 percent in 2003, 9.3 percent in 2004, and 14.7 percent for the twelve months ending June 30, 2005. However, NCUA indicated home prices in California had doubled in five years.⁷⁴

The Consumer Federation of America⁷⁵ reported in May 2006 that in certain California markets with high concentrations of non-traditional mortgages, foreclosure rates in the fourth quarter of 2005 were much higher than in the previous year.⁷⁶ For example, foreclosures in San Diego and Orange County grew by more than a third (34.5 percent and 34.2 percent respectively) between the fourth quarter of 2004 and the fourth quarter of 2005, and foreclosures in San Francisco grew by 45.2 percent over the same period.

⁷⁴ This data is according to the National Association of Realtors.

⁷⁵ Consumer Federation of America is an advocacy, research, education, and service organization that has been in existence since 1968 and has a membership of approximately 300 nonprofit organizations.

⁷⁶ Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders (Allen J. Fishbein, Patrick Woodall), May 2006.

Appendix D – Management Comments



National Credit Union Administration

VIA E-Mail

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

FROM: Executive Director David M. Marquis ^{LF}

SUBJ: Material Loss Review of Cal State 9 Credit Union #64449

DATE: April 9, 2010

This memorandum responds to your request for review and comments on the OIG report entitled *Material Loss Review of Cal State 9 Credit Union*.

Cal State 9 Credit Union (Cal 9) failed due to an extremely high concentration (up to 92 percent of the total loan portfolio) of indirect Home Equity Lines of Credit (HELOC) coupled with the dramatic decline in California real estate values. Specifically, Cal 9's management did not:

- Perform proper due diligence before implementing the HELOC program in 2003,
- Establish adequate risk management processes to monitor the HELOC portfolio over time,
- Implement appropriate internal controls to prevent payment of volume based incentives, and
- Establish appropriate concentration limits for the HELOC portfolio in relation to available liquidity, total assets and more importantly, in relation to net worth.

Examination reports indicated a majority of the loans in the HELOC portfolio contained subprime elements and most were underwritten with multiple subprime factors including high combined loan to values, low credit scores and stated incomes. Most of the HELOCs were adjustable rate, interest only loans tied to the Prime Rate. As the Prime Rate increased 13 times between June 2003 and December 2005, so too did the minimum payment requirements on the HELOCs. Examiners later learned a majority of the first mortgages held by other lenders contained variable rate features and subprime elements which only exacerbated the delinquency problems for the Cal 9 HELOCs since borrowers were having trouble paying their first mortgages. As the California real estate market crashed, the equity positions for Cal 9's HELOC portfolio eroded. Cal 9 charged off the HELOCs because there was insufficient equity in the properties to make it worthwhile to pay off the first mortgages to protect Cal 9's junior liens.

Cal 9 management funded the excessive growth in the portfolio with short term borrowings and by selling participations in the HELOC portfolio. Once the credit quality of the loan portfolio deteriorated, the borrowing source required Cal 9 to pay down the borrowings which Cal 9 could only accomplish by attracting high rate share certificates thus creating an even more volatile liquidity situation. The level of risk in the HELOC portfolio rapidly overwhelmed the credit union's net worth and ultimately led to Cal 9's insolvency.

We acknowledge your findings that although the examiners escalated their risk assessments and issued repeated warnings to Cal 9's management to control the risk, there were early opportunities to better understand the depth of the risk and for the State Supervisory Authority and NCUA to take stronger administrative actions to compel the credit union to alter or cease the HELOC program. Your report notes the multitude of guidance NCUA has issued relative to each of the factors contributing to Cal 9's failure. In addition to the guidance you cite, we recently issued a Supervisory Letter on Concentration Risk. We will be issuing a Supervisory Letter on Administrative Remedies and Enforcement Actions to remind examiners of the available informal and formal administrative actions, and are providing training at both the regional and national levels on real estate portfolio risks and risk management.

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