



**NCUA**  
National Credit Union Administration

OFFICE OF INSPECTOR  
GENERAL

**MATERIAL LOSS REVIEW OF  
MELROSE CREDIT UNION,  
LOMTO FEDERAL CREDIT UNION, AND  
BAY RIDGE FEDERAL CREDIT UNION**

**Report #OIG-19-06    March 29, 2019**





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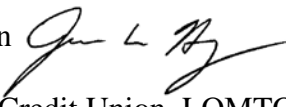
National Credit Union Administration

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**Office of Inspector General**

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**FROM:** Inspector General James W. Hagen 

**SUBJ:** Material Loss Review of Melrose Credit Union, LOMTO Federal Credit Union and Bay Ridge Federal Credit Union

**DATE:** March 29, 2019

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of three federally insured credit unions, Melrose Credit Union (Melrose), LOMTO Federal Credit Union (LOMTO), and Bay Ridge Federal Credit Union (Bay Ridge) (collectively “the Credit Unions”). LOMTO and Bay Ridge were federally chartered, and Melrose was chartered under the New York State Department of Financial Services (DFS). We reviewed the Credit Unions to: (1) determine the cause(s) of the Credit Unions’ failure and the resulting estimated \$765.5 million loss to the National Credit Union Share Insurance Fund (Share Insurance Fund); (2) assess NCUA’s supervision of the Credit Unions; and (3) provide appropriate suggestions and/or recommendations to mitigate future losses.

We determined the Credit Unions failed due to significant concentration of loans collateralized by taxi medallions, unsafe and unsound lending practices, and weak Board and management oversight and inadequate risk management practices. We provide details on each of these findings in the report below. As a result of our review, we are making three recommendations to NCUA management to correct these findings. Management agreed with all three recommendations and has either started or plans to take corrective action.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this audit.

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## TABLE OF CONTENTS

<b>Section</b>	<b>Page</b>
EXECUTIVE SUMMARY .....	1
BACKGROUND .....	4
RESULTS IN DETAIL.....	11
A. Why the Credit Unions Failed .....	11
B. NCUA’s Supervision of the Credit Unions .....	19
OBSERVATIONS AND RECOMMENDATIONS.....	25
A. Observations .....	25
B. Recommendations.....	26
APPENDICES:	
A. Objectives, Scope, and Methodology .....	28
B. NCUA Management Response .....	30
C. Acronyms and Abbreviations .....	32



## EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Moss Adams LLP (Moss Adams) to conduct a Material Loss Review (MLR) of three federally insured credit unions, Melrose Credit Union (Melrose), LOMTO Federal Credit Union (LOMTO), and Bay Ridge Federal Credit Union (Bay Ridge) (collectively “the Credit Unions”). LOMTO and Bay Ridge were federally chartered, and Melrose was chartered under the New York State Department of Financial Services (DFS). We reviewed the Credit Unions to: (1) determine the cause(s) of the Credit Unions’ failure and the resulting estimated \$765.5 million<sup>1</sup> loss to the National Credit Union Share Insurance Fund (Share Insurance Fund); (2) assess NCUA’s supervision of the Credit Unions; and (3) provide appropriate suggestions and/or recommendations to mitigate future losses.

To achieve these objectives, we analyzed NCUA and DFS examination and supervision reports, as well as related correspondence, for the period January 1, 2012 through December 31, 2016. We interviewed NCUA officials and regional staff, and reviewed NCUA guidance, regional policies and procedures and NCUA 5300 Call Reports (Call Reports).

We determined the Credit Unions failed due to the following reasons:

### Significant Concentration in Loans Collateralized by Taxi Medallions

The Credit Unions maintained significant concentrations in loans collateralized by taxi medallions. Except for credit unions that qualify for an exception, the Federal Credit Union Act limits the aggregate balance of member business loan (MBL) portfolios to 175 percent of the credit union’s net worth. This statutory requirement is implemented in NCUA’s regulations.<sup>2</sup> All three Credit Unions qualified for an exception<sup>3</sup> from this limit based on NCUA granting their charter for the purpose of making MBLs or having a history of

<sup>1</sup> The NCUA will not know the final cost to the NCUSIF until all assets are sold.

<sup>2</sup> Code of Federal Regulations (CFR) § 723.16 states the aggregate limit on a credit union’s net member business loan balances is the lesser of 1.75 times the credit union’s net worth or 12.25 percent of the credit union’s total assets. Loans that are exempt from the definition of member business loans are not counted for the purpose of the aggregate loan limit.

<sup>3</sup> CFR § 723.17 states there are three circumstances where a credit union qualifies for an exception from the aggregate limit. Loans that are excepted from the definition of member business loans are not counted for the purpose of the exceptions. The three exceptions are: (a) Credit unions that have a low-income designation or participate in the Community Development Financial Institutions program; (b) Credit unions that were chartered for the purpose of making member business loans and can provide documentary evidence (such evidence includes but is not limited to the original charter, original bylaws, original business plan, original field of membership, board minutes and loan portfolio); and (c) Credit unions that have a history of primarily making member business loans, meaning that either member business loans comprise at least 25 percent of the credit union’s outstanding loans (as evidenced in any call report filed between January 1995 and September 1998 or any equivalent documentation including financial statements) or member business loans comprise the largest portion of the credit union’s loan portfolio (as evidenced in any call report filed between January 1995 and September 1998 or any equivalent documentation including financial statements).



primarily making MBLs prior to September 30, 1998. Technological innovation, specifically mobile ridesharing (or ride-hailing) companies such as Uber and Lyft, gained market share in cities across the country and caused disruption to the taxi industry. The disruption to the industry resulted in financial difficulty for many traditional taxi drivers across the country, and impacted the Credit Unions significantly through increased delinquencies and losses on loans collateralized by taxi medallions.

The Credit Unions also failed to identify and appropriately monitor loans to associated borrowers.<sup>4</sup> For MBLs, regulations limit lending to associated borrowers to 15 percent of net worth.<sup>5</sup> Examination reports reflect several instances when the Credit Unions exceeded the regulatory limit to associated borrowers, resulting in additional concentration risk to the loan portfolios. Because the Credit Unions did not appropriately identify and document loans made to associated borrowers, the number of instances in which the Credit Unions exceeded the regulatory limit is not clear.

### Unsafe and Unsound Lending Practices

The Credit Unions failed to manage their respective loan portfolios in a safe and sound manner. Examiners repeatedly noted the Credit Unions were engaged in unsafe lending practices, in particular inadequate loan underwriting and monitoring of taxi medallion loans. Specific examples of inadequate underwriting include frequent failure of the Credit Unions to fully analyze borrower financial information, insufficient detail included in credit memoranda to make a fully informed lending decision, risky loan terms, unsupported cash out refinances, inadequate credit risk management policies, and failure to identify and account for modified loans as Troubled Debt Restructures (TDRs). Additionally, the Credit Unions frequently based lending decisions on inflated market values of taxi medallions rather than industry accepted best practices for loan underwriting such as cash flow analysis, debt service coverage, and secondary sources of repayment.<sup>6</sup> Borrowers ultimately were unable to repay loan balances when cash flow from operating a taxi did not cover the loan payment associated with buying the medallion.

### Weak Board and Management Oversight & Inadequate Risk Management Practices

We believe the Credit Unions' Boards of Directors and management failed in their responsibilities to oversee the activities of the Credit Unions. The Boards and management

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<sup>4</sup> Code of Federal Regulations (CFR) § 723.21 states that an associated borrower, or associated member, is defined as "any member with a shared ownership, investment or other pecuniary interest in a business or commercial endeavor with the borrower."

<sup>5</sup> Code of Federal Regulations (CFR) § 723.8 states that unless a greater amount is approved by the NCUA regional director, the aggregate amount of outstanding member business loans to any one member or group of associated members shall not exceed 15% of the credit union's net worth, or \$100,000, whichever is higher.

<sup>6</sup> The most recent member business lending rule, (CFR) § 723.4, that went into effect on January 1, 2017, requires credit unions to fully evaluate the ability of the borrower to meet debt service requirements. NCUA issued the proposed rule in June 2015 and finalized it in February 2016.



at the Credit Unions were unresponsive to repeated issues raised by examiners related to lending practices, concentration, liquidity, and overall risk management. Poor Board oversight allowed the Credit Unions' weak risk management practices to go unchecked and contributed to the deficient asset quality issues, which plagued the Credit Unions. The lack of governance created a corporate culture that inhibited or discouraged effective risk management policies for institutions with such high concentration risk. Inadequate responsiveness to examiner findings, as well as lack of overall risk management strategies, exposed the Credit Unions to the excessive credit and liquidity risk, which ultimately led to the Credit Unions' failure and loss to the Share Insurance Fund.

We determined NCUA may have mitigated the loss to the Share Insurance Fund had they taken a timelier and aggressive supervisory approach regarding the Credit Unions' concentration risk and failure to follow industry accepted lending practices for MBLs. Specifically, had the NCUA acted more aggressively through formal<sup>7</sup> enforcement actions for repeat DORs, which had not been corrected by management, improvements may have been made to inadequate lending practices and risk management policies, thus reducing the loss to the Share Insurance Fund.

As a result of our review, we made two observations and three recommendations to NCUA management.

We appreciate the effort, assistance, and cooperation NCUA management and staff provided to us during this review.

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<sup>7</sup> Administrative actions fall into two different categories: informal actions and formal actions (enforcement actions). Informal actions include a Document of Resolution (DOR) or a Regional Director Letter (RDL). These actions identify a problem through an examination and develop a plan to correct the issue. Formal Actions include a published Letter of Understanding and Agreement (LUA) Cease and Desist Order, and Conservatorship. LUAs are essentially a contract between the NCUA and a credit union identifying material problems and agreeing to take corrective action within a specific time period; however, an LUA is not a formal action until it is published.



## BACKGROUND

The NCUA OIG contracted with Moss Adams to conduct an MLR for Melrose Credit Union, LOMTO Federal Credit Union, and Bay Ridge Federal Credit Union, as required by Section 216 of the Federal Credit Union Act (FCU Act), 12 U.S.C. 1790d(j). Both LOMTO and Bay Ridge were federally chartered credit unions located in Woodside and Brooklyn, New York, respectively. Melrose was a state-chartered, federally insured credit union located in Briarwood, New York. NCUA's Region I (former)<sup>8</sup> provided supervision over the Credit Unions. Additionally, the New York State DFS provided supervision over Melrose.

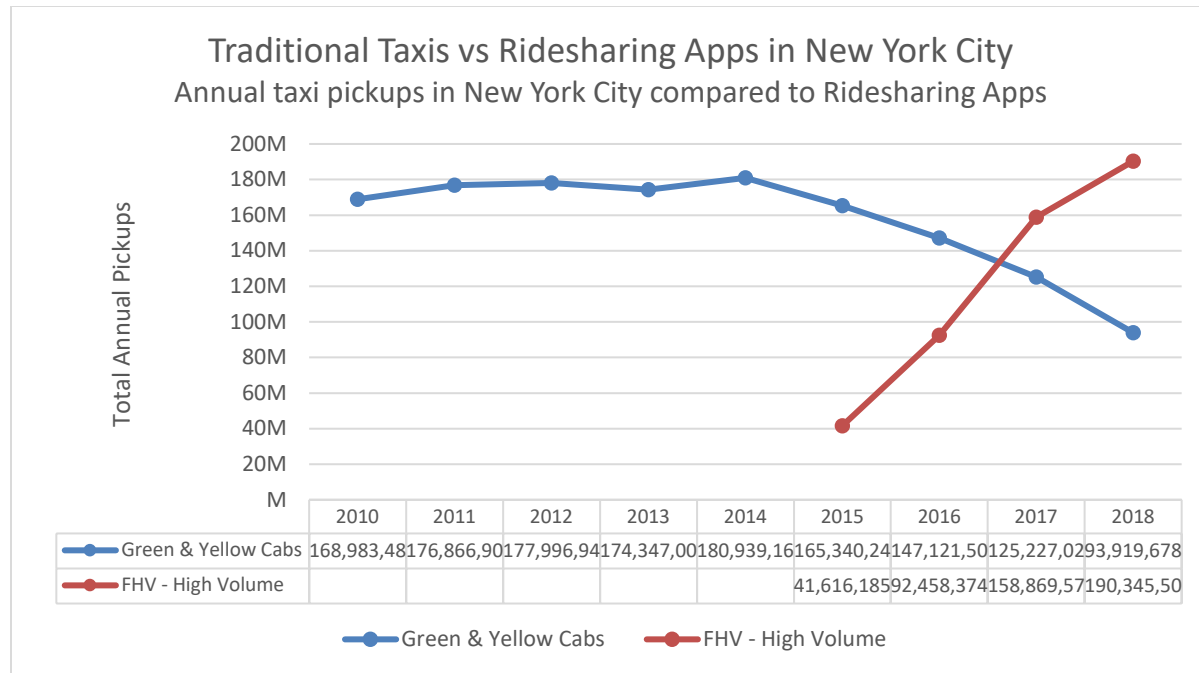
### General History of the Credit Unions

The Credit Unions were all based in the New York City metropolitan area and were heavily involved in taxi medallion lending. Taxi medallions, also known as Certificates of Public Necessity and Convenience, are transferable permits in the United States allowing an individual or company to operate a taxi. A number of major cities in the United States use taxi medallions for their taxi licensing systems, including New York City, Boston, Philadelphia, and Chicago. The supply of medallions is strictly controlled by the municipalities to prevent a surplus of taxis. The politically imposed limits on the number of medallions issued by cities coupled with increased demand caused values of taxi medallions to steadily increase in the early 2000s to levels above \$1 million in New York City during 2013. Taxi drivers and businesses, as well as investors speculating on rising medallion values, were the primary buyers of medallions during the 2000s. Medallions can be purchased from either the city or another medallion owner.

Mobile ridesharing companies such as Uber and Lyft began to enter the marketplace during 2012 and 2013. The companies began to gain significant market share in large cities during late 2013 and 2014. Disruptions to the taxi industry caused by ridesharing companies resulted in cash flow issues for taxi owners and a significant decline in values of taxi medallions. Loans collateralized by taxi medallions began to show signs of credit deterioration due to cash flow issues during 2014, which ultimately led to the failure of the Credit Unions.

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<sup>8</sup> In January 2019, the NCUA reorganized its regional structure as part of an agency-wide reorganization that began in 2017. NCUA consolidated its regions from five to three, Eastern, Southern, and Western.



Source: Data obtained from the New York City Taxi & Limousine Commission (NYC TLC)<sup>9</sup>

History of Melrose Credit Union

The state of New York chartered Melrose Credit Union in 1922. Melrose served eligible members subject to the provisions of its bylaws, which could include any person upon approval for membership. At the time of liquidation, Melrose served 19,864 members and had assets of approximately \$1.1 billion, according to the Credit Union’s June 30, 2018 Call Report. Melrose served all members out of one corporate office located in Briarwood, New York.

Melrose held an exception to the statutory aggregate MBL limits, because the Credit Union had a history of primarily making MBLs prior to September 30, 1998. According to Melrose’s June 30, 2018 Call Report, approximately 71 percent of the loan portfolio was made up of taxi medallion loans.

Our review of NCUA examinations during the period from January 2012 to December 2016 identified that Melrose received a CAMEL<sup>10</sup> composite rating of 2 until the December 31, 2014 examination when Melrose received a CAMEL 3 composite rating. Increased competition from ridesharing companies, which had gained a significant market share in large cities during 2013 and 2014, provided increased uncertainty at Melrose as of the December 31, 2014 examination. Thus, examiners recommended a CAMEL 3 composite rating. Melrose was subsequently moved

<sup>9</sup> Ridesharing data was not publicly available prior to 2015. Uber launched in New York City during May 2011, and expanded rapidly after announcing additional ridesharing services in April 2013. Lyft entered the New York City market during July 2014.

<sup>10</sup> The acronym CAMEL derives its name from the following components: [C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.





to a CAMEL 4 composite rating during the December 31, 2015 examination due to increased taxi medallion loan delinquencies and losses.

All examinations of Melrose during the period of review indicated issues with taxi medallion loan underwriting and monitoring, compliance with regulatory lending limits to associated borrowers, and risk management of the loan portfolio. The first examination included in our review, as of December 31, 2012, documents DORs for performing sufficient cash flow analyses for borrowers, revision of the member business lending policy to include loan monitoring and concentration risk, ensuring appropriate loan covenants are included in loan documents, supporting taxi medallion valuations, and curing violations of regulatory limits for loans to associated borrowers.

The New York State DFS issued a Memorandum of Understanding<sup>11</sup> (MOU) to Melrose on August 28, 2015. The MOU set forth significant weaknesses and concerns around MBL department structure, MBL portfolio monitoring and management, troubled debt restructuring classification, Allowance for Loan and Lease Losses (ALLL), risk rating of MBLs, and business planning, among others. The NCUA also issued Regional Director Letters to Melrose on January 25, 2016, and June 23, 2016, and a Preliminary Warning Letter to Melrose on December 15, 2016, related to these same issues.

On July 8, 2016, the New York State DFS executed a Consent Order<sup>12</sup> to Melrose, directing the Credit Union to discontinue unsafe practices due to supervisory concerns identified during the joint safety and soundness examination as of December 31, 2015. Included in the Consent Order were requirements to improve Board and Supervisory Committee participation; retain a qualified executive management team; implement a plan to reduce levels of classified assets; develop a plan to reduce concentration in taxi medallions; record additional funding to the ALLL; implement improvements to the MBL department; develop improvements to strategic planning; and create a plan to enhance liquidity, among other items.

The New York State DFS placed Melrose into receivership and named the NCUA as conservator on February 10, 2017. As a result of this action, a \$100 million guaranteed line of credit was established to provide liquidity assistance to Melrose. On May 24, 2018, the NCUA Board approved a Liquidation Order for Melrose, and on August 31, 2018, placed Melrose into liquidation. Teachers Federal Credit Union (Teachers) of Smithtown, New York assumed Melrose's members and certain assets, shares and liabilities on August 31, 2018. The NCUA estimated the combined loss to the Share Insurance Fund at approximately \$726 million for

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<sup>11</sup> A memorandum of understanding (MOU) is an enforcement action used by State supervisory authorities such as New York State DFS. It is a structured agreement signed by both the Board of Directors and New York State DFS, outlining corrective actions to be taken due to regulatory concern.

<sup>12</sup> Consent Orders are formal enforcement orders issued by NCUA pursuant to Section 206 of the Federal Credit Union Act (FCUA) (12 U.S.C. § 1786), or by the New York State DFS pursuant to the New York Banking Law, Article 2, Section 39. Generally, NCUA issues Administrative Orders such as Consent Orders when it finds that a credit union or persons affiliated with a credit union have violated a law, rule or regulation, or engaged in an unsafe or unsound practice.



Melrose and LOMTO (below); however, the NCUA will not know the final cost until all assets are sold.

### History of LOMTO Federal Credit Union

The NCUA chartered LOMTO Federal Credit Union in 1936. LOMTO's charter was originally granted to serve employees and members of the League of Mutual Taxi Owners in New York City. According to its final Call Report as of June 30, 2018, LOMTO reported total assets of \$156 million and membership of 2,283.

LOMTO held an exception to the aggregate statutory MBL limits, because the Credit Union was chartered for the purpose of making MBLs. According to LOMTO's June 30, 2018 Call Report, approximately 93 percent of the loan portfolio was made up of taxi medallion loans.

Our review of NCUA examinations during the period of review identified that LOMTO received CAMEL composite ratings of 2 until the December 31, 2014 examination, when examiners rated the Credit Union a composite CAMEL 3. Increased competition from ridesharing services, which had gained a significant market share in large cities during 2013 and 2014, provided increased uncertainty at LOMTO as of the December 31, 2014 examination. Thus, a CAMEL 3 composite rating was recommended. LOMTO was subsequently moved to a composite CAMEL 4 rating as of the September 30, 2015 examination due to increased medallion loan delinquencies and losses.

Examinations of LOMTO during the period of review indicate issues with taxi medallion loan underwriting and monitoring, as well as risk management of the loan portfolio. The first examination included in our review, as of March 31, 2013, includes DORs for analysis and monitoring of borrower cash flows for taxi medallion loans, performing a risk assessment to determine acceptable concentration levels for taxi medallion loans, identification and monitoring of associated borrowers, and identifying use of proceeds for cash out refinances. Loan underwriting and monitoring DORs were repeated in each examination reviewed through December 31, 2016.

The NCUA issued an LUA to LOMTO on December 10, 2015. The LUA set forth significant weaknesses and concerns around the MBL program, which included loan modifications, ALLL, strategic planning, liquidity risk, interest rate risk, and foreclosure accounting. The NCUA had identified these weaknesses during the September 30, 2015 follow-up examination. The NCUA also issued a Preliminary Warning Letter to LOMTO on November 23, 2016, related to these same issues. LOMTO submitted several noncompliant Net Worth Restoration Plans (NWRPs), and the Regional Director issued denial letters for these NWRPs on January 20, 2017, March 23, 2017, and May 18, 2017.

The NCUA Board approved conservatorship on June 21, 2017, and the NCUA placed LOMTO into conservatorship on June 26, 2017. On September 30, 2018, the NCUA placed LOMTO into liquidation. Teachers Federal Credit Union (Teachers) of Smithtown, New York immediately



assumed LOMTO's members and certain assets, shares, and liabilities. The NCUA estimated the combined loss to the Share Insurance Fund at approximately \$726 million for LOMTO and Melrose (above); however, the NCUA will not know the final cost until all assets are sold.

#### History of Bay Ridge Federal Credit Union

The NCUA chartered Bay Ridge Federal Credit Union in 1934. Bay Ridge was located in Brooklyn, New York, and primarily served those who live in Brooklyn Community Districts 7, 10, 11, 13, 15, and a select group of community organizations, schools, limousine groups, and longshoreman's associations. According to its June 30, 2018 Call Report, Bay Ridge reported total assets of \$183 million and membership of 8,438.

Bay Ridge held an exception to the statutory aggregate MBL limit because the Credit Union had a history of primarily making MBLs prior to September 30, 1998. According to Bay Ridge's June 30, 2018 Call Report, approximately 40 percent of the loan portfolio was made up of taxi medallion loans.

Our review of the NCUA's examinations during the period of review identified that Bay Ridge received CAMEL composite rating of 2 until the December 31, 2014 examination, when examiners rated the Credit Union a composite CAMEL 3. The CAMEL 3 composite rating was due mainly to increased competition from ridesharing services, which had gained a significant market share in large cities during 2013 and 2014. Bay Ridge remained at a composite CAMEL 3 rating through 2016. Throughout this time period the NCUA also issued Regional Director Letters to Bay Ridge on July 22, 2015, September 21, 2015, July 18, 2016, and December 4, 2017.

The NCUA issued an LUA to Bay Ridge on August 23, 2017, citing significant concerns over declining financial performance, unsafe and unsound underwriting, ALLL, and associated borrower analysis, among other items. The NCUA approved an assisted emergency merger of Bay Ridge into Island Federal Credit Union (Island) on August 2, 2018, which was effective October 1, 2018. The NCUA estimated the loss to the Share Insurance Fund at approximately \$39.5 million; however, the NCUA will not know the final cost until all assets are sold.

#### The NCUA Examination Process

##### *Total Analysis Process*

The 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 components, and reviewing qualitative and quantitative measures.

The NCUA uses the CAMEL Rating System for evaluating the soundness of credit unions on a uniform basis, the degree of risk to the Share Insurance Fund, and for identifying those institutions requiring special supervisory attention or concern. The CAMEL rating includes



consideration of key ratios, supporting ratios, and trends. Qualitative factors are also considered when assigning CAMEL ratings. Generally, the examiner uses the key ratios to evaluate and appraise the credit union's overall financial condition. At the conclusion of an examination, examiners assign a CAMEL rating.

Examiner judgment affects the overall analytical process. An examiner's review of data includes structural analysis,<sup>13</sup> trend analysis,<sup>14</sup> reasonableness analysis,<sup>15</sup> variable data analysis,<sup>16</sup> and qualitative data analysis.<sup>17</sup> Numerous ratios measuring a variety of credit union functions provide the basis for analysis. Examiners must understand these ratios both individually and as a group because some individual ratios may not provide an accurate picture without a review of the related trends.

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

### *Risk-Focused Examination Program*

In 2002, the NCUA adopted a Risk-Focused Examination (RFE) Program. Risk-focused supervision procedures often include reviewing off-site monitoring tools and risk evaluation reports as well as on-site work. 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 as well as the risks detected in the credit union's operations and in management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

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<sup>13</sup> Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

<sup>14</sup> Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

<sup>15</sup> As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

<sup>16</sup> Examiners can often analyze an examination area in many different ways. The 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.

<sup>17</sup> 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.



- Review of quarterly Financial Performance, Risk, and 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 Annual Examination Scheduling Program (AEP).<sup>18</sup> The NCUA indicated these changes were necessary due to adverse economic conditions and distress in the nation's entire financial structure, which placed credit unions at greater risk of loss. The NCUA stated that the Annual Program would provide more timely, relevant, qualitative, and quantitative data to recognize any sudden turn in a credit union's performance.

In 2009, the NCUA developed a new examination policy<sup>19</sup> that resulted in additional minimum required examination procedures based on a national review of risk. The policy directed a periodic national review of risk issues and adjustment to the minimum review procedures. The NCUA indicated the intent of the policy was to shape its examination and supervision program to consistently identify and mitigate emerging risks in response to changing environmental factors within the credit union industry. As a result of this policy, the NCUA's Office of Examination and Insurance (E&I), with input from the regions, now updates the minimum scope procedures, as necessary, by focusing on emerging risks, risk monitoring observations, results of quality control reviews, regulatory changes, and lessons learned from NCUA OIG Material Loss Reviews.

Starting in September 2013, agency policy instructed examiners to recommend additional enforcement actions, such as a Regional Director Letter (RDL), a Letter of Understanding and Agreement (LUA), or a Preliminary Warning Letter (PWL) if the Credit Unions failed to address outstanding DOR items, and to only include problems in the DOR that were significant enough that examiners would recommend escalating to the next level of elevated enforcement action (e.g., Regional Director Letter, Letter of Understanding and Agreement) for failure to correct the problem.

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<sup>18</sup> The AEP requires either an examination or a material on-site supervision contact within a 10 to 14 month timeframe based on risk-based scheduling availability.

<sup>19</sup> The NCUA revised this policy multiple times with Instruction No. 5000.20 (rev. 4), *Risk-Focused Examinations – Minimum Scope Requirements*, on June 25, 2012, Instruction No. 5000.20 (Rev. 5), *Risk-Focused Examination Scope*, on February 5, 2014, Instruction No. 5000.20 (Rev. 6), *Examination Scope*, on January 26, 2015, and Instruction No. 5000.20 (Rev. 7), *Examination Scope*, on January 14, 2016.



## RESULTS IN DETAIL

We determined that weak oversight by the Credit Unions’ management and Boards caused the failures and resulting loss to the Share Insurance Fund. Specifically, management and Boards of Directors exposed each of the Credit Unions to excessive amounts of credit and liquidity risk due to their failure to maintain the appropriate risk management infrastructure to address excessive concentrations in loans collateralized by taxi medallions. Additionally, the Credit Unions’ management and Boards of Directors failed to promote the safe and sound management of taxi medallion loan portfolios by following industry accepted best practices for commercial loan underwriting. We also determined NCUA may have mitigated the loss to the Share Insurance Fund had they taken a more timely and aggressive supervisory approach regarding the Credit Unions’ concentration risks in their loan portfolios. The loss to the Share Insurance Fund may also have been mitigated through a more aggressive supervisory approach regarding unsafe and unsound lending practices, ineffective risk management, and repeat violations of certain NCUA member business lending regulations.

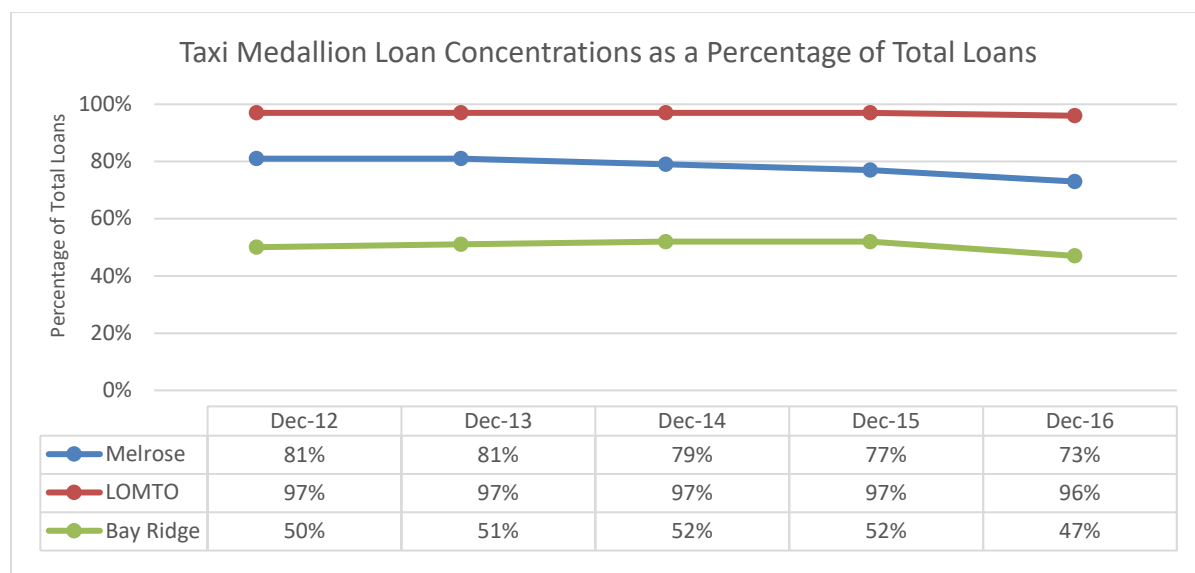
### A. Why the Credit Unions Failed

**Significant Concentration in Loans Collateralized by Taxi Medallions Led to Failure of the Credit Unions**

The Credit Unions maintained significant concentrations in loans collateralized by taxi medallions. The Credit Unions qualified for exceptions to the statutory limit, which allowed them to maintain a significant concentration in taxi medallion loans without being in violation of member business lending limits. Chart 1 (below) illustrates the

concentrations of the Credit Unions taxi medallion loans as compared to total loans.

**Chart 1**





*Source: Data obtained from NCUA examination materials provided by Region I and Asset Management and Assistance Center (AMAC) officials*

Over the decade from 2003 to 2013, management at all three Credit Unions focused on growing the taxi medallion loan portfolio. During this period, taxi medallion loans experienced low levels of delinquencies and losses, and significantly outperformed other types of MBLs through the economic downturn of 2008. Taxi medallion loans did not show significant signs of financial distress during the late 2000s.

Examiners did express concerns over concentration risk and overall business strategy of the Credit Unions throughout the period of our review, beginning in 2012. The December 31, 2013 Melrose examination stated the following:

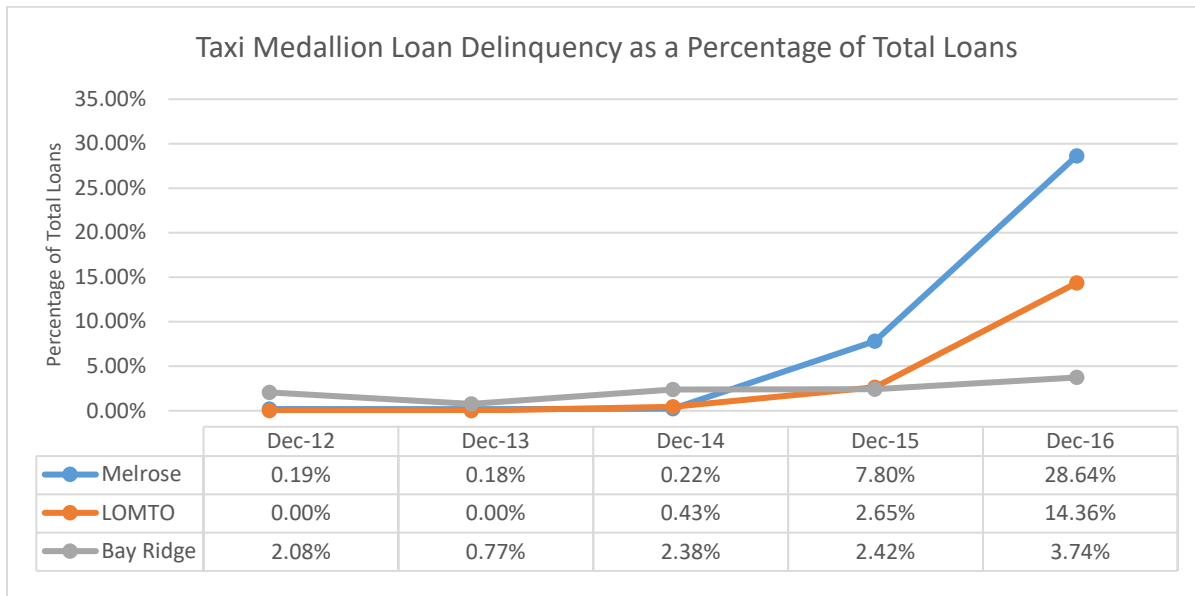
*“Melrose has a high concentration of taxi medallion loans in its MBL portfolio. The MBL DOR items from the 2012 exam are not fully addressed. Underwriting, cash flow analysis, documentation and borrower & related borrower concentration analysis remains deficient. The portfolio is highly collateral-dependent – severely so. The portfolio is highly collateral dependent on an intangible asset which has seen high levels of price escalation in recent years.”*

Examiners also documented violations to NCUA’s limit on loans to associated borrowers within examination reports. Section 723.8 of NCUA Rules and Regulations limits loans to associated borrowers to 15% of net worth. The regulation defines an associated borrower as “any person or entity that has a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with a borrower.” The December 31, 2013 examination of Melrose discussed a particular borrower who, when combined with loans held by immediate family members, had a combined exposure of \$59 million, or 16.2 percent of the Credit Unions’ net worth. As the Credit Unions did not appropriately monitor and document loans made to associated borrowers, the number of instances the Credit Unions exceeded the regulatory limit is not clear. A DOR was issued to Melrose for exceeding the regulatory limit to associated borrowers during the December 31, 2013 examination. This was a repeat DOR previously issued during the December 31, 2012 examination. The DOR was again repeated during the December 31, 2014 examination, when the same associated borrower relationship showed an exposure of 17.7 percent of Melrose’s net worth.

Although examiners issued repeat DORs for concentration risk, business strategy, and associated borrowers, management and the Board did not appear to make any significant changes to business operations. Once mobile ridesharing services began to gain market share in New York City during 2013 and 2014, delinquencies and losses rose to an amount greater than that of net worth and the significant loan concentration ultimately led to the failure of the Credit Unions. Chart 2 (below) illustrates delinquencies as a percentage of total loans at the Credit Unions.



**Chart 2**



Source: Data obtained from NCUA examination materials provided by Region I and AMAC officials

**Unsafe and Unsound Lending Practices**

In addition to failing to address concentration risk, the Credit Unions failed to manage the portfolios in a safe and sound manner. Unsafe lending practices were specifically exemplified by repeat examiner findings regarding underwriting and monitoring of taxi medallion loans.

Underwriting and Monitoring of Taxi Medallion Loans

Poor loan underwriting and monitoring were significant factors in the credit quality problems that developed at the Credit Unions. The NCUA and state examinations during the scope of our review included repeat findings related to underwriting and credit monitoring. The Credit Unions engaged in lending practices that were not in compliance with NCUA Regulation part 723. Specific examples of repeat DORs issued include:

- Underwriting and monitoring of taxi medallion loans did not include analyses of the borrowers’ ability to repay the loan documented by the review of borrower financial statements or tax returns. Although regulators documented findings and encouraged verification of borrower cash flow, the Credit Unions often refused to do so. The Credit Unions explained that obtaining a complete picture of borrower cash flows was not possible in a cash based business. In certain cases, borrower cash flow was supported through “industry data.”
- Examination findings for all three Credit Unions indicated issues with credit memoranda. In all cases, examiners indicated current credit memoranda for taxi medallion loans did





not provide enough detail to allow the approving loan officer to make a fully informed lending decision.

- Examiners documented concerns about risky credit terms for taxi medallion loans. Specifically, these terms often included extended amortization periods of up to 50 years or interest only payments for borrowers who appeared to have cash flow issues.
- The Credit Unions did not practice appropriate risk management in monitoring the taxi medallion loan portfolios. In certain cases, annual reviews of large medallion loans were not performed. Certain examinations also discussed the lack of sufficient risk rating policies to sufficiently monitor credit risk.

As the market for taxi medallion loans began to show signs of deterioration, an increased number of borrowers began to request loan modifications due to their inability to make payments. In various cases, the Credit Unions did not appropriately identify and account for these refinances as TDRs. Additionally, certain modifications were made to participation loans without the consent of other participating institutions. Due to the failure to identify TDRs and related loan impairments, the Credit Unions' ALLL was significantly underfunded for the Credit Unions. ALLL issues were documented in LUA's assessed to LOMTO and Bay Ridge, and in the MOU issued to Melrose.

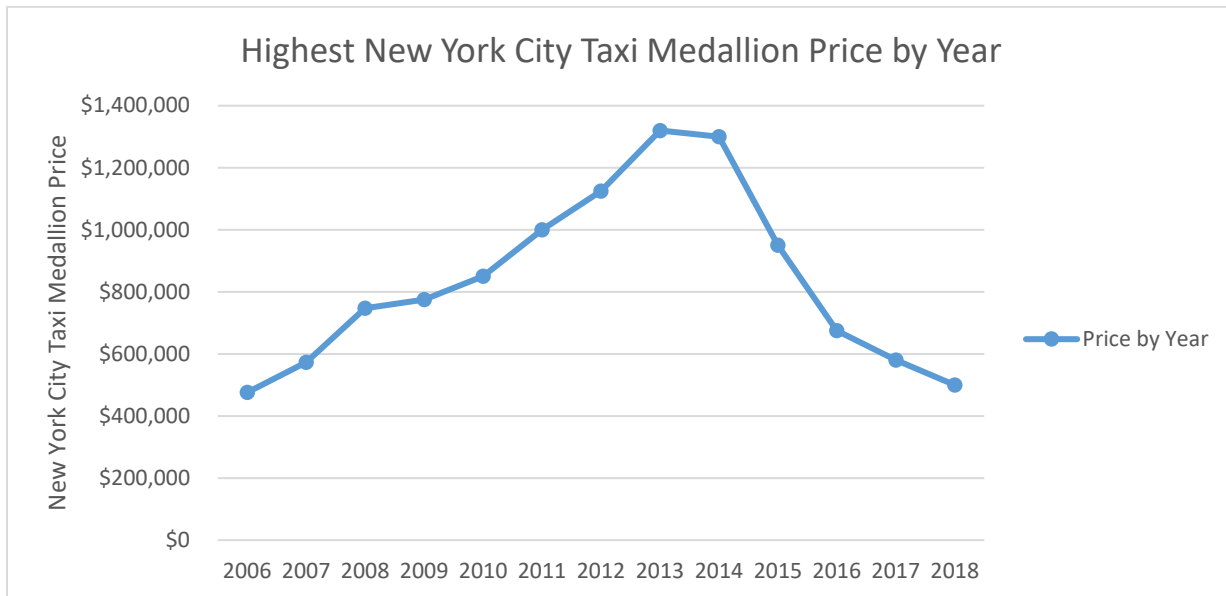
#### Valuation of Taxi Medallions & Asset Based Lending

Due to government mandated constraints on the supply of taxi medallions, such as capping the amount of available medallions in large cities, the values of medallions increased rapidly from 2000 to 2013. Individuals began to speculate on the value of taxi medallions and some bought medallions with no intention of operating a taxi. They simply were trying to make an investment gain. This market speculation contributed to the increase in values and ultimately the market bubble.

Medallion values continued to increase to levels greater than \$1 million in New York City during 2013. Examiners were concerned that medallions were trading above their economic values and encouraged the Credit Unions to focus on borrower cash flow for underwriting. However, the Credit Unions continued to lend based on inflated valuations from recent auction sales rather than industry accepted best practices for loan underwriting such as cash flow analysis, debt service coverage, and secondary sources of repayment. This resulted in larger loans to medallion owners that were unsupported by sufficient cash flow to service the underlying debt. Chart 3 (below), shows the rise and fall of New York City taxi medallion prices from 2006 to 2018.



**Chart 3**



Source: Data obtained from the NYC TLC

The Credit Unions frequently engaged in unsupported cash-out refinances to medallion owners as collateral values continued to increase. Borrowers would request restructures of current debt to increase loan balances based on higher collateral valuations from recent taxi medallion sales. The business purpose of the restructures were often undocumented and unsupported by the Credit Unions within loan files. Examiner findings document the need for the Credit Unions to support the use of funds for each cash-out refinance and to confirm the funds are being used for the documented purpose.

The December 31, 2012 Melrose examination stated:

*“Our loan review identified several instances where the use of funds from cash out refinances was not clearly identified. For example, in November 2012, MCU completed refinances for 16 corporations with total loans of \$26.4 million, with \$2.597 million cash out for “business investment.””*

The March 31, 2013 LOMTO examination stated:

*“Our loan review identified eleven cash out refinances where the loan documentation does not provide sufficient information for the purpose and use of all of the loan proceeds. For example, the cash out purpose is listed as “business investment.” Loans may only be granted for productive and provident purposes.”*

The Credit Unions continued to base lending decisions predominately on comparable sales value rather than industry accepted best practices for commercial loan underwriting. Borrowers



ultimately were unable to repay loan balances when cash flow from taxi operations would not cover the associated medallion loan payment.

**Inadequate Risk Management Practices**

We determined management of the Credit Unions failed to effectively manage risks and did not demonstrate a strong understanding of the risks inherent to their strategic decisions. Additionally, the Boards of Directors and management lacked sufficient and responsive action to address repeat findings raised by examiners related to underwriting, loan monitoring, concentration risk, business strategy, and risk management, among others.

Although examiners expressed concern with the Credit Unions' heavy concentration in taxi medallion loans, management appeared to disregard the issue and continued to focus on aggressively growing the taxi medallion portfolios each year. With profitability so heavily reliant on income from one business line—taxi medallion lending—management and the Boards of Directors should have maintained the highest standards of risk management practices. However, we determined the Boards of Directors and management did not effectively plan, manage, or control the credit, concentration, or liquidity risks.

**Weak Management and Board Oversight**

We determined the Credit Unions' Boards of Directors failed in their duties to provide general direction and control over the Credit Unions. In particular, we noted examiners exemplified governance issues through repeat examiner findings during the scope period of review, which the Boards of Directors did not address. The NCUA Rules and Regulations Part 701.4 states "The Board of Directors is responsible for the general direction and control of the affairs of each Federal Credit Union." The Boards of Directors are responsible for ensuring management takes necessary corrective actions in a timely manner, however we noted limited references within the Credit Unions' Board of Directors minutes to problems identified in examination reports.

Our review of the Credit Unions' Board of Directors minutes revealed a lack of detail regarding the Board Members' activities in directing and controlling the affairs of the Credit Unions. Many of the minutes were similar month over month, and strictly discussed financial trends of the Credit Union.

Our review of the Credit Unions' Board of Directors minutes, specifically of Melrose and LOMTO, also revealed a lack of urgency in addressing their rapidly decreasing financial position. Despite market indicators signaling that a change in strategy was necessary, the Boards of Directors and management failed to proactively react and adjust Credit Union strategy. Instead of focusing efforts on addressing risks posed by ridesharing services and rapidly increasing delinquencies, both Melrose and LOMTO filed a lawsuit in May of 2015 seeking an injunction to require New York City to enforce a law that prevents any vehicles except taxis from picking up street-hails. The lawsuit accused New York City and its Taxi and Limousine Commission of jeopardizing the survival of taxi owners by imposing burdensome regulations



and allowing ridesharing companies to take passengers away from taxi drivers. The lawsuit was eventually dismissed by New York City in 2017.

We determined the lack of governance shown by Melrose's Board allowed management to make questionable decisions. The Melrose Chief Executive Officer (CEO) was a controlling official at the Credit Union who, based on discussion with examiners, made most, if not all, operational and executive decisions. In November of 2015, the NCUA received an anonymous whistleblower tip concerning the Credit Union's CEO. The tipster accused the CEO and the Board of Directors of Melrose of perpetuating an environment of financial abuse and mismanagement, which in turn had stifled the natural growth of the Credit Union. Further, the tipster stated that the mismanagement had led to Melrose's dependence on taxi medallion lending, which jeopardized the financial integrity, stability, and solvency of Melrose and its members. Specifically, the whistleblower accused the CEO of nepotism, improper uses of Melrose funds, improper favors to friends and family, improper benefits from vendors and members, mistreatment of Melrose employees, and engaging in questionable and risky business practices.

In April of 2016, Melrose's independent auditors, Merrill Rosen, CPA, P.C. (Merrill Rosen), communicated further issues regarding the CEO to the Board of Directors. The most significant issue related to a deferred compensation plan entered into with the Melrose CEO on December 1, 2014. The plan called for a payment of approximately \$8 million to the CEO upon retirement on December 3, 2025. Merrill Rosen was concerned the deferred compensation plan was not properly approved by the Board of Directors, as required by New York State Banking Law.

Merrill Rosen's communications in April of 2016 prompted an investigation of the CEO by Melrose's general counsel, Dechert LLP (Dechert). The investigation concluded that the full Board of Directors did not approve the CEO's deferred compensation plan. The investigation noted that the CEO in fact drove the process of approving the deferred compensation plan and arguably misled the Board in doing so. Along with the deferred compensation issue, Dechert's investigation revealed the following issues related to the Melrose CEO:

- The CEO allegedly received improper benefits from substantial borrowers, allegedly violating the Bank Bribery Act. The CEO in turn approved several large loans for these borrowers against the recommendations of Melrose's Chief Lending Officer.
- The CEO allegedly received improper benefits from certain Melrose vendors. The investigation showed the CEO leveraged the amount of money spent with certain vendors to obtain these benefits.
- Dechert questioned excessive Credit Union expenses that personally benefited the CEO. Expenses included extravagant meals, trips, and sports tickets, benefiting the CEO's family and friends and paid for by Melrose. Dechert's report to the board showed the CEO had authorized spending of over \$1.3 million on sports tickets from 2011 through 2016.



According to the Board of Directors meeting minutes documenting the investigation of Melrose’s CEO, Dechert ended the presentation by emphasizing the importance of the Board’s fiduciary duty to Melrose in deciding the CEO’s future. Dechert stated “The Board members need to put their loyalties aside and put the Credit Union first.”

Dechert’s investigation further supports that the Board failed in their duties as required under NCUA Rules and Regulations to properly exercise the control and direction of the Credit Union. Although we cannot quantify the effects of the questionable decisions made by management at Melrose or the apparent lack of oversight of the Board, it is reasonable to assert that the evidence indicates ineffective Board oversight contributed to poor strategic decisions at the Credit Union.



## B. NCUA's Supervision of the Credit Unions

**With a More Aggressive Approach, NCUA Examiners May Have Mitigated the Loss to the Share Insurance Fund**

We determined NCUA may have mitigated the loss to the Share Insurance Fund had they taken a more timely and aggressive approach regarding the Credit Unions' concentration risk and failure to follow industry accepted lending practices for MBLs. Specifically, had the NCUA acted more aggressively through formal enforcement actions for repeat DORs, which had not been corrected by management, improvements may have been made to inadequate lending practices and risk management policies, thus potentially slowing the rapid growth of taxi medallion loans and reducing the loss to the Share Insurance Fund.

### Supervisory Background

Each of the Credit Unions received CAMEL composite ratings of 2 prior to 2014 when ridesharing companies began to gain market share. All three Credit Unions were downgraded to a CAMEL composite 3 rating as of their respective December 31, 2014 examinations. Further downgrades to CAMEL ratings and enforcement actions were as follows:

- Melrose was downgraded to a composite 4 as of the December 31, 2014 examination. Melrose was issued an MOU on August 28, 2015. The MOU set forth significant MBL underwriting, MBL monitoring, ALLL, and business planning concerns identified by the NCUA and the state during the examination of Melrose with an effective date of December 31, 2014. Effective July 8, 2016, the New York State DFS issued Melrose a Consent Order due to continuing concerns around items noted in the MOU. Melrose was placed into conservatorship by the state in February 2017. Region I approved an Order of Liquidation for Melrose on May 24, 2018, which was effective August 31, 2018.
- LOMTO was downgraded to a composite 4 as of the September 30, 2015 examination. An LUA was issued in December of 2015. The LUA cited significant weaknesses over MBL risk management, liquidity risk management, MBL collateral valuation, accounting for restructured loans, ALLL, and strategic planning, among other items identified by NCUA during the follow-up examination of LOMTO with an effective date of September 30, 2015. LOMTO was placed into conservatorship by the NCUA in June 2017. Region I executed an Order of Liquidation for LOMTO effective September 30, 2018.
- Bay Ridge was downgraded to a composite 4 as of the March 31, 2017 examination and issued an LUA on August 23, 2017. The LUA cited significant underwriting and MBL risk management weaknesses, as well as Bay Ridge's declining financial position identified by NCUA during the examination of Bay Ridge with an effective date of March 31, 2017. NCUA approved an assisted emergency merger of Bay Ridge on August 2, 2018, effective October 1, 2018.



The tables below provide composite and specific CAMEL ratings for the applicable examinations during the period of our review.

NCUA Examination Results for Melrose**							
Examination Effective Date	Exam Type <sup>20</sup>	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2016	22	4	4	4	4	4	4
September 2016	23	4	4	4	4	4	4
June 2016	23	4	4	4	4	4	4
December 2015	11	4	4	4	4	4	4
September 2015	23	3	1	4	3	2	3
June 2015	23	3	1	3	3	2	3
December 2014	11	3	1	3	3	2	3
December 2013	11	2	1	3	3	1	2
December 2012	23	2	1	3	3	1	2

NCUA Examination Results for LOMTO**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
December 2016	10	4	4	5	4	5	4
September 2016	22	4	4	4	4	5	5
June 2016	22	4	4	4	4	5	5
December 2015	10	4	4	4	4	4	4
September 2015	22	4	3	4	4	4	4
December 2014	10	3	1	3	3	2	3
March 2014	10	2	1	3	3	1	2
March 2013	10	2	1	3	3	1	2

<sup>20</sup> NCUA Work Classification Code (WCC) Examination Type 10 is a regular examination of a federally chartered credit union. WCC Examination Type 22 is an on-site supervision contact of a federally chartered credit union. WCC Examination Type 11 is an insurance review of a state chartered credit union and WCC Examination Type 23 is an on-site supervision contact of a state chartered credit union.



NCUA Examination Results for Bay Ridge**							
Examination Effective Date	Exam Type	CAMEL Composite	Capital / Net Worth	Asset Quality	Management	Earnings	Liquidity
September 2016	22	3	3	3	3	3	3
June 2016	22	3	3	3	3	3	3
March 2016	10	3	3	3	3	3	3
September 2015	22	3	3	3	3	3	3
December 2014	10	3	3	3	3	3	2
December 2013	10	2	1	2	2	2	2
December 2012	10	2	1	3	2	2	2
June 2012	22	2	1	2	2	2	2

\*\*Examination information provided by NCUA's Region I (former).

### Part 723 Exception and Loan Concentration

The Credit Unions held an exception to NCUA Rules and Regulations Part 723 for aggregate MBL limits. The Credit Union Membership Access Act of 1998 granted an exception to the Credit Unions from the MBL limits as they were chartered for the purpose of making, or had a history of primarily making, member business loans. Senate Report 105-193 on the Credit Union Membership Access Act noted loans for such purpose as “taxi cab medallions” should not be unduly constricted as a result of the Board’s actions.<sup>21</sup>

As ridesharing companies continued to gain a significant market share in large cities across the United States, taxi medallion loan delinquencies and losses rose to an amount greater than net worth, and the significant loan concentration ultimately led to the failure of the Credit Unions. We determined the Credit Unions’ loan concentrations and deteriorating quality of their loan portfolios, along with unsafe and unsound underwriting practices, were the main cause of failure and loss to the Share Insurance Fund.

We found no evidence of the NCUA directly communicating a recommendation to congress to rescind or modify the exception to NCUA Rules and Regulations Part 723 for aggregate MBL limits. We believe such recommendations may have slowed the growth of the Credit Unions’ taxi medallion portfolios or forced the Credit Unions to diversify lending practices, which ultimately may have mitigated the loss incurred by the Share Insurance Fund.

<sup>21</sup> The Senate report states “An exception was included to recognize the expertise developed in specialized credit unions, such as those that serve members of specific vocations, the religious community and members of the agricultural community. The Committee intends for the Board to interpret the exceptions under new section 107A(b), to permit worthy projects access to affordable credit union financing. Loans for such purposes as agriculture, self-employment, small business establishment, large up-front investment or maintenance of equipment such as fishing or shrimp boats, taxi cab medallions, tractor trailers, or church construction should not be unduly constricted as a result of the Board's actions.”





### Failure to Employ Timely and Aggressive Formal Enforcement Actions

The NCUA's enforcement actions were not timely or aggressive enough to limit the loss to the Share Insurance Fund. Although repeat findings regarding loan underwriting and loan monitoring, among others, were documented in examination reports, only DORs were issued to the Credit Unions to correct safety and soundness concerns until signs of severe financial distress were apparent in 2015. CAMEL ratings remained at a composite 2 for all three Credit Unions until 2014, even though all three credit unions had been given DORs over multiple examination cycles that were not fully addressed.

Additionally, no formal enforcement actions were assessed for repeat DORs at Melrose and LOMTO until the Credit Unions began showing signs of financial distress in late 2015 (Bay Ridge was issued an LUA during 2017). NCUA's Enforcement Manual states in part: "If a credit union fails to comply with an informal enforcement action [such as a DOR] within a specified time and doesn't justify the delay, promptly proceed with a formal enforcement action [such as an LUA]." We believe the repeat DORs, which the Credit Unions did not address to the examiner's satisfaction, should have prompted examiners to take immediate and more aggressive formal enforcement action.

During our review, examiners expressed frustration with the exception to aggregate MBL limits held by the Credit Unions. Although the Credit Unions did hold the exception, examination reports for Melrose beginning in 2012 documented clear violations of Section 723.8 limits on loan concentrations to associated borrowers. Examiners documented the violation as a concern, which was a repeat examination finding during 2012, 2013, and 2014. However, examiners only issued DORs to Melrose to correct the issue.

Melrose requested forbearance in regard to the associated borrower limitation in July of 2014, requesting the 15 percent limitation be increased to 25 percent to be consistent with New York State Banking Law. After much back and forth between Melrose, the New York State DFS, and the NCUA, the forbearance was formally denied in October of 2015. However, this was after Melrose had restructured and extended approximately \$113 million in loans to two different associated borrower relationships exceeding the 15 percent concentration during 2015 and exacerbating the issue. According to the September 30, 2015 examination, these two associated borrower relationships accounted for approximately \$177 million in loans. This particular DOR was never resolved by Melrose, and a significant portion of this balance was written off as Melrose's financial position continued to deteriorate in 2016 and 2017. We believe examiners should have escalated this repeat DOR to a formal enforcement action prior to 2015 to mitigate the loss to the Share Insurance Fund.

Further, we believe repeat informal enforcement actions issued to the Credit Unions prior to 2015 created a supervisory culture that lacked the level of discipline needed to cause meaningful change. Credit Union management and Boards of Directors became accustomed to DORs, which did not pose any penalty if not corrected. This was exemplified through a DOR related to violating Section 723.8 limits to associated borrowers. The DOR stated:



*“Develop a plan by June 30, 2015, to bring member business loans (MBLs) to [Member] and his associated borrowers to under 15% of Net Worth. This plan should include not renewing [Member’s] MBLs when the balloons come due, until the limit is below 15% of Net Worth.”*

Despite examiners’ request not to renew this particular member’s loans upon maturity, a follow up examination as of September 30, 2015, documented that Melrose had restructured, modified, and granted new loans to this particular relationship of approximately \$71 million during 2015.

We believe the NCUA’s actions were not aggressive enough. Examiners only took formal enforcement actions in 2015 for Melrose and LOMTO, and in 2017 for Bay Ridge, after the Credit Unions were showing deterioration in credit quality, including delinquencies and losses.

#### Timing and Aggressiveness of Supervisory Guidance

The NCUA has issued supervisory guidance addressing sound business lending practices dating back as far as 2001. Specific relevant guidance includes:

- a. LCU 08-CU-26 Evaluating Loan Participation programs
- b. LCU 10-CU-02 Current risks in Business lending
- c. LCU 10-CU-03 Concentration Risk
- d. LCU 13-CU-02 Evaluating MBL Waiver Requests
- e. 2002 Examiner’s Guide, Chapter 10—Loans provides guidance on all loans including MBLs.
- f. Accounting Bulletin 06-1: Interagency Policy Statement on the Allowance for Loan and Lease Losses which contains guidance on a loan review system
- g. LCU 10-CU-07 Commercial Real Estate Loan workout
- h. Accounting Bulletin 13-01 Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings
- i. LCU 13-CU-02 Evaluating MBL Waiver Requests
- j. LCU 13-CU-03 Troubled Debt Restructure

However, unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the agencies do not take enforcement actions based on supervisory guidance. Based on our review and discussions with examiners, it appears the Credit Unions did not believe the supervisory guidance on safe and sound member business lending practices was applicable to loans collateralized by taxi medallions.

Throughout the scope period of our review, examiners and Regional staff were aware of the safety and soundness lending issues at the Credit Unions as shown through repeat informal enforcement actions in their examination reports. During our review, we learned that in October 2011, Region II (former) produced a White Paper on emerging taxi medallion risk that it shared with all Regions and E&I’s subject matter expert who began working directly with Regional staff



on these cases starting in January 2012. We also learned that NCUA management began drafting Supervisory Letter 14-04 (Letter) beginning in the fourth quarter of 2011, prior to ridesharing services gaining market share in large cities and also created an inter-agency working group with the requisite knowledge and skills to begin drafting the necessary guidance.

In April of 2014, NCUA published Supervisory Letter No. 14-04, emphasizing the importance of sound underwriting and monitoring for institutions who engage in taxi medallion lending. The Letter “provides information about the taxi medallion industry and establishes a consistent framework for the examination and supervision field staff use to review loans secured by taxi medallions.” Certain areas of focus for examiners, which were communicated in the Letter, included:

- Ensuring credit unions have sound governance and policies over taxi medallion lending.
- Establishing recommended concentration limits in relation to net worth.
- Minimum debt service coverage recommended for taxi medallion loans.
- An overview of strong underwriting and documentation practices.

Although NCUA showed concern over the safety and soundness of taxi medallion lending dating back to October 2011, the Letter was not finalized and issued until April of 2014, after companies such as Uber and Lyft had begun to gain a presence in large cities across the country. We do not believe the NCUA was timely enough in issuing examiner guidance on taxi medallion lending to limit the total loss incurred by the Share Insurance Fund.

During our review, examiners expressed frustration with the lack of aggressiveness shown through Letter 14-04, along with the prior member business lending guidance listed above. In particular, examiners felt recommendations discussed in Letter 14-04 were a good baseline for safe and sound lending practices for taxi medallion loans. However, the Letter did not provide the definitive regulatory authority needed to cause significant changes to be made within the Credit Unions.



## OBSERVATIONS AND RECOMMENDATIONS

### A. Observations

Important observations from our review of the Credit Unions include:

- When the NCUA makes the decision to use enforcement actions, those actions should be executed aggressively and in a timely manner. If informal enforcement actions related to safety and soundness concerns are ignored and are repeated during examinations, the NCUA should execute formal enforcement actions in a timely manner to effect corrective action.
- Although a credit union is profitable and “well capitalized,” formal enforcement actions may still be necessary. Based on our interviews, examiners involved in supervision of the Credit Unions felt they had insufficient grounds for formal enforcement actions for repeat DORs prior to 2015 due to the profitability and strong capital positions of the Credit Unions. As of December 31, 2013, LOMTO had a net worth of 16.15 percent, Melrose had a net worth of 20.22 percent, and Bay Ridge had a net worth of 9.44 percent. All three of the Credit Unions were considered to be “well-capitalized”<sup>22</sup> at this time. Our review of NCUA Rules and Regulations does not support the examiners’ stance. Although there are mandated actions resulting from a status of adequately capitalized, Section 702.1 of the NCUA Rules and Regulations (below) specifies the following:

*“[N]either § 1790d<sup>23</sup> nor this part in any way limits the authority of the NCUA Board or appropriate State official under any other provision of law to take additional supervisory actions to address unsafe or unsound practices or conditions, or violations of applicable law or regulations. Action taken under this part may be taken independently of, in conjunction with, or in addition to any other enforcement action available to the NCUA Board or appropriate State official, including issuance of cease and desist orders, orders of prohibition, suspension and removal, or assessment of civil money penalties, or any other actions authorized by law.”*

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<sup>22</sup> Net worth categories are classified as:

- Well capitalized: Net worth ratio of 7 percent or greater.
- Adequately capitalized: Net worth ratio of 6 percent to 6.99 percent.
- Undercapitalized: Net worth ratio of 4 percent to 5.99 percent.
- Significantly undercapitalized: Net worth ratio of 2 percent to 3.99 percent.
- Critically undercapitalized: Net worth ratio of less than 2 percent.

<sup>23</sup> This reference is in Section 702.1 of NCUA Rules and Regulations and refers to the Federal Credit Union Act.



## B. Recommendations

Based on our review, we are making the following three recommendations.

We recognize that NCUA management does not have the latitude to adjust current net worth levels because such levels are driven by statute. However, to more effectively capture the concentration and other risks on an institution's balance sheet, we are making the following recommendation:

We recommend NCUA management:

1. Institute a formal process to regularly identify, analyze, and document concentration risk issues in credit unions or groups of credit unions, including but not limited to loan concentrations, that could potentially pose a significant risk to the share insurance fund. Additionally, the NCUA should consider developing appropriate thresholds for different concentrations that would require increased levels of risk mitigation and resources to minimize the risk to the Insurance Fund.

### **Management Response:**

Management agreed with this recommendation. Management indicated they have already started to evaluate ways to enhance their processes through their Enterprise Risk Management Counsel (ERMC). Management responded that the ERMC is reviewing the results of an initial analysis of loan concentrations within credit unions, and will consider thresholds as part of a process that will be in place by December 31, 2020.

### **OIG Response:**

We concur with management's actions taken and planned.

2. Revise examination quality control procedures to prioritize assessing and developing risk responses for credit unions with high levels of concentration risk. The procedures should require escalated review of repeat informal enforcement actions for unresolved recommendations. If the repeat actions represent safety and soundness concerns, require escalated enforcement action, including formal enforcement action, when warranted.

### **Management Response:**

Management agreed with this recommendation. Management indicated they have initiated an enhanced quality assurance program and noted by December 31, 2020, the program will include a more robust review of examination reports before they are released to credit unions. Management also indicated that this process will include a review of planned actions related to



any unresolved problems with the credit union and how any high concentrations of assets are addressed in the examination.

**OIG Response:**

We concur with management's actions taken and planned.

3. Include an update to the annual examination scope requirements that examiners review credit unions' lending procedures with respect to analyzing the ability of the borrower to meet debt service requirements. Ensure examiners address through the enforcement process any credit unions not sufficiently considering the borrower's ability to repay the loan due to undue reliance on the value of the collateral. If left unresolved, ensure the quality control procedures review the need for elevated enforcement action.

**Management Response:**

Management agreed with this recommendation. Management indicated that by January 31, 2020, they will update the annual examination scope instruction (NCUA Instruction 5000.20) to ensure there is a renewed emphasis on reviewing credit union underwriting practices with respect to determining a borrower's ability to meet debt service requirements.

**OIG Response:**

We concur with management's planned actions.



## Appendix A: Objective, Scope, and Methodology

We performed this material loss review to satisfy the requirements of Section 216(j) of the FCU Act, 12 U.S.C. §1790d(j), which requires the OIG to conduct a material loss review when the Share Insurance Fund has incurred a material loss, or when unusual circumstances exist that warrant an in-depth review of the loss.<sup>24</sup>

The objectives of the MLR were to:

1. Determine the cause(s) of the Credit Unions' failure and the resulting loss to the Share Insurance Fund;
2. Assess NCUA's supervision of the institutions, including implementation of the Prompt Corrective Action (PCA) requirements of Section 208 of the FCU Act; and
3. Make appropriate observations and/or recommendations to prevent future losses.

To accomplish our review, we performed fieldwork at NCUA's Region I office in Albany, New York. The scope of this review covered the period from January 2012 through December 2016.

To determine the cause(s) of the Credit Unions' failures and assess the adequacy of NCUA's supervision, we:

- Completed a risk assessment, which included a review of the Examination Overviews as well as other risk considerations, including consideration of the Credit Unions CFR part 723 Member Business Loan (MBL) exception to aggregate loan limits imposed by the Credit Union Membership Access Act of 1998. We also considered Supervisory Letter 14-04, Taxi Medallion Lending, which highlighted the risks associated with the taxi medallion industry and established a framework for examination and supervision field staff to use while reviewing loans secured by taxi medallions. Supervisory Letter 15-03, Taxi Medallion Lending Questions and Answers, which provided clarity to Letter 14-04 was also considered through our risk assessment.
- Prepared a chronology and summary table of regulatory examinations, which included examination date, regulator, CAMEL rating, supervisory actions, and significant examiner comments.
- Reviewed examination files, including examination reports, risk assessments, examination findings, documents of resolution, confidential sections, corrective actions, examination spreadsheet files, correspondence, analysis, and other documentation.

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<sup>24</sup> The FCU Act deems a loss "material" if the loss exceeds the sum of \$25 million or an amount equal to 10 percent of the total assets of the credit union at the time in which the NCUA Board initiated assistance under Section 208 or was appointed liquidating agent.



- Reviewed the Credit Unions' Board of Directors minutes and Board packets as provided.
- Reviewed examiner documentation of external financial statement audits, related management letters, and member account verifications, as provided.
- Conducted interviews with Region I management and staff involved with the examination, supervision, and liquidation of the Credit Unions.
- Downloaded Call Reports for the scope period and performed analysis of a number of financial indicators.
- Developed a timeline and summary of enforcement actions taken by the NCUA from 2012 through 2016.
- Assessed NCUA supervision and evaluated the timeliness of supervisory actions, including examiner comments and findings, as well as communication and follow up procedures.
- Assessed the effectiveness of the Credit Unions' business strategy, management, and oversight by the Supervisory Committee and the Board of Directors.

We relied upon materials provided by NCUA Region I and AMAC officials, including information and other data collected during interviews.

We used computer-processed data from NCUA's 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 review from January 2012 through December 2016, in accordance with Generally Accepted Government Auditing Standards (GAGAS) 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.





**TO:** Inspector General James Hagen  
**FROM:** Executive Director Mark Treichel John Kutchey  
**SUBJ:** Material Loss Review Management Response  
**DATE:** March 29, 2019

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Management agrees with the recommendations contained in the Office of Inspector General report titled “*Material Loss Review of Melrose Credit Union, LOMTO Federal Credit Union, Bay Ridge Federal Credit Union.*” The credit unions included in the material loss review failed primarily as a result of a severe disruption in the taxi market that impacted their significant concentration in loans collateralized by taxi medallions.

We note the report consistently mentions the examiner’s role with the need to take progressive corrective action. It is important to note that while the examiner is the first line in the process, responsibility in this area also includes the supervisory chain of command, as well as the quality control function over the examination program. A more robust quality control function that better incorporates the examiner, management, and the analysts is in beta testing.

Also relevant to this report is the NCUA’s current action to improve the ability to identify and address undue asset concentrations in credit unions that pose a material risk to the Share Insurance Fund. This has been a topic vetted within the NCUA’s Enterprise Risk Management Council (ERMC) in recent months. At the institution level, the review of concentration risk has long been part of the NCUA’s examination and supervision program and is a baseline examination area. Additionally, each quarter examiners review the Call Report and a variety of risk reports to identify and monitor significant trends and risk flags, such as high concentrations.

Adopting the material loss review’s recommendations will further strengthen the examination and supervision program.

**Recommendation:** *Institute a formal process to regularly identify, analyze and document concentration risk issues in credit unions or groups of credit unions, including but not limited to loan concentrations that could potentially pose a significant risk to the share insurance fund. Additionally, the NCUA should consider developing appropriate thresholds for different concentrations that would require increased levels of risk mitigation and resources to minimize the risk to the Insurance Fund.*

**Response:** Management agrees with this recommendation and has already started to evaluate ways to enhance our processes via the ERMC. The ERMC is reviewing the results of an initial analysis of loan concentrations within credit unions, and will consider thresholds as part of a process that will be in place by December 31, 2020.

**Recommendation:** *Revise examination quality control procedures to prioritize assessing and developing risk responses for credit unions with high levels of concentration risk. The procedures should require escalated review of repeat informal enforcement actions for unresolved recommendations. If the repeat actions represent safety and soundness concerns, require escalated enforcement action, including formal enforcement action, when warranted.*

**Response:** Management agrees with this recommendation, and as stated, has initiated an enhanced quality assurance program. By December 31, 2020, the NCUA's quality assurance program will include a more robust review of examination reports before they are released to credit unions. This process will include a review of planned actions related to any unresolved problems with the credit union and how any high concentrations of assets are addressed in the examination.

**Recommendation:** *Include an update to the annual examination scope requirements that examiners review credit unions' lending procedures with respect to analyzing the ability of the borrower to meet debt service requirements. Ensure examiners address through the enforcement process any credit unions not sufficiently considering the borrower's ability to repay the loan due to undue reliance on the value of the collateral. If left unresolved, ensure the quality control procedures review the need for elevated enforcement action.*

**Response:** By January 31, 2020, management will update the annual examination scope instruction (NCUA Instruction 5000.20) to ensure there is a renewed emphasis on reviewing credit union underwriting practices with respect to determining a borrower's ability to meet debt service requirements.

Thank you for the opportunity to comment.



## Appendix C: Acronyms and Abbreviations

AEP	Annual Examination Scheduling Program
AIRES	Automated Integrated Regulatory Examination System
ALLL	Allowance for loan and lease losses
AMAC	Asset Management Assistance Center
Bay Ridge	Bay Ridge Federal Credit Union
Call Reports	NCUA 5300 Call Reports
CAMEL	[C]apital Adequacy, [A]sset Quality, [M]anagement, [E]arnings, and [L]iquidity/Asset-Liability Management.
CEO	Chief Executive Officer
CFR	Code of Federal Regulations
The Credit Unions	Melrose Credit Union, LOMTO Federal Credit Union, Bay Ridge Federal Credit Union
DFS	New York State Department of Financial Services
DOR	Document of Resolution
E&I	Office of Examination and Insurance
FCU Act	Federal Credit Union Act
FPR	Financial Performance Report
GAGAS	Generally Accepted Government Auditing Standards
LUA	Letter of Understanding and Agreement
LOMTO	LOMTO Federal Credit Union
MBL	Member business loan
Melrose	Melrose Credit Union
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
PCA	Prompt Correct Action
RFE	Risk-Focused Examination
TDR	Troubled Debt Restructuring
WCC	Work Classification Code