NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF EASTERN FINANCIAL FLORIDA CREDIT UNION

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CONTENTS

Section	Page
EXECUTIVE SUMMARY	1
INTRODUCTION AND BACKGROUND	4
OBJECTIVES, SCOPE AND METHODOLOGY	6
RESULTS IN DETAIL	8
Why Eastern Financial Credit Union Failed	8
Florida State Supervisory Authority and NCUA Supervision of Eastern Financial Florida Credit Union	22
Findings and Suggestions	29
APPENDICES	32
A NCUA Management Comments	32
B Acronyms	34

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 Eastern Financial Florida Credit Union (Eastern Financial or EFFCU), a federally insured state-chartered credit union (FISCU). The material loss review objectives were to (1) determine the cause(s) of EFFCU's failure and the resulting loss to the National Credit Union Share Insurance Fund (NCUSIF), and (2) assess supervision of the credit union. To achieve these objectives, we analyzed NCUA and Florida State Supervisory Authority (Florida SSA) examination and supervision reports and related correspondence; interviewed management and staff from NCUA Region III and the Florida SSA; and reviewed NCUA and Florida SSA guides, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPRs).[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 OIG MLR reviews, the OIG will communicate those to management for its consideration. As resources allow, the OIG may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and make recommendations, as warranted.

Florida SSA and NCUA examiners determined and we agree that EFFCU's Board and management ignored sound risk management principles by:

- Exposing the credit union's net worth to a significant amount of risk due to investments in complex Collateralized Debt Obligations (CDOs) without management and the Board having sufficient expertise to understand and manage the risk of the CDOs.

- Implementing a growth strategy that was unsustainable in the current market environment.

- Not adjusting the Board and management's ability to handle the growth and sophistication of the Credit Union's activities, including complex CDO investments and construction and development (C&D) lending.

- Not implementing adequate steps to address the regulatory actions nor address the deterioration of the CAMEL ratings.

- Operating inefficiently with excessive operating expenses and a reliance on contracts for third-party providers.

[1] Section III of Crowe's report provides further details on the Objectives, Scope, and Methodologies utilized.

Eastern Financial'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 that put increasing pressure on the credit union to produce higher levels of revenue. As EFFCU's profitability lagged its asset growth, management and the board approved a leverage strategy to make significant investments in CDOs funded by short term borrowings without fully understanding the interest rate and credit risks associated with such complex investments and exposed EFFCU's net worth. Management allowed the CDO investment exposure to represent a significant concentration compared to net worth over a short period of time and failed to impose practical limits in the complex and risky investments. Once the investments deteriorated in value, EFFCU management had no course of action for proper divestiture of the assets, even when the investment grades fell below permissible levels per Florida statutes.

Eastern Financial suffered substantial losses in the CDO investments during 2007 and 2008 that, coupled with increasing loan losses and other contributing operating factors, quickly eroded the credit union's net worth and lead to its insolvency.

Eastern Financial purchased $94.8 million in CDOs from March 2007 to June 2007 funded by short term borrowings, which brought the total investments in CDOs to $149.2 million. Most of these CDOs deteriorated rapidly in value once purchased. Unrealized losses, eventually recognized through earnings as of September 30, 2007, were $63.4 million. By early 2009, twelve CDOs were completely written off for a $106 million loss the remaining CDOs had a $43.2 million book value with unrealized losses totaling $37.9 million. In the end, EFFCU essentially charged off all eighteen CDO investments, resulting in losses of $149.2 million between June 2007 and June 2009, when EFFCU was merged into Space Coast Credit Union by the NCUA.

Management also allowed numerous regulatory violations in the area of member business loan (MBL) limits, with C&D loans representing over 40 percent of net worth. Management failed to properly classify two large loans as C&D loans on quarterly call reports. The credit union experienced increasing delinquencies and loan losses, suffering especially large losses on two larger C&D loans. Eastern Financial's participation in a Centrix participation program[2] also contributed to overall deteriorating credit quality and increased loan losses.

Eastern Financial management had allowed several years of rapidly increasing operating expenses and inefficient operations. During the 3 year period from June 2004 through June 2007, EFFCU grew its assets by $400 million, for a 25 percent increase during that period. By February 2008, the Chief Executive Officer had resigned and the Board's inability to find a suitable replacement left

[2] Centrix Financial, LLP loan participation program where Centrix acted as marketer, underwriter, and servicer for EFFCU in an indirect automobile loan program designed for credit-impaired and sub-prime borrowers.

the institution without qualified leadership until being placed into conservatorship by the Florida SSA in April 2009.

NCUA and Florida SSA Supervision of Eastern Financial

Stronger supervisory action earlier in the institution's aggressive growth strategy and CDO investment strategy may have influenced EFFCU's Board and management to limit the significant level of risk assumed during the institution's rapid growth period. It may also have established a more appropriate supervisory tone and prompted the Board and management to take more timely and adequate action to address examiner concerns, thereby mitigating, to some extent, the losses incurred by the NCUSIF.

Observations made as a result of our review of EFFCU's failure include:

- We believe examiners should have deemed the planned CDO investment activity as a higher risk warranting greater supervisory efforts, especially given that the CDOs were not typical investments held by natural person credit unions. Eastern Financial was the only FISCU to invest in CDOs. We further believe that the Florida SSA could have benefited from seeking additional expertise, possibly utilizing outside consultants, to help evaluate the complex securities in which EFFCU planned to invest.

- Florida SSA and NCUA examiners and officials did not appear to fully understand the severity of the risks associated with the purchases of the 18 CDO investments, nor does it appear that examiners performed further evaluation of CDO investments as would have been required under the NCUA Examiner's Guide.

- Eastern Financial's management and Board exposed the credit union to excessive risks by not placing prudent limits on CDO sectors. Furthermore, the lack of reasonable limits on the CDO exposure was found to be the major factor leading to the large mark-to-market losses in the investment portfolio and continued write downs of the CDOs. Reasonable measures would have included lower limits for the CDO sector and further limits on underlying collateral exposure as % of net worth.

- We believe the NCUA and Florida SSA could have benefited from more active dialogue and more detailed workpapers during the supervision of this FISCU due to its size and complexity. Of particular focus should be encouraging or requiring more communication and analysis of credit union requests to purchase complex investments that are not typical of natural person credit unions.

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

INTRODUCTION AND BACKGROUND

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) authorized Crowe Horwath LLP (Crowe) to conduct a Material Loss Review (MLR) for the Eastern Financial Florida Credit Union (Eastern Financial or EFFCU), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). Eastern Financial was chartered as a federal credit union in 1937 to serve the employees of Eastern Airline Transport Company working in or out of Miami, Florida, and their immediate family members. In November 2001, EFFCU converted to a federally insured state-chartered credit union (FISCU) serving Eastern Airlines and numerous other select employee groups. Eastern Financial added several Florida counties to their field of membership between 2002 and 2006. As of March 21, 2009, EFFCU served approximately 208,000 members.

Eastern Financial received a composite CAMEL[3] composite rating of 2[4] for annual examinations and insurance reviews[5] performed by the Florida State Supervisory Authority (Florida SSA) and NCUA from June 2003 through March 2007. During the September 30, 2007 annual joint examination and insurance review, the composite CAMEL was downgraded to a CAMEL 3[6], with a management component rating of 4. EFFCU's net worth ratio declined from over 11 percent in 2004 to 9.7 percent as of September 30, 2007, with examiners citing the decline being caused by high operating expenses and marginal earnings. The insurance review noted concerns with the CDO investment portfolio, which was severely distressed and illiquid due to adverse market conditions. The commercial loan portfolio was also noted as a growing concern with 40 percent of member business loans in construction and development (C&D) loans. The weakening economy in Florida and the decline in value of real estate securing the C&D loans were noted as additional threats to EFFCU's net worth. Delinquency and loan

[3] The acronym CAMEL is derived from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and Asset/[L]iability Management. See 61 Federal Register 67021 (12/19/1996) – Federal Financial Institutions Examination Council-Uniform Financial Institutions Rating System (UFIRS).

[4] Financial institutions in this group are fundamentally sound. For a financial institution to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These financial institutions are stable and are capable of withstanding business fluctuations. These financial institutions are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

[5] During an insurance review in a FISCU, NCUA examiners limit their role to the review and analysis of existing or potential risks to the NCUSIF only, rather than to complete an examination of the FISCU.

[6] Financial institutions in this group exhibit some degree of supervisory concern in one or more of the component areas. These financial institutions exhibit a combination of weaknesses that may range from moderate to severe; however, the magnitude of the deficiencies generally will not cause a CAMEL component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure appears unlikely, however, given the overall strength and financial capacity of these institutions.

losses were increasing and expected to continue rising due to the weakened economy, coupled with expected uncertainty on further declines in the CDO portfolio. Table 1 (below) provides a timeline of significant events related to EFFCU.

Table 1

Timeline of Significant Events	
September 2005	EFFCU management and Board approved investments in CDOs
March 2007	EFFCU management and Board approved expansion of CDO investment strategy to include CDOs backed by HEL ABS
May 2007 (Effective Date - March 2007)	NCUA performed ALM and Investment contact, which identified significant planned purchases of CDOs
September 30, 2007	EFFCU CAMEL composite rating downgraded to “3”
December 2007	EFFCU was assigned to NCUA Division of Special Actions
January 25, 2008	Joint Letter of Understanding & Agreement Issued
February 2008	EFFCU CEO permitted to resign
December 18, 2008	Florida SSA Issued Temporary Cease & Desist
March 19, 2009	Florida SSA Issued Permanent Cease & Desist
April 24, 2009	EFFCU Placed into conservatorship
June 30, 2009	NCUA merges EFFCU into Space Coast Credit Union

As a result of the significant findings and numerous outstanding issues related to the DOR issued during the September 30, 2007 examination and insurance review, a joint Letter of Understanding and Agreement was signed on January 25, 2008. At the September 30, 2008 insurance review, EFFCU was further downgraded to a CAMEL composite 4,[7] with examiners citing EFFCU’s continued declining financial trends associated with large losses on the CDO investments, deteriorating asset quality, Bank Secrecy Act and Office of Foreign Assets Control[8] violations, and their inability to hire a permanent CEO.

[7] CAMEL composite rating “4” under UFIRS - Financial institutions in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.
[8] The Office of Foreign Assets Control (OFAC) is an agency of the United States Department of the Treasury under the auspices of the Under Secretary of the Treasury for Terrorism and Financial Intelligence. OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign states, organizations, and individuals.

On March 19, 2009, the Florida SSA issued a permanent and published Cease and Desist Order, Board Resolution, and Stipulation due to the expiration of the effective date of the previously issued temporary Cease and Desist and the existence of many other issues not addressed in the temporary Cease and Desist. The permanent Cease and Desist addressed severe deficiencies in board and management oversight, inadequate maintenance of capital, deterioration of asset quality, inadequate liquidity, and excessive levels of concentrations in the member business loan portfolio.

On April 24, 2009, the Florida SSA placed EFFCU into conservatorship as they were determined to be significantly undercapitalized with no reasonable prospect of becoming adequately capitalized. The Florida SSA immediately appointed NCUA as agent for the conservator. The Florida SSA cited the following reasons for the conservatorship action:

- The credit union does not have sufficient earnings, and has no effective capital maintenance plan to halt the rapid depletion of net worth;

- The credit union is operating without adequate core deposits to ensure it can meet financial obligations as they become due without the mandatory use of borrower funds.

- The credit union is operating without effective leadership, oversight, executive management supervision, and direction from the Board of Directors.

The NCUA merged EFFCU into Space Coast Credit Union effective June 30, 2009. The estimated loss to the National Credit Union Share Insurance Fund (NCUSIF) was approximately $40 million.

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 if the loss to the NCUSIF exceeds $10 million.[9] NCUA notified the OIG of a loss reserve for EFFCU of approximately $41 million. 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 EFFCU.

Our material loss review objectives were to (1) determine the cause(s) of EFFCU's failure and the resulting loss to the NCUSIF, and (2) assess NCUA's supervision of the credit union. We conducted this review from November 2009 to April 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a

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

reasonable basis for our findings and conclusions based on our review objectives. We believe that the evidence obtained as described in the Scope and Methodology section, provides a reasonable basis for our findings and conclusions based on our review objectives.

The scope of this review included an analysis of EFFCU from June 30, 2004 until it was placed in conservatorship on April 24, 2009. Our review also included an assessment of Florida SSA and NCUA regulatory supervision of the institution during the same period.

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

- We analyzed NCUA and Florida State Supervisory Authority (SSA) examination and supervision contact reports and related correspondence (workpapers contained within the AIRES[10] system).

- Interviewed management and staff from NCUA Region III and the Florida SSA; and reviewed NCUA and SSA guides, policies and procedures, NCUA Call Reports, and NCUA Financial Performance Reports (FPRs).

- Reviewed EFFCU data and correspondence maintained at the NCUA Region III office in Atlanta, GA as provided to Crowe by NCUA.

Crowe relied primarily upon the materials provided by the NCUA OIG and NCUA Region III officials and examiners, including information and other data collected during interviews. Crowe did not perform specific review procedures to ensure the information and data were complete and accurate. Interviews were conducted to gain a better understanding of decisions made regarding the activities of the credit union management and the supervisory approach and to clarify information and conclusions contained in reports of examination and other relevant supervisory correspondence between the NCUA, Florida SSA and EFFCU. Crowe relied on the information provided in the interviews without conducting additional specific review procedures to test such information.

[10] NCUA's Automated Integrated Regulatory Examination Software.

RESULTS IN DETAIL

Why Eastern Financial Florida Credit Union Failed

Eastern Financial's failure can be attributed to inadequate management and Board of Directors (Board) oversight that exposed the credit union to excessive amounts of risk due to investments in complex private-placement Collateralized Debt Obligations (CDOs), weak business loan underwriting and credit administration, poor earnings resulting from an aggressive growth strategy, and an inadequate strategic plan.

The most significant losses suffered as a consequence to EFFCU's inadequate management oversight were related to large investments made in CDOs backed by subprime home equity/auto loans and corporate debt. Eastern Financial's management and Board performed limited analysis prior to approving the investments in CDOs and ongoing monitoring also appeared weak. Examiners determined that EFFCU management and Board relied too heavily on the ratings assigned to the CDOs by the Nationally Recognized Statistical Rating Organization (NRSRO)[11]. The credit union also had rapid growth in Construction and Development (C&D) loans through an EFFCU majority-owned Credit Union Service Organization (CUSO) in which CUSO and EFFCU management had limited expertise, as evidenced by significant losses and rapidly increasing delinquencies.

These factors and others led to increased exposure to high risk investments and loans secured by subprime assets and commercial real estate property. Eastern Financial's concentration of CDO investments and C&D member business loans left the credit union vulnerable to downturns in national and local economic conditions and the real estate market. Eastern Financial's Board and management failed to adequately diversify the investment and loan portfolios. Moreover, the use of short-term borrowings to fund the CDOs, as well as an unusually high reliance on overdraft privilege (ODP) fees for earnings and inefficient operations, compounded the risks of the credit union. Table 2 (below) summarizes selected financial information for EFFCU.

[11] NRSRO is a credit rating agency which issues credit ratings that the U.S. Securities and Exchange Commission (SEC) permits other financial firms to use for certain regulatory purposes.

Table 2

Key Financial Data and Ratios (000's)				
	Dec-05	**Dec-06**	**Dec-07**	**Dec-08**
Total Assets	1,908,465	2,348,141	1,832,050	1,638,660
Net Worth/Total Assets	10.62%	8.97%	8.21%	2.25%
Impaired Assets/Net Worth	5.51%	5.43%	10.70%	123.76%
Return on Average Assets (ROAA)[12] (Loss)	0.91%	0.38%	(3.3%)	(6.54%)
Net Income (Loss)	16,309	8,107	(68,907)	(113,463)

CDO Leverage Strategy

Summary

Florida SSA and NCUA examiners determined, and we agree, that EFFCU management and Board failed to perform adequate due diligence and establish appropriate limits and controls on investments in CDOs backed by home equity loan (HEL) asset-backed securities (ABS) and other subprime collateral. Specifically, examiners noted that EFFCU management and Board:

- Relied too heavily on rating agencies' grading of CDO investments,
- Failed to fully evaluate and understand the complexity of the CDO investments, and
- Created a concentration risk by investing a total of eighteen CDOs for $149 million, of which nearly $100 million were backed by HEL ABS.

Eastern Financial failed to fully understand the complexities of the structured finance CDOs and appeared to rely too heavily on the historical performance of the underlying collateral, as was determined by the rating agencies. Furthermore, once the investments began deteriorating in value, EFFCU policy did not incorporate divestiture based on value declines. Rather, the policy focused on investment grade decreases to prompt divestiture. This resulted in EFFCU holding the CDOs and taking enormous

[12] The Return on Average Assets ratio is annualized net income divided by average assets for the period.

write downs. By the time the investments were downgraded, there was little or no opportunity for the credit union to divest the illiquid assets.

<u>CDO Investments</u>

Examiners determined that EFFCU's investment in CDOs initially began in December 2005. Eastern Financial had requested the Florida SSA approve whether CDOs would be permissible investments during September 2005. The Florida SSA provided a response letter, dated September 13, 2005, to EFFCU stating that CDOs collateralized by loans such as motor vehicle, credit card, home equity or other bank loans were permissible investments. A copy of the letter was provided to NCUA in September 2005.

In their response letter, the Florida SSA concluded that "since CDOs have characteristics similar to corporate bonds, which are permitted under Section 657.042(7)(b), it appears the investment in CDOs would be permissible." The Florida SSA also stated in the letter that Section 657.042 (7)(a) requires appropriate policies, as follows:

- The Board of Directors must establish comprehensive policies on investments in CDOs. The policies should dictate limits on CDOs, limits on the underlying collateral in the CDOs, and appropriate documentation to substantiate the legality, credit and investment risk;

- The CDOs must meet the credit quality ratings specified in Section 657.042(7)(a), Florida Statutes;

- Credit union must maintain a current credit file for each CDO, containing sufficient information to determine whether the investment complies with the credit quality section of Section 657.042(7)(b), Florida Statutes. If the investment fails to comply with the credit quality requirements, the credit union must divest itself of the investment; and

- Total investment in CDOs would be limited to the percentage limits of Section 657.042(3)(b), Florida Statutes.

The Florida SSA's letter concluded with language that it was approving the legality of the investment pursuant to governing regulations and did not express opinion of the quality or acceptability of the investment. The SSA also stated it:

> "*neither endorses nor recommends investment in Trust CDOs"* and that the *"credit union must know what it is acquiring, its ramifications, impact on liquidity, and the risk associated with this particular investment."*

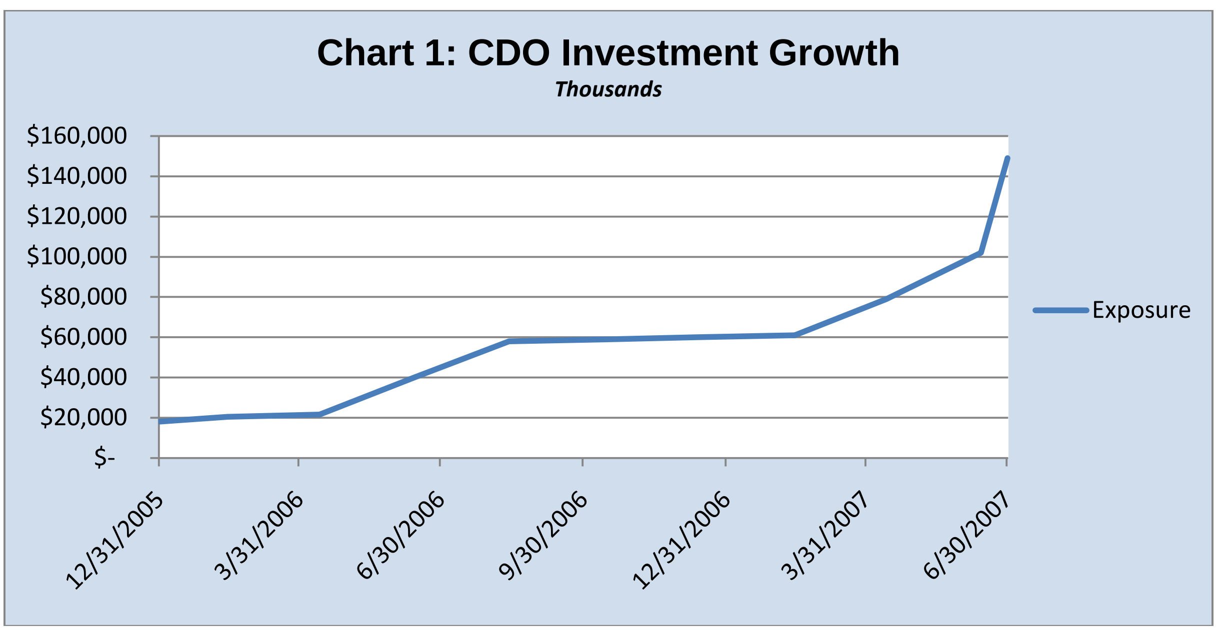
The letter also stated that the SSA would:

> "*expect due diligence on each CDO to ensure the Board of Directors and management thoroughly understand the intended security and that the investment's risk characteristics are consistent with the credit union's overall investment objectives, policies, and business goals.*"

We believe the Florida SSA's letter should have prompted EFFCU's Board to perform stronger due diligence on each CDO security purchased. However, EFFCU's investment committee did not perform adequate due diligence on the CDO purchases, as recommended by the SSA's letter, nor did EFFCU's CDO investment policy reflect prudent limits on underlying collateral.

<u>CDO Purchase Activity</u>

In November 2006, the EFFCU Board approved a change to the credit union's investment policy to allow investment in private label mortgage backed securities (MBS). Expanding the acquisition of HEL ABS CDOs was further approved at EFFCU's March 3, 2007 Board Investment Committee Meeting. All acquisitions were to be AA or A rated by the rating agencies, as required by EFFCU's investment policy. Purchases in CDOs were at relatively modest levels until early 2007, when EFFCU dramatically expanded their planned CDO investment strategy. From March 2007 to June 2007, EFFCU purchased an additional $94.8 million in CDOs. Chart 1 (below) illustrates EFFCU's CDO investment growth through June 2007, when new purchases were suspended.



In respect to the CDO strategy, examiners determined that EFFCU management and Board:

- Failed to place reasonable or prudent limits on CDOs or the types of underlying collateral;
- Had weak investment policy and committee oversight regarding CDOs;
- Lacked Board/investment committee expertise;
- Allowed large purchases of CDOs over a short period of time, putting net worth at risk to a large concentration of CDOs, and
- Failed to account for large risks in monitoring investment decisions (like a nationwide collapse of housing values).

NCUA examiners reported that EFFCU sold $301 million of fixed-rate CMOs and MBS during March 2007 at a net gain of $1.7 million. The sales proceeds were used to pay off short-term borrowings and reduce balance sheet leverage and market risk. From that point forward, the credit union's investment/leverage strategy shifted to a focus on purchasing CDOs funded by short-term borrowings.

Several CDO purchases early in the strategy were backed by corporate bonds. Examiners considered the corporate bond CDOs were not exposed to sub-prime residential mortgage loans that experienced much less market value losses than the 2007 CDO purchases backed by HEL ABS. Initial purchases of CDOs backed by HEL ABS had also initially performed better as the underlying loans were originated in 2005.

During the March – June 2007 timeframe when EFFCU purchased $94.8 million in CDOs, examiners reported that spreads realized over 3 month LIBOR[13] widened considerably. The examiner noted that A-rated CDO spreads ranged from 325-450 basis points and AA-rated CDO spreads realized 130-300 basis points. As such, most of these CDOs deteriorated rapidly in value once purchased. However, we believe that readily available market data existed that should have prompted EFFCU management and Board to further evaluate planned CDO purchases during early 2007, or at least to have limited exposure to types of underlying collateral. In industry circles, it is reasonable to expect prudent management would have reviewed such readily available market data. Since CDOs historically paid higher yields than corporate bonds, EFFCU management and the Board should have understood that higher yields came from taking greater risk associated with uncertainties and risks associated with the CDOs.

[13] The London Interbank Offered Rate (LIBOR) is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market.

Additional CDO purchases were eventually suspended on June 22, 2007, but EFFCU had already purchased $149.2 million. The August 28, 2007 Internal Investment Committee Minutes stated that the market began to turn in mid-June when news came out indicating Bear Stearns' hedge funds with sub-prime exposure were being seriously impacted by margin calls. Market conditions for CDOs with sub-prime exposure became increasingly distressed and illiquid and remained so in 2008 and beyond. The estimated market values for EFFCU's CDOs at September 30, 2007 reflected unrealized market value losses on CDOs of $63.4 million, which amounted to 42 percent of the CDOs' book value at that point in time. Even before the crash of the CDO market, it was apparent that there were real risks and difficulties in valuing CDOs. We believe management and the Board should have recognized that even though they purchased eighteen different securities, the CDOs were quite similar and provided little diversification.

<u>Management and Board oversight of CDO Investment Strategy</u>

Based on reviews of EFFCU's Investment Committee minutes and discussions with examiners, little evidence exists to indicate that management and the investment committee performed extensive analysis regarding the decisions to approve CDO investments for purchase. Furthermore, the Board and management allowed EFFCU to purchase large amounts of CDOs within a short period of time without prudent limits being in place. Credit Union management and the Board looked at CDOs as an opportunity to increase earnings (yields) without fully understanding the dramatic market decreases that could occur given the riskiness of the underlying collateral of the CDOs which consisted of home equity lines of credit (HELOCs) and other subprime loan products.

We believe additional readily available market intelligence existed that management could have used as part of performing proper due diligence and addressing the issues raised in the Florida SSA letter on CDO permissibility. A CDO Primer published in 2004 by Bond Market Association (now the Securities Industry and Financial Management Association), described the benefits of investing in CDO's and their risks. (Note: This was published before the CDO market collapsed.) The following are risks specifically cited as associated with CDO's:

- Systemic or modeling risk: Investors should complete a thorough review with respect to:
    - the appropriateness of the statistical models employed by the rating agencies and;
    - the accuracy and reasonableness of the default and recovery data.
- Collateral credit risk: Investors should assess the collateral risk of the pool.

- Structural risk: Investors should perform a breakeven analysis to determine the amount of collateral net losses that can occur before a tranche[14] becomes cash flow impaired.

Since CDOs represented a unique and new investment decision for EFFCU in 2005, we believe management and the board should have been able to consider readily available information such as the Bond Market Primer and other sources as part of the due diligence process on CDOs.

Eastern Financial invested in private placement CDOs which provided less readily available market data to perform analysis and provide better understanding of underlying assets and grading system, tranches, etc. While EFFCU's CDOs deteriorated rapidly in late 2007, management and the Board would have benefited from more extensive research prior to purchasing the CDOs. Such research and due diligence would have allowed EFFCU management and Board to understand the risk of loss due to subprime assets that were backing the securities.

In August 2007, EFFCU's Investment Committee minutes reflected a discussion by a portfolio manager who provided the Board with an update on issues in the CDO sector and the impact on their portfolio. The portfolio manager noted the following:

> *"…intense analysis of the portfolio has taken place within the last two months. The 2006 vintage has not performed to historical norms because in late 2005 loan standards declined and individuals who did not qualify were being approved for loans, and as a result, hedge funds that were highly leveraged in these securities were forced to liquidate…"*

The portfolio manager further indicated that the "no liquidity" environment was expected to last through the end of 2007. He noted an approximate $50 million total (10 percent) drop in mark–to-market was expected in August 2007, before a bottom-out was expected.

Also during the August 2007 meeting, the investment committee, at the request of the CFO, reviewed and approved a significant expenditure to purchase Standard and Poor's software to provide an additional tool to monitor and evaluate the CDO investments. We believe these are all steps that the credit union should have taken in the due diligence process prior to approving investment in the CDOs. Also, we believe that the Florida SSA and NCUA could have taken steps to ensure EFFCU management possessed the expertise and tools to evaluate CDOs when EFFCU initially requested whether CDOs would be permissible investments in 2005.

[14] Tranches are different "classes" of notes within a security that together make up what is referred to as the deal's capital structure or liability structure. Tranches are generally paid sequentially from the most senior to most subordinate (and generally unsecured). The more senior rated tranches generally have higher ratings than the lower rated tranches. For example, senior tranches may be rated AAA, AA or A, while a junior, unsecured tranche may be rated BB. However, ratings can fluctuate after the debt is issued and even senior tranches could be rated below investment grade (less than BBB).

Examiners reported that EFFCU relied heavily on a modeling program produced by Western Corporate Federal Credit Union (WesCorp) in evaluating its asset/liability management (ALM) and more importantly, its CDO activity. Eastern Financial Investment Committee minutes noted that an August 31, 2007 WesCorp report highlighted the continuing “Headline” risk associated with the CDOs. The report stated that further declines in price were possible, which could contribute to an increase in interest rate risk. The minutes further stated the WesCorp report:

> *“…does not address the underlying credit risk of the CDOs, and that interest rate risk would be impacted if their prices were to decline because of “credit” related issues…”*

We believe this suggests that EFFCU did not perform the required due diligence on CDO investments when they first expanded their investment policy and planned the investments, thus they failed to understand the significant credit risk and interest rate risk that the CDOs posed to EFFCU capital and net worth.

Although addressed by EFFCU’s Investment Policy as required by the Florida SSA, NCUA examiners determined the CDO sector limits appeared to be imprudent, which allowed EFFCU to take excessive risk. Furthermore, the lack of reasonable limits on the CDO exposure was found to be the major factor leading to the large mark-to-market losses in the investment portfolio and continued write downs of the CDOs. NCUA examiners suggested, and we agree, that reasonable limits would have included lower limits for the CDO sector and further limits on underlying collateral exposure.

Eastern Financial’s CDOs first started showing problems in June 2007 ($8 million charge off) but no formal risk management actions were put in place to evaluate potential further losses and mitigate continuing exposure. Eastern Financial’s July 21, 2007 Board minutes reflect a review of CDO investment activity and the portfolio for June 2007. The minutes of the Investment Committee meeting of June 16, 2007, were accepted as submitted, with notation that there was a CDO mark-to-market adjustment of $8 million in June. It was also noted that an analysis of securities was underway to look at the credit union’s possible exposure. Based on our review of these minutes and discussions held with examiners, we determined there was no further action taken or exploration by management or the Board to prevent further exposure to losses in the CDO portfolio.

<u>Examiner Review and Significant Deterioration of CDOs</u>

Examiners determined at the September 30, 2007 examination that management allowed the CDO investment exposure to represent a significant concentration compared to net worth over a short period of time. Additionally, examiners determined that EFFCU had increasing exposure to C&D loans that, once properly classified on Call Reports, represented over 40 percent of net worth in violation of Section 723.3 of NCUA Rules and Regulations. Substantial losses on the CDOs and MBLs, coupled with extremely high operating expenses and other contributing factors, quickly eroded the credit union's net worth in 2007 and 2008 that eventually lead to its insolvency.

In February 2009, the NCUA Regional Capital Markets Specialist (RCMS) reported on EFFCU's CDO activity and determined that initial purchases of CDO investments began in December 2005. The report identified a total of eighteen CDOs purchased through June 2007, totaling $149.2 million. All CDOs were assigned an AA or A- rating as required by EFFCU's investment policy and Florida statute. Sixteen were residential mortgage backed CDOs, collateralized by HEL ABS. The remaining two CDOs were backed by corporate bonds.

The RCMS report also confirmed the Florida SSA's ruling from September 2005, which as previously noted, had provided a letter of approval for the permissibility of CDOs under Section 657.042(7)(b) of Florida Statutes.

NCUA examiners determined, and we agreed, that EFFCU did not appear to be in compliance with the requirement to establish limits on underlying collateral in the CDOs. The only limits EFFCU included in their investment policy on CDOs was with regards to a maximum investment between $10 and $20 million per security depending on the investment grades ranging from A to AAA**.**

Management Exposed Eastern Financial to Significant Credit Risk

<u>Background on Lending Activity</u>

In 2004 and 2005, the credit union generated significant loan growth (in excess of 20 percent annually) through real estate lending, indirect and direct consumer loans, and member business lending. Over this same period, the credit union continued to maintain a high loan to share ratio as loan yields over this period steadily increased though the credit union's overall net income did not.

<u>Credit Union Business Capital (CUBC)</u>

During 2005, EFFCU transferred all member business loan underwriting to CUBC a CUSO, which EFFCU initially wholly-owned. Our review of EFFCU Board minutes and the regulatory review of the CUSO from 2006 to 2007 indicated that the CUSO struggled to add new Credit Union members and EFFCU remained the majority owner. NCUA and Florida SSA examiner's initial reviews of CUBC suggested strong underwriting, but it became apparent that underwriting was not as robust given the substantial losses on two larger MBLs underwritten by CUBC that became severely delinquent and lead to foreclosures and eventual charge-offs on loans to construction projects where the properties provided insufficient protection.

Eastern Financial's June 16, 2007 Board minutes indicated that CUBC continued to be behind budget and attributed this mostly to staffing issues and delays with loan production. NCUA's Asset Management & Assistance Center and the Florida SSA performed a review of CUBC as of September 30, 2006. During this review, examiners found that CUBC estimated it would have 130 credit union clients by September 2007, but only had 13. The CUBC also had projected it would be profitable by mid-year 2006, but they continued to revise projections to suggest positive earnings would not be achieved until sometime beyond 2007. Based on interviews with NCUA examiners, CUBC did not produce a profit prior to EFFCU being placed into conservatorship.

Examiners determined during the September 30, 2007 examination that part of the increase in yields was due to an increased loan to share ratio and emphasis of higher risk loans. Along with loan growth, EFFCU experienced a significant increase in overall loan delinquencies and loan charge-offs which translated into an increased provision for loan losses.

Also at September 30, 2007, examiners determined that EFFCU's commercial loan portfolio exceeded three of the maximum limitations set by Federal Regulations. Of more concern was the fact that 40 percent of the commercial loan portfolio (over $90 million) was C&D loans. Examiners cited the weakened real estate market in Florida which amplified the threat to net worth and increased the credit union's overall credit risk exposure.

As the real estate market deteriorated and the economic environment weakened in Florida, management anticipated continued increases in delinquencies beyond September 2007. Despite this fact, examiners determined that management was still in the process of adding to the credit risk by decentralizing the lending function and increasing unsecured lower grade paper ("C", "D" and "E") loans. Eastern Financial had a large volume of mortgage products with high loan to value (LTV) ratios, which added to its increased credit risk profile during 2007. As of September 30, 2007, over 34 percent of the total mortgage loan portfolio represented loans with a LTV ratio exceeding 90 percent. Approximately 8 percent of these were HELOC related loans (line of credit and credit card) where the credit union did not have a first lien.

Examiners determined that the climate at September 30, 2007 reflected a real estate market slump that was not expected to recover any time soon. As a result, examiners recommended management obtain updated valuations of the properties securing loans issued over 12 months prior where loan to value ratios exceeded 90 percent at the time the loan was granted; especially if the credit union had a second lien on the property. Examiners further urged management to perform an analysis to determine the risk exposure of these loans and set up a specific reserve for this portfolio segmentation, if warranted.

Regulatory Violations

At the September 30, 2007 examination, examiners discovered that by not classifying land intended to be developed for income producing property as a C&D loan, EFFCU understated total C&D loans resulting in a violation of federal regulations. Therefore, C&D loans were understated by approximately $61 million. Once properly classified, C&D loans totaled $91 million and represented 40.66 percent of net worth which exceed the 15 percent limitation by $57.4 million.

Examiners determined two large MBLs became delinquent in late 2007. Although EFFCU management worked to foreclose on the properties, the ability of the credit union to obtain ownership was hindered by the overall volume foreclosures in the state of Florida and legal complexities with one of the properties. Approximately $51 million of the MBL balances remained on the delinquency report for the first three Call Report cycles in 2008.

One of the larger MBLs in delinquent status was not properly classified in EFFCU's Call Report resulting in an understated delinquent loan ratio. Specifically, the credit union's September 30, 2007 FPR identified the credit union's delinquent loan ratio at 0.66 percent when it actually was 2.58 percent. Examiners determined the construction project was cancelled on the delinquent $30 million MBL. However, EFFCU continued to accrue interest at November 2007, despite the loan being 5 months delinquent and there being no more funds in the interest reserve. The NCUA examiner concluded that there was still sufficient equity in the property to cover principal and interest, but EFFCU was required to classify the loan as substandard and evaluate if there was a potential loss under FAS 114 and set-up a reserve if it was determined necessary.

Examiners subsequently reported that this loan went to summary judgment in December 2008 and the loan in the amount of $30 million was transferred to Foreclosed and Repossessed Assets. The second loan for $19 million was in the process of foreclosure with summary judgment expected in the second quarter of 2009. Prior to merging EFFCU into Space Coast credit union, approximately $33 million was charged off for both loans. There was no information on whether there were any recoveries related to those charged off loans.

<u>MBL Waiver Limit Requests</u>

Eastern Financial requested the Florida SSA and NCUA for several waivers from NCUA limits for MBLs set forth in Section 723.3(b) of NCUA Rules and Regulations, which require a borrower to have a minimum of 25 percent equity interest in the project being financed. One request was for a C&D loan where the borrower's equity interest in the project was as low as 5 percent. Through our review of examiner workpapers (contained in AIRES) as well as discussions with examiners, we determined that NCUA examiners recommended that NCUA regional office deny the EFFCU MBL waiver requests. The examiner stated that approving this or other loan waivers that significantly depart from the requirements of the MBL regulations could establish an unsafe and unsound precedent. Nonetheless, several of the waivers were granted by NCUA and Florida SSA, allowing EFFCU to make MBLs to borrowers with less than the regulatory mandated 25 percent equity in the project.

A review of the March 30, 2007 EFFCU Board minutes also reflected a discussion by management and the Board to request approval from the Florida SSA to increase their business lending ceiling cap to 20 percent of total assets. We believe these types of waiver requests exemplify management and the Board's willingness to circumvent regulatory limits in order to expand business lending activity, at the expense of putting the credit union's financial stability and sound net worth position at risk.

Centrix Participation Program

Examiners reported that EFFCU management and the Board approved the participation up to 5 percent of assets or $70 million in a Centrix Financial, LLP loan participation program where Centrix acted as marketer, underwriter, and servicer for an indirect automobile loan program designed for credit-impaired and sub-prime borrowers. Florida SSA reviewed the program at the June 30, 2004 report. Loans under the Centrix program totaled $29.8 million by August 2004. Examiners noted that the Centrix Sub Prime Auto Loan Program was a high-risk program that required an increased level of monitoring by management and that borrowers were marginal, loan terms did not correspond with the age of collateral (e.g. 66 month loan for a 3 year old car) and interest rates were high. Examiners determined such loans would require constant monitoring and verification of the reports and information provided by Centrix.

Eastern Financial August 2007 Board minutes indicated the CFO made the Board aware of $3 million in charge offs expected in 2007 on the Centrix portfolio. The September 20, 2007 examiner informal discussion items included comments on the bankruptcy of Centrix, LLC in October 2006 that caused charge offs to more than double from September 2006 to September 2007, close to $2 million in that time period.

Forgery and Loss on Member Business Loan

During the September 30, 2007 examination, examiners noted a past due $22 million balloon loan that matured in October 2007. Examiners noted the borrowers were in the process of refinancing this loan through another credit union. As of the exam, the borrowers were attempting to obtain a three-month extension from EFFCU. However, the following required documents had not been received to complete the extension:

- Three month extension agreement (received November 15, 2007),
- Executed contract (joint venture between borrower and new investor),
- Commitment Letter from the take-out institution. Only a Letter of Interest was received,
- $30,000 extension fee, and
- $510,000 interest reserve to be deposited at the credit union.

On February 12, 2008, EFFCU was made aware of an alleged forgery in their $22 million loan for South Florida Properties. The loan was for the refinance of an existing mortgage held by Florida Community Bank, and to provide funds for closing costs and interest reserve. In legal documents presented to EFFCU, the managing member of South Florida Properties stated that all signatures on the loan were forged. He was seeking to rescind on the personal guaranty and mortgage. Some of the documents were notarized in Florida despite proof the borrower was at home in Connecticut.

Additional Issues Providing Evidence of Poor Management and Board Oversight

Outside of the large losses associated with CDOs and MBL activity, there were additional factors that raised EFFCU's risk profile that further demonstrate the lack of effective management and Board oversight:

- **Costly Branch Expansions -** Examiners noted EFFCU's rapid branch expansion strategy dated back to 2004 with continuous branch expansions costing EFFCU significantly more than originally budgeted. For example, the very costly opening of EFFCU's Sunrise branch and other planned expansions continued even as the credit union's financial condition deteriorated. The June 16, 2007 Board minutes focused on the credit union's need to control expenses, while the Board approved additional overruns on the Sunrise branch. Ultimately, the Sunrise branch opening cost EFFCU approximately $3.4 million, which represented $1 million to $1.5 million more than initially budgeted.

- **Reliance on Overdraft Privilege Fees -** Examiners indicated that as EFFCU's operating expenses were increasing significantly as early as 2001, EFFCU decided to offer overdraft privilege (ODP) as a member service and a profit center at the end of the first quarter in 2002. The resulting increase of fee income enabled management to increase operating expenses to such a high level that by 2007, EFFCU became significantly dependent on ODP as a source of income, which produced a positive return on average assets. As of September 30, 2007, ODP fee income represented an annualized 1.43 percent of average assets compared with the total return on average assets of 0.26 percent. ODP income accounted for roughly $20.2 million, or 65 percent of total fee income at September 30, 2007.

- **Lack of Management Succession Plan -** A review of the March 30, 2007 Board minutes includes a discussion on a Succession Plan presentation that disclosed ten out of 36 key positions within EFFFCU did not have a named successor. There was no evidence of further discussion at the board level or what corrective actions were taken. This is of particular importance because EFFCU became subject to regulatory actions in late 2007 as the financial condition deteriorated, the CEO resigned after the Board signed an LUA in February 2008. However, EFFCU management and the Board were unable to fill the vacant CEO position. The position was offered to three individuals during 2008; however, all three declined to take the position. The CEO position was never filled until EFFCU was placed into conservatorship, at which point EFFCU was being managed by officials from Space Coast Credit Union.

- **Service Contracts -** Through the review of the due diligence process as part of the planned acquisition of EFFCU, NCUA officials determined Space Coast Credit Union had discovered that EFFCU had over 400 contracts in place with outside service providers. Further review of Space Coast and NCUA documentation on the planned acquisition determined that three of the largest contracts in place would cost roughly $8.5 million to terminate, since EFFCU had signed 5-year agreements with all of these providers.

Florida State Supervisory Authority and NCUA Supervision of Eastern Financial Florida Credit Union

Supervisory Background

Florida SSA and NCUA examiners had few criticisms of EFFCU operations or its management in examination reports leading up to September 30, 2007. Prior to September 2007, EFFCU consistently received composite CAMEL ratings of 1 or 2, with examiners generally citing a traditional business plan (prior to 2005) and EFFCU maintaining a consistently strong net worth position.

Eastern Financial's earnings component rating dropped to a 3 during the June 30, 2006 examination, the remaining components were rated 1 or 2, with a composite of 2. Examiners concluded that the ROAA of 0.53 percent could have initiated Administrative Action in the form of a DOR which would have outlined a course for corrective action. However, Florida SSA decided against issuing a DOR as examiners felt it would not substantially add anything to management's ongoing efforts. Examiners determined that management was being proactive and that earnings would improve as "strategies change, services expand, and lending products are enhanced."

Eastern Financial's component and composite ratings were substantially downgraded as a result of the September 30, 2007 examination, based largely on the losses associated with the substantial write-downs being required in the CDO investments. Eastern Financial's composite rating was downgraded to a 3. The financial condition continued to deteriorate in 2008 and the credit union was downgraded further to a CAMEL composite 4 following the September 30, 2008 insurance review. With the seriously distressed CDO portfolio, concerns with the member business loan portfolio, and impact of the overall economic issues on the state of Florida, the Florida SSA issued a temporary Cease and Desist in December 2008 and a permanent Cease and Desist on March 19, 2009. The asset and liability account records of EFFCU as of March 31, 2009 showed assets of approximately $1.62 billion and liabilities of approximately $100 million. Since EFFCU's shares of $1.53 billion exceeded the cash value of assets less liabilities, the credit union was found to be insolvent with a Problem Asset / Share ratio of 99.77 percent. The Florida SSA placed EFFCU into conservatorship and appointed the NCUA conservator on April 24, 2009. Table 3 (below) provides an overview of significant contacts by the Florida SSA and NCUA Region III.

Table 3

Exam Report Date	Exam / Insurance Review Type	Performed by	C-A-M-E-L / Composite
6/30/04	Annual	SSA lead / joint	1-2-2-3-2 / 2
6/30/05	Annual	NCUA lead / joint	1-2-1-2-2 / 2
6/30/06	Annual	SSA lead / joint	1-2-2-3-2 / 2
9/30/07*	Annual	NCUA lead / joint	3-3-4-3-3 / 3
9/30/08	Annual	Joint (Special Actions)	4-4-4-5-3 / 4
4/24/09	On-site Contact	NCUA	5-5-5-5-4 / 5

** NCUA placed Eastern Financial into Special Actions after the September 2007 annual exam.*

Supervisory Efforts to Key Risks Were Not Adequate or Timely

We determined NCUA and Florida SSA examiners could have identified key risk areas such as planned purchases of substantial amounts of CDO investments in early 2007 and the extension of larger member business construction loans in 2006. Under the risk-focused examination approach, NCUA guidance:

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

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

As earnings began to deteriorate, the credit union initiated a leverage strategy where they requested approval from the Florida SSA on whether CDOs would be a permissible investment. As discussed in the previous section of this report, the Florida SSA responded to credit union management in September 2005 and again in 2007 that investments in CDOs “appeared to be permissible” under Florida statutes. We believe the September 2005 CDO letter should have prompted the Florida SSA to require that EFFCU implement strong CDO policies to include prudent limits on initial CDO purchases to ensure EFFCU could properly manage the complex investments, before permitting EFFCU to purchase larger volumes of CDOs. We found no evidence that the Florida SSA adequately evaluated compliance of EFFCU’s CDO policies or initial CDO purchases with the provisions in the SSA letter. It was not until the September 2007 examination that the Florida SSA and NCUA cited EFFCU’s CDO investment policy for not reflecting prudent limits on underlying collateral, which was one of the provisions in the Florida SSA’s 2005 letter.

As part of their leverage strategy to improve yields and produce income, EFFCU eventually purchased approximately $150 million of CDOs between December 2005 and June 2007.

We believe examiners should have deemed the planned CDO investment activity as a higher risk activity warranting greater supervisory efforts, especially given that the CDOs were not typical investments held by natural person credit unions. Based on information reviewed during our review and discussions with examiners and NCUA officials, EFFCU was the only FISCU to invest in CDOs. We further believe that the Florida SSA, once made aware that EFFCU planned to invest in CDOs in 2005, could have benefited from seeking additional expertise, possibly utilizing outside consultants, to help evaluate the complex securities in which EFFCU planned to invest.

Purchases in CDOs were at relatively modest levels until early 2007, when EFFCU dramatically expanded their planned CDO investment strategy. Expanding the acquisition of HEL ABS CDOs was approved at the credit union's March 3, 2007 Board investment committee meeting. From March 2007 to June 2007, EFFCU purchased an additional $94.8 million in CDOs.

We believe that NCUA and Florida SSA examiners missed another opportunity in 2006 or early 2007 to perform further review of EFFCU's initial approval to invest in CDOs and additional expansion of the program in 2007. We also believe NCUA and SSA examiners would have benefited from performing further analysis on the unusual and very complex investment activity for natural person credit unions that were beyond the expertise of EFFCU management.

The NCUA Examiner's Guide provides that if the examiner's analysis determines the credit union has a significant position in high-risk securities (e.g., CMOs, Real Estate Mortgage Investment Conduits, or other complex securities that have excessive risk) or inconsistencies with its investment, liquidity, or asset-liability policies, the examiner may review management's analysis and determine whether the credit union can manage the risk of holding the high-risk CMOs or complex securities. We found no evidence that NCUA or Florida SSA examiners evaluated whether EFFCU could manage the risk of holding the high-risk CDOs.

The Examiner's Guide further indicates that some of the factors examiners should consider in evaluating whether a credit union may safely hold high-risk investments include:

- The ability of the officials to explain the instrument's characteristics and risks to the examiner;

- The ability of the officials to obtain and adequately evaluate the instrument's market pricing, cash flows, and test modeling;

- The ability of the officials to define, explain and document how the high-risk investments fit into the credit union's ALM strategy; and

- The effect that either holding or selling the high-risk bonds will have on earnings, liquidity, and net worth in different interest rate environments.

We again found no evidence that examiners considered the above factors in evaluating whether EFFCU possessed the ability to safely hold the high-risk CDO investments. In particular, we found no evidence where the examiners considered the ability of EFFCU officials to explain the instruments' characteristics and risks.

Lastly, the Examiner's Guide indicates that after obtaining the concurrence of the supervisory examiner and regional office, examiners may seek divestiture if they believe continued ownership of high-risk securities represents an undue risk to the credit union. This risk can arise from the following:

- The size of a credit union's holdings of high-risk securities in relation to its capital and earnings;

- Management's inability to demonstrate an understanding of the nature of the risks inherent in the securities;

- The absence of internal monitoring systems and other internal controls to appropriately measure the market and interest rate risk (IRR) of these securities; or Management's inability to manage its overall IRR.

We believe had the NCUA and Florida SSA examiners performed further evaluation of EFFCU management and Board's lack of understanding of the risks and characteristics of the CDO investments earlier in the process, they could have concluded that EFFCU's ownership of the high-risk securities represented an undue risk to the credit union, and could have required EFFCU to place more prudent limits on CDO holdings, or otherwise required earlier divestiture.

For example, the NCUA could have required that EFFCU commit to a written plan and timeline for addressing key risks identified by examiners prior to September 2007 and monitored EFFCU's performance relative to the plan. Among other things, the plan could have required EFFCU to:

- Establish prudent risk management practices for CDO investment activities prior to the initial CDO purchases;

- Establish reasonable growth projections and parameters for ensuring that member business loans and C&D loan growth was appropriately constrained;

- Mitigate the C&D and subprime credit concentration risk in its investment and loan portfolios; and
- Reduce its dependence on ODP Fees as a primary source of income.

<u>Florida SSA and NCUA Supervision of Eastern Financial's CDO Investment Strategy</u>

The following are highlights of events and actions surrounding the SSA and NCUA supervision of EFFCU's overall CDO Investment strategy.

The NCUA RCMS participated in the September 30, 2005 annual examination with the Florida SSA to review Liquidity and ALM. At September 30, 2005, EFFCU had not yet purchased any CDOs, nor was there any mention in the examination report with regards to EFFCU's request from the Florida SSA on whether CDOs would be permissible investments. Recommendations were made for EFFCU to:

1. Expand liquidity policies for the following areas:
    - Primary liquidity sources/monitoring procedures,
    - Alternative liquidity sources,
    - Liquidity procedures under normal business conditions,
    - Liquidity procedures under emergency or stressed conditions.
2. Develop policy limits on leveraging to address the following:
    - Adequate capital maintenance for the balance sheet leverage and risk,
    - The extent of mismatch risk allowed in the leveraged strategies,
    - Adequate availability of credit lines and other alternative liquidity sources for potential emergency or stressed conditions.

The NCUA RCMS did not participate in the September 30, 2006 annual examination of EFFCU. However, during this examination a Florida SSA examiner reviewed liquidity and ALM and noted in the preliminary risk assessment that EFFCU had "sophisticated investments." The September 30, 2006 exam scope identified that EFFCU received approval from Florida SSA to invest in CDOs effective September 13, 2005. This report also noted that the credit union was growing quickly and that capital was on a declining trend. Examiners further recognized the level of complexity and sophistication in the credit union. Examiners commented that while management was strong in the area of research and setting controls before program implementation, management was often too aggressive and overlooked the need to ensure regulatory compliance. Examiners concluded that although the credit union was operating soundly at September 30, 2006, it would be necessary for supervisory review of the monthly financial condition, new credit union services and programs and overall performance to continue in order to properly monitor the constant ongoing changes at this credit union.

The RCMS conducted an ALM Investment contact for the March 30, 2007 financial date. The examiner cited the credit union's current investment strategy involving purchasing HEL ABS and CDOs funded with short-term borrowings. The examiner determined that $45 million of CDOs were purchased during March and April 2007. The examiner further determined that the total acquisitions approved under this strategy would raise the investments in ABS and CDOs close to the Florida Statute limit of $168 million, which was based on 10 percent of EFFCU's shares and retained earnings at March 31, 2007. In addition, correspondence sent from the RCMS to the NCUA Examiner in Charge and Supervising Examiner for EFFCU indicated:

- The $99 million CDO portfolio consisted of private placement CDOs under SEC Rule 144A. The examiner further reported that the CDOs were not registered with the SEC so they were only available to qualified institutional buyers.[15]

- Eastern Financial was the only natural person credit union to invest in CDOs.

- The RCMS requested assistance from NCUA's Office of Capital Markets and Planning (OCMP) on the upcoming September 30, 2007 examination of EFFCU to review the CDOs and the CDO investment strategy.

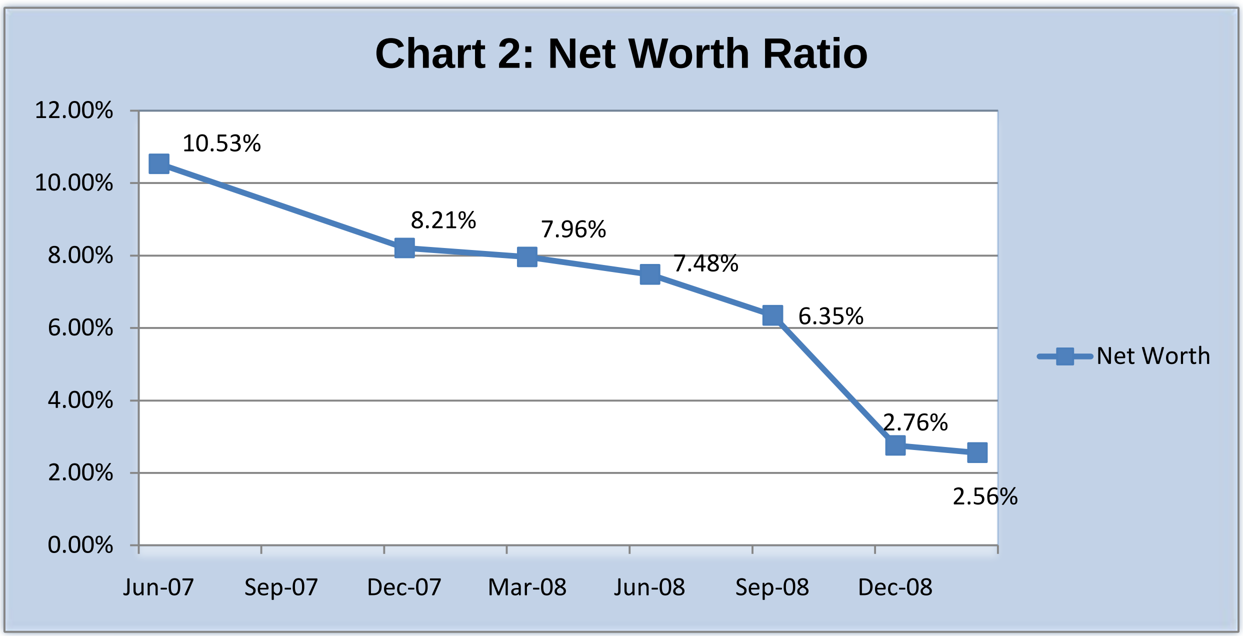
During the September 30, 2007 examination, EFFCU's CDOs had unrealized market value losses of $63.4 million, or 42 percent of the CDOs' book value. As a result of this September 2007 exam, the NCUA and Florida SSA issued a DOR and eventually a joint LUA to instruct management and the Board to perform a risk assessment on the entire loan and investment portfolio to determine the current risk exposure to the credit union's net worth. The DOR included numerous provisions for EFFCU to better manage operating expenses, cease further CDO purchases, and develop, adopt, and implement maximum risk levels to be maintained. We believe that if some of the corrective actions were brought to EFFCU management's attention before September 2007, EFFCU management could have been better informed about the risk of the underlying collateral and potential losses that could be recognized by the CDOs.

Based on the NCUA and Florida SSA observations at each examination, in retrospect, a stronger supervisory response at earlier examinations may have been prudent in light of the nature and extent of the risks and the institution's lack of adequate or timely corrective action. Earlier and stronger supervisory action may have influenced EFFCU's Board and management to limit the significant level of risk assumed during the institution's rapid

[15] Bloomberg and other financial data services would have limited information available on private-label CDOs.

growth period, especially in their CDO leverage strategy and MBL activities, where they suffered the largest losses that caused the failure.

During the September 2007 examination, NCUA and the Florida SSA examiners issued a DOR to EFFCU management directing them to establish comprehensive policies on: (1) reasonable limits on CDOs, and (2) limits on underlying collateral in the CDOs (or appropriate documentation to substantiate the legality, credit, and investment risks of CDOs). Unfortunately, by September 30, 2007, EFFCU had already purchased close to $150 million in CDOs that were rapidly deteriorating in value with limited opportunities for divestiture. As the CDO losses were recorded to earnings in 2007 through 2009, this significantly impacted EFFCU's net worth. Chart 2 (below) illustrates EFFCU's Net Worth ratio from June 2007 through December 2008.



FINDINGS AND SUGGESTIONS

This section summarizes key report findings and suggestions for NCUA management to consider in addressing issues leading to the failure of the credit union as well as with NCUA and Florida SSA supervision of the credit union.

I. Finding:

Eastern Financial's management and Board exposed the credit union to excessive risks by not placing prudent limits on CDO sectors. Furthermore, the lack of reasonable limits on the CDO exposure was found to be the major factor leading to the large mark-to-market losses in the investment portfolio and continued write downs of the CDOs. Reasonable measures would have included lower limits for the CDO sector and further limits on underlying collateral exposure as percent of net worth.

Suggestion

When a credit union requests approval to purchase investments in complex securities not typically seen by the examiners, NCUA could instruct examiners to perform additional analysis to ensure credit union management and Board understand the nature of the securities and the related risks. NCUA should require the credit union to:

- Establish prudent risk management practices for CDO investment activities prior to the initial CDO purchases;
- Establish reasonable growth projections and parameters for ensuring that member business loans and C&D loan growth was appropriately constrained; and
- Mitigate the C&D and subprime credit concentration risk in its investment and loan portfolios;

II. Finding

We believe had the NCUA and Florida SSA examiners performed further evaluation of EFFCU management and Board's lack of understanding of the risks and characteristics of the CDO investments earlier in the process, they could have concluded that EFFCU's ownership of the high-risk securities represented an undue risk to the credit union, and could have required EFFCU to place more prudent limits on CDO holdings, or otherwise required earlier divestiture.

<u>Suggestion</u>

We believe NCUA should consider evaluating the guidance provided to examiners when encountering CDOs to possibly include better defined limits on CDO sectors and underlying collateral as a percent of Net worth, and consider requiring further evaluation of CDO sector and collateral exposure during examinations to better understand risk to NCUSIF. We do not believe NCUA should rely solely on State Statutes to determine limits on investments in complex securities such as CDOs.

In addition, when highly complex investments are considered by credit union management, we believe the Region should request the assistance from the NCUA Chief Accountant and/or the Office of Capital Markets and Planning (OCMP) early in the process to obtain a broader understanding of the features and specific risks of the securities. NCUA officials at the national level would be better positioned to obtain outside expertise as warranted – especially when the securities are highly complex and not typical credit union investments. It is difficult for a regional expert to obtain the level of knowledge required to fully understand the features and risks of all types of securities products developed, and this may be better managed at a national level.

III. <u>Finding</u>

Eastern Financial's Board supported a high cost, aggressive growth strategy that ultimately drove down core earnings and encouraged management to search for higher returns in higher risk investments. Eastern Financial's management routinely exceeded the projected costs for opening new branch locations without any resulting actions by the Board being taken regarding the growth strategy. Eastern Financial's Board failed to understand and manage the level of risk undertaken by management in both its acceptance of the strategy to invest in higher risk CDO investments as well as the higher risk C&D Member Business lending.

<u>Suggestion</u>

NCUA should consider more careful analysis of Boards at larger, more complex credit unions, and encourage Board members to more carefully evaluate credit union expertise with new and expanded products or activities during an aggressive growth period.

IV. <u>Finding</u>

Examiners recognized the level of complexity and sophistication in the credit union before significant problems surfaced and commented that while management was strong in the area of research and setting controls, management was often too aggressive and overlooked the need to ensure regulatory compliance. The credit union also had a history of requesting waivers from regulatory limits while violating others.

<u>Suggestion</u>

NCUA should consider encouraging examiners and Regional offices to perform further analysis of instances where a credit union has recurring regulatory violations or otherwise demonstrates a desire to circumvent regulatory limits or fails to respect regulatory compliance.

Appendix A - NCUA Management Comments

VIA E-Mail

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

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

SUBJ: Material Loss Review of Eastern Financial Florida Credit Union #68486

DATE: April 30, 2010

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

Eastern Financial Florida Credit Union (EFFCU) failed due to management's inability and a lack of oversight by the board of directors to keep up with the credit union's growth and sophistication. Specifically, EFFCU's management:

- Exposed the credit union's net worth by purchasing Collateralized Debt Obligations[1] (CDOs) without possessing the requisite expertise needed to manage the risks associated with this complex type of investment.

- Lacked a sound risk management program to manage strategic plans. For example:

    - Implemented an unsustainable growth strategy;

    - Created an environment of excessive spending and inefficient operations; and

    - Offered construction and development member business loans (MBLs) which exceeded statutory limits. Construction and development loans exceeded net worth by 40 percent.

- Failed to adequately respond effectively to SSA and NCUA examiners' findings and recommendations.

We acknowledge your findings that management exposed the credit union to excessive risks. NCUA has long provided guidance to credit unions regarding the importance of having the proper knowledge, policies, and procedures in place before beginning any new program.

[1] During September 2005, EFFCU's management sought and received concurrence from the Florida SSA that CDOs were permissible under Section 657.042(7)(b) of Florida Statutes.

NCUA also recognizes that strong supervisory attention is necessary for credit unions with complex balance sheets. There were early opportunities to better understand the depth of the risks and for the State Supervisory Authority and NCUA to increase its supervision efforts to monitor this credit union. NCUA has intensified its monitoring and supervision efforts in all credit unions including state chartered credit unions to ensure more timely corrective actions.

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

APPENDIX B - Acronyms

Acronym	Definition
ABS	Asset-Backed Security
AIRES	Automated Integrated Regulatory Examination Software
C&D	Construction and Development
CDO	Collateralized Debt Obligation
Eastern Financial or EFFCU	Eastern Financial Florida Credit Union
FISCU	Federally Insured State-Chartered Credit Union
Florida SSA	Florida State Supervisory Authority
FPR	Financial Performance Reports
HEL	Home Equity Loan
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
ODP	Overdraft Privilege
OIG	Office of Inspector General
ROAA	Return on Average Assets