

**NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL**

**MATERIAL LOSS REVIEW
OF
EASTERN NEW YORK FEDERAL
CREDIT UNION**

**Report #OIG-12-14
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Table of Contents

Section	Page
ACRONYMS AND ABBREVIATIONS	ii
EXECUTIVE SUMMARY	1
INTRODUCTION AND BACKGROUND	4
OBJECTIVES, SCOPE, AND METHODOLOGY	11
RESULTS IN DETAIL	13
A. Why Eastern New York Federal Credit Union Failed	13
B. NCUA Supervision of Eastern New York Federal Credit Union	18
OBSERVATIONS AND LESSONS LEARNED	24
SUGGESTIONS	24
RECOMMENDATIONS	25
APPENDIX	
A. NCUA Management Response	27

Acronyms and Abbreviations

Board	Board of Directors
Crowe	Crowe Horwath LLP
CU	Credit Union
CUSO	Credit Union Service Organization
DOR	Document of Resolution
EIC	Examiner in Charge
ENY FCU	Eastern New York Federal Credit Union
FCU	Federal Credit Union
FOM	Field of Membership
FPR	Financial Performance Reports
Examiner's Guide	NCUA Examiner's Guide
MBL	Member Business Loans
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OIG	Office of Inspector General
RegFlex	Regulatory Flexibility Program
RBNW	Risk Based Net Worth
TIP	Trade and Industry Professional
UCC	Uniform Commercial Code

Executive Summary

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Crowe Horwath LLP (Crowe) to conduct a Material Loss Review (MLR) of Eastern New York Federal Credit Union (ENY FCU or Credit Union), a federally insured credit union (federal credit union (FCU)). We conducted this review to: (1) determine the cause(s) related to the liquidation of ENY FCU 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 observations/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 Region I; reviewed NCUA guides, policies and procedures, and NCUA Call Reports, and NCUA Financial Performance Reports (FPRs).¹

We determined Eastern New York Federal Credit Union failed for the following reasons:

- Poor Corporate Governance – ENY FCU's former Chief Executive Officer (CEO) served from August 2006 to September 3, 2010. The Board of Directors (Board) gave the CEO broad authority to conduct various and significant transactions with very little push back. The CEO instilled an unhealthy tone at the top as questioning his decisions was not permitted. In addition, the Board failed to understand and establish appropriate limits over the level of risk undertaken by the CEO. Due to a lack of effective corporate governance, the following problem areas resulted in the credit union's liquidation.
 - Credit Union Service Organization (CUSO) – ENY FCU developed a complex, multi-layered network of CUSOs in which funds were loaned between CUSO's with little or no documentation supporting collateral positions. Additionally, the credit union recorded accrued income of almost \$900 thousand related to the potential gain on the sale of CUSO patent rights in 2008 and 2009. ENY FCU management did not properly support the accruals, which gave the Credit Union the appearance of profitability. The entries were later reversed in 2010.
 - Member Business Loans (MBL) – The MBL portfolio grew from one loan of \$200,000 in 2007 to 26 loans totaling approximately \$3.5 million by the end of 2009. ENY FCU failed to demonstrate effective due diligence or a thorough understanding of the business loan customers to identify the relationships between the borrowing entities.

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

As a result, the Credit Union made loans to two separate, but related, families creating a concentration of \$2.8 million.

- Fixed Assets – Liberty branch Acquisition – The Credit Union acquired the Liberty branch office through a merger with Catskill Regional Credit Union. As a result of the acquisition, the Credit Union exceeded the maximum allowable fixed asset ratio. ENY FCU management later sold the building to an investor and then entered into a capital lease arrangement for the same building with the same investor. Management did not properly record the lease as a capital lease, misrepresenting the Credit Union's financial statements. Compounding the already high fixed asset position of ENY FCU, management set about a branch modernization plan that resulted in nearly \$1 million in additional leasehold improvements to this branch.

NCUA Supervision

NCUA's Region I supervised ENY FCU up to and through the liquidation process. The Credit Union received composite CAMEL ratings of 3 during examinations and supervision contacts occurring in 2006 and 2010. During these examinations, we believe the NCUA took the correct actions based on issues and concerns identified. However, during 2007, 2008, and 2009 the composite CAMEL ratings consistently remained a 2 despite negative trends involving earnings, net worth, net income, and unusually large increases in investment income. There was a single examiner in charge (EIC)² assigned to the Credit Union between 2006 through 2009. Upon this EIC's departure, Region I management reassigned the Credit Union in early 2010 to a different EIC with more experience. During the newly assigned, more experienced EIC's first examination, the composite CAMEL rating was downgraded to 3.

We believe the first EIC assigned to ENY FCU from 2006 through 2009 had the appropriate information to identify early warning signs that should have elicited further research. While we cannot conclude that further analysis of the negative trends would have prevented the Credit Union's liquidation, we can reason that detection could serve as a 'red flag,' prompting examiners to conduct more frequent, thorough or detailed examinations. Based on our review, we determined the following contributory factors:

- The initial EIC had limited experience and lacked adequate oversight,
- Lack of detailed quality review to aid in identifying potential issues overlooked by the examination process,

² NCUA hired the EIC in July 2005 and assigned her to ENY FCU after promoting her to a Grade 9 in July 2006.

- Lack of in-depth examinations related to CUSO activity.

As a result of our review of the liquidation of ENY FCU, we are making two recommendations and two suggestions. Our recommendations relate to expanding the quality control function for critical elements and potential red flag issues, and reviewing current examination procedures over CUSOs to determine whether current procedures are adequate to identify the degree of risk a CUSO poses. Our suggestions relate to NCUA's National Instruction on EIC rotation and developing a Risk Report threshold that addresses anomalies on yields for major asset categories such as loans and investments.

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

Introduction and Background

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

History of Eastern New York Federal Credit Union

NCUA chartered ENY FCU in 1961 to serve employees and family members of the Eastern New York Correctional Facility in Napanoch, New York. Additional mergers over time with other correction facility credit unions expanded the Field of Membership (FOM) to serve employees of medium and maximum-security state correctional facilities located in the New York counties of Ulster, Orange, and Sullivan, as well as state and municipal employees in the town of Liberty, New York. In 2008, ENY FCU applied for a charter conversion to Trade and Industry Professional (TIP) serving all state and municipal employees in seven counties making up the lower Hudson Valley region in New York State. Prior to the TIP conversion (as noted in the December 31, 2007, Call Report), ENY FCU reported 7,032 members and a potential membership of 20,000. ENY FCU had limited penetration into the potential FOM from the TIP conversion. On the September 30, 2011 Call Report, ENY FCU reported 6,865 members with a potential membership of 158,044.

Prior to 2006, the Credit Union was participating in the RegFlex program offered by the NCUA. This program gave eligible institutions flexibility regarding certain regulations.

Between July 2006 and September 2006, the NCUA initiated a full scope exam in which examiners were critical of management and the Board indicating that there had been little leadership for close to two years. As a result, NCUA lowered the Credit Union's composite CAMEL rating to a 3, with the Management component being assigned a 4 due to the lack of oversight and leadership from executive management and the Board. The NCUA issued a DOR with corrective action issued for identified problem areas relating to credit risk, transaction risk, and strategic risk. Upon receiving the DOR and downgraded CAMEL rating, the CU immediately lost RegFlex eligibility. It was also during this time that the Board hired a new Chief Executive Officer.

In March 2007, examiners performed a follow-up supervision contact to evaluate the progress the Credit Union had made regarding a recent DOR. The examiner complimented the responsiveness of management and the Board noting that all

DOR items had been resolved and upgraded ENY FCU's composite CAMEL rating to a 2.

In July 2007, the Credit Union merged with Catskills Regional Credit Union, which included the acquisition of a branch in Liberty, NY. As a result of this acquisition, the Credit Union exceeded the maximum regulatory fixed asset ratio of 5 percent. Assisted by the assigned examiner, the Credit Union filed for a fixed asset waiver. NCUA ultimately declined the waiver due to Credit Union management's inability to supply all requested documentation. Ultimately, ENY FCU sold the facility in June 2008 to ENY Holdings LLC (ENY Holdings), a CUSO of the ENY FCU, and entered into a 20-year capital lease to retain use of the building as a working branch.

ENY FCU created its first wholly owned CUSO, ENY Holdings, on October 11, 2007. The CUSO named ENY FCU's CEO as its vice-president. A sale-leaseback transfer of ENY FCU's ATMs (\$123 thousand equity investment) provided the CUSO's initial equity. Three months later, in December 2007, the Credit Union granted the first of many CUSO related loans to ENY Holdings for \$370 thousand.

The following month, in July 2008, ENY Holdings obtained a study to analyze the offering price of a partially developed patent referred to as Rate Match. This planning report returned a hypothetical valuation of \$450 thousand based on potential cash flow of \$70 to \$75 thousand per month from monthly technical subscriptions for the Rate Match product from client financial institutions. The Credit Union recorded monthly income entries from \$70 – \$75 thousand between July 2008 and April 2010 related to this activity.

On September 16, 2008, ENY FCU formed a second CUSO, Syphr LLC (Syphr), in New York State and funded it as follows:

- \$50,000 cash funding by ENY FCU;
- \$250,000 deposit by ENY Holdings in the form of goodwill for Rate Match;
- \$300,000 from National Innovative Software Solutions (NISS) in the form of goodwill, and
- \$300,000 from Equidata in the form of goodwill for its subscriber codes.

ENY FCU provided the only cash investments recorded during the formation of Syphr. The remaining entities deposited unsupported and undocumented goodwill into the Syphr, LLC CUSO.

In December 2008, examiners completed a full scope examination as of June 30, 2008 (effective) in which the Credit Union received a composite CAMEL rating of 2. Examiners first began to acknowledge that ENY FCU's profitability was the result of income received directly from Syphr LLC during this examination.

Between March and May 2009, the following three transactions occurred:

- The Credit Union loaned ENY Holdings \$400 thousand;
- ENY Holdings loaned Syphr \$300 thousand;
- The Credit Union capitalized an \$80 thousand loan for ENY Holdings.

Three additional entities were created and funded between July 2009 and November 2009:

- Save on Your Loan (SOYL) – created by funding from Syphr and an unrelated consulting company, Wirikuta. Syphr created this CUSO as a sub-CUSO. Wirikuta's initial investment would be reduced to \$0 by the end of the year as the result of multiple payments from the CUSO.
- SettleMyLoan.com (SML.com) The CEO created this LLC from funding of a \$40 thousand loan from the Credit Union. Subsequent to initial funding, there were two transfers of \$5 thousand to ENY Holdings and the CEO.
- In the Margins LLC – The CEO created this LLC by funding from ENY FCU through a \$45 thousand loan. In the Margins LLC transferred \$42 thousand to SOYL and \$1,500 to the CEO, neither of which were registered on the transaction register.

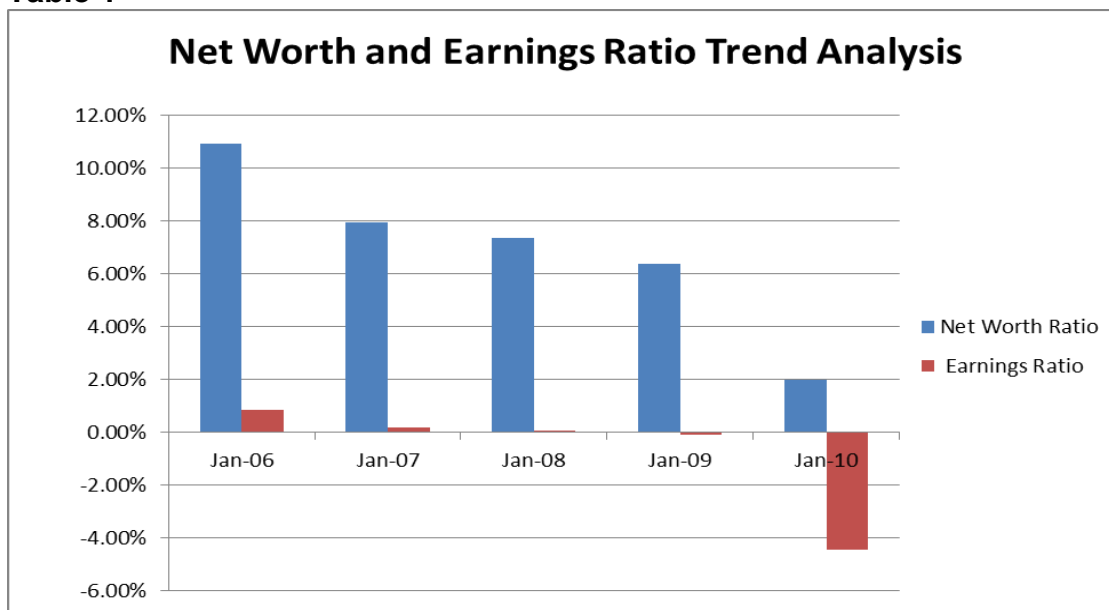
The Credit Union's MBL activity grew from less than \$1 million in 2008 to \$3.5 million in 2009. Of this amount, 17 loans totaling \$3.1 million or 88 percent of the total dollar value originated to family members of member business loan customers. ENY FCU's CEO and Chairman of the Board approved all loans.

During 2009, the NCUA performed two on-site supervision contacts at the Credit Union, both of which resulted in composite CAMEL ratings of 2 and no DORs issued.

Syphr made a capital contribution to SOYL of \$798 thousand in December 2009. In January 2012, Advance Decisions received a loan from ENY FCU, which was used in part to provide \$50 thousand in new investor funding to Syphr.

In June 2010, examiners conducted a supervision contact of ENY FCU for two reasons: 1) regional management assigned a new, more experienced EIC; and 2) the Credit Union’s ratios and profitability were declining. As a result of the review, the composite CAMEL rating was downgraded to a 3. The examiner specifically cited the observation of the downward trend that began in 2006 as shown in Table 1 (below):

Table 1



Source: Financial Performance Reports (FPR) and examination information.

The ENY FCU CEO resigned in September 2010 to become President and CEO of Syphr LLC. The Credit Union’s Board appointed the Vice President as the interim CEO.

In October 2010, the NCUA performed a full scope examination with an effective date of June 30, 2010. Examiners determined ENY FCU management did not correctly report or include the capital lease for the Liberty Branch in its disclosure of fixed assets until directed to do so following the June 30, 2010, NCUA examination. By the time the Credit Union was correctly treating and accounting for fixed assets, the fixed assets ratio had risen to 11.06 percent in violation of NCUA Rules and Regulation Section 701.36. Additionally, examiners raised concerns related to the former CEO's involvement with the numerous CUSOs and LLCs created and interrelated with Syphr LLC. Examiners also issued DORs related to credit risk (concentration in MBLs), strategic risk (unprofitability, no net worth restoration plan (NWRP), collapsed merger), and compliance risk (excessive fixed assets and inadequate Allowance for Loan and Lease Losses (ALLL) policy).

The Credit Union attempted to merge with other institutions several times. The NCUA reached out to three large local credit unions in an attempt to find a suitable merger partner. One of the potential merger partners showed interest in the merger and began performing due diligence procedures. In December 2010, the potential merger partner withdrew from the merger process due to concerns it found with respect to a myriad of issues in the Credit Union, namely the validity and complexity of CUSO investments, excessive leasehold improvements, overbearing contractual (lease) obligations, and MBLs.

In January 2011, examiners began a full scope examination as a direct result of the breakdown of the merger. Examiners noted unusual activity between ENY FCU and the multiple CUSOs and subsidiary LLCs, including a \$900 thousand receivable entered on ENY Holdings' books, due from Syphr, LLC. Upon further investigation, examiners determined the receivable related to income accruals from 2009 and 2010 for potential gain on the sale of patent rights of the CUSO.

On March 16, 2011, Regional officials assigned ENY FCU to the Division of Special Actions, and thereafter the Credit Union operated with consistent on-site Problem Case Officer presence. The extended delay in uploading the December 31, 2010, examination (effective) was due to the extensive research required on the MBLs, CUSOs, and fixed asset issues. In addition, NCUA's Asset Management and Assistance Center (AMAC) performed an on-site visit in August 2011 to assist in valuing assets related to the problem areas noted. ENY FCU recorded a reversal of \$887,500 of income accruals from 2009 and 2010 related to the potential gain on the sale of patent rights owned by the CUSO. As a result, Net Worth ratio declined to 2.06 percent as of March 31, 2011.

AMAC also assisted in valuing assets related to the other problem areas noted (primarily the capital lease/lease back and member business loans). AMAC estimated impairment losses from MBLs to be \$2.4 million.

A final CAMEL downgrade occurred in October 2011 in which examiners lowered the composite CAMEL rating to 5. Subsequently, NCUA placed ENY FCU into involuntary liquidation and completed a purchase and assumption (P&A), and entered into an agreement with U.S. Alliance Federal Credit Union. As of September 2012, the estimated loss to the NCUSIF was approximately \$3.6 million; however, the final cost to the NCUSIF will not be known until all assets are sold.

NCUA Examination 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 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 analysis³, trend analysis⁴, reasonableness analysis⁵, variable data analysis⁶, and qualitative data analysis⁷. 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. The NCUA also instructs examiners to look behind the numbers to determine the significance of the supporting ratios and trends. Furthermore, the 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 both 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 and direction of the risks detected in the credit union's operation and on management's demonstrated ability to manage those risks. A credit union's risk profile may change between examinations. Therefore, the supervision process encourages the examiner to identify those changes in profile through:

³ Structural analysis includes the review of the component parts of a financial statement in relation to the complete financial statement.

⁴ Trend analysis involves comparing the component parts of a structural ratio to itself over several periods.

⁵ As needed, the examiner performs reasonableness tests to ensure the accuracy of financial performance ratios.

⁶ 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.

⁷ Qualitative data includes information and conditions that are not measurable in dollars and cents, percentage.

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

Regulatory Flexibility Program

The NCUA Board established a RegFlex in 2002 to exempt qualifying credit unions in whole or in part from a series of regulatory restrictions and grant them additional powers.⁸ A credit union may qualify for RegFlex automatically or by application to the appropriate Regional Director. To qualify automatically for RegFlex, a credit union must have a composite CAMEL rating of 1 or 2 for two consecutive examination cycles and, under existing part 742, also must achieve a net worth ratio of nine percent⁹ for a single Call Reporting period. If the credit union is subject to a risk-based net worth (“RBNW”) requirement, however, the credit union’s net worth must surpass that requirement by 200 basis points.¹⁰

A credit union that is unable to qualify automatically for RegFlex may apply to the appropriate Regional Director for a RegFlex designation. To be eligible to apply, a credit union must either have a composite CAMEL rating of 3 or better or meet the present nine percent net worth criterion, but not both.¹¹ A Regional Director has the discretion to grant RegFlex relief in whole or in part to an eligible credit union. A federal credit union’s RegFlex authority can be lost or revoked. A credit union that qualified for RegFlex automatically is disqualified once it fails as the result of an examination (but not a supervision contact), to meet either the CAMEL or net worth criteria.¹²

RegFlex authority can be revoked by action of the Regional Director for “substantive and documented safety and soundness reasons”.¹³ The decision to revoke is appealable to NCUA’s Supervisory Review Committee, and thereafter to the NCUA Board.¹⁴ RegFlex authority ceases when that authority is lost or revoked, even if an appeal of a revocation is pending¹⁵. However, past actions taken under that authority are “grandfathered,” i.e., they will not be disturbed or undone.

⁸ 12 CFR part 742 (2005); 66 FR 58656 (Nov. 23, 2001)

⁹ 200 basis points above the net worth ratio to be classified “well capitalized”

¹⁰ 12 CFR 742.1 (2005)

¹¹ 12 CFR 742.2 (2005)

¹² § 742.2(a). 12 CFR 742.6 (2005)

¹³ § 742.2(b)(2005)

¹⁴ 12 CFR 742.7 (2005)

¹⁵ 12 CFR 742.6 (2005)

Objectives, 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 NCUSIF has incurred a material loss.¹⁶ Additionally, the 2010 amendments to the FCU Act, embodied in the “Dodd-Frank Wall Street Reform and Consumer Protection Act,”¹⁷ further require the OIG to conduct an in-depth review of any loss to the NCUSIF where unusual circumstances exist that might warrant an in-depth review of the loss. In the case of ENY FCU, the OIG determined the circumstances surrounding the loss to the NCUSIF were unusual enough to warrant a review, even though the loss did not exceed the \$25 million threshold. Specifically, the OIG determined the losses related to the CUSOs warranted the OIG performing a full-scope MLR.

Our audit objectives were to: (1) determine the cause(s) related to ENY FCU’s failure and the resulting loss to the NCUSIF; (2) assess NCUA’s supervision of the credit union, and (3) make appropriate observations/recommendations to prevent future losses.

We conducted this review from May 2012 to November 2012 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained as described in the Scope and Methodology section, provides a reasonable basis for our findings and conclusions based on our audit objectives.

The scope of this audit included an analysis of ENY FCU from 2006 to January 20, 2012; the date NCUA involuntarily liquidated ENY FCU. Our review also included an assessment of NCUA regulatory supervision of the institution during the same period.

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

- We analyzed NCUA examination and supervision contact reports and related correspondence and examiner work papers contained within the AIREs¹⁸ system.

¹⁶ 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.

¹⁷ Public Law 111-203–July 21, 2010, 124 Stat.1939.

¹⁸ NCUA’s Automated Integrated Regulatory Examination Software.

- We interviewed management and/or staff from NCUA Region I and reviewed NCUA guides, policies and procedures, as well as NCUA Call Reports, and NCUA Financial Performance Reports (FPRS).
- We reviewed ENY FCU data and correspondence maintained at the NCUA Regional Office in Albany, New York as provided to Crowe by NCUA.

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

Results in Detail

We determined that ENY FCU's management and Board contributed to the credit union's failure as well as the resulting loss. In addition, we determined Region I examiners could have earlier identified some of the significant issues that contributed to the loss to the NCUSIF had they placed additional focus on the Credit Union's CUSO activities.

A. Why Eastern New York Federal Credit Union Failed

**Management's
Actions Led to
Eastern New York
FCU's Failure**

We determined ENY FCU's Board did not provide appropriate leadership or oversight of the credit union. Specifically, Board members granted excessive authority to the CEO and he used that authority and undertook business ventures that would prove to be catastrophic to the credit union. These ventures involved complex CUSO activity, unsound MBL origination practices, and excessive fixed assets. As a result, ENY FCU failed on January 20, 2012.

CUSO Activity

Beginning as early as 2007, the Credit Union began to create relationships with a complex network of CUSO's. Although NCUA regulations provide specific guidance regarding CUSO activity, Credit Union management and the Board of Directors did not perform the necessary due diligence to ensure each CUSO was compliant with all regulations. Such requirements include obtaining the opinion of an attorney regarding corporate separateness of the CUSO's operations, contracts and agreements between entities in order to establish responsibilities and protect the Credit Union membership, and annual financial statement audits of the books and records of the CUSO. Additionally, the Credit Union was the sole owner of one CUSO and as such, the financial statements of both entities should have been consolidated; however, management chose to present the financial statement under the old equity method of accounting.

We determined CUSO assets were mostly comprised of Credit Union invested assets and a number of intangible assets including patents, license subscriptions, and goodwill, all of which the Credit Union used to represent the equity interest of the other stakeholders. Several CUSOs were set up to generate income; however, most CUSOs had very few customers. During 2010 examinations, examiners determined that the loans made by the Credit Union to the network of CUSO's exceeded \$820,000. Additionally, further research by Region I's Division of Special Actions indicated the Credit Union recorded fabricated income recognition on future sale of patent and license intangibles belonging to the Credit Union's wholly owned CUSO, Syphr, and its subsidiary company SOYL in 2009 and 2010. The

considerable income ENY FCU made in those years masked the fact that the credit union was actually highly unprofitable due to unsound infrastructure and contractual relationships implemented under the former CEO. During each examination occurring between 2007 and 2009, examiners identified that profitability was dependent upon income generated from the CUSO's. However, examiners did not issue DOR's related to ENY FCU's lack of profitability from credit union operations. In 2010, a new, more experienced, EIC identified concerns regarding profitability and issued a DOR.

The following diagram illustrates the ownership of each CUSO:

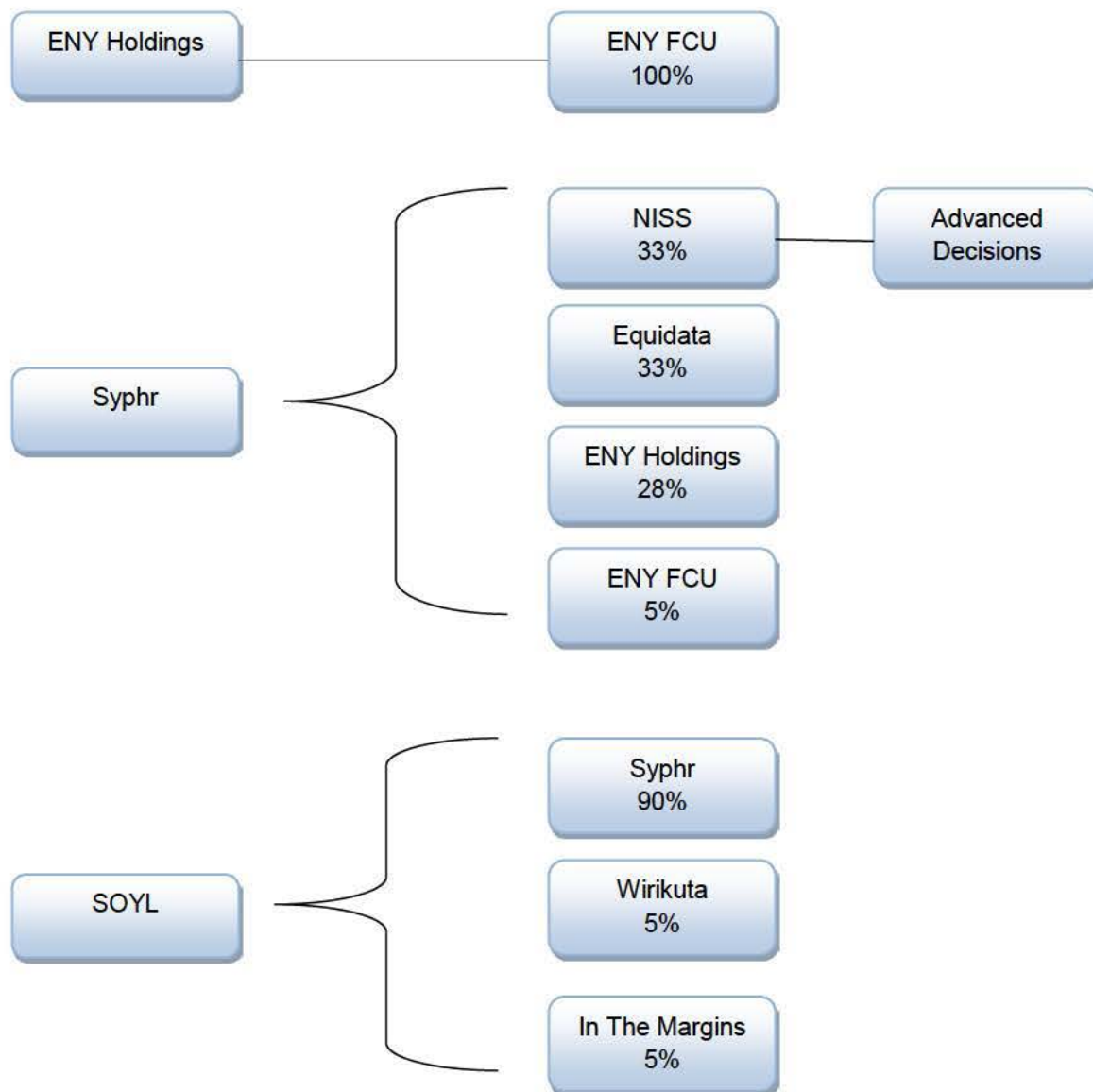
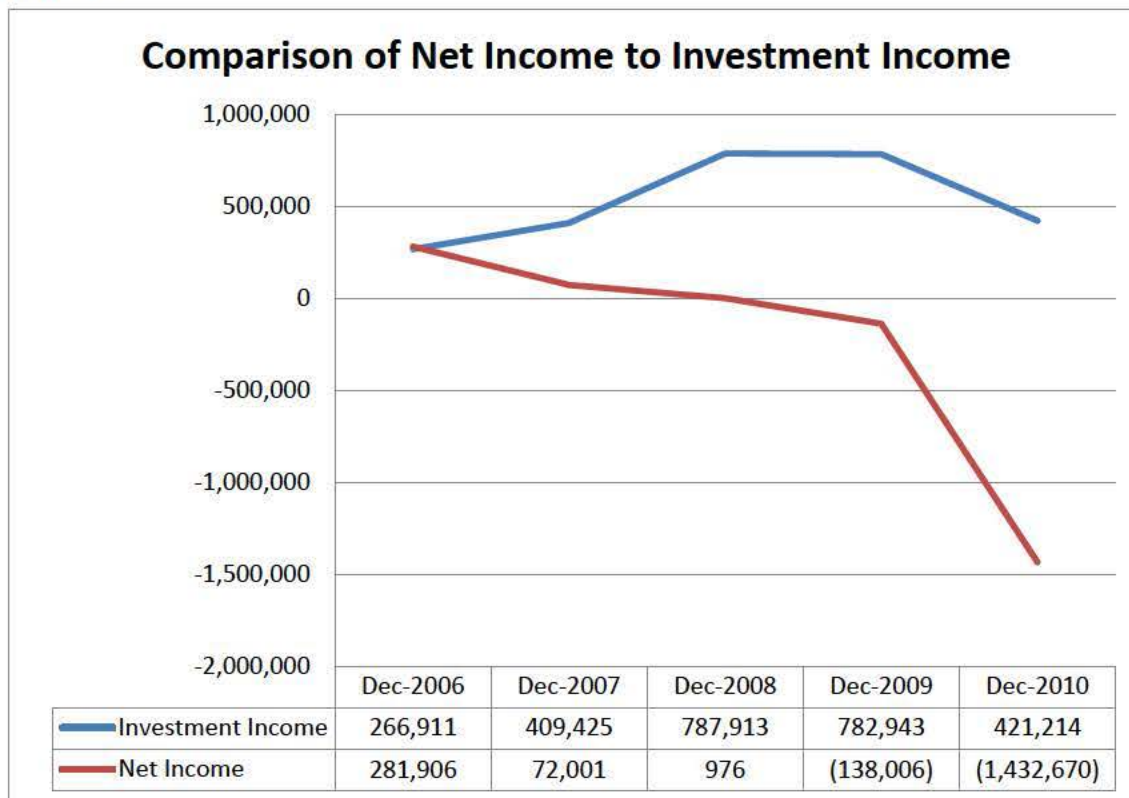


Table 2 (below) illustrates the trends related to the investment income recorded between 2006 and 2010 as compared to overall net income.

Table 2



Source: Financial Performance Reports (FPR) and examination records.

Member Business Lending

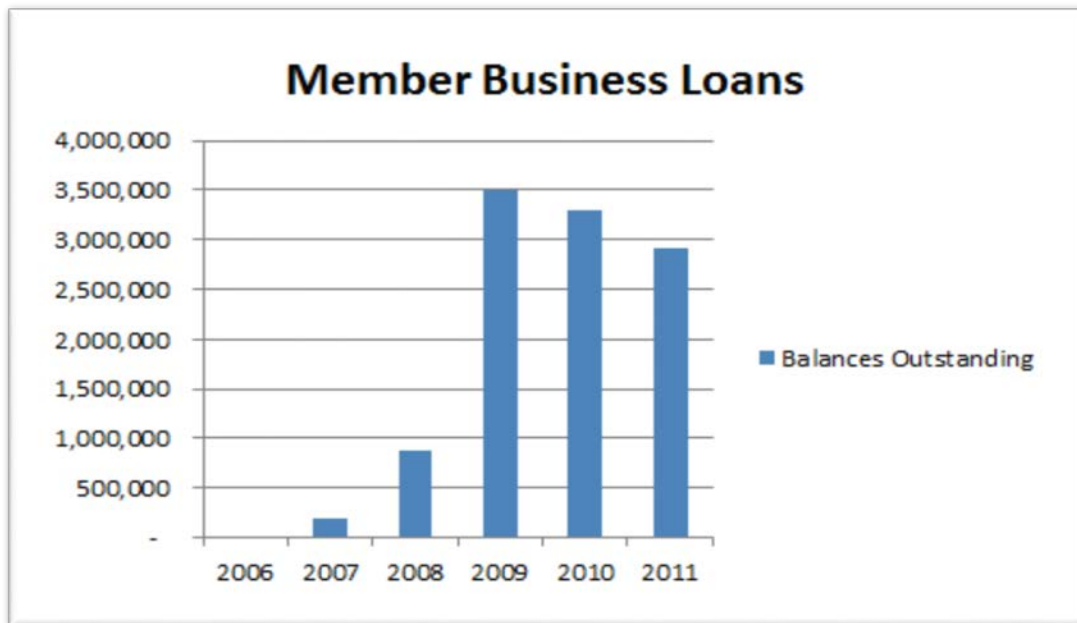
During the December 31, 2010 examination (effective), examiners noted the MBL portfolio consisted of 23 MBLs totaling approximately \$3.5 million. Of this amount, ENY FCU management had originated 17 loans totaling over \$3.07 million (88 percent) to family members of member business loan customers. The loan files contained poor underwriting, almost no credit analysis, and were mostly secured by worthless blanket Uniform Commercial Code (UCC) filings on inventory and/or assets. In addition, there was no collateral valuation of such inventory or collateral, thus making these loans effectively unsecured.

The CEO and Chairman of the Board approved all loans. Although these two individuals represented the majority of the Credit Committee, neither met the regulatory requirement related to experience in making business loans. In many cases, Credit Union management obtained loan approval documentation well after

they had disbursed the loan proceeds. Examiners estimated the ALLL account was under funded by \$819,433 for these unsecured loans in violation of NCUA Rules and Regulations.¹⁹

Table 3 (below) illustrates the majority of the MBL activity occurred between 2009 and 2011.

Table 3



Source: Financial Performance Reports (FPR) and annual examination records

Excessive Fixed Assets and Leasehold Activity

Credit Union management acquired the Liberty branch through a merger with Catskill Regional Credit Union in early 2007. As a result of the acquisition and loss of the RegFlex eligibility, ENY FCU exceeded the maximum fixed asset ratio. The Credit Union had the opportunity to apply for a fixed asset waiver, but failed to supply the required documentation. After several attempts, NCUA’s Region I declined the waiver.

In 2007, Credit Union management sold the branch to its wholly owned CUSO, ENY Holdings LLC, in an attempt to eliminate the fixed assets from the Credit Union’s balance sheet. Shortly thereafter, the CUSO sold the building for a \$200,000 profit, as part of a sale and leaseback agreement to conceal fixed assets that were growing out of control. The Credit Union committed to a 20-year lease for this branch that would cost over \$1.7 million over the life of the lease. As part of

¹⁹ Section 723(c) (2).

this agreement, ENY FCU was responsible for maintenance, as well as property taxes.

Credit Union management also spent more than \$1 million in leasehold improvements on the Liberty Branch. A subsequent inspection of the branch concluded that the improvements were incomplete and would require significant additional funds to complete (estimated at nearly another \$500,000).

Examiners determined ENY FCU did not benefit from this transaction and neither the Board nor CEO could provide an explanation other than a regulatory fixed asset concern. ENY FCU failed to record the lease as a capital lease either on the books of the CUSO or the Credit Union. Ultimately, if Credit Union management had properly recorded the lease, and properly consolidated the financial statements of ENY FCU and its wholly owned CUSO, the fixed asset violation and related issues would have been immediately apparent.

B. NCUA's Supervision of Eastern New York Federal Credit Union

Examiners Could Have Mitigated the Loss to the NCUSIF

We determined NCUA Region I examiners did not perform adequate RFEs, as evidenced by the number of potential issues overlooked during the examination process. Specifically, we found inadequate examination procedures related to investments, earnings, net worth, and income, as well as the lack of examination depth for CUSO-related activity. We believe this occurred because the EIC assigned to examine ENY FCU from 2006 through 2009 had limited experience and received insufficient supervisory oversight. As a result, the NCUSIF suffered a loss of approximately \$3 million.

We determined examiners required ENY FCU management to develop an NWRP based on the decline of the Credit Union's capital. ENY FCU management failed to complete a plan in the allotted time and on September 27, 2011; the Regional Director approved the Credit Union's plan to seek a merger instead. The Regional Director gave ENY FCU management until December 31, 2011 to complete the merger plan. Examiners determined during the 4th quarter of 2011 a merger could not be completed due to the credit union's severe decline in net worth. The inability to merge and the continuing decline in net worth led to the insolvency of the credit union, its involuntary liquidation, and the purchase and assumption agreement with USAlliance Federal Credit Union.

Table 4 (below) demonstrates selected financial indicators and the growth experienced by Eastern New York Federal Credit Union from 2006 through 2010. A concerning trend was evident as early as 2008 when investment income grew by nearly 100 percent in 2007 and 2008, yet earnings, net worth ratio, and net income declined considerably.

Table 4

Selected Financial Data					
	12/31/2006	12/31/2007	12/31/2008	12/31/2009	12/31/2010
Total Assets	34,766,757	47,483,878	51,170,484	56,867,829	53,194,561
Net worth	3,798,897	3,765,896	3,766,872	3,628,866	1,045,925
Net worth Ratio	10.92%	7.93%	7.36%	6.38%	1.96%
Earnings	.82%	.18%	.002%	-.11%	-4.44%
Investment Income	266,911	409,425	787,913	782,943	(485,994)
Net Interest Income	1,803,978	1,800,237	2,290,537	2,599,590	1,428,583
Non-Interest Income	1,747,000	1,422,862	761,031	581,159	693,823
Net Income (Loss)	281,906	72,001	976	(138,006)	(1,432,670)

Source: Financial Performance Reports (FPR) and examination records

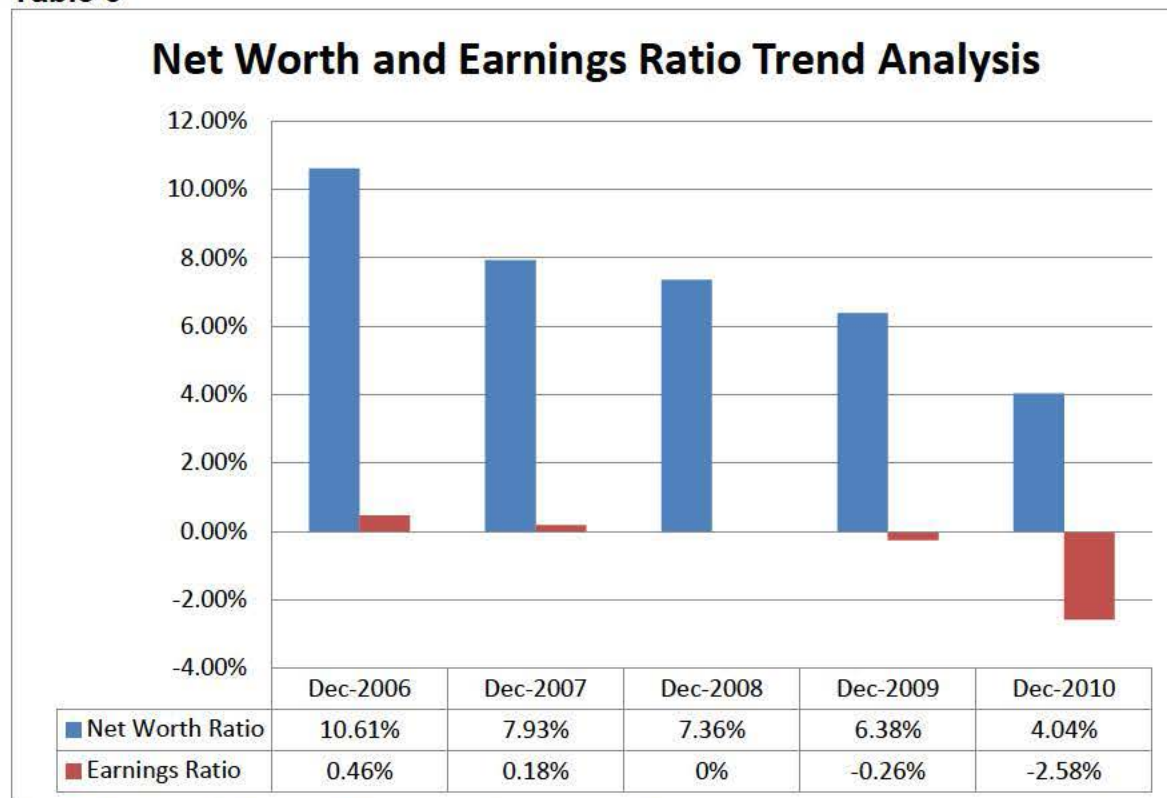
We believe the NCUA examiners had the information necessary to question the credit union's rapid decline in net worth, such as performing trend analysis over the following:

- Net worth and earnings ratios,
- Investment income to overall income,
- Business loan originations.

Examiners did not question the credit union's capitalization level until the March 31, 2010 examination when Regional I officials assigned ENY FCU to a new EIC.

Table 5 (below) indicates net worth rapidly declined starting in 2007. During the March 2010 examination, the newly assigned EIC determined the 'root cause' of the net worth decline was due to earnings not being sufficient to support the increase in assets and operating expenses. Ultimately, we believe examiners had the available data to identify and question the 'root cause' before the March 31, 2010 examination.

Table 5



Source: Financial Performance Reports (FPR) and examination records.

Oversight of Inexperienced Examiner

During our review, we determined the EIC assigned to examine ENY FCU from 2006 through 2009 had less experience [REDACTED]

[REDACTED] Although, the oversight of this examiner was the standard protocol in place during this time period, oversight did not include a detailed review of work performed in order to identify deficiencies within the examination process. We also determined there was no criticism of the Credit Union from 2007 until NCUA Region I officials reassigned the Credit Union to a different, more experienced, examiner in late 2009. We believe that this was a contributory factor to the delay in identifying early warning signs.

Examiner Rotation

We determined that the new, inexperienced EIC was assigned to ENY FCU for three calendar years, an amount of time well within NCUA guidelines, and according to NCUA guidelines, could have remained involved for a fourth year but for departing the NCUA in 2009.

The National Supervision Policy Manual (NSPM) states:

“NCUA Instruction No. 5000.19, Examiner-In-Charge Rotation, dated November 23, 2005, describes the current policy for examiner rotation. Supervisors will ensure adequate rotation of EICs occurs.”

The aforementioned instruction indicates that a credit union could have the same EIC for up to four calendar years. We believe there may be instances where it is prudent to rotate an EIC sooner than what the current timeframe allows, such as in the case of ENY FCU where a new, inexperienced examiner [REDACTED] was allowed to remain the EIC for three years.

Mandatory Quality Control

During our review, we determined there was no mandatory quality control function in place over examiner workpapers and supporting documentation. The oversight function was selective based upon the circumstances presented with each examiner and credit union. As a result, there was increased risk that examiners and SEs overlooked violations and possible red flags. Although this would not have prevented the collapse of ENY FCU, we believe examiners could have identified the issues much sooner.

NCUA's Examiner's Guide, Chapter 22 *“Examination Evaluation and Review Policy”* addresses quality control, as does Chapter 4 *“Quality Assurance Program”* of NCUA's

recently issued National Supervision Policy Manual²⁰ (NSPM). In keeping with the Examiner's Guide, the NSPM notes the three main contributors to quality assurance "...are DOS, supervisors, and E&I."

The NSPM also includes a quarterly required review process for all credit unions that requires supervisors to review risk report summaries submitted by examiners. Although this should improve oversight of cases like this, we believe SEs should – as time permits – spend time on site with new and less experienced examiners, [REDACTED]

Region I management informed us they require supervisors to perform a minimum of five report appraisals each year; however, we learned this did not include examiner workpapers or supporting documentation. Region I management also informed us their Division of Supervision (DOS) reviews a sample of the field staff's risk report review summaries (on a quarterly basis) to assure higher risk credit unions receive priority in examination scheduling as required in NCUA's National Instruction 5000.20 (Rev. 4), "*Risk Focused Examinations – Minimum Scope Requirements.*" Regional management explained DOS conducts reviews of the selected summaries to ensure examiners maintain proper support to evidence that the objectives of the National Instruction are being met. This includes ensuring that the risk reports were reviewed, risks were properly identified/ addressed, and supervision plans were adjusted, as appropriate, based on risk.

CUSO Oversight

During our review, we found no evidence of violations related to the Credit Union's CUSO activity. NCUA regulations require CUSOs follow explicit requirements, yet the examination workpapers made no mention whether examiners reviewed the CUSOs for these requirements. However, the EIC did make special note in several cases that the Credit Union remained profitable due to the income from the CUSOs, which came primarily from improper accruals and other activity. Additionally, charts prepared by the EIC and included within the Reports of Examination clearly showed increased investment income and the examiner's review of the "*yield on average investments*" from the FPR should have raised a red flag that the Credit Union's investment income was well above average. However, we found no evidence that examiners questioned the source of the income until 2010.

We learned during the review that NCUA does not currently have a Risk Report threshold that addresses anomalies on yields for major asset categories such as loans and investments. We believe such a report would serve well to highlight such extreme outliers, and the current requirements to report on such risk thresholds could serve as an indicator to examiners that they need to conduct a closer review.

²⁰ NCUA issued the NSPM on July 1, 2012.

In September 2006, NCUA Region I performed an examination as of June 30, 2006 (effective) that resulted in the Credit Union's composite CAMEL rating being downgraded from 2 to 3. This downgrade also resulted in the Credit Union losing their RegFlex designation and examiners issuing a DOR with corrective action for observed problem areas related to credit risk, transaction risk, and strategic risk. Examiners performed a follow-up examination in early 2007 in which the composite CAMEL rating was returned to 2. The examiner stated:

[T]he Board of Directors, Supervisory Committee, CEO, and staff of Eastern [sic] FCU are commended for the corrective action taken to address all concerns raised in the previous Document of Resolution.

Examiners completed their June 30, 2007 (effective) full-scope examination in October 2007, which also resulted in a composite rating of 2. However, the examiner observed that the ROA was "negative due to ongoing charge-offs from the previous year," but they "are profitable in August."

During 2009, NCUA did not conduct a full scope examination. Rather, examiners conducted two on-site supervision contacts effective as of March 31, 2009 and September 30, 2009. The Credit Union again lost RegFlex eligibility as of March 31, 2009 due to their net worth falling below seven percent, yet, CAMEL ratings remained consistent.

Investment income trends indicated an unusual spike in the income component beginning in mid-2008, yet we found no supporting documentation in 2009 regarding the investigation into the nature of the income. In each examination between 2007 and 2009, the examiner identified declining profitability yet determined the Credit Union would be profitable within the next quarter or by year-end. In late 2009, the EIC left the employment of the NCUA and Region I officials reassigned the Credit Union to a different, more experienced, EIC.

In May 2010, the newly assigned EIC made initial supervisory contact and expressed concerns to ENY FCU management officials regarding:

- The declining Net Worth (NW) and the expectation the Credit Union would hit 4 percent NW by December 31, 2010.
- The expectation that the Credit Union would be undercapitalized by June 30, 2010.
- Urgency needed by the Board and the lack of action currently being taken.
- The impending departure of the current CEO and the concern regarding the lack of experience of the interim CEO.

- Challenges regarding finding a qualified merger partner due to ENYFCU's charter.

In December 2010, a potential merger partner conducted merger due diligence on ENY FCU. The potential merger partner withdrew from the merger process as a result of concerns identified with respect to a myriad of issues in the Credit Union, namely the validity and complexity of CUSO investments, excessive leasehold improvements, overbearing contractual (lease) obligations, and quality concerns related to MBL.

The potential merger partners' refusal to perform an unassisted merger with ENY FCU necessitated an immediate examination by NCUA to identify and address the concerns noted as obstacles to the merger. Region I examiners initiated an examination on January 10, 2011. The examination developed a detailed analysis of key problem areas namely with the credit union CUSO operations. In addition, the examination focused on the other primary areas of concern including fixed assets in the form Leasehold improvements, unrecognized capital Leases, and MBL.

We determined examiners did not properly address ENY FCU's ability to generate income independent of the CUSO. NCUA developed an expanded Scope Workbook for field staff within the last year that includes CUSO examination steps. These steps indicate what examiners should review when they address CUSOs at each exam, which includes completing a CUSO questionnaire. We believe current guidance should also address a credit union's ability to generate income independent of the CUSO, which would highlight concerns that could lead to expanding the scope where unusual trends are identified.

Chapter 7 of the new NSPM addresses CUSOs, and has a brief discussion on the scope of CUSO reviews, and notes, "Chapter 25 of the Examiner's Guide provides guidance on the review's scope." However, we believe this chapter is in need of updating to reflect the current supervision needs given the complexity of today's CUSOs.

Table 6 (below) provides examination results for examinations and supervision contacts from June 30, 2006 (effective) through November 21, 2011 (effective).

Table 6

Examination Results							
Examination Effectiveness Dates	Work Code ²¹	Composite CAMEL Rating	Capital/ Net Worth	Asset Quality	Management	Earnings	Liquidity
6/30/2006	10	3	1	3	4	1	3
12/31/2006	22	2	1	2	2	2	2
6/30/2007	10	2	1	2	2	4	2
12/31/2007	22	2	1	2	2	4	2
6/30/2008	10	2	1	2	2	3	2
3/31/2009	22	2	2	2	2	3	2
9/30/2009	22	2	3	2	2	2	2
3/31/2010	22	3	3	2	3	4	3
6/30/2010	10	3	3	2	4	4	3
12/31/2010	10	5	5	3	5	5	5
11/21/2011	22	5	5	4	5	5	5

Source: Examination information in AIREs.

Observations and Lessons Learned

Important observations and lessons learned from our review of this liquidation include:

- Strong supervisory oversight is critical for new and inexperienced examiners, [REDACTED] Increased supervisory involvement in the planning and risk identification process, along with more detailed reviews of working papers and supporting documentation can help identify red flags earlier.
- Complex CUSO ownership structure, activities, and risks require a need for in depth analysis by experienced examiners. CUSO violations identified within the examination should impact final CAMEL and composite ratings.

Suggestions

Based on observations from our review, we are making the following two suggestions to NCUA management:

We suggest NCUA management:

1. Consider expanding on the discussion in NCUA guidance regarding EIC rotation because it may be prudent to rotate EICs earlier than current timeframes

²¹ Work Classification Code (WCC) 10 is a regular on-site examination of a federally chartered credit union and WCC 22 is a more limited supervision on-site contact of a federal credit union.

suggest. For example, it may be reasonable to rotate EICs earlier when the EIC has been with the agency for less than five years, [REDACTED]

Management Response

Management indicated they are currently evaluating additional alternatives to NCUA's current guidance on examiner rotation, including enhanced quality control sampling.

OIG Response

We concur with management's response.

2. Consider developing a Risk Report threshold that addresses anomalies on yields for major asset categories such as loans and investments. This type of report would highlight extreme outliers, which would indicate to examiners the need to expand examination procedures.

Management Response

Management indicated they believe such fields may be beneficial and will explore the feasibility of including them in the Risk Report in 2013.

OIG Response

We concur with management's response.

Recommendations

Based on the findings in this report, we are making the following two recommendations to NCUA management:

We recommend NCUA management:

1. Consider expanding current quality control functions to include a review of examination working papers and supporting documentation performed by the Supervisory Examiner for critical elements and potential red flag issues, especially for new or less-experienced examiners, [REDACTED]

Management Response

Management indicated the guidance incorporated in the National Supervision Policy Manual and the Examiner's Guide adequately addresses this issue and includes specific requirements for supervisors. Management indicated supervisors may perform a full review of all documents if they determine this level of review is necessary.

OIG Response

We concur with management's response.

2. Review current examination procedures over CUSOs to not only ensure regulatory compliance, but most importantly, to determine whether current procedures are adequate to identify the degree of risk the CUSO poses to the affiliated credit union.

Management Response

Management indicated that within the last year NCUA expanded the Scope Workbook including CUSO examination steps, as well as a CUSO questionnaire noting they believe there is currently sound direction regarding which CUSO related information should be reviewed during each examination. However, management also indicated that current guidance does not require a review of a credit union's ability to generate income independent of its CUSOs and agreed to evaluate the feasibility of expanding current examination procedures over CUSOs, and whether to include a review of the credit union and CUSO as standalone entities in regards to profitability.

OIG Response

We concur with management's response.

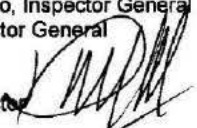
Appendix A - Management Response



National Credit Union Administration

SENT VIA E-MAIL

TO: William DeSarno, Inspector General
Office of Inspector General

FROM: Dave Marquis
Executive Director 

SUBJ: Comments on Material Loss Review of Eastern New York FCU

DATE: November 12, 2012

We reviewed the Office of Inspector General's (OIG) draft report titled Material Loss Review (MLR) of Eastern New York Federal Credit Union #14693. Eastern New York Federal Credit Union (Eastern NY) failed as a result of poor corporate governance resulting in:

1. Improper CUSO accounting which gave Eastern NY the false appearance of profitability;
2. Exposure to excessive concentration risk in Member Business Loans (MBLs); and
3. Costly fixed assets in excess of the regulatory maximum.

MLR Report Recommendations

The MLR includes two recommendations. We agree with the recommendations and have taken appropriate action or will take action as outlined below:

1. *Consider expanding current quality control functions to include a review of examination working papers and supporting documentation performed by the Supervisory Examiner for critical elements and potential red flag issues, especially for new or less-experienced examiners, [REDACTED]*

Response: We agree quality control functions should include a review of examination work papers. We believe guidance incorporated in the National Supervision Policy Manual (NSPM), released in July 2012, and the Examiner's Guide adequately addresses this issue. All examination work papers are generally maintained within the ARIES examination program. Supervisors may perform a full review of all documents provided in a backup ARIES examination file if they determine this level of review is necessary. The guidance includes specific requirements for reviews of examiners at each level.

2. *Review current examination procedures over CUSOs to not only ensure regulatory compliance, but most importantly, to determine whether current procedures are adequate to identify the degree of risk the CUSO poses to the affiliated credit union.*

Response: We agree examination procedures should insure regulatory compliance and adequately identify the degree of risk a CUSO poses to an affiliated credit union. Chapter 25 of the Examiner's Guide outlines examination procedures regarding CUSOs. One of the examination objectives is to determine the degree of risk the CUSO poses to the affiliated credit union.

Within the last year, and after the exam period in question, NCUA expanded the Scope Workbook including CUSO examination steps as well as a CUSO questionnaire. We believe there is currently sound direction regarding which CUSO related information should be reviewed during each examination. However, guidance does not require a review of a credit union's ability to generate income independent of its CUSOs, which was a key issue with Eastern NY. We will evaluate the feasibility of expanding examination procedures over CUSOs, and whether to include a review of the credit union and CUSO as standalone entities in regards to profitability. Examiners may currently review Schedule C on the 5300 Call Report to see a break out of income for wholly owned CUSOs.

NCUA does not have regulatory authority over CUSOs, although proposed changes to Part 712 of NCUA's Rules and Regulations would require all CUSOs to file financial reports directly with NCUA. Currently, Part 712 requires an FCU, prior to investing in or lending to the CUSO, to obtain written agreements that require the CUSO to provide NCUA and its representatives with complete access to any books and records of the CUSO and the ability to review CUSO internal controls, as deemed necessary. Chapter 7, Section 1 of the NSPM states examiners are responsible for identifying potential problems in CUSO-provided services based on information gathered during routine credit union reviews and insurance reviews. Information normally reviewed includes financial statements and audit reports. Examiners should make a determination regarding the financial health of the CUSO if it provides a material amount of income to the credit union. If deemed necessary NCUA may perform a CUSO review following guidance in Chapter 25 of the Examiner's Guide and Chapter 7 of the NSPM.

MLR Report Suggestions

In addition to the two recommendations, OIG provides two suggestions. Our response, including corrective actions taken or planned, is below:

1. *Consider expanding on the discussion in NCUA guidance regarding EIC rotation because it may be prudent to rotate EICs earlier than current timeframes suggest. For example, it may be reasonable to rotate EICs earlier when the EIC has been with the agency for less than five years, [REDACTED]*

Response: NCUA's current guidance on examiner rotation provides flexibility and discretion in the rotation of EICs. NCUA Instruction No. 5000.19, Examiner-In-Charge Rotation states the EIC may be the same examiner for consecutive examinations

completed within a four calendar year time period unless an exception is granted by the Regional Director. Chapter 1, Section 8. L. of the NSPM requires that supervisors ensure adequate rotation of EICs occurs. Supervisors have the discretion to rotate EICs more frequently than every four calendar years when concerns exist. We are currently evaluating additional alternatives including enhanced quality control sampling.

2. *Consider developing a Risk Report threshold that addresses anomalies on yields for major asset categories such as loans and investments. This type of report would highlight extreme outliers, which would indicate to examiners the need to expand examination procedures.*

Response: The current Risk Report parameters do not include yields for major asset categories. We believe such fields may be beneficial and will explore the feasibility of including them in the Risk Report in 2013. Currently examiners have the ability to review the yield on average loans and yield on average investments on the Financial Performance Report. When these ratios are out of line with peer ratios, examiners will be encouraged to perform additional analysis.

Thank you for the opportunity to comment.

cc: DED Kutchey
DEI Fazio
DDEI Segerson
DRM Komyathy
RD Treichel
ARDO Paliwodzinski
ARDP Sarrazin
DIG Hagen
OIG Senior Auditor Bruns
AMAC President Barton
GC McKenna
LRAO Moore