NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

**MATERIAL LOSS REVIEW OF
MEMBERS UNITED CORPORATE
FEDERAL CREDIT UNION**

Report #OIG-11-01

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ACRONYMS AND ABBREVIATIONS

ALCO	Asset/Liability Committee
CRIS	Corporate Risk Information System
Crowe	Crowe Horwath LLP
DANA	Daily Average Net Assets
DOR	Document of Resolution
Empire	Empire Corporate Federal Credit Union
FCU	Federal Credit Union
FICO	Fair Isaac Corporation
FRAP	Floating Rate Asset Program
Guide	NCUA Corporate Exam Guide
IAP	Investment Action Plan
Mid-States	Mid-States Corporate Federal Credit Union
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NEV	Net Economic Value
NPCU	Natural Person Credit Union
NRSRO	Nationally Recognized Statistical Rating
OCCU	Office of Corporate Credit Unions
OCI	Other Comprehensive Income
OCM	Office of Capital Markets
OIG	Office of Inspector General
OTTI	Other-than-temporary Impairment
RMBS	Residential Mortgage-backed Securities
SIP	Credit Union System Investment Program
SMSIA	Standard Maximum Share Insurance Amount
TCCUSF	Temporary Corporate Credit Union Stabilization Fund
U.S. Central	U.S. Central Federal Credit Union

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Crowe Horwath LLP (Crowe) to conduct a Material Loss Review (MLR) of Members United Corporate Federal Credit Union (Members United), a federally chartered credit union. We reviewed Members United to (1) determine why NCUA placed Members United under federal conservatorship; (2) assess NCUA's supervision of the corporate credit union, and (3) make appropriate recommendations to prevent future losses. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence; interviewed management and staff from the NCUA Office of Corporate Credit Unions (OCCU) and Office of Capital Markets (OCM); reviewed NCUA guides, policies and procedures, and NCUA Call Reports (Corporate 5310 Reports).[1]

Our review determined Members United's management and Board of Directors (Board) contributed to the conservatorship of Members United and resulting material loss to the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). Specifically, management and the Board's inadequate oversight resulted in Members United purchasing significant holdings of private-label mortgage-backed securities, many of which were later downgraded to subprime[2] and Alt-A,[3] that exposed the credit union to excessive amounts of financial risk. Members United's management and the Board failed to identify and manage this risk exposure prior to the mortgage-backed securities market dislocation that occurred in mid-2007.[4] Specifically, in regards to managing the investment portfolio, Members United management:

- Did not establish investment sector concentration limits in a timely manner;

- Relied heavily on ratings assigned to the securities by Nationally Recognized Statistical Rating Organizations (NRSRO) when purchasing securities for the portfolio and when monitoring the amount of credit risk

[1] Section III of Crowe's report provides further details on the Objectives, Scope, and Methodologies utilized.
[2] Private-label subprime is a classification of mortgages where borrowers have a tarnished or limited credit history. Subprime borrowers are often identified by having a FICO credit score below 640. Subprime loans carry more credit risk, and as such, carry higher interest rates as well.
[3] Alt-A is a classification of mortgages where the risk profile falls between prime and subprime. The borrowers behind these mortgages typically have clean credit histories, but the mortgage itself generally has some issues that increase its risk profile. These issues include higher loan-to-value and debt-to-income ratios or inadequate documentation of the borrower's income.
[4] The market dislocation refers to events, which began in 2007 and continued into 2009, when securities collateralized by mortgages, typically considered sub-prime, began to lose value due to high borrower defaults in the underlying mortgages and declines in value of the property securing those mortgages. Because of this market dislocation, mortgage-backed securities, which were initially high rated, were downgraded to reflect the greater risk in the underlying mortgages. The value of the securities declined due to the downgrades and trading in these securities eventually halted in mid-2007. The problems in the subprime mortgage market were largely blamed on loose lending practices, low interest rates, a housing bubble, and excessive risk taking by lenders and investors.

in the investment portfolio; Relied on monoline insurers[5] to provide credit enhancement to a portion of the non-agency mortgage-backed securities in the portfolio;

- Did not properly identify and monitor credit risk exposure in the underlying mortgage loan collateral of the mortgage-backed securities held in the investment portfolio; and

- Relied on the corporate credit union structure to provide financial strength and liquidity.

Members United achieved growth over the years through mergers with three other retail corporate credit unions. In mid-2006, a merger of Mid-States and Empire Corporate Federal Credit Union created Members United. As of December 31, 2006, Members United's assets totaled $10 billion.

Members United's management and Board failed to recognize the substantial risk they were undertaking with significant investments in complex mortgage-backed securities, with a substantial portion of these securities backed by subprime assets. Management allowed the investments in mortgage-backed products to represent a significant concentration compared to net worth and they failed to impose limits in these securities. Management and the Board also did not adequately recognize the credit risk associated with the underlying collateral, much of which was subprime and Alt-A mortgage loans, including home equity loans. Once the investments deteriorated in value, Members United management had no course of action for divestiture of the securities other than to sell the securities at extreme discounts.

Members United suffered substantial losses due to other-than-temporary market value impairment on their holdings of mortgage-backed securities in 2008, 2009 and early 2010, which quickly eroded the credit union's net worth and net economic value (NEV)[6] and eventually led to conservatorship.

Members United recorded Other Than Temporary Impairment (OTTI)[7] charges of $608 million from 2008 through July 2010. These charges resulted in an undivided earnings deficit. Members United had to deplete its member-contributed capital to eliminate the undivided earnings deficit. The retained earnings and membership capital dollars declined from $884 million at the end of 2007 to $18 million at July 31, 2010. The retained earnings ratio declined to 0.05 percent and the capital ratio[8] to 0.22 percent.

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[5] An insurance company that provides guarantees to issuers, often in the form of credit wraps, that enhance the credit of the issuer.
[6] Net Economic Value measures the economic solvency of a corporate credit union. It is defined as "the fair value of assets minus the fair value of liabilities (12 C.F.R 704.2).
[7] OTTI is an accounting requirement under GAAP. The premise for OTTI is that certain price declines are not temporary, but reflect fundamental losses in a security that are considered to impair the security's long-term value.
[8] The capital ratio includes retained earnings and membership capital accounts.

On September 28, 2010, the NCUA Board created the Members United Bridge Corporate Federal Credit Union (Members United Bridge) to facilitate the transfer of assets, liabilities, and contracts upon liquidation of Members United. On that same date, the Director, OCCU, placed the credit union into conservatorship.

On October 31, 2010, the NCUA Board liquidated Members United. The liquidation was necessary in order to allow OCCU to implement the corporate system resolution plan. The liquidation action was necessary to remove the privately issued mortgage-backed securities from Members United's balance sheet so the corporate system resolution plan could be executed.

NCUA Supervision of Members United

We determined NCUA failed to adequately assess or timely identify key risks related to Members United's investment portfolio related to the concentration of mortgage-backed securities, until it was too late. We also determined the lack of adequate and timely oversight of Members United was partially attributable to corporate examiners not having the appropriate regulatory support, such as more specific investment concentration limits, to adequately address Members United's concentration risk and the exposure to credit, market, and liquidity risks.

We determined the first time examiners commented on issues related to sub-prime mortgage-backed securities held in Members United's investment portfolio was in the August 2007 examination report. The examination report indicated Members United held approximately $4.9 billion of mortgage-backed securities in its portfolio. As of August 31, 2007, $1.2 billion of these securities were considered sub-prime and $2.1 billion were in Alt-A mortgage-backed securities. This represented 67 percent of the mortgage-related securities held in the portfolio. Although examiners noted Members United management adequately monitored the sub-prime mortgage exposure and underlying collateral value of these securities and that capital was sufficient to cover the exposure even under stressed conditions, examiners did not raise supervisory concerns or issue a document of resolution (DOR) related to the sub-prime nature of the mortgage-backed securities at that time.

In the May 2008 examination report, examiners issued stronger concerns regarding Members United's significant concentration in mortgage-backed securities and issued a DOR recommending that management re-evaluate the appropriateness of the existing concentration limits given the recent unprecedented market dislocations in the mortgage-backed securities markets. As of the date of the examination, Members United had already recorded significant fair value losses due to the deteriorating value of the mortgage-backed securities.

We believe stronger and timelier supervisory action regarding Members United's concentration in mortgage-backed securities could have resulted in a reduced loss to the TCCUSF. Although NCUA does not provide examiners with specific guidance regarding sector concentration limits, we believe NCUA examiners should have recognized the risk exposure that Members United's significant concentration

in mortgage-backed securities represented earlier than 2007 and 2008. Similar to Members United's management, NCUA also placed significant reliance on the high ratings assigned by the NRSRO on the purchased mortgage-backed securities, and failed to recognize Members United's exposure to significant concentration risk due to the lack of diversification in their investments.

Introduction and Background

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

History of Members United Corporate Federal Credit Union

In 1975, Members United received a federal charter as Mid-States Corporate Federal Credit Union (Mid-States). Members United's membership is the result of several mergers. Mid-States merged with Indiana Corporate Federal Credit Union, Minnesota Corporate Federal Credit Union, and Empire Corporate Federal Credit Union (Empire). Prior to its merger with Mid-States, Empire merged with Garden State Corporate Federal Credit Union, Rhode Island Corporate Federal Credit Union, and South Dakota Corporate Federal Credit Union. In April 2006, after its merger with Empire, Mid-States received approval to change its name to Members United. Subsequent to the Empire, Mid States merger, Central Credit Union Fund also merged into Members United during late 2007.

With a membership of 2,053 "natural person" credit unions (NPCUs), Members United served approximately one-quarter of the 7,600 NPCUs in the United States. As of July 31, 2010, Members United managed approximately $9 billion in assets for its members.

Members United was a mid-tier retail corporate credit union within a three-tiered structure of the Nation's credit union system. The mid-tier retail corporate credit unions provide liquidity, as well as a range of transactional products and services, to the bottom tier, which consists of the NPCUs. The NPCUs invest their excess funds in a corporate credit union. The invested funds are drawn down to meet increasing liquidity demands due to member loan demand and share withdrawals. The retail corporate credit unions in turn invest much of their excess liquidity in investment securities and the third-tier wholesale corporate credit union, U.S. Central Federal Credit Union (U.S. Central). The retail corporate credit unions draw down on those investments as demands for liquidity from their NPCU members increase.

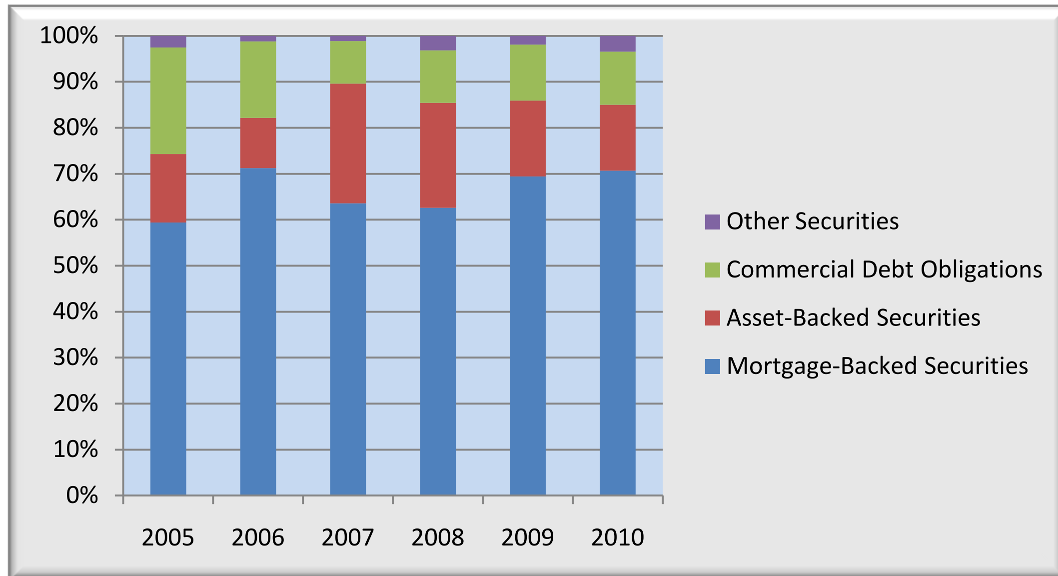
NCUA's Evaluation of Investment Activities

Members United invested members' liquid funds primarily in investment securities and interest-earning deposits at U. S. Central. These investments represented approximately 80 to 90 percent of Members United's total assets from December 31, 2005 through December 31, 2008; before declining to approximately 60 percent in 2009. This decline was due to the continued devaluation of mortgage-backed securities held in the portfolio, decrease in reinvestment of

securities' proceeds as they matured, and greater retention of cash to meet members' liquidity needs.

The investment securities portfolio consisted primarily of mortgage-backed and asset-backed securities, which ranged from approximately 74 to 89 percent of the total securities portfolio from December 31, 2005 through December 31, 2009, and as of September 30, 2010 as illustrated in Chart 1 (below).

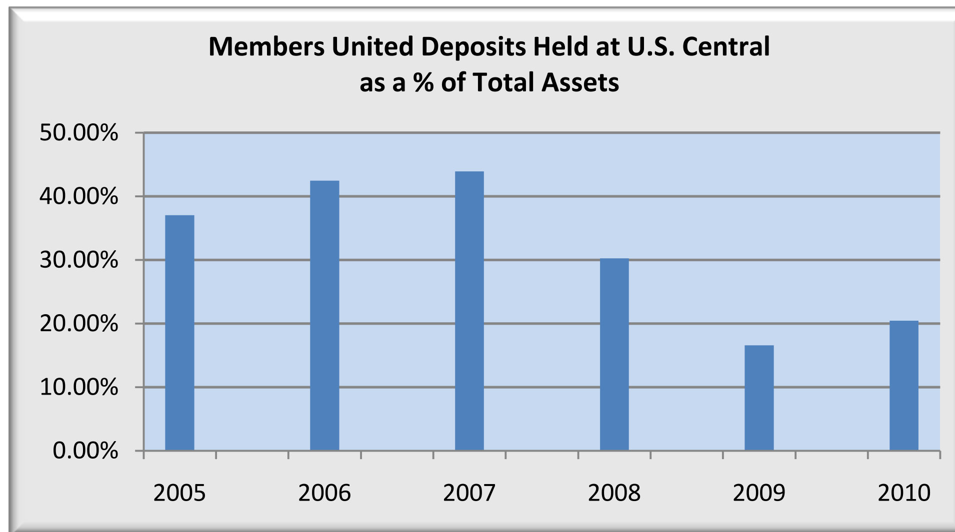
Chart 1: Members United's Investment Securities Portfolio Composition



Source: NCUA 5310 Reports as of December 31, 2005, 2006, 2007, 2008 and 2009; and as of September 30, 2010

Members United also invested a significant amount of funds with U.S. Central for purposes of meeting the short-term liquidity needs of their members. Chart 2 (below) indicates the percentage of Members United funds held at U.S. Central as a percent of total assets from December 31, 2005 through December 31, 2009, and as of September 30, 2010. These deposits were primarily in the form of interest-earning share and certificate accounts. Share accounts are readily available for liquidity purposes while certificates contain contractual maturity dates.

Chart 2: Deposits Held At U.S. Central Federal Credit Union



Source: NCUA 5310 Reports as of December 31, 2005, 2006, 2007, 2008 and 2009; and as of September 30, 2010

As depicted in Chart 2 above, deposits held at U.S. Central declined in 2008 and 2009 as Members United invested excess cash balances in shorter-term investments at the Federal Reserve Bank. Balances held at the Federal Reserve increased from approximately $51 million as of December 31, 2007 to $221 million and $2.5 billion as of December 31, 2008 and 2009, respectively.

Beginning mid-2007, the mortgage-backed securities market experienced a significant dislocation, which resulted in severe declines in the market value of these types of structured securities. Trading of mortgage-backed securities was substantially restricted later that year due to investors' uncertainty regarding the quality and value of the underlying loans. Due to the market deterioration, Members United's investment portfolio experienced significant declines in credit ratings and market value.

As of December 31, 2007, Members United reported net unrealized losses on securities of $356 million, compared with the prior year in which a small unrealized gain was recorded. Members United's management decided not to recognize these unrealized losses into income at that time because the securities were of high credit quality (i.e., investment grade of AAA or AA) and Members United had the intent and ability to hold these securities. Members United's management believed, at that time, that the market dislocation that occurred in 2007 was temporary and the fair value of the securities was expected to recover as the market volatility stabilized and the demand for mortgage-backed securities returned.

As of July 31, 2010, Members United held marketable securities with a book value of $4.2 billion. Of these $4.2 billion, approximately $2.2 billion or 52 percent had fallen to non-investment grade ratings (rated BB or below) or were not rated.

Members United recorded Other Than Temporary Impairment (OTTI) charges of $608 million from 2008 through July 2010. These charges resulted in an undivided earnings deficit. Members United had to deplete its member-contributed capital to eliminate the undivided earnings deficit. The retained earnings and membership capital dollars declined from $884 million at the end of 2007 to $18 million at July 31, 2010. The retained earnings ratio declined to 0.05 percent and the capital ratio to 0.22 percent.

Members United posted a net loss of $1.2 billion in 2008, $295 million in 2009 and $11.2 million through July 2010. Estimated losses through the end of 2010 due to additional OTTI charges and the potential of selling investments at significant losses to maintain liquidity were expected to completely deplete the remaining capital and result in an undivided earnings deficit.

During this time, Members United's Net Economic Value (NEV) declined below regulatory requirements. In July 2008, the Office of Corporate Credit Unions (OCCU) approved Members United's NEV action plan for reducing unrealized losses and raising additional capital. Due to the continued market dislocation, the strategies for restoring the NEV above regulatory limits were ineffective. As of July 2010, the NEV ratio was -9.05 percent ($860 million) which was well below the 2 percent regulatory requirement.

The illiquidity of the mortgage-backed securities market severely impacted Members United's ability to provide liquidity for its own and its members' needs. The devaluation of these securities prevented Members United from selling these securities held in their portfolio, other than at distressed prices, or using them as collateral for borrowings.

Members United experienced further restrictions in its liquidity sources as U.S. Central also realized losses resulting from the declining value of their own mortgage-related securities portfolio and could not meet the liquidity demands of its retail corporate credit union members.

In October 2008, NCUA implemented the Corporate Stabilization Plan, which included several liquidity programs designed to provide funding to the corporate credit unions through the Central Liquidity Fund. The Temporary Corporate Credit Union Liquidity Guarantee Program stabilized Members United's remaining unsecured borrowing sources. NCUA stabilization efforts continued with the Temporary Corporate Credit Union Share Guarantee Program, which offered a 100 percent guarantee[9] of a corporate credit union member's excess shares[10] in a participating corporate credit union. This move appeared to restore some confidence in Members United when comparing the 42 percent decline in member

[9] The guarantee applies only to credit unions insured by the NCUSIF.
[10] The term excess shares means any shares in a qualifying share account that are in excess of the Standard Maximum Share Insurance Amount (SMSIA), which does not include Member Capital and Paid-in Capital accounts, or obligations that are not share obligations. Congress permanently increased the SMSIA to $250,000.

shares (non-capital accounts) between March and December 2008, with the 24 percent increase in 2009 and the 3 percent increase through July 2010.

On September 28, 2010, the NCUA Board created the Members United Bridge Corporate Federal Credit Union (Members United Bridge) to serve as a transition entity to provide uninterrupted services to Members United members. On that same date, the Director, OCCU, placed Members United into conservatorship.

On October 31, 2010, the OCCU received NCUA Board approval to liquidate Members United. The liquidation was necessary in order to allow OCCU to implement the corporate system resolution plan. The liquidation action was necessary to remove the privately issued mortgage-backed securities from Members United's balance sheet so the corporate system resolution plan could be executed.

Objectives, Scope and Methodology

We performed this material loss review to satisfy the requirements of the FCU Act, which requires the NCUA OIG to conduct a material loss review of an insured credit union if the loss to the NCUSIF[11] exceeds $25 million.[12] NCUA confirmed that as of February 28, 2011 the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) had recorded a loss of $400.1 million for Members United. Consequently, in accordance with the FCU Act and Chapter 3 of the NCUA Special Assistance Manual, NCUA OIG contracted with Crowe to conduct a material loss review of Members United.

Our audit objectives were to: (1) determine the cause(s) of Members United's conservatorship, (2) assess NCUA's supervision of the corporate credit union, and (3) make appropriate recommendations to prevent future losses.

We conducted this review from December 2010 to May 2011 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained as described in the Scope and Methodology

[11] On May 20, 2009, Congress enacted the Helping Families Save Their Homes Act, which amended the Federal Credit Union Act to create the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). The TCCUSF established a process for attaining funds to pay costs associated with the corporate credit union stabilization by borrowing from the U.S. Department of the Treasury and repaying the borrowed funds with assessments of all federally insured credit unions over a seven-year period. One of the costs incurred to stabilize the corporate credit unions included guaranteeing the natural person credit unions' deposits in the corporate credit unions. The payment of the insured amounts in a liquidating corporate credit union is primarily a liability of the NCUSIF. However, the TCCSUF legislation allows the NCUA Board to use the TCCSUF to make the payment.

[12] The FCU Act, 12 U.S.C. § 1790d, §216(j) requires that the OIG conduct a review when the NCUSIF has incurred a material loss with respect to a credit union. A material loss is defined as (1) exceeding the sum of $25 million and (2) an amount equal to 10 percent of the total assets of the credit union at the time at which the Board initiated assistance or was appointed liquidating agent.

section, provides a reasonable basis for our findings and conclusions based on our audit objectives.

The scope of this audit included an analysis of Members United from January 1, 2006 to September 28, 2010, the date the NCUA placed the credit union in conservatorship. Our review also included an assessment of NCUA regulatory supervision of the institution during the same period. In determining why NCUA placed Members United in conservatorship, we did not analyze any potential impact the actions of third-party providers. This included, but was not limited to underwriters, issuers, or NRSROs that may have impacted the losses sustained by Members United to the TCCUSF.

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

- We analyzed NCUA examination and supervision contact reports and related correspondence and workpapers contained within the examination databases.

- We interviewed management and/or staff from NCUA's OCCU and Office of Capital Markets (OCM) and reviewed NCUA guides, policies and procedures, as well as NCUA Call Reports (Corporate 5310 Reports).

- We reviewed Members United data and correspondence maintained at the NCUA in Alexandria, VA as provided to Crowe by NCUA.

Crowe relied primarily upon the materials provided by the NCUA OIG and NCUA OCCU officials, including information and other data collected during interviews. We relied on our analysis of information from management reports, correspondence files, and interviews to corroborate data obtained to support our audit conclusions. We conducted interviews to gain a better understanding of decisions made regarding the activities of credit union management and the NCUA's supervisory approach, and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the NCUA and Members United. Crowe relied on the information provided in the interviews without conducting additional specific audit procedures to test such information.

Results in Detail

We determined that Members United's management and Board of Directors (Board) contributed to the conservatorship and resulting material loss. Further, we determined that the NCUA[13] could have reduced the loss to the TCCUSF had they adequately assessed and more aggressively pursued resolution to issues related to Members United's high credit risk and concentration in its investment portfolio.

A. Why NCUA Conserved Members United Corporate Federal Credit Union

Members United conservatorship can be attributed, in part, to inadequate management and Board oversight that exposed the credit union to excessive amounts of financial risk due to significant holdings of private label mortgage-backed securities including subprime and Alt-A mortgage-related securities. Members United's management and Board failed to identify and manage this risk prior to the severe market value decline that occurred starting in mid-2007 and became more severe in 2008 and 2009. Specifically, in regards to managing the investment portfolio, Members United management:

- Did not establish investment sector concentration limits in a timely manner;
- Relied heavily on ratings assigned to the securities by Nationally Recognized Statistical Rating Organizations (NRSRO) when purchasing securities for the portfolio and when monitoring the amount of credit risk in the investment portfolio;
- Relied on monoline insurers to provide credit enhancement to a portion of the non-agency mortgage-backed securities in the portfolio;
- Did not properly identify and monitor credit risk exposure in the underlying mortgage loan collateral of the mortgage-backed securities held in the investment portfolio; and
- Relied on the corporate credit union structure to provide financial strength and liquidity. Members United invested excess funds at U.S. Central Federal Credit Union for short-term liquidity needs and had its only line of credit with U.S. Central. U.S. Central also had a concentration of mortgage-backed securities in its portfolio and experienced its own liquidity problems due to losses related to these mortgage-backed

[13] Primary supervisory responsibility of corporate credit unions lies with OCCU. In addition, OCM develops agency policies and procedures related to credit union investments and asset liability management. OCM also assists OCCU examiners in evaluating investment and asset liability management issues in credit unions. We reviewed OCM's role in the examination of Members United during the August 2005 through July 2009 examinations and determined that prior to the August 2007 examination, OCM's assistance was primarily used for reviewing Asset/Liability Management. The August 2007 examination marked the first significant involvement of OCM staff in reviews specifically addressing the concentration and credit quality of MU's investment portfolio, which was near the start of the market dislocation.

securities. Members United did not adequately evaluate the risk of investing with and limiting its borrowing facilities with U.S. Central.

These factors led to increased exposure to higher risk investments largely secured by subprime and Alt-A mortgage loan collateral, including exposure at U. S. Central due to its significant concentration of mortgage-backed securities. The concentration in mortgage-backed securities left Members United vulnerable to downturns in national and local economic conditions and the decline in the residential real estate market. Members United's Board and management failed to adequately diversify the investment portfolio and secure other sources of liquidity outside of the credit union structure.

The consequences of Members United's management and Board's inadequate oversight were:

- Substantial unrealized losses recorded to capital related to the deterioration of the market value of mortgage-backed securities held in Members United's investment portfolio. According to Members United's 2007 audited financial statements, unrealized losses in the investment portfolio continued to grow as Members United's management and Board believed the securities were not other-than-temporarily impaired and did not record the fair market losses against income. Members United management subsequently recorded these losses in conjunction with the December 31, 2008, audited financial statements.

- Market value declines and ratings downgrades severely limited Members United's ability to sell mortgage-backed securities in the marketplace, hampering liquidity sources necessary to meet member credit union needs. Members United's ability to obtain funding sources on reasonable terms and costs became difficult due to the declining value of the securities portfolio which restricted them from having securities available to pledge against borrowings, leading to an unsatisfactory liquidity position.

- Downgrades to Members United's commercial paper credit rating eroded public confidence in Members United's debt, impeding efforts to issue debt to fund liquidity.

- Economic insolvency as Members United's NEV deteriorated due to the market value declines in the investment portfolio.

- In September 2010, NCUA placed Members United in conservatorship. In order to maintain public confidence in the corporate credit union system a long-term legacy asset resolution plan was executed by NCUA. This plan isolated Members United's legacy assets from assets necessary to continue normal member services. NCUA created Members United Bridge to hold the

non-legacy assets and immediately place the credit union into conservatorship.

Table 1 (below) summarizes selected financial information for Members United:

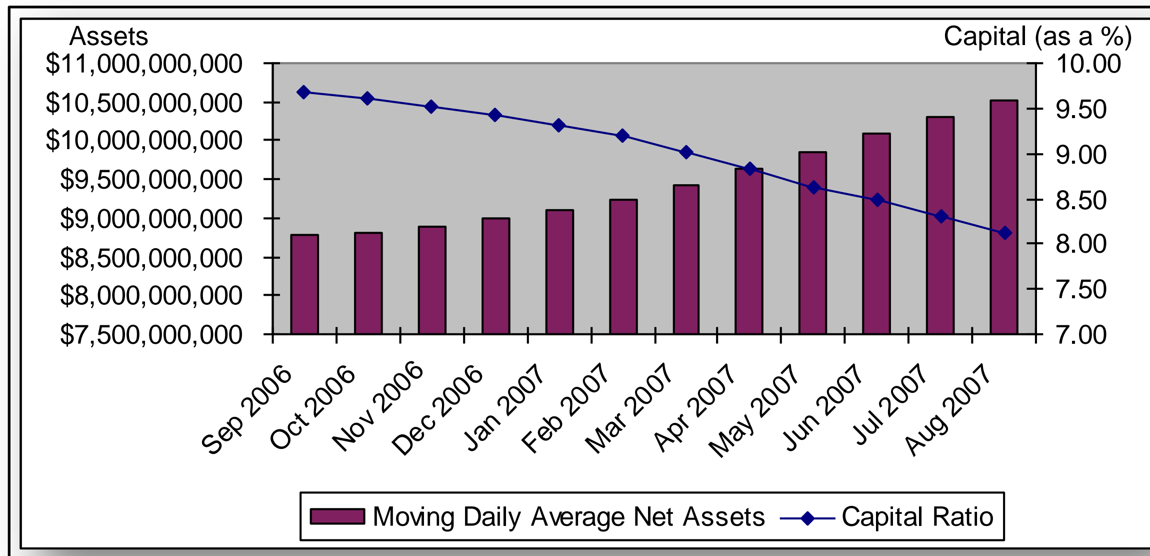
Table 1

Key Financial Data and Ratios ($000's)				
	12/31/2006	**12/31/2007**	**12/31/2008**	**12/31/2009**
Total Assets	10,086,892	14,047,693	7,955,478	8,367,677
Shares and Certificates	8,680,145	10,108,750	7,457,483	9,238,127
Interest-earning Deposits	4,598,336	6,359,316	1,359,153	726,641
Investments (amortized cost)	4,762,356	7,074,076	5,264,277	4,702,041
Accumulated Unrealized Gains (Losses) from Available for Sales Securities	1,382	(355,905)	(1,172,917)	(1,117,214)
Borrowings and Repurchase Agreements	415,397	3,191,760	1,879,095	166,312
Total Member's Equity (Deficit)	874,722	526,251	(1,534,212)	(1,116,260)
Net Economic Value	848,719	506,055	(1,260,525)	(1,116,417)
Regulatory Capital Ratio	9.40%	7.42%	(2.80%)	0.28%
Retained Earnings Ratio	3.30%	2.68%	(7.72%)	(1.37)%
Net Income (loss)	6,486	15,403	(1,208,210)	(253,512)

Source: Audited financial statements

As noted in Table 1, Members United's assets grew approximately 39 percent between December 31, 2006 and December 31, 2007. Beginning in late-2006, the significant asset growth began to outpace capital growth, resulting in declines to Members United's capital ratio. Chart 3 (below) shows the effect of the significant asset growth over the period from September 2006 through August 2007, measured by Daily Average Net Assets (DANA), on Members United's capital ratios.

Chart 3: Effect of Asset Growth on Capital Ratios



Source: August 2007 examination report

As stated in the August 2007 NCUA examination report, due to the increase in DANA, both the retained earnings and capital ratios declined from the August 2006 examination. During this time, the retained earnings ratio declined from 3.36 percent to 2.87 percent and the capital ratio declined from 9.71 percent to 8.13 percent. Although the capital measures declined, actual dollars in undivided earnings increased over the period but at a slower rate than DANA.

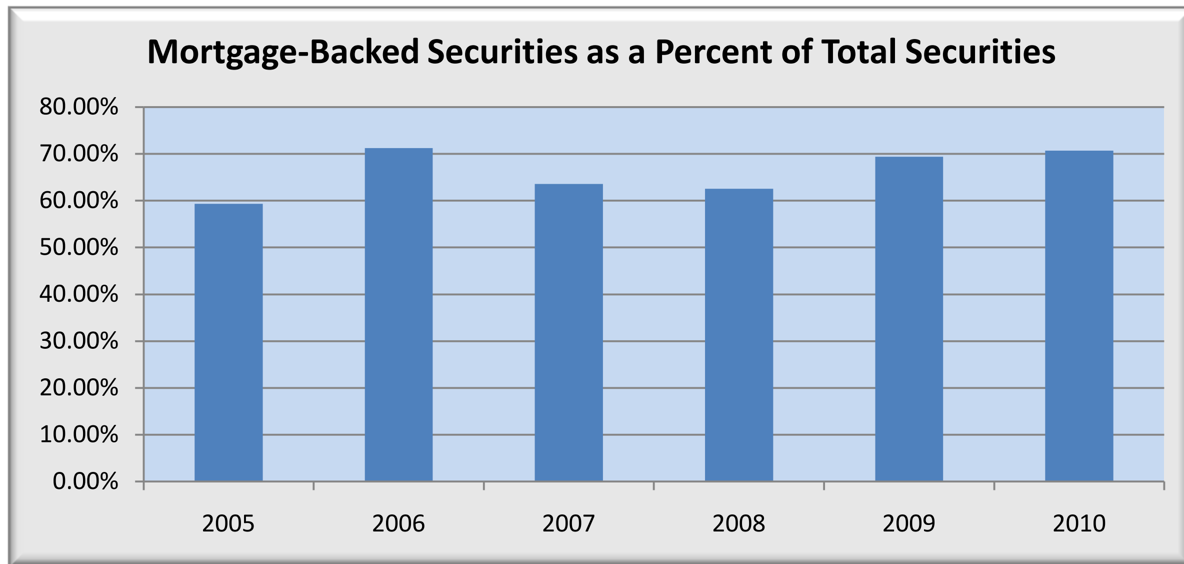
Subsequent to the merger between Mid-States and Empire, Members United struggled to control its operating expenses and restore profitability to levels experienced prior to the merger. Although operating expenses as a percent of DANA did decline, they remained above their competitors. This resulted in decreased profitability and less contribution to capital from earnings.

Members United's Investment Strategy

<u>Mortgage-Backed Securities</u>

During the period from 2005 through September 2010, mortgage-backed securities represented the majority of Members United's investment securities portfolio at approximately 60 to 70 percent of the total portfolio. In 2006, mortgage-backed securities represented a larger percentage of the portfolio, increasing to 71percent of the total portfolio, due to the merger with Empire Corporate Federal Credit Union. In 2007 and 2008, mortgage-backed securities declined to approximately 63 percent of the investment portfolio but rose to approximately 70 percent in 2009 and 2010 as non-mortgage-backed securities either matured, had principal paid down, or were sold for liquidity purposes. Chart 4 (below) provides mortgage-backed securities as a percentage of total investments.

Chart 4:



Source: NCUA 5310 Report as of December 31st and September 30, 2010

Due to the market dislocation, many of Members United's securities began to show signs of deterioration in market value. As of December 31, 2007, Members United reported net unrealized losses on securities of $356 million, compared with the prior year in which a small unrealized gain was recorded. These unrealized losses were identified as being primarily related to mortgage-backed securities, which represented the highest percentage of the portfolio. Members United's 2007 financial statements revealed that management decided not to recognize these unrealized losses into income at that time because management believed the securities were of high credit quality (i.e., investment grade of AAA or AA) and Members United had the intent and ability to hold these securities. Members United's management believed that the market dislocation that occurred in 2007 was temporary and that the fair value of the securities was expected to recover as the market volatility stabilized and the demand for mortgage-backed securities returned.

Prior to the market dislocation in 2007, the majority of Members United's investment securities portfolio consisted of highly rated, investment grade securities (i.e., rated at BBB or higher). The August 31, 2007 examination report indicated that 94 percent of Members United's long-term holdings carried a rating of BBB or higher, with approximately 83 percent of the securities carrying a rating of AAA. As illustrated in Table 2 (below), securities carrying a rating of AAA declined to 66 percent and then to 42 percent as of the May 31, 2008 and July 31, 2009 examination reports, respectively. As of July 31, 2009, 26 percent of the securities carried a rating below investment grade.[14]

[14] Members United was granted Part II Expanded Authority on September 11, 2007. Members United had not purchased any investments rated BBB; however, due to downgrades, Members United held investments rated BBB or below.

Table 2:

Investment Portfolio Breakdown by Credit Rating									
	August 31, 2007			May 31, 2008			July 31, 2009		
	Amount	No.	%	Amount	No.	%	Amount	No.	%
AAA	$5,717,233,457	324	82.78	$4,382,982,308	260	65.68	$2,345,509,407	169	41.88
AA	$652,637,261	54	9.45	$1,358,299,826	88	20.36	$605,031,850	46	10.80
A	$131,500,000	10	1.90	$260,222,786	18	3.90	$412,149,678	29	7.36
BBB	$10,000,000	2	0.14	$164,842,121	18	2.47	$803,240,874	58	14.34
BB	-	0	0.00	$141,960,077	7	2.13	$196,232,583	12	3.50
B	-	0	0.00	-	0	0.00	$199,684,736	8	3.57
CCC	-	0	0.00	-	0	0.00	$608,426,836	32	10.86
CC	-	0	0.00	-	0	0.00	$74,627,241	8	1.33
D	-	0	0.00	-	0	0.00	$44,480,322	2	0.79
Unrated /Not Rated	$395,495,845	90	5.73	$364,506,834	93	5.46	$310,907,318	87	5.55
Total	$6,906,866,563	480	100 %	$6,672,813,952	484	100 %	$5,600,290,845	451	100 %

Source: Reports of Examination

The August 31, 2007 Examination report noted that of the $4.9 billion in non-agency mortgage-backed securities held in the portfolio, Members United had an uninsured subprime exposure of $1.2 billion and $2.1 billion in Alt-A rated securities. As of December 31, 2008, of the $3.9 billion of non-agency mortgage-backed securities held, $1.0 billion were considered subprime and $1.7 billion were rated Alt-A. As of December 31, 2009, subprime non-agency mortgage-backed securities equaled $868 million and Alt-A non-agency mortgage-backed securities equaled $1.6 billion. Table 3 (below) illustrates the composition of Members United's non-agency mortgage-backed securities.

Table 3:

Composition of Non-Agency Mortgage-Backed Securities			
(in $000's)	**August 31, 2007**	**December 31, 2008**	**December 31, 2009**
Non-agency, mortgage-backed securities	$4,869,375	$3,933,346	$3,290,160
Prime	33%	30%	26%
Sub-prime	25%	26%	26%
Alt-A	42%	44%	48%

Source: August 2007 Report of Examination and Members United Portfolio Update (unaudited) as of December 31, 2008 and 2009

Members United's management relied heavily on monoline insurers to provide credit enhancement to a portion of the non-agency mortgage-backed securities in the portfolio to mitigate credit risk in the investment portfolio. Once the securities deteriorated in value, the credit enhancement provided by the monoline insurers proved to be largely worthless. Monoline insurers did not possess the ability to honor the guarantee on the securities, so Members United's exposure to these insurers proved costly. We believe that Members United did not fully evaluate the level of credit enhancement provided by the monoline insurers or consider the insurers ability to honor the substantial guarantees.

Table 4 (below) depicts Members United's exposure to these insurers as of the 2007 and 2008 examination dates.

Table 4:

Exposure to Monoline Insurers		
Guarantor	**August 31, 2007**	**May 31, 2008**
AMBAC	$443,151,656	$418,488,426
CIFG	$24,600,006	$19,005,170
FGIC	$300,989,402	$225,945,306
FSA	$130,354,064	$114,501,739
MBIA	$489,015,989	$417,507,999
XLCA/SGI	$75,781,114	$64,111,161
Total	**$1,463,892,231**	**$1,259,559,801**

Source: Reports of Examination

The credit ratings of the monoline insurers dramatically declined from the August 2007 examination to the May 2008 examination, indicating that the insurer may not be able to honor the guarantee issued on the mortgage-backed securities purchased. Table 5 (below) details the credit ratings of the monoline insurers as of the 2007 and 2008 examination dates.

Table 5:

Monoline Insurer Credit Ratings				
	August 31, 2007		May 31, 2008	
	Moody's	S & P	Moody's	S & P
AMBAC	Aaa	AAA	Aa3	AA
CIFG	Aaa	AAA	Ba2	A-
FGIC	Aa2	AA	Caa2	B
FSA/AGM	Aaa	AAA	Aaa**	AAA
MBIA	Aaa	AAA	A2	AA
XLCA/SGI	Aaa	AAA	B2	BB

*** On review by Moody's for possible downgrade. Source: Reports of Examination*

The August 31, 2008 examination report further indicates that, as a direct result of the downgrades in the credit ratings of the monoline insurers, Members United filed investment action plans (IAPs)[15] for 11securities.

As of December 31, 2009, net unrealized losses on the investment securities portfolio totaled approximately $1.1 billion, or the equivalent of 47 times capital. From December 31, 2008 through December 2009, Members United recorded approximately $579 million in charges against income as Other-than-Temporary Impairment (OTTI) related to the deterioration in the value of the investment securities portfolio. In determining OTTI for 2009, Members United placed no reliance on the insurance provided by XCLA/SGI, FGIG and CIFG, partial reliance on AMBAC (25%) and maintained full reliance with FSA/AGM and MBIA as they continued to be highly rated and timely paying claims.

Under the NCUA expanded authorities, granted to Members United under Part 704, Members United was allowed to purchase and/or hold securities with long-term credit ratings of BBB or higher. As of December 31, 2009, Members United owned 153 securities with a par value of $2.4 billion that had been downgraded below the minimum rating requirement. As a result of these credit downgrades, Members United filed the required IAPs with the NCUA requesting permission to continue to hold the downgraded securities.

[15] When a corporate credit union is in possession of an investment that fails to meet one or more of the NCUA requirements for permissible investments, the credit union is required to file a written investment action plan (IAP) with the OCCU Director within 30 days of failure. The IAP addresses the investment's characteristics and risks, process for obtaining and evaluating market value and cash flows, how the investment fits into the credit union's asset/liability strategy, the impact of selling or holding the investment to the credit union's earnings, liquidity and capital under different interest rate scenarios, and whether the investment may again meet investment requirements. The OCCU Director may approve the plan or require a different course of action.

Deposits at U.S. Central

Members United had a significant amount of funds invested at U.S. Central. Table 6 (below) depicts the different investment types and amounts:

Table 6:

Members United Investments at U.S. Central						
	Balance at 8/31/2007	%	Balance at 5/31/2008	%	Balance at 7/31/2009	%
DAILY SHARES	$930,808,321	22.45	$33,695,720	0.52	$355,693,458	27.04
TIME CERTIFICATES	$1,768,132,661	42.65	$2,356,724,751	35.98	$552,168,329	41.98
AMORTIZING CERTIFICATES	$64,040,441	1.54	$51,893,489	0.79	$33,629,441	2.56
CALLABLE CERTIFICATES	$559,317,000	13.49	$303,836,000	4.64	$44,220,000	3.36
FRAPS[16]	$605,000,000	14.59	$258,000,000	3.94	$255,000,000	19.39
MEMBER CAPITAL SHARES	$181,619,204	4.38	$228,191,233	3.48	$74,561,209	5.67
PAID-IN CAPITAL	$36,980,000	0.89	$38,080,000	0.58	$0	0.00
FED FUNDS SOLD TO U.S. Central	0	0.00	$3,279,818,294	50.07	$0	0.00
TOTAL	$4,145,897,627	100 %	$6,550,239,487	100 %	$1,315,272,437	100 %

Source: Reports of Examination

Because U.S. Central had a significant amount of funds invested in mortgage-backed securities, these investments at U.S. Central represented indirect credit exposure related to investments in mortgage-backed securities. Members United, when determining concentration limits in mortgage-backed securities, did not consider this indirect exposure. We learned the CEO of Members United was also on the Board of Directors for U.S. Central. As a result, we believe the CEO should have been fully aware of U.S. Central's concentration in mortgage-backed securities and the additional level of concentration risk. As of February 28, 2011, Members United's losses at U.S. Central totaled $308.2 million.

Members United reduced its exposure to U.S. Central from May 31, 2008 to July 31, 2009. We determined a portion of this reduction was related to Members United's loss of Paid-in-Capital and depletion of their Members Capital Shares at U.S. Central due to losses recorded related to the significant decline in market value of U.S. Central's RMBS portfolio. Although, investments at U.S. Central

[16] FRAPS is a U.S. Central floating rate Certificate of Deposit program – Floating Rate Asset Program.

added to the overall RMBS exposure at Members United, the Share Guarantee put in place by the NCUA mitigated the impact of this exposure. As previously explained, the Share Guarantee Program offered a 100 percent guarantee of a corporate credit union member's shares in excess of the SMSIA.

Diminished Liquidity

To meet its short-term liquidity needs, Members United relied primarily on funds invested and borrowed from U.S. Central. As of December 31, 2006 and 2007, funds invested at U.S. Central represented just over 40 percent of Members United's total assets. Prior to 2008, Members United had established lines of credit with U.S. Central including a $3 billion advised line of credit and a $300 million committed line of credit. Members United had no other lines of credit established with any other corporate credit union or other financial institution.

In addition, U.S. Central authorized Members United to issue up to $1 billion in commercial paper rated A-1+/P-1. Other borrowings included securities sold under agreements to repurchase, deposits accepted under an agreement with the State of Illinois and fed funds purchased from members. Members United also participated in the Federal Reserve Bank's term investment option program and had borrowed up to $300 million from this program prior to 2008.

As U.S. Central began to experience liquidity constraints due to losses resulting from the declining value of their own mortgage-related securities portfolio, Members United looked for additional sources of liquidity. During 2008, Members United became a member of the Federal Home Loan Bank of Chicago. As a member of the FHLB Chicago, Members United was provided with a line of credit for $240 million. Members United also established reserves at the Federal Reserve to become a full member and allowing it access to the discount window. Additionally, Members United established a deposit relationship with Citibank in an effort to obtain future lines of credit and established a line of credit with Pacific Coast Bank.

Members United's capacity to borrow funds was further curtailed as the value of Members United's RMBS portfolio continued to decline and their credit ratings were downgraded by the nationally recognized statistical ratings organizations. In late 2008, both Standard and Poor's and Fitch Rating Service (Fitch) placed Members United on their "negative watch" list. In 2009, Members United no longer considered issuing commercial paper as a source of liquidity due to the downgrades to their credit ratings and therefore, requested Standard and Poor's, Moody's and Fitch to withdraw their commercial paper ratings.

As previously noted, in October 2008, NCUA implemented the Corporate Stabilization Plan,[17] which included several liquidity programs designed to provide

[17] The NCUA's Corporate Stabilization Program, approved in January 2009, consisted of a series of actions designed to add stability to and strengthen corporate credit unions. The purpose of these actions was to maintain liquidity, strengthen capital, and restructure the corporate system.

funding to the corporate credit unions. The Corporation Stabilization Program included the following efforts by the NCUA:

- Established a Temporary Corporate Credit Union Liquidity Guarantee Program by which the Insurance Fund guaranteed repayments of unsecured debt issued by a corporate between October 16, 2008 and June 30, 2009;

- Established a Temporary Corporate Credit Union Share Guarantee Program to build member confidence in the credit union system. The Share Guarantee extended the existing Insurance Fund coverage for corporate credit union's member share accounts beyond the $250,000 statutory limit to cover the entire balance of each such account.

The Temporary Corporate Credit Union Liquidity Guarantee Program stabilized Members United's remaining unsecured borrowing sources. The Temporary Corporate Credit Union Share Guarantee Program restored some confidence in Members United when comparing the 42 percent decline in member shares between March and December 2008, with the 24 percent increase in 2009 and the 3 percent increase though July 2010.

Management and Board Oversight of Members United's Investment Strategy

Based on our review of Members United's Policies, Asset/Liability Committee (ALCO) reports and meeting minutes, and discussions with examiners, we determined Members United's management and Board did not practice sound risk management and created an environment of excessive spending, rapid expansion, increased concentration risk, and a flawed overall strategic plan. Members United's management permitted significant holdings of mortgage-backed securities without fully understanding the credit risks associated with such complex investments and the related risk this concentration posed on the ability of Members United to serve its primary purpose of being a liquidity source for its members. The investment portfolio had a significant level of credit risk associated with the large concentration of mortgage-backed securities and was not adequately identified and managed by its management and Board.

In addition, Members United management did not establish prudent sector concentration limits to limit exposure to the underlying assets related to mortgage-backed securities until late 2008. Management and the Board placed over-reliance on the high credit ratings assigned by NRSRO that kept them from performing further evaluation of the concentration and credit risks associated with their investment purchases. In addition, management placed reliance on monoline insurers and allowed monoline insurance to serve as a significant credit enhancement to securities. This monoline insurance turned out to provide very little, if any, support for a significant portion of the mortgage-backed securities as they rapidly deteriorated in value.

Members United's ALCO minutes indicated management was focusing on yields, to allow them to service natural person credit unions. As previously noted, the merger of Mid-States and Empire Credit Union effective June 30, 2006 created Members United. From December 31, 2006 through December 31, 2007, total assets grew by approximately 39 percent.

We determined the March 2007 ALCO minutes also reflected discussion related to the stress in the markets related to subprime mortgage-backed securities. Management's response to market deterioration was that the declines in the securities were temporary and they expected the values to recover. Even though the market had already started to display signs of stress, management continued to purchase mortgage-backed securities until October 2007. The March 2007 ALCO report indicated the following:

> "*Portfolio activity continues to consist largely of floating rate securities purchases for the overnight book and improving returns on current excess cash balances. Approximately $650 million in investment purchases have been made during the month of February and over $1 billion has been made year-to-date, with most purchases consisting of AAA residential ABS securities. The best relative value continues to reside in Alt-A collateral types, especially senior mezzanine AAA classes.*"

In June 2007, management noted the following during the ALCO meeting:

> "*Purchase activity has slowed somewhat in May with lower asset-backed securities (ABS) supply and recent changes in internal credit underwriting requirements for residential mortgage securities. As a result, purchases of USC term investments have increased and are expected to remain a greater portion of investment allocations over the near term. In addition to U.S. Central Federal Credit Union (U.S. Central) investments, purchase activity in commercial mortgage-backed securities (CMBS) investments is also expected to remain robust.*"

As management began increasing their investments at U.S. Central, they were also increasing their exposure and concentration in mortgage-backed securities. We found no evidence that Members United considered the fact that their investments in U.S. Central were exposed to the same market factors as their own RMBS, because of U.S. Central's investment in similar products. It was not until October 2007 when the ALCO minutes reflected that management did start to recognize concerns with the market dislocation and national economy. Per the October 2007 ALCO package:

> "*Investment purchases have come to a virtual halt, as almost all member deposits and portfolio runoff is currently being maintained in cash. We are also actively tapping all available financing sources to*

> *ensure their availability through what is a typical seasonal trough in member liquidity. These transactions include term borrowings from U.S. Central, a limited number of term reverse repurchase trades, daily issuance in overnight and term commercial paper, periodic purchases of Fed Funds, and active participation in the TIO market."*[18]

The decisions and discussions reflected in the ALCO minutes throughout 2007 show management and the Board's lack of understanding regarding Members United's risk related to the emerging market concerns regarding subprime and Alt-A mortgage-backed securities, as well as Members United's significant exposure in these types of securities. Their inability to adequately identify and manage this risk prevented them from appropriately addressing the risk and taking steps to possibly divest some of the assets and reduce exposure to further market value declines and subsequent losses.

As the market dislocation continued, management initially failed to recognize how serious the deterioration in the securities portfolio was and its potential impact on the credit union's ability to remain solvent. For example, in the May 2008 report of examination, examiners noted management's focus on creating a new headquarters building for the company. We believe management should have been more concerned with addressing the mounting losses in their holdings of RMBS as well as deterioration in their investments in U.S. Central.

Our review of ALCO minutes noted that Members United did not establish any concentration limits until October 2008, at which point the securities portfolio was overly concentrated in mortgage-backed securities. The July 2009 ALCO package revealed that although management had created sector limits in October 2008, they did not monitor and report on the concentrations until July 2009. As noted in the excerpt from the July 2009 ALCO minutes below, management knew they exceeded sector limits as soon as they created them and was attempting to work towards long-term goals of complying with recently created policies.

> *"May 2009 month-end holdings in the non-agency residential mortgage-backed sector exceeded limits established in Policy (2.VIII.C.10.a and 2.VIII.C.b). Results showed nonagency [sic] RMBS as a portion of Total Investments at 41.57% versus the policy limit of 20%, and non-agency RMBS as a portion of Total Marketable Securities at 62.34% versus the policy limit of 40%.*
>
> *Management Rationale: It was recently discovered that this policy violation failed to be included in prior compliance reports. This violation is the result of the creation and implementation in October 2008 of non-agency RMBS sector limits that were significantly below current non-agency RMBS holdings. While these limits knowingly*

[18] The Term Investment Option (TIO) is an investment opportunity offered to Treasury Tax and Loan (TT&L) participants. The Treasury will frequently auction excess operating funds to participants for a fixed term and rate determined through a competitive bidding process.

created immediate policy violations, the intent behind the sector limits was to create a long-term target within which total non-agency RMBS risk exposures would be managed."

The 2009 NCUA report of examination also pointed out corporate governance issues. While the corporate governance issues in and of themselves are not the primary factor that led to Members United's conservatorship, these issues reveal the lack of management and the Board's focus on the well-being of the credit union. Examiners noted the following items in the 2009 report of examination:

- Members United maintained a headquarters in Warrenville, Illinois and a major operations center in Albany, NY. Each of these corporate offices had significant independent functions, which led examiners to question the efficiency of the structure. Examiners believed the organization would be better served with one true location serving as corporate headquarters in which the CEO could lead the organization and spend the majority of his time. The CEO essentially split his time between Albany and Warrenville, which caused the examiner to further question the structure.

- The examination included several incidences where Members United violated policy on limits and approvals required for numerous expenditures such as life insurance, credit card reimbursements, and other expenses for travel for the CEO.

Additionally, although not specifically noted in a report of examination, the CEO of Members United was also the Chairman of the Board at U.S. Central. Although this was in-line with how corporate credit unions and the Boards are structured, there are governance issues and inherent conflicts of interest with this practice, as evidenced by Members United's investments in U.S. Central as discussed above.

B. NCUA Supervision of Members United Corporate Federal Credit Union

Supervisory Background

Members United, previously Mid-States prior to the merger with Empire, consistently received Corporate Risk Information System (CRIS).[19] Composite Risk Ratings of 2 for both Financial Risk and Risk Management during the three annual examinations prior to May 2008 examination, when the composite risk ratings were downgraded to a 3. In the 2005 through 2007 reports of examination, examiners

[19] The Corporate Risk Information System (CRIS) is used to measure and report risk in the corporate credit union system. As such, CRIS separates the assessment and communication of quantitative financial risk from qualitative operational and managerial risks and assign individual Financial Risk and Risk Management Composite and Component ratings. The Composite Financial Risk rating and its components represent the degree of risk to Capital and Earnings. The ratings are defined as follows: 1 – Low Risk; 2 – Moderate (Managed) Risk; 3 - High Risk; 4 – Excessive Risk; and 5 – Critical Risk. The Composite Risk Management rating and its components represent the Quality of Policy or Risk Management Process. The ratings are defined as follows: 1 – Exceptional; 2 – Acceptable; 3 – Minimally Acceptable; 4 – Inadequate; and 5 – Seriously Deficient.

noted strong capital levels in relation to risk profile, strong earnings performance, low investment credit risk and NEV volatility, ample liquidity and alternative funding sources and effective risk management practices as support for the 2 ratings.

The downgrades to both the Composite Financial Risk and Composite Risk Management ratings from 2 to 3 during the May 2008 examination were made based on downgrades to each of the five components of the Financial Risk Composite rating. Examiners cited Members United's increased risk exposure resulting from significant concentrations in RMBS securities and high accumulated unrealized losses on available for sale securities resulting from the market dislocation. Examiners further identified low capital levels in relation to this increased credit risk, negative trends in the NEV ratio, NEV exposure and NEV volatility measures due to continued securities devaluation and increased liquidity risk due to current market conditions. In addition, growth in daily average assets continued to outpace growth in capital, which further resulted in deterioration of capital measurements.

The most significant downgrades as a result of the May 2008 examination were to the Liquidity Risk and Credit Risk components. Liquidity Risk was previously rated a 1 and was downgraded to a 4 due to the inability for Members United to sell a majority of its marketable securities without experiencing substantial losses and the inability to pledge marketable securities as a liquidity source due to pricing of the securities at that time. Credit Risk was previously rated a 2 and was downgraded to a 4 due to credit rating downgrades on the RMBS and monoline insurers who provided credit enhancement to the RMBS that was now diminished.

Examiners also downgraded five of the seven components of the Risk Management Composite Rating, including Capital Accumulation Planning, Liquidity Risk Rate Management, Credit Risk Management, Operating Risk and Board Oversight and Compliance. Examiners noted that although capital planning, budgeting, NEV modeling and liquidity management is comprehensive and sufficient given normal market conditions, current methods for monitoring exposures to credit and liquidity risk may not be robust enough given the unprecedented decline in market values of the significant holdings of RMBS.

As of June 30, 2008, accumulated unrealized losses exceeded Members United's capital. Based on this fact, examiners concluded,

> *"The board and operating management through policies and practices have positioned the corporate into an untenable liquidity and operational position. The lack of reasonable sector limits and an aggressive structuring of the portfolio in mortgage related securities contributed to the current operating difficulties. In the past corporate management has indicated comfort in the fact the investment portfolio was diversified by issuer or trust and type of RMBS. These limitations have proven ineffective. Adequate sector limitations must be*

established to ensure this type of concentration in the investment portfolio does not recur."

As a result of the May 2008 examination, examiners issued a Document of Resolution (DOR) stating that Members United's current and allowable RMBS concentrations were excessive. The DOR called for the following action from management:

"Reevaluate the appropriateness of the existing concentration limit structure and the individual concentration limits within that structure given the recent credit and liquidity crisis in the RMBS markets. Special attention should be paid to the Non-Agency RMBS sector. It should be noted Members United's ability to retain existing investments is solely governed by board established diversification limits at time of purchase."

Further downgrades were made in April 2009 as a result of routine supervision contacts from the period of November 2008 through March 2009. Both the Financial Risk and Risk Management Composite ratings were downgraded from 3 to 4 due to further erosion of Members United's financial condition caused largely by the continued deterioration in the value of it RMBS and management and the Board's inability to implement strategies to manage the risks related to the RMBS concentration during the market dislocation.

The Financial Risk Composite rating was eventually downgraded from a 4 to a 5 as a result of the July 31, 2009 annual examination. Downgrades were made to three of the five components of the Financial Risk Composite Rating, including Empirical Capital Level, Earnings Risk and Credit Risk. Each of these components was downgraded from 4 to 5 due to the fact that retained earnings and member paid-in-capital (PIC) had been extinguished, members' capital was substantially depleted, and significant losses were recognized due to OTTI charges recorded against earnings.

The Risk Management Composite rating remained unchanged although Capital Accumulation Planning, Liquidity Risk Rate Management and Board Oversight and Compliance were downgraded from 3 to 4 while Credit Risk Management was downgraded from 4 to 5. These downgrades were based on inadequate capital planning and expense reduction, limited liquidity sources, governance issues related to the CEO's performance and business expenses. Several DORs were issued related to corporate governance, investment credit risk, asset/liability management, accounting for capital leases, information security, funds transfer, item processing and Automated Clearing House transactions.

Table 7 (below) provides the history of NCUA examinations and resulting CRIS Composite ratings from 2005 through July 2009:

Table 7:

NCUA Examination History						
Report Issuance Date	**09/17/09**	**04/08/09**	**09/04/08**	**12/06/07**	**12/07/06**	**12/12/05**
Exam As of Date	**07/31/09**	**12/31/08**	**05/31/08**	**08/31/07**	**08/31/06**	**08/31/05**
Exam Type	**Annual**	**Routine Contact**	**Annual**	**Annual**	**Annual**	**Annual**
Composite Financial Risk	**5**	**4**	**3**	**2**	**2**	**2**
Component:						
Empirical Capital Level	5	4	3	2	1	2
Earnings Risk	5	4	3	2	2	2
Interest Rate Risk	3	3	3	2	2	2
Liquidity Risk	4	4	4	1	1	1
Credit Risk	5	4	4	2	2	1
Composite Risk Management	**4**	**4**	**3**	**2**	**2**	**2**
Component:						
Capital Accumulation Planning	4	3	3	2	2	2
Profit Planning and Control	4	4	2	2	2	2
Interest Rate Risk Management	2	2	2	2	2	2
Liquidity Risk Management	4	3	3	2	1	1
Credit Risk Management	5	4	3	2	2	2
Operating Risk	3	4	4	2	2	2
Board Oversight, Audit & Compliance	4	4	3	1	2	2

Source: Reports of Examination

Supervisory Efforts to Identify and Correct Key Risks Were Not Adequate or Timely

We determined NCUA did not timely or adequately identify key risks related to Members United's investment portfolio. Specifically, NCUA failed to identify and require corrective action on the credit risk in Members United's investment portfolio related to the concentration of mortgage-backed securities until May 2008. By that time, severe market dislocation had occurred and Members United's significant holdings of RMBS were experiencing rapid declines in value and were increasingly illiquid. We believe stronger, more-timely supervisory actions and restrictions on concentrations could have provided opportunities for reasonable divestiture of investment securities without incurring significant realized losses, which eventually caused the NCUA to conserve Members United.

We also determined the lack of adequate and timely oversight of Members United is partially attributable to NCUA not having appropriate regulatory support, such as specific investment concentration limits, to adequately address Members United's concentration risk and increasing exposure to credit, market, and liquidity risks. It became apparent that examiners largely lacked the regulatory leverage to limit or stop Members United's purchase of sub-prime RMBS, which would have likely mitigated the rapid deterioration of Members United's financial condition and mounting investment losses as a result of the extended credit market dislocation.

Prior to the August 2007 examination, NCUA noted no significant concerns regarding Members United's investment function or its strategy to purchase large amounts of securities backed by subprime RMBS, consistently citing the following conclusion in examination reports:

> *"The portfolio remains composed of highly rated, acceptably diversified, liquid financial assets consistent with Members United's Expanded Authorities. Additionally, the depth and frequency of investment purchase and investment credit analysis is commensurate with risk exposures. The investment portfolio continues to present low to moderate liquidity, credit, and interest rate risks."*

We determined the August 2007 examination was the first time the OCCU examiners commented on the level of sub-prime mortgage-backed securities held in Members United's investment portfolio. The examination report indicated that Members United held approximately $4.9 billion of mortgage-backed securities in its portfolio as of August 31, 2007. Of these securities, $1.2 billion were considered sub-prime (FICO score under 680) and $2.1 billion in Alt-A mortgage-backed securities as of August 31, 2007, representing a total of 67 percent of the mortgage-related securities held in the portfolio. Examiners noted that the sub-prime mortgage exposure and underlying collateral value of these securities is adequately monitored and capital was sufficient to cover the exposure even under stressed conditions.

The August 2007 examination report also indicated that Members United's net retained earnings declined from approximately $371.6 million as of August 31, 2006, to approximately $258.6 as of August 31, 2007 as a result of the Accumulated Unrealized Loss on Available for Sale Securities increasing from approximately $950,000 to approximately $124.3 million. We found no evidence of supervisory concerns being raised or DORs issued as a result of the August 2007 examination despite the market dislocation and deterioration of the sub-prime mortgage sector that began in mid-2007 and Member United's concentration of mortgage-backed securities held in its portfolio. Examiners cited the following conclusion in the examination report:

"There have not been any material changes in the composition of the investment portfolio. Practices and personnel in the ALM/Lending (Investment) and Fixed Income Research have remained relatively stable. No issues were noted with the review or trends. Members United was proactive in keeping its members informed about its Sub-Prime Mortgage-Backed Securities exposure."

We believe NCUA should have recognized the substantial concentration risk posed by Members United's significant holdings in mortgage-backed securities, especially the subprime and Alt-A mortgage related securities. The limits outlined in the Members United's Fixed Income Credit and Investment Policy were in compliance with NCUA Regulation Parts 704.5(c) and 704.6 - Credit Risk Management. However, NCUA Regulations suggest that Members United should have established concentration limits by sector prior to October 2008. The regulations do not provide specific guidance regarding concentration limits other than for investments in any single obligor, as follows:

(4) Concentrations of credit risk (e.g., originator of receivables, insurer, industry type, sector type, and geographic).
(c) Concentration limits—(1) General rule. The aggregate of all investments in any single obligor is limited to 50 percent of capital or $5 million, whichever is greater.

The NCUA Corporate Exam Guide (Guide), which was updated in March 2008, discusses the varying degrees of credit risk in the investment portfolio including the risk of the obligor or counterparty and the structure of the transaction (i.e., quality of the underlying collateral, level of subordination and/or credit enhancements). The Guide encourages examiners to ensure that corporate credit unions are properly measuring, monitoring, reporting, and controlling credit risk; particularly complex structured securities such as mortgage-backed securities, which may have numerous components of credit exposure.

The Guide also discusses the affect of credit risk in the investment portfolio on NEV and liquidity. For example, the Guide states in part,

"…it is important for corporate credit unions to understand and monitor the impact to NEV of potential volatility in the market value of the investment portfolio. As NEV declines, the ability to meet members' potential liquidity demands diminishes..."

The Guide further warns of the danger of focusing on high credit ratings and the probability of default (i.e., the higher the rating the less the probability of default) stating in part:

"…Failing to recognize the impact on NEV of credit events other than an event of default ignores a major component of risk…"

Based on our review, we believe examiners, as well as Members United management, relied too heavily on credit ratings to determine credit risk in the portfolio. Through interviews, we found that examiners and other NCUA staff did not perform further analysis on the potential credit and liquidity risks associated with Members United's significant holdings and concentrations of mortgage-backed securities prior to 2008 because they were mostly AAA rated and included the monoline insurer enhancement. Failure to further asses these risks prevented them from recognizing earlier in the process, the inadequacy of management's assessment and monitoring of credit risk in the investment portfolio due to the large concentrations of mortgage-backed and asset-backed securities.

We determined increased supervisory oversight was warranted, in the form of:

- More timely supervisory action related to the credit risk in Members United's significant concentration in mortgage-backed securities. By the time the DOR was issued in September 2008 (Effective May 31, 2008), the mortgage-backed securities market had deteriorated to the point where these securities were no longer being actively traded. We believe had NCUA required Members United to perform more extensive evaluation on its securities concentrations and credit risk exposure prior to the market dislocation in 2007, Members United may have had the opportunity to divest some of these securities or limit additional purchases of these securities.

- More authoritative guidance related to sector concentrations and identifying and monitoring risk related to the market value of securities through the NEV may have allowed NCUA to more effectively encourage Members United's management to more proactively address the significant risks associated with Members United's investment portfolio.

As stated earlier in this report, we believe NCUA's over-reliance on investment ratings and credit enhancements provided by monoline insurance prevented them from performing further evaluation on the significant risks that the large holdings of non-agency mortgage-backed securities posed to the safety and soundness of Members United and the credit union system as a whole. We also believe substantial purchases of these investments by Members United and other corporate credit unions should have prompted NCUA to review examiner guidance and training to enhance on the ability of its examiners and analysts to evaluate risks associated with the complex assets, the underlying assets securing the collateral, and the level of support proposed by the monoline insurers. Accordingly, we are making the following recommendations:

Recommendations

We recommend NCUA management:

1. Provide corporate credit unions with more definitive guidance on limiting investment portfolio concentrations by security type (agency-backed versus

non-agency backed securities), sector type (residential real estate versus non-residential real estate), and by supporting collateral (private label sub-prime, Alt-A, prime, exotic mortgage, etc.).

Auditor's Note: On September 24, 2010, the NCUA Board took several actions to reform the corporate credit union system under a stronger regulatory framework. One of those actions was to finalize major revisions to Part 704, NCUA's rule governing corporate credit unions.[20] The final rule includes new limitations on corporate credit union investments and credit risks, as well as asset-liability management controls, so that high concentrations of the types of investments as noted in this review, will not be permitted. Specifically, the final rule includes the following provisions which would have significantly reduced the losses experienced by Members United:

- *Prohibits investments in private label residential mortgage-backed securities and subordinated securities.*
- *Imposes specific concentration limits by investment sector.[21]*
- *Eliminates Part II expanded authority, thus making "A-" the lowest possible rating for an NRSRO-rated investment purchase by a corporate credit union with expanded investment authority. To qualify for expanded investment authority, a corporate credit union must achieve and maintain higher capital levels (i.e., a minimum of six percent leverage ratio).*

The final rule also requires that a corporate credit union examine the NRSRO rating from every NRSRO that publicly rates a particular investment and only employ the lowest of those ratings. It further requires that at least 90 percent of a corporate credit union's investments be rated by at least two NRSROs.[22]

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[20] The new corporate rule becomes effective 90 days after publication in the *Federal Register.* The revised rule was published in the *Federal Register* on February 4, 2011.

[21] Sectors are defined as residential mortgage-backed securities, commercial mortgage-backed securities, student loan asset-backed securities, automobile loan/lease assets-backed securities, credit card asset-backed securities, other asset-backed securities, corporate debt obligations, municipal securities, money market mutual funds, and an "all others" category to account for the development of new investment types. Sector limits are, generally, 1) the lower of 500 percent of capital/25 percent of assets, or 2) the lower of 1000 percent of capital/50 percent of assets (for less risky sectors).

[22] This requirement is in accordance with provisions of the Dodd-Frank Act. S*ection 939A of the Dodd Frank Act requires every federal agency, prior to July 21, 2011, review existing regulations that require the use of an assessment of the credit-worthiness of a security or money market instrument and any references to credit ratings in such regulations. In addition, Section 939A requires agencies to modify regulations identified in the review to remove any reference to, or requirement of, reliance on credit ratings; and substitute for such removal with an alternative standard of credit worthiness as the agency determines appropriate. In February 2011, NCUA issued a proposal that, if finalized, would remove all references to NRSRO credit ratings from all NCUA regulations. (76 Federal Regulation 11164 - March 1, 2011). Generally, for purposes of the investment limitations in the corporate rule, the proposal would replace the minimum NRSRO credit rating requirements*

Management Response

Concur. Management agreed with the OIG's recommended action and has already taken corrective action. Management explained the revised Corporate Credit Union Rule, approved in September 2010, contains provisions prohibiting the purchase of privately issued RMBS, and imposes stronger concentration limits.

OIG Response

Agree. Management's action taken to revise the Corporate Credit Union Rule addresses the issue moving forward.

We recommend NCUA management:

2. Institute requirements for corporate credit union board membership to eliminate conflicts of interest. Specifically, the NCUA should determine whether it is appropriate for retail corporate credit union board members to sit on the boards of the top-tier corporate credit unions.

   Auditor's Note: Revisions to Part 704, require that the majority of a corporate credit union's board members be representatives of NPCU members. Additionally, no person may sit on the boards of two or more corporate credit unions at the same time, nor may a single organizational member have more than one individual representative on the board at any given corporate credit union.[23]

Management Response

Concur. Management agreed with the OIG's recommended action and has already taken corrective action. Management explained the revised Corporate Credit Union Rule requires a majority of a credit union's board members be representatives of natural person credit unions and limits a person serving on multiple corporate credit union boards.

OIG Response

Agree. Management's action taken to revise the Corporate Credit Union Rule addresses the issue moving forward.

We recommend NCUA management:

3. Provide NCUA examiners training to identify higher risk assets, especially if those assets are higher yielding products that involve a higher level of

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with a requirement that corporate credit unions conduct an internal credit analysis of each pending investment purchase employing a given narrative standard of credit-worthiness.

[23] This provision of the revised rule will go into effect 36 months after publication in the *Federal Register*. NCUA published the revised rule in the *Federal Register* on February 4, 2011.

sophistication and several counterparties. Additionally, outside of previously raised recommendations for sector limit concentrations and diversification, NCUA should consider off-site monitoring enhancements of Call Report data to identify rapidly increasing holdings of certain types of assets and ensure that examiners and credit union management fully understand the risks posed by the products. NCUA should require credit unions to perform stress testing or scenario analysis to evaluate potential losses in the event of market dislocations or adjustments to other economic conditions.

Management Response

Concur. Management agreed with the OIG's recommendation and stated that improvements could be made in the areas of identification, reporting, and monitoring of higher risk assets. Management explained that in addition to the establishment and reporting of sector limits, the revised Corporate Credit Union Rule prohibits certain high-risk assets that were primarily responsible for the credit crisis. Management also explained regulatory stress tests, measuring interest rate risk exposure, and weighted average life extension risk will assist in identification and reporting of high-risk assets. Additionally, management explained they are exploring the development of additional off-site risk monitoring reports to aid examiners in identifying significant changes in risk exposures.

OIG Response

Agree. Management's actions taken and planned should address the issues identified in the recommendation.

Appendix A: NCUA Management Comments

National Credit Union Administration

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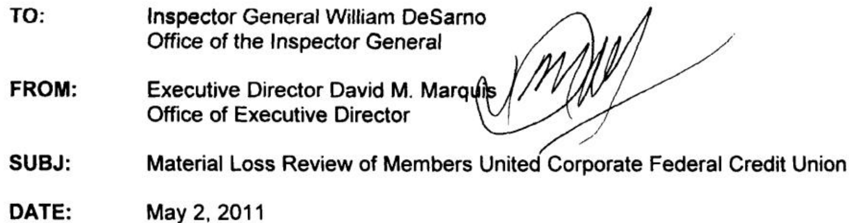

TO: Inspector General William DeSarno
Office of the Inspector General

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

SUBJ: Material Loss Review of Members United Corporate Federal Credit Union

DATE: May 2, 2011

This memorandum responds to your request for review and comments on the *Material Loss Review of Members United Corporate Federal Credit Union* provided on April 6, 2011. Pursuant to Section 206(j) of the Federal Credit Union Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the National Credit Union Administration's Office of Inspector (OIG) contracted with Crowe Horwath, LLP to conduct a material loss review of Members United Corporate Federal Credit Union (Members United), Warrenville, Illinois. Members United was placed under NCUA conservatorship on September 24, 2010 and liquidated on October 31, 2010. Members United Bridge Corporate Federal Credit Union was chartered to assume the operation of the liquidated credit union.

After the mid-2006 merger between Mid-States and Empire Corporate Credit Unions created Members United, share growth outpaced capital growth, resulting in a decline in the retained earnings ratio and capital ratio. Subsequent to the merger, Members United struggled to control operating expenses impacting the credit union's profitability, capital level, and competitive position.

An investment strategy resulting in an excessive concentration of sub-prime and Alt-A, non-agency residential mortgage-backed securities (RMBS) is the main cause of the failure of Members United. Members United's board and management relied on the credit enhancement provided by monoline insurers. The monoline insurers did not possess the ability to honor the guarantees. Members United's investments at U.S.Central Corporate Credit Union were also backed by similar non-agency RMBS, further increasing the concentration risk. Institutional limits on non-agency RMBS were not established until after the market dislocation.

Third parties who originated, securitized and rated the RMBS were a material factor in contributing to Members United's losses and the subsequent losses to the Temporary Corporate Credit Union Stabilization Fund. Members United and NCUA relied heavily on the representations made by the issuers of the securities, as well as the credit ratings assigned by the Nationally Recognized Statistical Rating Organizations (NRSROs) which were the prevalent measure of risk in the financial markets at that time. Just prior to the market dislocation in 2007, 92 percent of the securities received AAA or AA ratings.

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The first report recommendation calls for more definitive guidance limiting investment portfolio concentration risk. NCUA agrees with this recommendation and has already taken action to rectify this issue. As the report notes, the revised Corporate Credit Union Rule, approved in September 2010, contains provisions prohibiting the purchase of privately-issued RMBS and imposes stronger concentration limits.

The second report recommendation addresses concerns with the conflict of interest created by board members of retail corporate credit unions on the board of top-tier corporate credit unions. As dividends paid to retail corporates were derived from investment yields at US Central, such conflicts of interest led to US Central bearing excessive investment credit risks. Accordingly, NCUA agrees with this recommendation. The revised Corporate Credit Union Rule requires a majority of a corporate credit union's board members be representatives of natural person credit unions and limits a person serving on multiple corporate credit union boards.

The third report recommendation calls for improved identification, reporting, and monitoring of higher risk assets. NCUA agrees improvements can be made in these areas. In addition to the establishment and reporting of the sector limits, the revised Corporate Credit Union Rule prohibits certain high risk assets that were primarily responsible for the credit crisis. Regulatory stress tests measuring interest rate risk exposure and weighted average life extension risk will assist in identification and reporting of high risk assets. NCUA is currently exploring development of additional off-site risk monitoring reports to aid examiners in identifying significant changes in risk exposures. The Office of Corporate Credit Unions will address training requirements to ensure staff understands the risks posed by high risk assets.