NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW
OF
ENSIGN FEDERAL CREDIT UNION

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William A. DeSarno
Inspector General

Released by:

James W. Hagen
Deputy Inspector General

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ACRONYMS

AIRES	Automated Integrated Regulatory Examination Software
ALCO	Asset Liability Committee
ALLL	Allowance for Loan and Lease Loss
ALM	Asset Liability Management
CEO	Chief Executive Officer
CLF	Central Liquidity Fund
CUSO	Credit Union Service Organization
DOR	Document of Resolution
FCU Act	Federal Credit Union Act
FHLB	Federal Home Loan Bank
FPR	Financial Performance Reports
GAAP	Generally Accepted Accounting Principles
HELOC	Home Equity Lines of Credit
IRR	Interest Rate Risk
LTV	Loan-to-Value
LUA	Letter of Understanding and Agreement
MBL	Member Business Loan
MLR	Material Loss Review
NCUA	National Credit Union Association
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
QCR	Quality Control Review
RegFlex	Regulatory Flexibility Program
RFE	Risk-Focused Examination
TDR	Troubled Debt Restructuring
WCC	Work Classification Code

Executive Summary

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP to conduct a Material Loss Review (MLR) for the Ensign Federal Credit Union (Ensign or the Credit Union). We reviewed Ensign to: (1) determine the cause(s) of the Credit Union's failure and the resulting loss to the National Credit Union Share Insurance Fund (NCUSIF); (2) assess NCUA's supervision of the 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 NCUA Regions I & V, and reviewed NCUA guidance. We also reviewed Regions I & V policies and procedures, NCUA 5300 Call Reports, and NCUA Financial Performance Reports (FPR).

We determined Ensign failed because its Board of Directors and management did not implement appropriate risk management practices related to concentration and credit risks. Specifically, management adopted a high-risk strategy that allowed concentrations of up to 80 percent of the loan portfolio in loans secured by real estate, making them vulnerable to the steep and rapid decline in Nevada property values.

Additionally, management failed to ensure proper risk mitigation practices were in place at the Credit Union. Management did not have a proper allowance for loan loss methodology, allowed loan-to-value ratios on Home Equity Lines of Credit (HELOC) loans up to 100 percent, and allowed for 40-year terms on mortgages. Management also failed to implement an effective collection program or conduct regular Asset Liability Management (ALM) meetings. Furthermore, management created additional strain on the Credit Union by not formulating an effective business strategy, committing to excessive fixed assets in the form of branch expansion, and failing to control liquidity risk.

NCUA examiners determined, and we agree, that Ensign management:

- Practiced poor management and lacked adequate Board oversight; and
- Allowed large concentrations in mortgage loans.

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

Examiners followed NCUA guidance with regard to monitoring and frequency of examinations. Although examiners properly identified the significant issues at Ensign, we believe examiners did not sufficiently downgrade the Credit Union in a

timely manner. As a result, we believe examiners missed opportunities to mitigate the loss to the NCUSIF.

This report does not contain recommendations, but provides observations and suggestions. However, the OIG plans to issue an MLR capping report with recommendations based on issues raised in this report as well as the other nine Material Loss Reviews conducted by the OIG. As resources allow, the OIG may also conduct more in-depth reviews of specific aspects of the NCUA's supervision program and also make recommendations, as warranted.

Auditor observations made as a result of our review of Ensign's failure include:

- A documented secondary review by the Supervisory Examiner of the final CAMEL ratings prior to issuance to credit union management would ensure examination evidence gathered is sufficient, competent, and relevant, to reasonably support the ratings. In addition, NCUA could enhance its quality control review process by better defining the sampling strategy and criteria, the supervisory review procedures, and the follow up requirements to ensure conclusions, and enforcement actions are properly supported and more consistent between regions.

- The risk-focused examination process would benefit from the development of a stronger more specific process to better identify, analyze, and monitor loan concentrations during examinations, as well as between examinations. Consideration should also be given to whether to propose and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk, and to determine an appropriate range of examiner response to high risk concentrations.

- The off-site monitoring process could be improved by placing more emphasis on quarterly monitoring of 5300 Call Reports. Specific monitoring triggers could be developed to more easily 'red flag' areas to be investigated, as well as provide a specific time allocation. In addition, examiners need to better document and retain the analysis and specific procedures performed during their quarterly review of 5300 Call Reports.

- Re-emphasize to examiners the importance of evaluating management's due diligence over new and fast growing programs, as well as other areas of emphasis, to ensure appropriate analysis was considered by management and to provide support for examiner ratings.

NCUA management's comments can be found in Appendix B. We appreciate the effort, assistance, and cooperation management and staff provided to us during this review.

Background

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) authorized Moss Adams LLP to conduct a Material Loss Review (MLR) for Ensign Federal Credit Union (Ensign or the Credit Union), as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j).[1] Ensign was a federally chartered credit union, headquartered in Henderson, Nevada. Ensign was located in NCUA's Region V until January 2009 when through an NCUA restructuring, the state of Nevada was transferred to NCUA's Region I.

History of Ensign Federal Credit Union

Chartered in 1961, Ensign Federal Credit Union served employees and members of the Church of Jesus Christ of Latter Day Saints in the Nevada counties of Clark, Nye, and Lincoln. Ensign served approximately 8,000 members through five branches in the Henderson, Nevada area.

The Credit Union focused heavily on residential real estate lending in the Las Vegas metropolitan area. A significant number of these loans were originated prior to 2007, when the values of residential real estate peaked in this area. The Las Vegas metropolitan area experienced declines in real estate values of over 50 percent between January 2007 and March 2009.[2] Additionally, unemployment in the area reached over 14 percent by September 2009.[3] The combination of rapidly declining real estate values and increasing unemployment led to increased loan delinquency rates beginning in mid-2007. By mid-2008, losses on these loans began to increase due to continuing economic decline in the area. Delinquency rates by September 2009 were in excess of 13 percent compared to less than one percent two years earlier.

The December 2007 examination identified several problem areas including monitoring and managing interest rate and liquidity risks; risky construction and development lending; member business loan violations; lack of credit risk profiling and risk mitigation; under funding of the Allowance for Loan and Lease Loss[4] (ALLL) account; and insufficient financial reporting to the Asset Liability Committee (ALCO) and the Board of Directors. These items resulted in a composite CAMEL rating of 3.

[1] On July 21, the President signed into law the Wall Street Reform and Consumer Protection Act of 2010, raising the threshold for future NCUA-OIG MLRs to $25 million.
[2] Source: National Association of Realtors
[3] Source: U.S. Bureau of Labor Statistics
[4] Allowance for Loan and Lease Losses is a valuation account established to recognize estimated loan impairment before probable losses on individual loans have been confirmed resulting in a subsequent charge-off or write-down. The ALLL is an accounting estimate of probable but unconfirmed asset impairment that had occurred in the loan portfolio as of the financial statement date.

NCUA's Region V conducted three supervisory contacts during 2008 and the composite CAMEL rating remained at 3. The Credit Union's balance sheet was heavily concentrated in real estate loans and during 2008, delinquency and charge-off rates increased dramatically with nonperforming assets growing from six percent at the beginning of 2008 to 13.5 percent one year later.

Examiners noted several violations of NCUA Rules and Regulations in the December 2007 examination report. Specifically, examiners identified violations of Parts 723.3, 723.8, and 723.16, which govern Member Business Loan (MBL) limitations for Construction and Development loans, MBLs to one individual or associated group, and aggregate MBLs, respectively. These were repeat violations from the 2004 examination. Ensign also violated section 701.21(c)(4) of the FCU Act by granting certain MBLs in excess of 15-year terms.

Examiners also noted Ensign violated NCUA Rules and Regulations section 701.36(a)(i) by continuing to invest in fixed assets subsequent to losing its Regulatory Flexibility Program[5] (RegFlex) eligibility and not obtaining a waiver from the Regional Director to continue investing in fixed assets. Ensign's fixed asset ratio was in excess of regulatory limits when examiners downgraded Ensign to a composite CAMEL 3 during the December 2007, examination.

Throughout 2007 and 2008, home values within Ensign's field of membership area rapidly declined and unemployment increased significantly, resulting in mounting delinquencies and charge-offs for the credit union. Ensign reported a net operating loss of $4 million during 2008, due primarily to $4.2 million in funding to the ALLL account and the net worth ratio was reduced from 9.56 percent to 7.32 percent by the end of 2008.

In February 2009, examiners conducted an examination and concluded Ensign was in an "unsatisfactory condition" and gave the credit union a composite CAMEL rating of 4 noting weak management, including a significant lack of planning, monitoring, and controlling the Credit Union's risk areas. The examination cited several Document of Resolution (DOR) matters for management to address, as well as the issuance of a Letter of Understanding and Agreement (LUA) to Credit Union management. Management signed the LUA on February 26, 2009, and agreed to seek a merger partner.

As previously noted, in January 2009, Ensign and all other Nevada credit unions were transferred and reassigned to Region I. As a result of the declining conditions at Ensign, Region I assigned the Credit Union to its Division of Special Actions. As delinquency and loan losses continued to escalate, and net worth continued to

[5] Regulatory Flexibility Program allows eligible credit unions to be exempted from all or part of specific regulations if they meet specific parameters related to CAMEL ratings and net worth.

deteriorate, it was clear by April 2009 that Ensign was in serious financial trouble with little ability to improve. Examiners further downgraded Ensign to a composite CAMEL 5 following the March 31, 2009, examination and by July 31, 2009, Ensign had become "critically undercapitalized" with a net worth ratio of less than two percent reported on its June 30, 2009, Call Report.

On November 13, 2009, NCUA closed Ensign and authorized the purchase and assumption (P&A) of member share accounts by EDS Credit Union of Plano, Texas. The loss to the NCUSIF is estimated not to exceed $30 million.

NCUA Examination Process

Total Analysis Process

NCUA uses a total analysis process that includes: collecting, reviewing, and interpreting data; reaching conclusions; making recommendations; and developing action plans. The objectives of the total analysis process include evaluating CAMEL[6] components and reviewing qualitative and quantitative measures.

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

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,[7] trend analysis,[8] reasonableness analysis,[9] variable data analysis,[10] and qualitative data analysis.[11] Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

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

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

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

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

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

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

Financial indicators such as adverse trends, unusual growth patterns, or concentration activities can serve as triggers of changing risk and possible causes for future problems. NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, NCUA requires examiners to determine whether material negative trends exist; ascertain the action needed to reverse unfavorable trends; and formulate, with credit union management, recommendations and plans to ensure implementation of these actions.

Risk-Focused Examination Program

In 2002, NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include both off-site and on-site work that includes reviewing off-site monitoring tools and risk evaluation reports. The RFE process includes reviewing seven categories of risk: *Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic,* and *Reputation.* Examination planning tasks may include: (a) reviewing the prior examination report to identify the credit union's highest risk areas and areas that require examiner follow-up, and (b) analyzing Call Reports and direction of the risks detected in the credit union's operation and on management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in the profile through:

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

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

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

Objectives, Scope, and Methodology

We performed this MLR as required by section 216 of the Federal Credit Union Act, 12 U.S.C. 1790d(j) for Ensign Federal Credit Union. Section 216(j) of the FCU Act provides that the Inspector General must conduct a review when the NCUSIF has incurred a material loss. For purposes of determining whether the fund has incurred a loss that is "material," a loss is material if it exceeds the sum of:

- $10,000,000;[13] and
- An amount equal to 10 percent of the total assets of the credit union at the time in which the Board initiated assistance under Section 208 or was appointed liquidating agent.

The objectives of the MLR were to:

- Determine the causes of the Credit Union's failure and any material loss to the NCUSIF;
- Assess NCUA supervision of the institution, including implementation of the Prompt Corrective Action requirements of Section 208 of the FCU Act; and
- Make appropriate recommendations to prevent future losses.

The scope of this review included an analysis of NCUA examinations and the Credit Union's transactions and activities from 2004 to 2009.

To achieve the objectives, our methodology included the following procedures:

- Completed a Risk Assessment based on review of NCUA examination files;
- Prepared a chronology of examination scope and procedures, comments, and corrective actions;
- Prepared data tables and analyses related to lending activities;
- Reviewed Board minutes;
- Summarized external audit findings and follow-up procedures;

[13] On July 21, 2010, the President signed into law the Wall Street Reform and Consumer Protection Act of 2010, raising the threshold for future NCUA-OIG MLRs to $25 million.

- Conducted interviews with NCUA officials involved at various levels in the examination process;

- Evaluated risk management and internal controls, including effectiveness of corporate governance, management oversight, and decision making;

- Performed loan quality procedures, particularly related to concentrations, underwriting, and documentation;

- Reviewed policies and procedures included in examination files related to investment quality, liquidity management, and earnings;

- Reviewed NCUA and Region V and Region I rules, regulations, and guidelines; and

- Assessed NCUA supervision as it relates to Ensign.

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

We conducted this audit from April through September 2010 in accordance with Generally Accepted Government Auditing Standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Results in Detail

We determined that Ensign Federal Credit Union management and Board of Directors contributed directly to the Credit Union's failure. In addition, we determined NCUA examiners could have reduced the loss to the NCUSIF had they adequately assessed and more aggressively pursued resolution to issues related to the Credit Union's high concentration and credit risk related to its real estate loan portfolio.

A. Why Ensign Federal Credit Union Failed

Management's inadequate risk management and lack of Board oversight led to Ensign's failure. Management of Ensign adopted strategies that created a high level of risk, particularly related to concentration and credit, without the necessary risk management policies and procedures to monitor and control these risks. Ensign charged off in excess of $5.4 million in loans between January 1, 2008, and October 31, 2009, 80 percent of which were related to real estate loans.

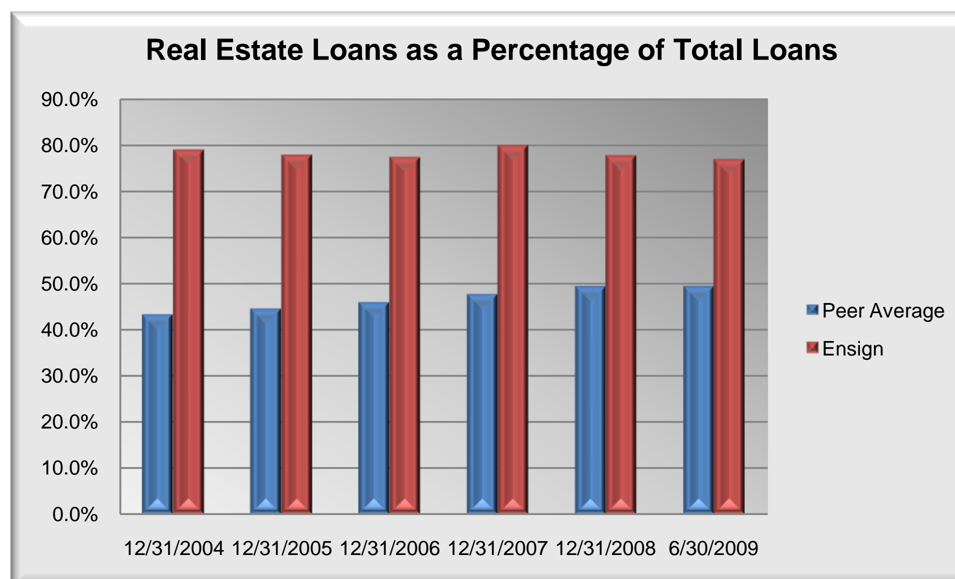
Concentration Risk

Ensign's Board and management created concentration risk in its real estate loan portfolio as a result of its focus on loan growth. Specifically, Ensign created an unsafe exposure to losses on real estate loans by growing the portfolio's concentration to over 75 percent of total loans as early as 2004. These loans were primarily in the Las Vegas metropolitan area, which experienced declines in real estate values of over 50 percent between January 1, 2007, and March 31, 2009, according to the National Association of Realtors. Additionally, unemployment in the Las Vegas area hit over 10 percent by mid-2009.

The combination of rapidly declining real estate values and increasing unemployment led to rapidly increasing delinquency rates beginning in mid-2007. By mid-2008, loan losses began to climb as a result of continued economic decline in the area. Delinquency rates at September 2009 were in excess of 13.6 percent as compared to 0.30 percent two years earlier.

Chart A (below) illustrates Ensign's excessive concentration of first mortgage and other real estate loans over the five-year period from December 2004 through June 2009. The level of real estate loan concentrations during this period was never below 75 percent of the total loans, and at its peak reached 80 percent. Ensign's real estate loan concentration was also significantly higher than its peers.

Chart A



NCUA defines concentration risk as "any single exposure or group of exposures with the potential to produce losses large enough (relative to capital, total assets, or overall risk level) to threaten a financial institution's health or ability to maintain its core operations."[14] NCUA does not define optimal concentration levels; as management is responsible for performing analysis over the portfolio composition and establishing appropriate concentration limits.

As previously noted, Ensign management failed to understand the risks associated with excessive concentrations. In addition, management did not have the tools in place that would have helped control concentration levels. For example, management did not have mechanisms in place to monitor and report to the Board risk factors within the portfolio such as loan-to-value (LTV) amounts, credit score tiers, fixed and variable rate amounts, and geographical concentrations.

During discussions with examiners, we learned Ensign management and its Board were reluctant to reduce the credit union's concentration in real estate loans because they did not perceive these loans as being risky. There was also little evidence in the monthly Board minutes to suggest that management was actively monitoring the concentration levels and the associated risks.

[14] Letter to Credit Unions, No.10-CU-03, "Concentrations," issued March 2010.

Credit Risk

We determined Ensign management failed to monitor and control the credit risk associated with its lending activities and used a flawed ALLL methodology. Additionally, the Credit Union's lenient lending policy allowed LTV ratios on HELOCs of up to 100 percent and 40-year terms on mortgages.

NCUA guidance requires the Boards of Directors of federally-insured credit unions to ensure the credit unions have controls in place to consistently maintain the ALLL in accordance with the credit union's stated policies and procedures, generally accepted accounting principles, and ALLL supervisory guidance. We found no evidence Ensign's Board reviewed the ALLL during monthly Board meetings. Specifically, we found Ensign's Board did not adequately monitor management's process to determine the ALLL. Additionally, we determined examiners identified several weaknesses in the ALLL methodology that were not corrected or addressed by the Board or management. These weaknesses included a lack of review of individual loans for specific impairments or any environmental or qualitative factors in the ALLL calculation, despite the declining Nevada real estate market and rising loan delinquencies.

Ensign management's policy to allow HELOCs to be originated at amounts up to 100 percent of the value of the underlying collateral greatly contributed to its large losses. Examiners found this to be an unsafe and unsound practice when combined with the excessive decline in the Las Vegas area real estate market.

Ensign management's policies also allowed for mortgage terms in excess of 30 years, specifically up to 40 years. The Board and management allowed these loans to be originated without properly understanding or properly monitoring the increased interest rate risk (IRR)[15] associated with these loans.

Examiners identified errors in reporting to the ALM committee, which resulted in the committee believing there was a smaller amount of 40-year mortgages. As a result, the committee made inappropriate decisions when matching liabilities to these assets. Examiners identified an under-reporting of these loans in the amount of approximately $17 million. The reporting errors served to increase the risk environment, ultimately limiting management's ability to control risks.

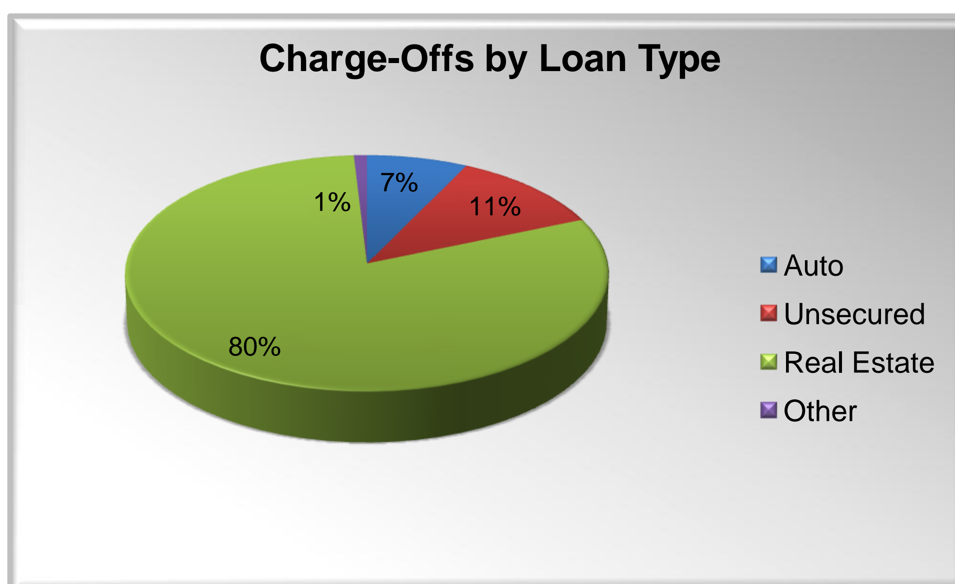
Management also failed to implement an effective collection program. Examiners noted that, despite the material increase in delinquency and charge-off amounts, the collection department was staffed by only two collectors who did not have significant

[15] NCUA policy defines IRR as the potential decline in earnings and net worth arising from changes in interest rates. This risk generally occurs because a credit union may have a disproportionate amount of fixed and variable rate instruments on either side of the balance sheet. Thus, as interest rates change, the earnings stream or dividend expense on variable rate balances will change while fixed rate balances will remain the same.

experience. Additionally, we found no evidence in the Board minutes that management provided timely reporting of the delinquencies to the Board, a clear indication of a lack of oversight. The weak collection practices at Ensign likely contributed to the large delinquencies, but were not a direct cause of the failure.

As a result of management's inability to manage and control its concentration and credit risk, Ensign experienced significant losses in its real estate loan portfolio. Between January 1, 2008, and October 31, 2009, Ensign charged off in excess of $5.4 million in loans, with 80 percent coming from the real estate portfolio. Chart B (below) provides a detailed breakout of charge-offs by loan type.

Chart B



Source: Ensign Board Packets and 5300 Call Reports for 2008 - 2009.

<u>Oversight and Risk Management</u>

We determined management and Board oversight as well as management's poor risk management practices did not effectively monitor or control Ensign's overall risk.

Much of the losses at Ensign were due to insufficient income being generated because of an increase in fixed assets during the five years preceding its failure. Although concentration and credit risk greatly contributed to its losses, Ensign was operating at a net loss on a monthly basis from basic operations. Despite management taking steps to reduce expenses in the year prior to failure, expenses could not be reduced enough to restore profitability.

Under an ill-timed expansion strategy adopted by management and the Board, the Credit Union expanded from two to five branches from 2004 through 2009. Total fixed assets, including operating leases, totaled $11.8 million by the date of failure. This represented 11 percent of total assets. The level of fixed assets in relation to the total assets was outside of regulatory limits; however, Ensign was given a waiver under the NCUA's Regflex program as long as the Credit Union maintained a composite CAMEL rating of 2 or better.

The increase in branches also led to an increase in operating expenses. The Credit Union owned two branches, the main headquarters in Henderson, Nevada with a book value of $5.7 million and the Southwest branch, with a book value of $1.8 million. The other three branches were leased under restricted lease agreements with no escape clauses. This made the possibility of breaking the leases cost prohibitive. Additionally, the decrease in the market values of the owned buildings would have resulted in significant losses if a sale was completed.

Ensign had a net loss of $4 million in 2008 with an additional $10 million through September 2009. While the majority of these losses were attributable to the provision and Other Real Estate Owned (OREO) expenses, the Credit Union was still not generating positive income without these items. This was primarily due to acceleration in fixed asset growth, which increased operating expenses and decreased income earning assets. This mismanagement of the balance sheet placed significant strains on Ensign's ability to cope with the declining economic conditions.

In addition to the fixed asset growth, Ensign was placed in a position of having to sell performing first mortgage loans in 2008 and 2009 and had unplanned borrowings and high cost CDs to satisfy liquidity problems. This negatively impacted the yield on assets and the cost of funds. Operating expenses escalated as a result of increased branch facilities and collection expenses increased as default rates climbed. An additional effect of increased delinquencies was the high provision expenses. All of these items resulted in decreased return on assets and, ultimately, a deficit in retained earnings.

Management also demonstrated poor liquidity strategies. Management accepted a $12 million share account from one member in December 2007 and the ALCO did not establish a contingency plan in the event this money was withdrawn. In January 2009, the member requested to close this account but Ensign did not have sufficient liquidity to process the withdrawal. With NCUA's assistance, Ensign obtained a $12.5 million 30-day loan from the Central Liquidity Fund (CLF). With their options limited due to poor planning, management sold $6 million worth of 30-year fixed rate real estate loans, $500,000 worth of investments, and solicited $8 million in nonmember deposits in order to repay the loan. The Credit Union did not incur

losses on the asset sales; however, these moves reduced the net interest margin leading to increased operating losses each month in 2009.

Management and the Board did not have a sound, written business plan. Because of this lack of direction, they made poor strategic decisions in the years leading up to the failure, which included:

- Investing in a concentration of long-term fixed rate mortgages, $16 million in 40-year terms for example, without properly evaluating liquidity and interest rate risks;

- Opening new branches without properly evaluating the effect on expenses and the balance sheet;

- Approving two large member business loans ($2.2 million and $3.6 million), one of which represented 25 percent of net worth when it was approved, and ultimately foreclosed, costing the Credit Union over $1.5 million in losses due to property devaluations;

- Inaccurate budgeting practices, which in the 2009 budget included projected asset growth that was inconsistent with the negative share growth Ensign experienced during 2008; and

- Approved unsupported budget strategies, including operating expenses that were budgeted well below actual figures with no supporting plan for how management would achieve their goals.

Examiners noted that, in general, senior management was late to recognize and address problem areas. Departments were not integrated properly and the ALCO function was severely lacking. Balance sheet risk management did not promote integration of planning, profitability, safeguarding of net worth, and risk management. Management continued to make decisions based on reactionary instincts rather than being proactive. Improvements were made during and subsequent to the 2009 examination; however, the improvements were not significant enough to turn the course of Ensign's financial performance.

We learned through interviews and examination reports that NCUA officials believed that Ensign's management team was inexperienced and ill-equipped to effectively address and resolve the Credit Union's problem areas. In addition, NCUA officials indicated Ensign management needed the constant presence of the NCUA to help make decisions. Examiners believed management was reactive and lacked the expertise to analyze the Credit Union's risks and implement corrective action.

Examiners noted Ensign's chief executive officer (CEO) lacked leadership and initiative; attributes examiners indicated were systemic throughout the Credit Union.

Further, examiners indicated they essentially had to direct Credit Union management to make basic decisions. For example, examiners:

- Provided the recommendation to sell mortgages and investments, and obtain nonmember deposits to meet the CLF loan obligation;
- Directed management to establish a system to market to large shareholders who were threatening to close their accounts by offering to meet competitors' rates;
- Directed management to hire an experienced collector to address the growing delinquency and charge-offs;
- Directed the Credit Union to bring the servicing of the MBL portfolio in-house because of the deteriorating servicing by the Credit Union Service Organization (CUSO); and
- Directed the Credit Union to reduce unnecessary staff.

While we acknowledge the unprecedented economic decline in 2007 and 2008 contributed to the losses at Ensign and its ultimate failure, it is clear the Board and management failed to understand, control, and respond to the risks created by its own actions and strategies.

B. NCUA Supervision of Ensign Federal Credit Union

We determined examiners did not adequately assess critical risks created by management decisions and strategies related to concentration, credit, liquidity, and profitability. Further, we believe examiners did not aggressively pursue a timely resolution to concerns raised in examinations, resulting in missed opportunities to mitigate those risks and limit NCUSIF exposure.

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

Examiners did not adequately or consistently identify key risks at Ensign and failed to appropriately downgrade the CAMEL components in a timely manner, resulting in a lack of focus, communication, and attention on growing risks. Further, they did not aggressively monitor corrective actions in a timely or effective manner. Examples include:

- Examiners rated Ensign a composite CAMEL 2 and 1 in the 2004 and 2006 exams, respectively. The factors that were determined to be the ultimate causes of failure, including management strategies and high real estate loan concentrations, were present in all examinations issued during the years in the scope of this MLR.

- For the 2006 NCUA examination, examiners assigned a CAMEL 1 rating to the Asset Liability Management (ALM) component and stated in the report the Credit Union had "active and sound ALM oversight." Our review of the Board minutes and examiner workpapers, however, determined the ALM oversight in the 2006 examination was consistent with the ALM oversight in 2007 examination when examiners downgraded this component to a CAMEL 3.

- Examiners identified the risk in the real estate loan concentration in their assessment of interest rate risk as early as 2005; however, examiners indicated the risk was mitigated by the appropriate ALM practices and did not provide sufficient evidence supporting that conclusion.

- The "Capital" component of the CAMEL rating was rated a 1 until the 2008 examination, even after the examiners identified the ALM process as less than adequate in the 2007 examination. Given the continuing decline in the performance of the Credit Union, we believe this rating was not well supported.

- "Management" was downgraded to a CAMEL 3 in the 2007 examination, in which an extensive DOR noted significant issues with management oversight, including deficient policies, inadequate monitoring, and incomplete reporting.

A CAMEL rating of 3 indicates that, "management and board performance needs improvement or risk management practices are less than satisfactory" and a CAMEL rating of 4 indicates," management and board performance needs improvement or risk management practices are inadequate". Given the seriousness of the management concerns expressed in the DOR and the accompanying decline in the performance of the Credit Union, we believe the CAMEL 3 rating for the Management component was not appropriate and did not focus enough attention on management's competence.

- The December 31, 2008, examination resulted in a composite CAMEL 4 rating; however, the language in the examination stated:

  > *"We feel the overall financial and operational condition of your credit union is of such supervisory concern, that a high potential for failure within the next 12 months exists."*

  We believe this statement indicates a composite CAMEL 5 rating would have been more appropriate. NCUA's internal Quality Control Review (QCR) of this examination also questioned why the examination did not result in a CAMEL 5 rating; however, the quality control reviewer still agreed with the overall examination results.

- The 2007 examination included an extensive DOR, as noted above. In the off-site June 2008 examination that followed, it was noted that Ensign had not yet complied with the 2007 DOR with regard to concentration limits, a moratorium on 30 to 40-year fixed rate mortgages, and updating the ALLL methodology as directed for qualitative and environmental factors based on current market conditions and trends. Given the significance of these issues in the failure of Ensign, we believe more aggressive follow-up action was warranted.

Additionally, we did not find consistent evidence of Supervisory Examiner (SE) review of examination workpapers prepared by field examiners, nor documented concurrence on findings and CAMEL ratings prior to report issuance. We further noted that the QCR process is done on a sample basis after an examination is finalized and communicated with management, and that the scope and quality of the SE review of the QCR varies between regions.

As noted in the NCUA Letter to credit unions on the CAMEL Rating System dated December 2007, this system is a tool to evaluate a credit union's performance and risk profile, and "examiners are expected to used their professional judgment and consider both qualitative and quantitative factors when analyzing a credit union's performance." NCUA examiners followed the total analyses and risk-focused

examination process, as well as their professional judgment, to determine and guide their assessment of Ensign operations, safety, and soundness.

Until the December 31, 2007, examination, Ensign received composite CAMEL ratings of 1 or 2, indicating a long track record of strong performance. The December 2007 examination identified several problem areas and deteriorating performance, resulting in a downgrade from a composite CAMEL 1 to a CAMEL 3 rating. Ensign management did not correct the problems, therefore examiners further downgraded the Credit Union in December 2008 to a composite CAMEL 4, and finally to a composite CAMEL 5 in March 2009.

The rapid decline of Ensign's CAMEL rating for the period from September 2004 through March 2009 is detailed in Table 1 (below):

Table 1

Examination Date	**Sept-04**	**June-06**	**Dec-07**	**Dec-08**	**Mar-09**
Completion Date	1/20/05	9/14/06	2/28/08	2/27/09	6/30/09
Contact Type[16]	10	10	10	10	22
CAMEL Composite	**2**	**1**	**3**	**4**	**5**
Capital/Net Worth	1	1	1	4	5
Asset Quality	2	1	2	4	5
Management	2	2	3	4	5
Earnings	2	2	3	5	5
Liquidity/ALM	1	1	3	5	5

In addition to the examinations detailed above, examiners also conducted a limited scope examination in 2007; three limited scope examinations in 2008, and two limited scope examinations in 2009. These examinations were conducted on-site to follow up on problems identified during previous examinations and to monitor the performance of the Credit Union and its management.

[16] The NCUA uses various work classification codes (WCC) to standardize the types of examinations performed. An examination with a WCC "10" is a regular examination of a federally insured credit union. An examination with a WCC "22" is an on-site supervision of a federal credit union. Limited scope examinations are generally conducted to follow up on specific problems identified in previous examinations.

Observations

NCUA's total analysis and risk-focused examination process guides examiner judgment by providing the requisite and appropriate tools and guidance with which to assess the safety and soundness of credit union operations and any risk to the NCUSIF. However, we believe examiners did not adequately or consistently identify critical risks associated with Ensign's real estate loan program. Consequently, the examiners failed to appropriately downgrade the CAMEL components and aggressively monitor corrective actions in a timely manner. The supervision of Ensign highlights a lax review process that warrants consideration of a documented secondary review by the SE of the final CAMEL ratings. A secondary review prior to issuance to credit union management would ensure examination evidence gathered is sufficient, competent, and relevant, to reasonably support the CAMEL ratings

Furthermore, NCUA management should consider reviewing and revising the QCR process to better define the sampling strategy and criteria, the supervisory review procedures, and the follow up requirements, thereby assuring that conclusions and enforcement actions are properly supported and more consistent between regions.

<u>Guidelines and Processes to Identify, Limit, Analyze, and Monitor Concentration Risk Exposures are Inadequate</u>

Loan concentrations are not clearly identified and analyzed, nor are reasonable range limits established by the NCUA systematically monitored. In addition, the risk associated with the concentrations does not appear to have been considered in establishing the CAMEL ratings during the examinations.

There is a lack of clear guidance on acceptable loan concentration ranges for both examiners and credit unions. Examiners noted high real estate loan concentrations as early as 2005, and required Ensign to establish reduced concentration limits for real estate loans in the 2007 DOR. NCUA guidelines do not specify appropriate concentration ranges, so this directive was not sufficiently clear to either Ensign or examiners in monitoring compliance.

In our opinion, credit unions have too much flexibility in developing their lending policies and risk profile related to concentrations. The competitive market conditions that surrounded the real estate boom encouraged lenient lending policies and resulted in excessive risk taking. More defined concentration limits would serve to limit this risk exposure.

Observations

Examiner guidelines state that indicators such as concentration activities can serve as triggers of changing risk and possible causes for future problems. Based on loan

concentrations not adequately identified and considered in Ensign's loan portfolio, we believe the risk-focused examination process would benefit from the development of a stronger more specific process to better identify, analyze, and monitor loan concentrations during examinations, as well as between examinations. Finally, and most importantly, NCUA management should consider whether to propose and/or change regulatory guidance to establish limits or other controls for concentrations that pose an unacceptable safety and soundness risk and determine an appropriate range of examiner response to high risk concentrations. The development of asset concentration guidelines would assist both examiners and credit unions in identifying and monitoring the associated risks.

More Regulatory Emphasis Needed on Quarterly Monitoring of Call Reports

Ensign achieved a composite CAMEL 1 rating in June 2006, then dropped dramatically to a composite CAMEL 3 rating during the December 2007 examination. Further rapid decline was noted as Ensign dropped to a composite CAMEL 4 rating in the December 2008 examination and finally to a composite CAMEL 5 rating just three months later at the conclusion of the March 31, 2009 (Effective Date) examination.

Call Reports are filed quarterly and are important trend and issue indicators. Quarterly monitoring of the Call Reports is part of the NCUA examination process and such a rapid decline would be indicated in these reports, particularly in 2007, when economic conditions changed and the Nevada real estate market dropped. It does not appear that deteriorating trends and issues were detected nor was there any contact with Ensign until the next normally scheduled examination in December 2007, eighteen months later, when the problems were nearing the crisis point.

Because of inadequate monitoring of quarterly financial results, Ensign's dramatic decline was not detected by examiners soon enough to make the course changes that could have minimized the loss. In addition, the questionnaire and checklists supporting the examiner's quarterly review of 5300 Call Reports did not sufficiently document issues identified and the analysis performed.

Observations

One method NCUA examiners use to monitor the financial condition and the progress of FISCUs are through 5300 Call Reports. Specifically, NCUA's risk-focused program places a reliance on examiners using the 5300 Risk Parameters tool to assist in off-site monitoring. We believe improvements could be made in the off-site monitoring process if NCUA management were to develop and issue a national instruction to all regional offices placing more emphasis on quarterly monitoring of 5300 Call Reports. The instruction should outline the process and include specific monitoring triggers to more easily 'red flag' areas to be investigated,

as well as provide a specific time allocation. In addition, we believe any newly developed national instruction should include the requirement that examiners document and retain the specific procedures and analysis performed during their quarterly review of 5300 Call Reports.

Management Competency, Risk Management Practices, and Due Diligence Assessment Documentation is Lacking

No formal documentation was found to determine how management competence and overall risk management practices were analyzed and assessed by the examiners.

Based on our review of the Board packets and examiner workpapers, it was evident that management and the Board lacked understanding of appropriate risk management practices or the underlying risks inherent in their growth strategies, which played a large role in the demise of Ensign, most notably:

- There was no comprehensive business plan or model to guide strategic decisions;

- Policies were adopted that increased rather than limited risk, such as the policies allowing for 80 percent concentration in real estate loans and 100 percent loan-to-value HELOCs. No policy was developed to manage OREO properties;

- ALLL strategy was faulty and did not include environmental and quality considerations;

- Risk management practices and monitoring reports were inadequate and not well understood;

- Management allowed inaccurate and incomplete financial, credit, and budget reporting; an ineffective collection process; infrequent ALCO meetings; and failed to comply with the 2007 DOR;

- Management and the Board failed to respond in an effective and timely way to the economic downturn; and

- Poor asset and liquidity management practices were employed, including the decision to build more branches and take on more operating expenses, as well as the decision to take on a very large deposit and no associated plan when the deposit was withdrawn.

Additionally, Board meeting minutes were general in nature and did not fully explain or support risk management practices and policy decisions.

We found no evidence in examination files of a focused assessment on management's competence and risk management practices, both of which factored significantly in the failure of Ensign. Further, no evidence was found to support any form of due diligence on the part of Ensign management or examiners related to the policies and strategies they adopted.

Observations

Evaluating the quality and the effectiveness of management is an important part of the total analysis process and a major examination objective. Examiners evaluate the quality of management by determining the effectiveness of the Board, the committees, and operational management. Effective management includes providing adequate support, planning, and oversight when the credit union enters new business ventures, or begins offering a new product and/or service. In addition, management must perform due diligence to ensure that products and services coincide with the credit union's overall risk profile.

Because our review found that Ensign management did not understand appropriate risk management practices or the underlying risks inherent in their growth strategies, we believe NCUA management should consider establishing a renewed emphasis on evaluating management's due diligence over new or fast growing programs, as well as other areas of emphasis, with particular attention to the risk the program or area may pose to the credit union's safety and soundness.

Appendix A

Examination History

The following provides NCUA supervision contacts conducted from September 30, 2004, through March 31, 2009, for Ensign Federal Credit Union. The information provided is limited to key findings and Documents of Resolution items associated with management's capability; Board oversight; and concentration, credit, and liquidity risk.

<table>
<tr><th>September 30, 2004
Effective Date</th><th>Contact Type - 10
Completed January 2005
CAMEL Rating: 2/12221</th></tr>
<tr><td colspan="2">Examiners concluded that Ensign Federal Credit Union was fundamentally sound.
• Examiners noted the Credit Union engages in risk-based pricing and required the lending policy be updated to incorporate elements of the risk based program.
• Examiners identified several examples of non-amortizing loans and recommended these loans be monitored to ensure they amortize in accordance with the loan agreement, or should be charged off.
• Examiners recommended the ALLL policy be revised to address member business loans, which were then included within the real estate loan pool.
• Examiners noted that accounting for troubled debt restructuring (TDR) was not in accordance with generally accepted accounting principles (GAAP), and stated that Ensign must develop reporting methods that would allow it to monitor TDRs and report delinquency according to GAAP.
• Examiners commended management for “strong performance in the area of accounting and recordkeeping, ALM oversight and analysis, as well as solid performance in mitigating loan losses.”</td></tr>
<tr><td colspan="2">DOR – Examiners required the Credit Union to:
• In the area of credit risk: Complete the profitability analysis of risk-based loans to ensure each tier generates adequate income to cover underwriting and servicing costs, operating expenses, and resultant loan losses. Adjust pricing strategies as required to ensure each tier produces sufficient income.</td></tr>
</table>

<table>
<tr><th>June 30, 2006
Effective Date</th><th>Contact Type - 10
Completed September 2006
CAMEL Rating: 1/11221</th></tr>
<tr><td colspan="2">Examiners concluded that Ensign Federal Credit Union was sound.
The prior examination noted issues requiring attention, including enhanced oversight of business lending, information systems and follow-up for various risk assessments, and the need for analyzing the risk-based lending program. Examiners noted management addressed all concerns in an appropriate and timely manner.
In the area of credit risk, examiners noted, “solid underwriting, low delinquency, and minimal loan losses reflect a sound loan portfolio.”
Examiners noted moderate interest rate risk resulting from higher total real estate loan portfolio (10 percent growth since the prior examination), as well as the higher level of fixed rate real estate loans (25 percent growth since the prior examination), but concluded that the risk was mitigated by “active and sound ALM oversight.”
Examiners concluded that liquidity risk was mitigated with “solid oversight, monitoring controls, and established secondary liquidity sources.”</td></tr>
<tr><td colspan="2">DOR – Examiners issued a DOR; however, all issues related to compliance risk.</td></tr>
</table>

<table>
<tr><th>December 31, 2007
Effective Date</th><th>Contact Type - 10
Completed February 2008
CAMEL Rating: 3/12333</th></tr>
<tr><td colspan="2">Examiners noted heightened concern in several areas:
Examiners noted loan growth in the past year (8 percent annualized), combined with declining financial real estate markets – particularly so in the Las Vegas metropolitan area – resulted in excessive concentration risk, unacceptable interest rate risk, and heightened liquidity risk.
Examiners noted violations of regulatory limits for member business loans – in aggregate and granted to one member – as well as construction and development (C&D) loans.
Regarding strategic risk, examiners noted, “The internal control systems at Ensign Federal Credit Union are not operating as intended. Staff has violated regulatory lending limits and consistently operates outside of established Board limits with respect to interest rate and liquidity risks. This is unacceptable. The Board must ensure compliance with established risk parameters and regulatory limits.”
Regarding interest rate risk, examiners noted the following:
Ensign operated outside of established ALM and liquidity limits for most of the previous 18 months. The Examination Overview stated that “Quarterly ALM reports clearly identify noncompliance for the past year, yet there are no documented efforts to address these</td></tr>
</table>

concerns; rather, you exacerbated the situation by continuing to book real estate loans through most of 2007, resulting in even higher interest rate risk."

- There was no evidence that violations of IRR policy limits were presented or discussed at Board meetings. There was also no documentation of a corrective plan by management to bring the balance sheet structure within policy limits.
- The Board received limited information regarding the loan and deposit structure of the balance sheet.
- The ALM model for IRR calculation was significantly inaccurate for 30-year and 40-year mortgages. As a result, the risk measures calculated were understated and the IRR was higher than reported to ALCO committee members.

(*in millions*)	**30-year mortgages**	**40-year mortgages**
Used in risk model	$38.1	$3.5
Actual	$13.3	$21.0

- Ensign's risk monitoring and reporting processes for the real estate loan portfolio were weak. Examiners specifically cited the following items: concentration risk concerns, geographical concerns, and a portfolio shift from 30-year to 40-year loan maturities, and from adjustable to fixed-rate mortgages. Further, as noted above, management was unaware of how large the 40-year mortgage concentration had grown.

- Regarding **liquidity risk**, examiners noted the following:
  - Ensign operated outside of liquidity guidelines for almost all of 2007.
  - Significant decline in shares of $12.5 million (11.5 percent) over the year resulted in the Credit Union utilizing almost all available Federal Home Loan Bank (FHLB) borrowing and over 1/3 of the corporate overnight line of credit.
  - The decrease in shares, combined with the 8 percent annual increase in loans, caused liquidity risk to be rated as high.
- Regarding **credit risk**, examiners noted the following:
  - The ALLL account was underfunded. Examiners required additional funding of $435K.
  - Ensign did not include any environmental or qualitative factors in the ALLL calculation, although the real estate market was declining and loan delinquencies were rising.
  - Examiners concluded that Ensign's balance sheet had high concentration risk. Specifically, the Credit Union's high concentration of real estate loans was unsafe and unsound. Limits

	of up to 80 pecent of loans in first mortgages were deemed inappropriate benchmarks. The examiners required that prudent limits be established as a percentage of total assets and net worth, and based on the Credit Union's ability to measure and mitigate risk.

DOR – Examiners required the Credit Union to respond to the following items and report on corrective actions taken. Note that other compliance related items were included in this and other DORs; only items that relate to management's capability, Board oversight, and concentration, credit and liquidity risk are listed here:

- In the area of **asset/liability management**:
  - Establish reduced concentration limits for the real estate loan portfolio, addressing credit risk tiers, fixed vs. variable rate loans, and other relevant factors.
  - Develop and provide to the Board of Directors an action plan with alternative strategies for reducing interest rate and concentration risk. Ensure the plan includes current and future impacts to earnings and capital.
  - Meet and discuss interest rate measures on a monthly basis until such time as actual interest rate risk measures fall within existing Board-established risk limits, and ensure IRR levels are reduced sufficiently to conform to risk limits established in the ALM policy.
  - Cease adding any 30 or 40-year fixed rate mortgages to the loan portfolio until such time as the Credit Union is in compliance with established interest rate risk and liquidity risk measures, as well as reduced concentration limits.
  - Correct all items identified in the Examiner's Findings report regarding the ALM Risk model to help ensure inputs and assumptions are reviewed and validated.
- In the area of **liquidity management**:
  - Ensure the Credit Union complies with established limits as outlined in Board-approved liquidity policies. Implement strategies (i.e. share pricing, share growth, etc) to decrease reliance on borrowings and improve the Credit Union's overall liquidity position.
- In the area of **risk monitoring and mitigation**:
  - Implement appropriate risk monitoring and reporting procedures to identify risk in the real estate loan portfolio. Ensure reports identify relevant risk factors, such as loan-to value, credit scores, geographical concentration, loan products, etc.
- In the area of **Allowance for Loan and Lease Losses**:
  - Fund the Allowance for Loan and Lease Losses account for $435,000.

- Update the ALLL funding methodology to incorporate qualitative and environmental factors based on current market conditions and trends. Apply these factors specifically to the real estate portfolio to ensure sufficient reserves are maintained for potential loan losses. Update the assessment in the future to ensure the account remains fully funded.

- In the area of **Board reports and monitoring**:
  - Expand the monthly financial reporting package provided to the Board to include the following:
    - Investment report - listing of all current investments, maturity, market values, and investment transactions.
    - Loan report - number and amount of new loans granted, loan applications rejected, stratification of existing loan portfolio, business and real estate loans in process, loans sold.
    - Deposit report - listing of current deposit categories with stratification by tier for money market accounts, and stratification of certificate accounts by remaining maturity.
    - Borrowing report - list of all borrowed funds, collateral pledged against borrowings, remaining capacity, and transactions during the month.
    - Compliance - target ranges for ALM - expand the existing report to include NEV and NII limits specified in the policy.

June 30, 2008 Effective Date	**Contact Type - 22 Completed August 2008 CAMEL Rating: 3/12333**

The purpose of the examination was to monitor Ensign's progress in responding to the previous DOR from the 2007 full scope examination.

- Regarding **concentration risk**, examiners noted the following:
  - Ensign was required by the previous DOR to establish prudent limits for real estate loans as a percentage of total assets and net worth, but had not done so. In fact, the ALM minutes indicate real estate limitations were discussed, but the committee declined to set concentration limits.
  - The monthly compliance report provided to the Board still showed the maximum limit for mortgage loans as 80 percent of total loans.
  - The Liquidity Risk section of the lending policy had been updated in April to set a 60 percent limit of real estate loans to assets. Examiners considered this limit "excessive and only slightly lower than concentration levels when we identified our initial concerns in December." This was especially excessive given current trends in the real estate market.
- Regarding **interest rate risk**, examiners noted the following:

- Interest rate risk was reduced and for the first time in nearly two years was within established limits. However, the main cause of improved results was a change in model assumptions. Examiners advised Ensign that "Changing assumptions does not mitigate risk – even though output reports may show compliance with board limits. Changes to model assumptions should be documented and approved by the board prior to implementation."
- Examiners recommended the minutes for the ALM committee should be expanded to include: strategies for dealing with IRR, impacts of volatile shares, strategies for mitigating risk of losing high-balance shares, borrowing activity, and investment strategies and decisions.

- Regarding **credit risk**, examiners noted the following:
  - Delinquency increased sharply in 2008, causing concern and requiring action to mitigate increased risk.
  - Reportable delinquency was 3 percent of total loans as of June, including $2 million of workout loans ($1.2 million which is a single real estate loan).
  - Delinquency also increased in the non-reportable "1-2 month" category and is 3.2 percent of total loans. This brings the total to 6.2 percent of loans over 30 days delinquent - indicating high credit risk in the portfolio.
- Regarding **liquidity risk**, examiners noted the following:
  - Overall liquidity was improved, with shares growing by $24 million. This growth primarily consisted of money market shares and one $14 million deposit by Provident Trust Group.
  - Concerns included: concentration of $29 million in shares held by 28 member accounts, volatility of high balance uninsured shares in the current economic environment, increasing reliance on noncore deposits, and alternatives if secondary lines of credit were limited/closed.
- Regarding **risk management and monitoring**, examiners noted the following:
  - Risk management reporting processes need to be more robust to fully identify and quantify risk in the real estate portfolio.
  - The loan policy still allows for HELOCs up to 100 percent loan-to-value, which are unsafe and unsound.
- Regarding **Allowance for Loan and Lease Losses**, examiners noted the following:
  - Ensign's method of basing loss factors on a 3-year period did not accurately reflect current trends or conditions of the marketplace.
  - Ensign's ALLL methodology still did not include funding based on qualitative and environmental factors, as required per the previous

DOR.

- Regarding **OREO and nonearning assets**, examiners noted the following:
    - Ensign had three OREO properties totaling $4 million on the balance sheet, and additional OREO was deemed to be likely in the near future. The examiners required that Ensign establish policies and procedures for handling the OREO portfolio.
    - As shown, nonearning assets represented approximately 13% of total assets:

	Percent of Total Assets
Fixed Assets	7.9%
OREO	4.0%
Other Non-Earning	1.0%
Total	**12.9%, or $17 million**

    - As a comparison, examiners noted that most institutions of Ensign's asset size had only 3 percent nonearning assets.

DOR – Examiners required the Credit Union to respond to the following items and report on corrective actions taken:

- In the area of **concentration risk and risk management**:
    - Some repeated items from the previous DOR, which were still applicable and still needed to be addressed, including:
        - Establish documented concentration limits for real estate loans
        - Maintain moratorium on 30 or 40- year fixed rate mortgages
    - Establish detailed risk monitoring and reporting procedures for real estate loan portfolio. Ensure reports identify relevant risk factors, such as loan-to value, credit scores, geographical concentration, loan products, etc., as well as address risk from layering of multiple risk elements. Ensure the Credit Union validates source data for determining current market values.
    - Develop and document specific risk mitigation strategies for high risk loan pools. Document review and analysis of alternative strategies for reducing interest rate and concentration risk.
- In the area of **credit risk**:
    - As required in the previous DOR: update the ALLL funding methodology to incorporate qualitative and environmental factors based on current market conditions and trends. Apply these factors specifically to the real estate portfolio to ensure sufficient reserves are maintained for potential loan losses. Update the assessment in the future to ensure the account remains fully funded.

- Ensure all loans in the portfolio that qualify as Troubled Debt Restructuring (TDR) are properly identified, and are included in the monthly delinquency reporting until such time as the borrower has made six timely consecutive monthly payments at the restructured payment amount.

- In the area of **Other Real Estate Owned:**
  - Develop a policy for handling OREO, which includes proper initial recording, subsequent measurement, semi-annual appraisals, and proper recordkeeping.

December 31, 2008 Effective Date	Contact Type - 10 Completed February 2009 CAMEL Rating: 4/44455

Examiners noted deteriorating financial condition, and assessed risk as “high” in six of the seven risk areas. The overall CAMEL rating was also downgraded to a 4 at this time. Examiners noted that the “overall financial and operational condition of your credit union is of such supervisory concern, that a **high potential for failure within the next 12 months exists**. Management and officials have resumed their search for a merger partner. Given your current financial condition, associated trends, and the outlook for 2009, we feel it is in the best interest of your members to continue to actively pursue a merger.” Furthermore, although examiners noted economic conditions contributed to Ensign’s problems, they also determined that “a lack of sound planning on the part of management and officials contributed significantly to the problems.”

- Regarding **liquidity risk**, examiners noted the following:
  - Ensign had been operating in crisis mode for a two-week period in January of 2009, which was caused when the Provident Trust Group requested to close their $12 million share account. Funds were unavailable to meet this request, and management had to borrow $12.5 million from the NCUA Central Liquidity Fund.
  - Liquidity risk remains extremely high as management proved unable to manage unplanned decreases and/or changes in funding sources, and also failed to recognize the interrelationship between interest rate risk management and liquidity.
  - Examiners concluded that the liquidity issues have been an ongoing concern caused by poor planning:
    - During 2007, total shares declined by $13 million while the loan portfolio increased by $9 million. This increased the loan to share ratio to 118 percent and resulted in additional borrowings of $20 million.
    - Between June 30 and December 31, 2008, total shares decreased by $18 million, or 14 percent. The greatest decline was in CDs (decline of $9 million).

- The Board and ALCO minutes had limited discussions regarding borrowing analysis, and most borrowings had been unplanned.
- Examiners strongly suggested that Ensign limit and closely monitor lending volume in the near future.

- Regarding **strategic risk**, examiners noted the following:
  - Ensign's total net worth declined from $12.9 million to $8.9 million during 2008, which represents a 31 percent decline in one year. The net worth ratio declined from 9.56 percent to 7.32 percent during 2008.
  - Furthermore, an updated appraisal on an OREO property obtained in the first quarter of 2009 would require an additional write down of $1.5 million. Projected new worth ratio by the end of February 2009 was 5.5 percent.
  - With a net worth ratio below 6 percent, the Credit Union would be subject to Prompt Corrective Action and NCUA would require a Net Worth Restoration Plan by June 14, 2009.
  - In reviewing net return on assets, examiners noted that in three of the previous four years, Ensign's net return was aided by non-operating gains, which in some cases substantially affected net income.
  - As of the examination, examiners noted that Ensign would likely operate at a net loss from basic operations (before PLLL) in 2009. In addition, Ensign had budgeted for a further increase in operating expenses due to the addition of a fifth branch.
  - Examiners concluded that management had been operating with no business plan or business model. There was no evidence of a formal plan to address the issues the Credit Union faced or to reverse the negative trends.
  - The Board minutes were reviewed and found "lacking in detailed discussions. We did not see evidence that management and officials considered all risk factors prior to implementing strategic initiatives."
  - As examples of poor strategic decisions, examiners cited both Ensign's unsound loan concentrations, and over 12 percent of the Credit Union's total assets being invested in nonearning assets.
  - Land was purchased in North Las Vegas but never used by Ensign. As of the examination, it had been on the market for one year at a 17 percent discount to cost, with no interested buyers. The total investment was $1.1 million, and examiners believed the Credit Union could recognize a potential loss of several hundred thousand dollars.
- Regarding **credit risk**, examiners noted the following:
  - Delinquency and charge-offs were increasing at an alarming rate.
  - As of September 30, 2008, real estate loans totaled $78.9 million,

or 79 percent of the total loan portfolio. Examiners noted the decline in the Nevada real estate market of 25-30 percent, with no signs of reversal in the near future.

- Examiners believe that the risk rating model used for the real estate loan portfolio was "somewhat liberal."
- Examiners had concerns regarding home equity loans where Ensign was not in first lien position. For loans of this type where the credit score was below 600 ($1.9 million), the average loan-to-value exceeded 100 percent.
- Examiners specifically noted two Member Business Loans that were of particular concern:
  - One was a loan in a workout stage that would require an additional impairment of $200,000 based on a recent appraisal.
  - The other was an OREO property that was previously appraised in June 2008 at $4.4 million with a carrying balance of $3.6 million. However, a recent appraisal in February 2009 gave a value of $2.15 million, which would require an additional write down of $1.5 million.
- Workout loans were not coded on the Credit Union's system until September 2008. There was no policy in place for workout loans regarding loan-to-value limits, reappraisal, title search, credit score, stability of employment, etc.
- Examiners recommended that management establish a mandatory reserve of at least 5 percent on this pool of loans.

- Regarding **interest rate risk**, examiners noted the following:
  - As of late January 2009, the ALCO had not held a meeting since October 2008. Examiners noted that "Given Ensign's size, complexity, and IRR and Liquidity risk profiles, we would expect ALCO to meet monthly, and considering recent events, perhaps weekly."

DOR – The DOR was extensive and required the Credit Union to expedite pursuit of a merger partner, revisiting the current list and seeking additional candidates. The Credit Union was also required to respond to the following items and report on corrective actions taken:

- In the area of **liquidity risk**:
  - Assign responsibility for monitoring and documenting daily cash management, short-term liquidity (i.e. weekly/monthly), and balance sheet trend analysis.
  - Develop a written net cash flow analysis (i.e. minimum period of six months) with emphasis placed on the next 90 days to:
    - Analyze projected sources and uses of funds;
    - Identify the existence and potential existence of future cash flow strains; and

        - Identify emerging liquidity pressures.
    - Evaluate available liquidity contingency resources and prioritize and evaluate them in terms of: available amount, reliability, cost, maturity, source, stability, and timeframe needed to obtain funds.
    - Amend the liquidity policy to clearly define responsibilities to ensure accountability.
- In the area of **business planning/profitability/net worth**:
    - Monitor the Credit Union's net worth closely, and become familiar with Prompt Corrective Action (PCA) provisions should net worth decrease further.
    - Develop a comprehensive, written business plan.
    - Reevaluate and amend the 2009 operating budget.
    - Document detailed discussions of major areas of concern (liquidity, profitability, credit risk), and the actions taken to address these issues at each board meeting.
- In the area of **credit risk**:
    - Summarize the credit profile characteristics of the real estate loan portfolio. Separate second mortgages by first lien position (Ensign has 1st lien vs. not).
    - Establish a watch list for any loans that exhibit a declining risk rating or the member has demonstrated reduced cash flow. Establish a reserve in the allowance for loan losses account for any loans where the risk rating has declined to at least a sub-standard level.
    - Develop a separate report for work out loans, including loan data, delinquency (if any) prior to the workout, credit score, loan-to-value, current status (performing/nonperforming), reason for workout.
    - Revise workout policies to require a complete analysis of the borrower's capacity to repay under the terms of the workout agreement.
    - Establish a reserve for workout loans for funding the allowance for loan losses. A reserve of 5 percent of the outstanding balance was recommended initially.
- In the area of **interest rate risk**:
    - Continue to take appropriate action(s) to mitigate interest rate risk (e.g. sell mortgage originations, adjust mortgage rates, reduce the first mortgage concentration, etc).
    - Integrate interest rate risk management with strategic and financial planning.
    - Amend the ALM policy to require monthly ALCO meetings. Expand ALCO to include key operating units (i.e. lending, operations, and marketing) since ALM affects the entire scope of the Credit Union's operation. Record all pertinent activities/discussions in the ALCO minutes. Provide the Board of Directors and ALCO an ALM

summary.
- Conduct a review of ALM model assumptions to ensure forecasted earnings projections provide a reasonable estimate of potential earnings exposure.

March 31, 2009 Effective Date	**Contact Type - 22** **Completed June 2009** **CAMEL Rating: 5/55555**

This examination was a follow-up supervision contact to the December 31, 2008 (Effective Date) examination, in order to determine management's compliance with the LUA and DOR issued during that examination. Examiners concluded that the financial condition of Ensign had continued to deteriorate significantly. According to the Examination Overview, "Ensign FCU has no real prospects of being able to restore profitability and build net worth to adequately capitalized levels within a reasonable period of time." A merger was considered imminent at this time.

- Regarding **net worth**, examiners noted the following:
  - From December 2008 through May 2009, Ensign's net worth declined from 7.32 percent to 1.69 percent.
  - With a net worth ratio of 4.7 percent as of March 31, 2009, Ensign fell under the PCA category of an "undercapitalized" institution. Management submitted a Net Worth Restoration Plan, which indicated they would be unable to establish a reasonable plan and would instead seek a merger.
  - Examiners revisited the environmental reserve for real estate loans in Ensign's ALLL methodology, noting the reserve had remained at $300,000, which is less than one half percent of the Credit Union's total real estate loan portfolio. Credit Union management agreed that "the risk factors included in this methodology are liberal and should be increased."
  - Examiners recommended the following increases to the factors:

Risk Score	Current Factor	New Factor
9-12	10%	15%
6-8	3%	10%
3-5	0%	5%

    These changes would increase the ALLL by approximately $2.5 million, which would essentially eliminate all remaining capital.

  - Ensign was deemed to be an insolvent institution, with a solvency ratio of 98.23% as of May 31, 2009.
  - Examiners determined the optimal resolution for Ensign would be to pursue a liquidation and purchase and assumption.

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- Regarding **delinquency**, examiners noted the following:
    - Delinquency in dollars had increased every month since the last examination, despite charge-offs of over $600,000 during the first five months of 2009.
- Regarding **profitability**, examiners noted the following:
    - Ensign experienced a net loss of $7.1 million during the first five months of 2009.
    - While the majority of these losses were due to provision expense, the Credit Union also lost an average of over $50,000 per month from basic operations before taking into account the provision expense.
    - Examiners concluded that the reason for the operating losses was the large amount of nonearning assets the Credit Union possessed.

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DOR – The Credit Union was required to continue pursuit of a merger partner, and also to respond to the following items and report on corrective actions taken:

- Continue to monitor the Credit Union's net worth position closely.
- Terminate any unused lines of credit where the loan-to-value is over 80 percent and the member's credit score has declined to 640 or less
- Continue to review staffing needs and operating expenses, making adjustments/reductions where necessary.
- In the area of **allowance for loan and lease losses**:
    - Update the environmental real estate loan report with respect to loan balances, market values, and credit scores.
    - Increase the reserve factors from their current levels. Examiners recommended the Credit Union use the factors given above. If Ensign were to use the factors recommended, the increase would be $2.5 million.
    - Increase the ALLL by the amount reflected after updating the environmental data and factors.
- In the area of **asset liability management**:
    - Conduct a review of ALM model assumptions to ensure forecasted earnings projections provide a reasonable estimate of potential earnings exposure.

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Appendix B

NCUA Management Comments

VIA E-Mail

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

FROM: Executive Director David M. Marquis /S/

SUBJ: Material Loss Review of Ensign Federal Credit Union #14348

DATE: September 20, 2010

This memorandum responds to your request for review and comments on the OIG report titled *Material Loss Review of Ensign Federal Credit Union #14348 (MLR).*

Ensign Federal Credit Union (EFCU) failed due to the credit union's lack of appropriate risk management practices related to concentration and credit risk. Specifically, management adopted a high-risk strategy that allowed high concentrations in real estate secured loans, making them vulnerable to the steep and rapid decline in Nevada property values. Additionally, management failed to ensure proper risk mitigation practices were in place at the credit union to offset the high concentrations.

We acknowledge your findings that EFCU management exposed the credit union to excessive risks and did not implement appropriate risk management practices. NCUA has long provided guidance to credit unions regarding the importance of strong policies, procedures and practices regarding the management and mitigation of concentration risk, liquidity risk, and interest rate risk. For example, in March 2010, we issued a supervisory letter to examiners that was shared with credit unions addressing concentration risk. We are also in the process of drafting regulatory changes to address concentration risk.

NCUA also recognizes that strong supervisory attention is necessary for credit unions with increased levels of concentration and credit risks. There were opportunities for NCUA to increase its supervision efforts to monitor this credit union. NCUA has intensified its monitoring and supervision efforts in all credit unions to ensure more timely corrective actions.

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