NATIONAL CREDIT UNION ADMINISTRATION

OFFICE OF INSPECTOR GENERAL

MATERIAL LOSS REVIEW OF
SOUTHWEST CORPORATE
FEDERAL CREDIT UNION

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Executive Summary

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) conducted a Material Loss Review (MLR) of Southwest Corporate Federal Credit Union (Southwest). We reviewed Southwest to: 1) determine why NCUA placed Southwest under federal conservatorship and ultimately liquidated the corporate; and (2) assess NCUA's supervision of Southwest. To achieve these objectives, we:

- Analyzed NCUA examination and supervision reports and related documents;
- Interviewed NCUA management and staff;
- Interviewed a management official from the former Southwest Corporate Federal Credit Union;
- Reviewed NCUA policies and procedures;
- Reviewed Southwest's Statements of Financial Condition (Corporate 5310 Reports); and
- Reviewed Southwest's policies and procedures and other corporate documentation and reports.

We determined Southwest's management and Board of Directors (management) did not implement appropriate risk management practices to adequately limit or control significant risks in its investment strategy. Specifically, although management invested in high investment grade securities, management implemented an aggressive investment strategy with high limits in place that allowed for a significant concentration of investments directly in privately-issued residential mortgage backed securities[1] (RMBS), and additional indirect exposure through U.S. Central Federal Credit Union's (U.S. Central) investments in RMBS. Management's actions resulted in substantial exposure to privately-issued RMBS, which resulted in significant concentration risk and left Southwest vulnerable to significant credit, market, and liquidity risks. Southwest management's actions contributed directly to the conditions that resulted in NCUA placing Southwest into conservatorship on September 24, 2010 and involuntarily liquidating the corporate effective October 31, 2010. NCUA expects the estimated loss to its Stabilization Fund from Southwest's failure to be $141 million.

In addition, we determined that NCUA Office of Corporate Credit Unions (OCCU) staff did not adequately and timely address the risks associated with Southwest's direct concentration of and indirect exposure to privately-issued RMBS. Specifically, we determined OCCU staff did not: (1) take exception with Southwest's increasing and eventually significant concentrations of RMBS early on; (2) take exception with the significant geographic concentration of Southwest's investments in privately-issued

[1] An RMBS provides cash flows from residential debt such as mortgages, home-equity loans and sub-prime mortgages.

RMBS; and (3) adequately address the risk of Southwest's indirect exposure to privately-issued RMBS investments through its deposits with U.S. Central.

We believe these shortfalls occurred in part because OCCU staff did not properly aggregate or correlate Southwest's concentration of privately-issued RMBS. In addition, OCCU staff did not have the appropriate regulatory support in the form of specific investment concentration limits to address the growing and risky concentrations that OCCU staff reviewed during its examinations. Furthermore, NCUA regulations: (1) did not place any limits on corporate investments with other corporates as obligors; and (2) did not require special emphasis on monitoring investments with other corporates considering there were no regulatory restrictions on the level of such deposits.

We also determined NCUA's assessment of Southwest's credit risk may have been improved had NCUA's policies and procedures required independent analysis of Southwest's credit exposure and potential risk.

On September 24, 2010, the NCUA Board took several actions to reform the corporate credit union system under a stronger regulatory framework. One of those actions was to finalize major revisions to Part 704, NCUA's rule governing corporate credit unions. The final rule includes new limitations on corporate credit union investments and credit risks, as well as asset-liability management controls, so that high concentrations of the types of investments that caused the corporate crisis are no longer permitted. Based on these revisions, we are not making any recommendations to address concentration limits, credit analysis, or credit risks related to investments in privately-issued RMBS. However, we recommended NCUA management identify and determine the best use of available resources to independently assess risks within corporate credit unions and other complex credit unions.

Background

The Corporate Credit Union System

The credit union system is a three-tiered system consisting of one wholesale corporate credit union, 26 retail corporate credit unions, and nearly 7,600 natural person credit unions. The wholesale corporate credit union provided services to the 26 retail corporate credit unions, while the retail corporate credit unions provided services to natural person credit unions (NPCU), which served the financial needs of more than 90 million members, including individuals, associations and businesses. Retail corporate credit unions provided essential support to NPCUs through the delivery of liquidity, financial, payment, and correspondent products and services.

One of a retail corporate credit union's primary responsibilities is to serve as a liquidity depository and facilitate the liquidity needs of its NPCU members. As such, an inflow of deposits from member NPCUs is ordinarily the primary source of liquidity for retail corporate credit unions. NPCUs generally invest their excess liquidity when their members' loan demand is low and/or their members' deposits are high. Conversely, when their members' loan demand and/or deposit withdrawals are high, NPCUs draw on funds previously invested for liquidity or borrow funds as needed.

One of the many security types corporates can invest in are mortgage-backed securities (MBS), which include residential mortgage-backed securities[2] (RMBS) and commercial mortgage-backed securities (CMBS)[3]. An investor in RMBS owns an interest in a pool of mortgages, which serves as the underlying asset and source of cash flow for the security.[4] (For details on RMBS, see the summary starting on page 5 below).

In mid-2007, the mortgage market faced a credit crisis (credit market dislocation) which persisted, leading to unprecedented reevaluation and re-pricing of credit risk.[5] As a result, there was virtually no market for RMBS other than at distressed sales prices. With the reduction in the lendable value of retail corporate credit union securities, typical collateralized funding from sources such as Federal Home Loan Banks has been impaired and is, consequently, a less stable option for corporate credit unions.[6] In addition, waning member confidence throughout this period of unprecedented economic and market disruption resulted in abnormal deposit outflows (before NCUA implemented the share guarantee program).

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[2] A residential mortgage-backed security provides cash flows from residential debt such as mortgages, home-equity loans and sub-prime mortgages.
[3] A CMBS is security backed by mortgages on commercial properties.
[4] Throughout the remainder of the report, we will use the term RMBS as synonymous with MBS unless otherwise indicated.
[5] The credit market dislocation started with sub-prime mortgages. However, by the end of 2007 and into early 2008, the mortgage problem spread to Alt-A loans, Option ARM loans, and to prime mortgage loans.
[6] The Federal Home Loan Bank (FHLB) system is a government-chartered but member-owned enterprise that works to increase the liquidity of mortgage markets. The FHLB increases liquidity by advancing funds to institutions that originate mortgages; which, in turn, collateralize the advances.

Southwest Corporate Federal Credit Union (Southwest) History

Southwest - headquartered in Plano, TX - was chartered in 1975. As one of the middle tier retail corporates in the three-tiered system, Southwest had 1,393 NPCU members that provided services to an estimated 33 million consumers in the United States. Southwest provided critical ACH, share draft, and wire processing for these NPCUs which in turn provided these payment processing services to their member consumers. Southwest merged with Northwest Federal Credit Union (Northwest) effective November 1, 2007. Southwest then maintained a Northwest Regional Office in Portland, Oregon.

Southwest had previously been able to meet member liquidity needs with cash, selling marketable securities, or borrowing short-term. Beginning in July 2007, the structured securities (i.e., MBS) markets became illiquid and stopped actively trading, which made it difficult to sell securities or use the securities as collateral for borrowings. The illiquidity of the markets hindered Southwest's ability to meet its liquidity demands. NCUA indicated that because of the NCUA Board's Temporary Corporate Credit Union Share Guarantee Program (Share Guarantee; announced on January 28, 2009), Southwest did not need to borrow funds to meet liquidity demands. NCUA also indicated, however, that it was highly probable that had it not been for the Share Guarantee, Southwest would have experienced a material withdrawal of its deposits at some point.

As of March 2010, Standard and Poor's (S&P) and Fitch had downgraded Southwest's Long-Term and Short-Term credit ratings. As of August 31, 2010, Southwest had assets valued at $7.5 billion. NCUA determined Southwest's 91.88 percent solvency ratio clearly demonstrated the corporate was insolvent. In addition, NCUA indicated there was no reasonable prospect of restoring Southwest's solvency. Furthermore, NCUA determined Southwest was economically insolvent based on its net economic value (NEV) of -9.10 percent.[7] On September 24, 2010, the NCUA Board authorized placing Southwest into conservatorship due to concerns about its financial and operational conditions and its ability to continue providing critical payment systems and liquidity services to its membership. The NCUA Board also delegated the authority to OCCU to place Southwest into involuntary liquidation on this date. The involuntary liquidation became effective on October 31, 2010, at which time OCCU revoked Southwest's charter. NCUA expects Southwest's estimated loss associated to be $141 million.

Southwest Bridge Corporate Federal Credit Union (Southwest Bridge) was chartered on September 28, 2010, to serve as a transition institution to provide uninterrupted services to Southwest's members. NCUA expected Southwest Bridge to be in existence for approximately 24 months at which time NCUA expects to determine the least costly and most viable long-term solution to Southwest Bridge.

[7] The economic solvency of a corporate is measured by its net economic value (NEV), which is defined as "the fair value of assets minus the fair value of liabilities."

Summary of Residential Mortgage-Backed Securities (RMBS) Markets[8]

The process of creating an RMBS begins, in general, when an arranger packages thousands of mortgage loans into a pool, and transfers them to a trust that will issue securities collateralized by the pool. The trust purchases the loan pool and becomes entitled to the interest and principal payments made by the borrowers. The trust finances the purchase of the loan pool through the issuance of RMBS to investors. The monthly interest and principal payments from the loan pool are used to make monthly interest and principal payments to the investors in the RMBS.[9]

The mortgage loans backing an RMBS are issued by a national network of lenders consisting of mortgage bankers, savings and loan associations, commercial banks, and other lending institutions. An investor can buy agency or non-agency RMBS:

- Agency RMBS are backed or issued by entities such as Government National Mortgage Association (GNMA or Ginnie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and Federal National Mortgage Association (FNMA or Fannie Mae). Ginnie Mae guarantees investors the timely payment of principal and interest on loans originated through the Federal Housing Association (FHA), the Department of Veterans Affairs (VA), the Rural Housing Service (RHS) and Public and Indian Housing (PIH). Freddie Mac and Fannie Mae purchase mortgages forming pools and issue RMBS on which they guarantee the timely payment of principal and interest to the investor. However, unlike GNMA, their obligations are not backed by the full faith and credit of the U.S. government.[10]

- Non-agency RMBS are bought through securities firms or other financial institutions. They are often referred to as private-label paper[11] and are not guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae.[12]

A trust typically issues different tranches[13] of RMBS offering a sliding scale of coupon rates based on the level of credit protection afforded to the security. Credit protection is designed to shield the tranche securities from the loss of interest and principal due to

[8] Much of this section includes information from: United States Securities and Exchange Commission, Office of Compliance Inspections and Examinations, Division of Trading and Markets, and Office of Economic Analysis. *Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies*, USSEC, July 2008

[9] To find out what is in an RMBS, investors need to thoroughly assess the security, including the originator, underwriter and borrowers--because when mortgage loans are nonperforming, the actual loss is passed on to investors.

[10] Fidelity Investments, "Mortgage-Backed Securities Product Overview". Fidelity.com. August 5, 2010 <http://personal.fidelity.com/products/fixedincome/pombs.shtml>

[11] Unless otherwise noted, we refer to these "private-label" securities as non-agency or privately-issued.

[12] RMBS not backed by the federal government generally carry a higher risk of default than RMBS backed by the federal government, which carry only some or no risk of default. Unlike with agency-backed securities, timely payment of principal and interest to investors in privately-issued securities is not guaranteed.

[13] A tranche is one of the classes of debt securities issued as part of a single bond or instrument. Securities often are issued in tranches to meet different investor objectives for portfolio diversification. Each tranche is paid off consecutively; as one bond matures, the next is paid down in a steppingstone progression.

defaults of the loans in the pool. The degree of credit protection afforded a tranche security is known as its credit enhancement[14] and is provided through several means, including:

- *Subordination* - The primary source of credit enhancement, which creates a hierarchy of loss absorption among the tranche securities. For example, if a trust issued securities in 10 different tranches, the first (or senior) tranche would have nine subordinate tranches; the next highest tranche would have eight subordinate tranches and so on down the capital structure. Any loss of interest and principal experienced by the trust from delinquencies and defaults in loans in the pool are allocated first to the lowest tranche until it loses all of its principal amount and then to the next lowest tranche and so on up the capital structure. Consequently, the senior tranche would not incur any loss until all the lower tranches have absorbed losses from the underlying loans.

- *Over-collateralization* - A second form of credit enhancement, which is the amount that the principal balance of the mortgage pool exceeds the principal balance of the tranche securities issued by the trust. This excess principal creates an additional “equity” tranche below the lowest tranche security to absorb losses. In the example above, the equity tranche would sit below the tenth tranche security and protect it from the first losses experienced as a result of defaulting loans.

- *Excess spread* - A third form of credit enhancement, which is the amount that the trust’s monthly interest income exceeds its monthly liabilities. Excess spread is comprised of the amount by which the total interest received on the underlying loans exceeds the total interest payments due to investors in the tranche securities. This excess spread can be used to build up loss reserves or pay off delinquent interest payments due to a tranche security.

A key step in the process of creating and ultimately selling an RMBS is the issuance of a credit rating for each of the tranches issued by a trust. The arranger of the RMBS initiates the ratings process by sending the credit rating agency a range of data on each of the loans to be held by the trust (e.g., principal amount, geographic location of the property, credit history and FICO score of the borrower, ratio of the loan amount to the value of the property and type of loan: first lien, second lien, primary residence, secondary residence), the proposed capital structure of the trust, and the proposed levels of credit enhancement to be provided to each RMBS tranche issued by the trust. A lead analyst at the rating agency is assigned responsibility for analyzing the loan pool, proposed capital structure, and proposed credit enhancement levels, and for ultimately formulating a ratings recommendation for a rating committee. The credit rating for each rated tranche indicates the credit rating agency’s view as to the creditworthiness of the debt instrument. Creditworthiness is assessed in terms of the likelihood that the issuer

[14] Credit enhancements are techniques used to improve the credit rating of securities, generally to get investment grade ratings from a bond rating agency and to improve the marketability of the securities to investors.

would default on its obligations to make interest and principal payments on the debt instrument.

By regulation, corporate credit unions were only allowed to invest in highly rated securities. Corporate credit unions traditionally used these securities as part of their overall balance sheet management in meeting their member liquidity needs. Historically, the securities could be readily sold in the market or used for collateralized borrowing to obtain liquidity, and the values of the securities had experienced little or no loss.[15]

Securities and Exchange Commission (SEC) Findings Regarding Nationally Recognized Statistical Rating Organizations (NRSRO)[16]

Beginning in 2007, delinquency and foreclosure rates for sub-prime mortgage loans in the United States dramatically increased, creating turmoil in the markets for RMBS backed by such loans. The rating agencies' performance in rating these structured finance products raised questions about the accuracy of their credit ratings generally, as well as the integrity of the ratings process as a whole. In August 2007, the SEC initiated examinations of three credit rating agencies (NRSROs) -- Fitch Ratings, Ltd. (Fitch), Moody's Investor Services, Inc. (Moody's), and Standard & Poor's Ratings Services (S&P) -- to review their role in the turmoil in the sub-prime mortgage-related securities markets.

The SEC's examination review generally covered a period starting from January 2004 through July 2008 when the report was issued. We identified the following three key findings from the SEC report that highlighted flaws in the RMBS ratings process:

- There was no requirement that a rating agency verify the information contained in RMBS loan portfolios presented to it for rating. Additionally, rating agencies were not required to insist that issuers perform due diligence, and they were not required to obtain reports concerning the level of due diligence performed by issuers. Each rating agency publicly disclosed that it did not engage in any due diligence or otherwise seek to verify the accuracy or quality of the loan data underlying the RMBS pools they rated during the review period. Each rating agency's "Code of Conduct" clearly stated that it was under no obligation to perform, and did not perform, due diligence. Each agency also noted that the assignment of a rating is not a guarantee of the accuracy, completeness, or timeliness of the information relied on in connection with the rating. The rating agencies each relied on the information provided to them by the sponsor of the RMBS. They did not verify the integrity and accuracy of such information as, in their view, due diligence duties belonged to the other parties in the process. They also did not seek representations from sponsors that due diligence was performed.

[15] NCUA, *Corporate Credit Union System Strategy,* January 2009 (Letter No. 09-CU-02)
[16] See, fn. 8, *supra.*

- Each of the NRSROs examined used the “issuer pays” model, in which the arranger or other entity that issues the security is also seeking the rating, and pays the rating agency for the rating. The conflict of interest inherent in this model is that rating agencies have an interest in generating business from the firms that seek the rating, which could conflict with providing ratings of integrity. NRSROs are required to establish, maintain and enforce policies and procedures reasonably designed to address and manage conflicts of interest. However, although each rating agency had policies and procedures restricting analysts from participating in fee discussions with issuers, these policies still allowed key participants in the ratings process to participate in fee discussions.

- While NRSROs were not required under the law to perform surveillance, a rating agency would generally monitor the accuracy of its ratings on an ongoing basis in order to change the ratings when circumstances indicate that a change is required. This process is generally called “monitoring” or “surveillance,” and each rating agency charges issuers, up front or annually, ratings surveillance fees. However, weaknesses existed in the rating agencies’ surveillance efforts – lack of resources, poor documentation, and lack of procedures.

<u>RMBS Collateral: Alt-A and Sub-Prime Mortgages</u>

Within the U.S. mortgage industry, different mortgage products are generally defined by how they differ from mortgages guaranteed by the Government-Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac. Sub-prime borrowers generally do not qualify for traditional loans because of their low credit ratings or other factors that suggest that they have a reasonable chance of defaulting on the debt repayment. In addition, there is the non-traditional Alt-A mortgage. While there is no true industry standard for Alt-A mortgages, there are numerous factors that might cause a mortgage to be classified as "alternative" to the standard of conforming, GSE-backed mortgages. The following are a few of the more important factors characterizing Alt-A mortgages:

- Reduced borrower income and asset documentation (e.g., "stated income," "stated assets," "no income verification"). Reduced documentation mortgage loans are intended to assist borrowers in obtaining mortgage financing when their income, employment, or assets are difficult to verify. For example:

    - With stated income mortgages, a borrower’s income is stated on the application, but is not verified.

    - In the case of ‘No Documentation’ mortgages, employment, income, or assets are not included on the loan application.

- Borrower debt-to-income ratios that are above what Fannie or Freddie will allow for the borrower credit, assets, and type of property being financed.

- Credit history with too many problems to qualify for an "agency" loan, but not so many as to require a sub-prime loan.

- Loan to value (LTV) ratios (percentage of the property price being borrowed) are above agency limits for the property, occupancy, or borrower characteristics involved.

Alt-A and sub-prime mortgages differ in that, generally speaking, while a sub-prime borrower would suffer from exceptionally weak credit, income or asset characteristics, an Alt-A borrower would have a sufficient financial profile to qualify for a "conforming" mortgage, if not for one of the above factors.

Industry experts indicated that the growing popularity of nontraditional loans created a rise in Alt-A RMBS, which was the biggest growth area within non-agency RMBS. As a result, far more RMBS are supported by borrowers who are considered riskier than borrowers with traditional "prime" credit, yet not as risky as sub-prime borrowers.[17]

RMBS Collateral: Home Equity Loans, Exotic Adjustable Rate Mortgages, and Non-Traditional Mortgages

In May 2005, NCUA issued guidance to its Federally Insured Credit Unions (FICU) regarding managing credit risk in home equity lending. NCUA indicated that: (1) home equity loans were typically long-term with interest-only features that did not require amortization of principal for a protracted period; (2) home equity lines of credit (HELOCs) were inherently vulnerable to rising interest rates; and (3) with the rise in home values and demand for home equity lending, many financial institutions relaxed underwriting standards associated with these loans, such as higher loan-to-value and debt-to-income ratios.

In October 2005, NCUA also issued guidance to its FICUs regarding generally increasing risks in mortgage lending. NCUA indicated there was: (1) a demand for more exotic adjustable rate mortgages, which may increase credit risk in an environment of increasing interest rates and flattening or declining home appreciation; and (2) a trend toward liberalized underwriting standards, which increases credit risk. NCUA highlighted that: (a) lenient credit and underwriting standards combined with higher LTVs, interest only, or negative amortization loans and rapid home value appreciation, could result in increased default rates; and (b) higher LTVs combined with lower credit scores results in increased defaults.

In October 2006, NCUA issued additional guidance to its FICUs with regard to: (1) managing risks associated with open-end HELOCs that contain interest-only features; and (2) addressing risks associated with the growing use of non-traditional

[17] Lenders may make sub-prime loans to borrowers who would not ordinarily qualify for credit if customary underwriting standards were applied. To offset the increased risk that these borrowers might default, lenders charge higher interest rates than they offer to creditworthy borrowers and assess additional fees.

mortgage products—including interest-only and payment option adjustable-rate mortgages--that allow borrowers to defer payment of principal and, sometimes, interest.

Corporate Credit Union Examinations

The NCUA Office of Corporate Credit Unions (OCCU) fulfills its mission by promoting and ensuring the safety and soundness of the Corporate Credit Union System (System), principally through a program of continual supervision. Supervision includes, but is not limited to, the on-site examination of corporate credit unions resulting in an examination report.[18]

OCCU's overall supervision goal is to ensure the safety and soundness of the System by: (1) continuously evaluating and supervising the financial condition and performance of individual corporates and their service organizations; and (2) reporting those conditions to the NCUA Board in a timely manner. The key element in accomplishing OCCU's goal is the timely identification and resolution of any problem or condition that might have a material impact on a corporate, the System, or the National Credit Union Share Insurance Fund (NCUSIF). Annual examinations are required and performed for all corporates. The scope of each examination and supervisory contact is determined by the examiner-in-charge and the Corporate Field Supervisor, in order to target problems and high-risk areas.

Corporates qualifying for Type III supervision[19] are assigned a capital markets specialist (CMS[20]) from OCCU on a full-time basis.[21] Maintaining an on-site presence promotes interaction with the corporate's staff and allows the CMS to maintain a working knowledge of the corporate's operations, especially in the capital markets areas (investments, asset and liability management, risk monitoring, etc.). The knowledge gained through on-site supervision allows the CMS to more effectively monitor and evaluate financial changes.

NCUA's Office of Capital Markets Role in Evaluating Investment Activity

The Office of Capital Markets (OCM) develops agency policies and procedures related to credit union investments and asset liability management. OCM also assists

[18] The goal of the on-site supervision presence is to develop and maintain a thorough understanding of the operations and risk profiles of large complex corporates.
[19] Corporates which qualify for Type III supervision generally have billions of dollars in assets, and/or have expanded powers in excess of Part I and exercise their approved powers in a significant and assertive manner. In addition, Type III corporates have complex and innovative operations, and/or have a significant impact in the marketplace and on the corporate and/or credit union system, and/or present unusual or unique examination and supervision problems, which cannot be adequately addressed by Type I or Type II supervision.
[20] Regarding new investment strategies, the CMS is responsible for monitoring the corporate's investment portfolio to identify changes in and/or variances from investment strategies and assessing the impact of changing economic conditions.
[21] Southwest met the requirements for Type III supervision.

examiners in evaluating investment and asset and liability management issues in credit unions and provides expert advice to the Board on investment issues.[22]

Objectives, Scope and Methodology

The Federal Credit Union Act (FCUA) requires the NCUA Office of Inspector General (OIG) to conduct a material loss review (MLR) of an insured credit union if the loss to the NCUSIF[23] exceeds $25 million and an amount equal to 10 percent of the total assets of the credit union at the time at which the Board initiated assistance or was appointed liquidating agent.[24] NCUA notified the OIG of a loss reserve for Southwest of $141 million. Consequently, in accordance with the FCUA and Chapter 3 of the NCUA Special Assistance Manual, we initiated a MLR.

The objectives of our review were to: (1) determine why NCUA placed Southwest under federal conservatorship; and (2) assess NCUA's supervision of the corporate. To accomplish our review, we conducted fieldwork at NCUA's headquarters in Alexandria, Virginia. The scope of our review covered the period from NCUA's March 2004 examination of Southwest through October 2010, when Southwest's involuntary liquidation became effective.[25]

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

To determine the cause of Southwest's conservatorship and assess the adequacy of NCUA's supervision we:

- Analyzed NCUA examination and supervision reports and related documents;[26]

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[22] On June 21, 2011, NCUA announced the integration of OCM within NCUA's Office of Examination and Insurance. NCUA indicated the change would better integrate all examination program activities within one office and facilitate the establishment of consistent national standards for credit unions.

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

[24] See section 216 of the FCU Act, 12 U.S.C. § 1790d(j).

[25] Our review focused on examinations conducted from March 2004 through March 2007, covering NCUA supervision activity to address Southwest management's activity leading up to Southwest's financial issues, which began starting in July 2007 with the credit market dislocation.

[26] We determined that of the four examinations OCCU conducted on Southwest between 2004 and 2007, OCM staff participated in the February 2005 and March 2007 examinations. OCM staff workload on these examinations accounted for five percent and seven percent of the total hours respectively.

- Interviewed NCUA management and staff;
- Interviewed a management official from the former Southwest Corporate Federal Credit Union;
- Reviewed NCUA policies and procedures;
- Reviewed Southwest's Statements of Financial Condition (Corporate 5310 Reports); and
- Reviewed Southwest's policies and procedures and other corporate documentation and reports.

We used computer-processed data from NCUA's Corporate 5310 Reports. We did not test the controls over this system. 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.

Results in Detail

We determined Southwest management's actions contributed directly to conditions that resulted in NCUA conserving and liquidating the corporate with an expected loss to the Stabilization Fund of $141 million. In addition, we determined Office of Corporate Credit Unions staff (OCCU staff) would have likely been able to mitigate these conditions and the expected loss to the Stabilization Fund had appropriate regulatory support--in the form of more specific investment concentration limits--been available to allow the OCCU staff to take exception with and aggressively address Southwest's investment strategy.

A. Why NCUA Conserved and Liquidated Southwest Corporate Federal Credit Union

Southwest management did not implement appropriate risk management practices to adequately limit or control significant risks in its investment strategy. Specifically, although management invested in high investment grade securities (see Table 1 below), management implemented an aggressive investment strategy with high limits in place that allowed for a significant concentration of investments directly in privately-issued RMBS,[27] and additional indirect exposure through U.S. Central's investments in RMBS. Management's actions resulted in substantial exposure to privately-issued RMBS, which resulted in significant concentration risk[28] and left Southwest increasingly vulnerable to significant credit risk,[29] market risk,[30] and liquidity risk[31].

Specifically, we determined that management's aggressive investment strategy created these increased risks by overexposing its investment portfolio to: (1) a significant concentration of privately-issued securities; (2) in a single market sector; (3) collateralized with higher risk underlying residential mortgages; and (4) in a single geographic real estate market.

As of July 31, 2007, 95 percent of Southwest's privately-issued RMBS were rated 'AAA', with the remaining five percent rated 'A' and 'AA'. Table 1 summarizes ratings on the portfolio held as of July 31, 2007:

[27] See fn. 1, *supra*.
[28] Concentration risk is the risk associated with having excessive exposure to securities that have related market and/or credit risk. Concentration in market risk could include, but is not limited to, excessive exposure to interest rate, basis, embedded option and/or liquidity risks. Concentration in credit risk usually includes excessive exposure to certain industries, groups, or individuals.
[29] Credit risk is: (1) Exposure to loss as a result of default on a debt, swap or some other counterparty instrument; (2) Exposure to loss as a result of a decline in market value stemming from a credit downgrade of an issuer or counterparty; (3) A component of return variability resulting from the possibility of an event of default; or (4) A change in the market's perception of the probability of an event of default (affecting spreads).
[30] Market risk is the risk that the value of a portfolio, either an investment portfolio or a trading portfolio, will decrease due to the change in value of the market risk factors.
[31] Liquidity risk is the risk that funds may not be available to meet cash outflows when they arise. This may arise because of insufficient cash flow or because the assets designated as cash equivalents are not able to be sold quickly without causing a large decline in the market value. Liquidity risk also can become significant if the financial condition of an institution is deteriorating and members and creditors begin to withdraw or demand payment of their funds.

RMBS Category	AAA	AA	A	Total
CMOs/MBS	242	18	1	**261**
ABS[32] (Home Equity)	256	5	1	**262**
Total	**498**	**23**	**2**	**523**
Percent of Total	**95%**	**4%**	**1%**	**100%**

Table 1: Ratings of Southwest Privately-Issued RMBS as of July 31, 2007

Table 2 below summarizes selected annual Southwest financial information for select periods between 2006 and 2010:[33]

	7/31/2010	12/31/2009	12/31/2008[34]	12/31/2007	12/31/2006
Assets	$8,788,397,421	$7,922,897,749	$7,532,036,645	$12,713,605,125	$11,499,616,557
Investments	$7,814,857,836	6,958,916,825	$6,513,489,873	$11,284,074,451	$9,006,720,006
Net Income	$2,075,976	($100,615,018)	($707,551,724)	$3,241,608	$1,813,057
Unrealized Gains (Losses)	($799,588,994)	($988,412,313)	($918,450,563)	($274,790,065)	($3,786,649)
Retained Earnings	($2,075,976)	($134,600,950)	($367,016,074)	$324,581,175	$259,128,358
Total Capital	$88,588,721	$105,973,862	$26,881,844	$722,848,473	$580,020,808
Net Economic Value (NEV)[35]	($718,400,000)	($885,500,000)	($800,100,000)	($455,000,000)	$579,500,000

Table 2: Select Southwest Financial Information

Concentration Risk, Credit Risk, Market Risk, and Liquidity Risk Associated with Southwest's Investment Portfolio

We determined Southwest management allowed for an overconcentration of Southwest's investment portfolio in privately-issued securities directly linked to the residential real estate mortgage sector. Southwest's investment portfolio included not only Mortgage-Related Securities[36] (MRS) (as defined by the SEC and hereinafter

[32] An Asset-Backed Security is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. This definition excludes "mortgage related securities."
[33] This financial data is from Southwest Corporate Statements of Financial Condition (5310 reports).
[34] The significant changes in losses and capital between December 31, 2007 and December 31, 2008 are due to the requirement for Southwest to recognize Other than Temporary Impairment (OTTI) charges in compliance with generally accepted accounting principles (GAAP).
[35] NEV measures the fair value of assets less the fair value of liabilities.
[36] A privately-issued security secured by real estate upon which is located a dwelling, mixed residential and commercial structure, residential manufactured home, or commercial structure, that is rated in one of the two highest rating categories by at least one nationally-recognized statistical rating organization.

referred to as MBS for the purposes of this report), but also Asset Backed Securities[37] (ABS) collateralized with home equity loans.[38],[39] In addition, the portfolio had a significant concentration of investments collateralized largely with higher risk underlying residential mortgages. Furthermore, Southwest's RMBS portfolio had underlying collateral more heavily concentrated in a single residential real estate market.

NCUA regulations required that:

- A corporate credit union's board of directors be responsible for approving the corporate's comprehensive written strategic plans and policies;

- Corporates operate according to a credit risk management policy that was commensurate with the investment risks and activities it undertook. At a minimum, corporates were required to implement a credit risk management policy that addressed concentrations of credit risk (e.g., originator of receivables, insurer, industry type, sector type, and geographic); and

- The aggregate of all investments in any single obligor be limited to 50 percent of capital or $5 million, whichever was greater except for such investments in corporate credit unions.

In addition, NCUA provided that all investments, other than in a corporate credit union or CUSO, required an applicable credit rating from at least one nationally recognized statistical rating organization (NRSRO).

NCUA guidance advised that:

- A credit rating is not a substitute for prudent due diligence and should only be considered as one factor in an investment decision. The ratings and other opinions issued by rating agencies are not recommendations to buy securities and there is not a warranty on the accuracy, timeliness, completeness or fitness of the information provided.

[37] Asset Backed Securities are bonds backed by home equity loans and other home loans of less than high quality, while bonds backed by high quality mortgage loans are considered Mortgage Backed Securities (MBS). An Asset-Backed Security is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders. This definition excludes "mortgage related securities."
[38] For the purposes of this review, we will refer to this portfolio of securities collectively as RMBS unless otherwise indicated.
[39] A September 17, 2009 report published by Standard & Poor's (S&P)--*Commentary Report: Mortgage-Related Losses Aren't Over for Bond Issuers*--addressed the deterioration of Alternative-A (Alt-A), subprime, closed-end second (CES), and home equity line of credit (HELOC) mortgages backing the 2005–2007 MBS vintages. The report indicated the industry's RMBS exposure to HELOC and CES products accounted for the majority of S&P's projected RMBS loss, accounting for 76.6 percent of total RMBS projected losses.

- Credit Analysts are not expected to possess greater insights than rating agencies, but they are expected to understand the implications and conclusions of a rating agency's research and form an independent judgment.

- There is a danger corporates may focus upon high credit ratings and therefore consider default improbable. Corporates need to consider how they will quantify and control concentrations (i.e., obligor, industry, type of instrument, etc.) of credit risk and how the risk will change when market and/or credit conditions change.

- Credit risk managers must be mindful that credit ratings are generally a lagging indicator.

- In order for corporates to best manage credit risk exposure, management should be predisposed to take rational and timely steps towards rebalancing or reducing credit risk in the portfolio as needed.

- The Asset/Liability Committee (ALCO) and board of directors have a fiduciary responsibility to be aware of the risk assumed by management and be assured that management is actively managing risk.

- Prudent investment portfolio management practices, such as managing concentration risk and maintaining diversification, are as important for corporates as for other investors.

- Failure to manage concentration risk or adequately diversify the portfolio may give rise to excessive liquidity risk. Corporates must be especially mindful of liquidity when making investment decisions since investment portfolio(s) are the primary source of funds to meet ongoing and contingent liquidity demands.

Concentration of Privately-Issued RMBS

We determined that between NCUA's March 2004 examination of Southwest and the start of the credit market dislocation in July 2007, Southwest management increasingly made privately-issued RMBS a significant concentration of its investment portfolio. During this period, Southwest management increased its direct concentration of privately-issued RMBS 263 percent from $1.39 billion to $5.05 billion.[40]

As a percentage of Southwest's overall investment portfolio, Southwest management increased its exposure to the residential real estate market through privately-issued RMBS from 16 percent of Southwest's $8.47 billion portfolio as of March 31, 2004 to nearly half of the corporate's $10.54 billion investment portfolio as of July 31, 2007. Chart 1 below illustrates the growth and concentration of Southwest's investments from March 31, 2004 through July 31. 2007.

[40] Southwest management increased investments in privately issued MRS and Home Equity ABS more than 465 percent and 158 percent respectively from March 31, 2004 through July 31, 2007.

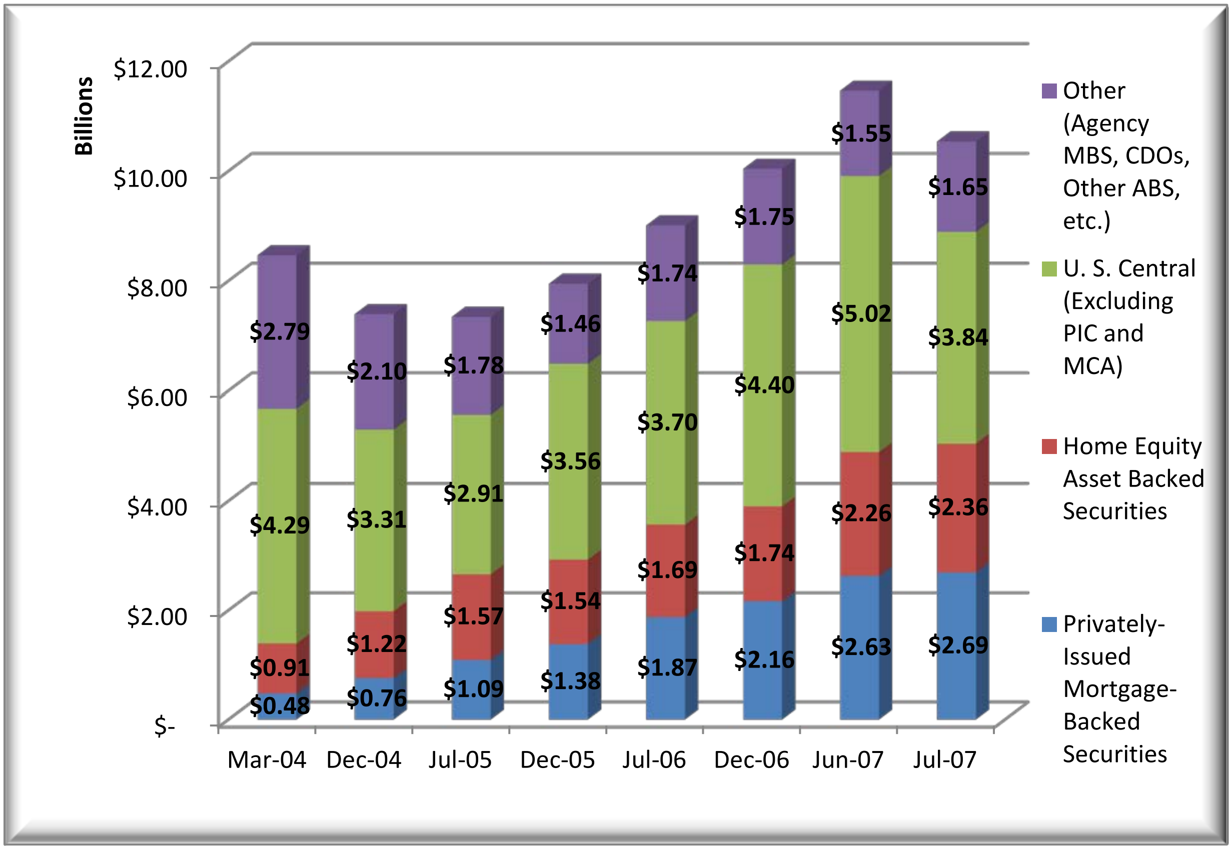

Chart 1: Growth and composition of Southwest's Total Investment Portfolio

Southwest management allowed for high concentration limits in privately-issued RMBS through its increasing investment policy limits, which management more than doubled from 400 percent of capital in 2004 to 900 percent of capital in 2006.[41] Table 3 below provides Southwest's maximum concentration limits (as a percentage of capital) between 2004 and 2007 for Non-Agency MBS and ABS (total and per collateral type, e.g., home equity, credit card, etc.):

[41] The total limit includes the Non Agency MBS percentage and the ABS percentage "for any one collateral type."

	Percentage of Capital by Year			
Investment Type	**2004** **(Policy as of October 04)**	**2005** **(Policy as of April 05)**	**2006** **(Policy as of May 06)**	**2007** **(Policy as of June 07)**
Private Label Non Agency CMOs[42]/MBS	150%	300%	500%	500%
ABS and Asset Backed Mortgage Paper	500% (total)	500% (total)	600% (total)	600% (total)
	250% ***(for any one collateral type)***	***300%*** ***(for any one collateral type)***	***400%*** ***(for any one collateral type)***	***400%*** ***(for any one collateral type)***

Table 3: Southwest's Maximum Allowable Concentrations of Select Securities per Southwest Policy

Southwest management's investment policy limits and strategy resulted in privately-issued RMBS representing increasing multiples of Southwest's capital. As of July 2007, at the start of the credit market dislocation, Southwest's direct exposure to the residential real estate market through privately-issued RMBS peaked at 839 percent of Southwest's capital. Chart 2 below illustrates Southwest's privately-issued MBS and Home Equity ABS as a percentage of total capital from March 2004 through July 2007.

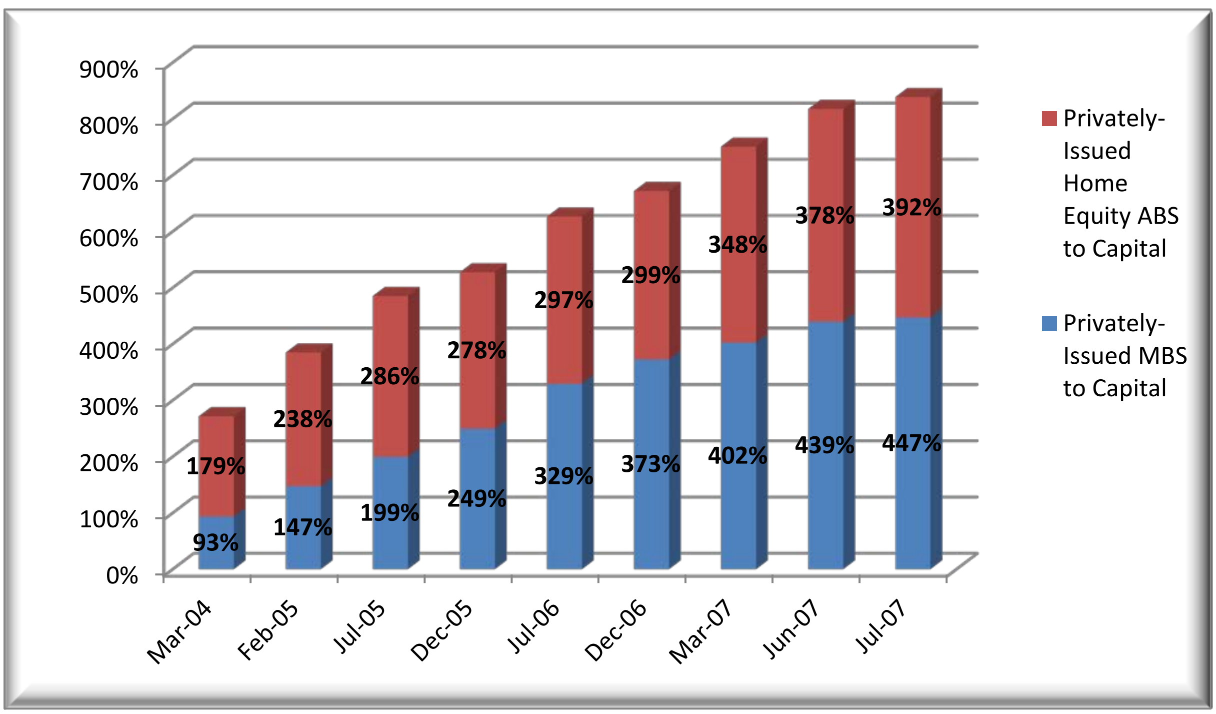

Chart 2: Southwest's Privately-Issued RMBS as a Percentage of Capital

[42] Collateralized Mortgage Obligations are a type of mortgage-backed security that represents claims to specific cash flows from large pools of home mortgages. The streams of principal and interest payments on the mortgages are distributed to the different classes of CMO interests, known as tranches, according to a complicated deal structure.

In addition, as of July 2007, 36 percent ($3.8 billion, excluding Paid-In Capital (PIC) and Member Capital Assets (MCA)) of Southwest's $10.54 billion investment portfolio was deposited at U.S. Central Federal Credit Union (U.S. Central). These deposits amounted to an additional 639 percent of Southwest's capital, making Southwest's total potential exposure to privately-issued RMBS nearly 1500 percent of its capital. Because of the risks within U.S. Central's investment strategy, Southwest's deposits at U.S. Central represented additional significant risk for Southwest. Specifically, in our U.S. Central MLR (OIG-10-17, October 18, 2010), we reported that U.S. Central had significant investments in private label sub-prime and ALT-A MBS, which exposed it to excessive financial risks. For example, as of July 2007, $22.6 billion (more than half) of U.S. Central's total investment portfolio was comprised of privately-issued RMBS. We concluded that U.S. Central's MBS investment portfolio incurred substantial losses that led to NCUA placing it into conservatorship in March 2009. Ultimately, NCUA began the involuntary liquidation of U.S. Central effective October 1, 2010.

Taking into account Southwest's: (1) direct investments in RMBS; and (2) indirect exposure to RMBS through U.S. Central's investment portfolio, the exposure of Southwest's balance sheet to the residential real estate market through privately-issued RMBS was substantial.

We learned Southwest management was monitoring its exposure to and attempted to ascertain its vulnerability to potential risks through U.S. Central's investment portfolio:

- During its May 2006 ALCO meeting, Southwest management:

    - Indicated that "in spite of some ongoing reservations, we would anticipate US Central's overall credit outlook to remain reasonably stable over the next few years. Although some significant economic concentration levels are possible, the available information regarding the credit quality of the company's investment portfolio (although very limited) does not indicate any substantial concerns in this area." Management pointed out that at the end of fiscal year 2005, US Central had reported that 100 percent of its portfolio was rated 'A' and above, with approximately 95.7 percent rated as 'AAA'.

    - Indicated that "US Central's investment portfolio appears to be conservatively managed with a reasonably high grade asset base from a ratings perspective. However, overall transparency into the company's asset base is considerably limited, and somewhat insufficient to imply any meaningful conclusions with regards to the inherent credit quality of this institution's asset base."

- During the June 2006 ALCO meeting, Southwest management indicated that U.S. Central management had given permission for Southwest to have detailed access to U.S. Central's investment portfolio in order to create a more extensive credit review.

- During the September 2006 ALCO meeting, Southwest management:
    - o Indicated the underlying quality of U.S. Central's investment portfolio appeared reasonably strong consisting predominately of senior pieces of asset-backed securities.
    - o Expressed concerns regarding U.S. Central's "focus on only credit cards and residential mortgages", indicating "U.S. Central's "portfolio is heavily weighted towards residential mortgage backed investments comprising 52.2 percent of investments and split somewhat evenly among home equity transactions and private label CMOs."

While we noted Southwest management was aware of and expressed some concerns regarding U.S. Central's exposure to the investment market, we also believe:

- Southwest management's perspective regarding its exposure to risks through U.S. Central's portfolio was somewhat optimistic early on, most likely due to the lack of detailed information about the portfolio.
- Southwest management's perspective of its risk exposure was influenced by its belief that any risks associated with its deposits with U.S. Central would be mitigated through regulatory intervention. Specifically, Southwest management indicated that "[g]iven current regulatory oversight and U.S. Central's core role as a liquidity provider to the credit union system, we would view the overriding potential for governmental/regulatory intervention, should financial conditions deteriorate, as relatively high." Although it turned out that Southwest management's view was correct, we do not believe this was an effective credit risk management strategy.

These perspectives may have influenced Southwest's increasing deposits with U.S. Central. Specifically, we determined Southwest's U.S. Central deposits (excluding PIC and MCA) increased significantly in the year leading up to the start of credit market dislocation--from $3.7 billion as of July 2006--to a pre-credit market dislocation high of $6.1 billion as of March 2007.

During its December 2007 ALCO meeting - five months after the credit market dislocation began - Southwest management presented what it learned about U.S. Central's investment portfolio. Southwest management's review of a sample of U.S. Central's investment portfolio revealed U.S. Central's "overall exposures include a significant level of investments in non-senior classes of residential mortgage backed transactions." Southwest management indicated that while U.S. Central "appears to have the required human and technical capital in place, we currently possess no evidence regarding the overall depth of review and monitoring of these transactions or in the overall effectiveness of the company's risk management processes and overall governance."

NOTE: Although Southwest's indirect exposure to the residential mortgage market through U.S. Central was significant, NCUA took several actions to address this problem as part of its Corporate Stabilization Program.[43] One of NCUA's actions was to create the Temporary Corporate Credit Union Share Guarantee Program (Share Guarantee) announced in January 2009. The Share Guarantee protected Southwest's investments at U.S. Central (except for its MCA and PIC) by guaranteeing 100 percent of Southwest's qualifying shares[44] to cover the entire balance of the accounts in excess of the Standard Maximum Share Insurance Amount (SMSIA).[45]

We believe that Southwest management allowed for such a significant concentration directly in RMBS because management: (1) pursued a more aggressive investment strategy in an effort to increase its profitability and to remain or become more competitive; and (2) sought alternative investments to limit its exposure to unsecured corporate debt, which had relatively recently incurred large losses. Specifically:

- In September 2004, the Government Accountability Office (GAO) issued a report which indicated that corporates were facing an increasingly challenging business environment that would potentially stress their overall financial condition.[46] According to GAO, since 2000, a large influx of deposits, coupled with low returns on traditional corporate investments, had constrained earnings and caused a downward trend in corporates' overall profitability. To generate earnings, corporates increasingly targeted more sophisticated and potentially riskier investments. This was generally supported recently by an OCCU staff member who indicated there were limited competitive alternatives at the time for investing member deposits to produce sufficient income.

- A former Southwest management official informed us that Southwest management wanted to pursue secured debt to avoid facing a repeat of relatively recent losses in the market incurred through unsecured debt issued by corporations.

Because of this significant concentration of privately-issued securities linked to the residential mortgages without the backing of the federal government, Southwest management left its balance sheet highly vulnerable to economic conditions in the residential real estate market. As a result, Southwest was exposed to significantly increased credit risk, market risk and liquidity risk.

[43] NCUA took action under the Corporate Stabilization Program to ensure ongoing daily operations of corporate credit unions continued during the economic downtown / trouble in the housing markets.
[44] A qualifying share account is any account that qualifies for NCUSIF share insurance coverage under Part 745 of the NCUA's regulations. It does not include capital accounts such as Member Capital and Paid-In Capital or non-share obligations.
[45] Congress permanently increased the SMSIA from $100,000 to $250,000 (effective September 2, 2010) as part of the "Dodd-Frank Wall Street Reform and Consumer Protection Act." (Dodd-Frank Act).
[46] Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate "Corporate Credit Unions: Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA Oversight" (GAO-04-977, September 2004)

Concentration of Privately-Issued RMBS with Higher Risk Mortgage Collateral

We determined Southwest management invested mostly in higher risk RMBS. Specifically, Southwest's RMBS portfolio was collateralized largely with non-prime mortgages, which contained higher risk characteristics. Based on data Southwest management presented in its December 2007 ALCO package[47], approximately two-thirds ($3.2 billion) of Southwest's $4.8 billion RMBS exposure was collateralized by Alt-A, Alt-B[48], and Sub-Prime mortgages.[49] Table 4 below presents the Alt-A, Alt-B and Sub-Prime composition of Southwest's $4.8 billion RMBS portfolio as presented at Southwest's December 2007 ALCO meeting:

RMBS Collateral Category	Percentage of Total RMBS Exposure	Value	RMBS Collateral Category as a Percent of Capital[50]
Alt-A	34%	$1.601 billion	262%
Alt-B	9%	$411 million	67%
Sub-Prime	25%	$1.213 billion	198%
Total	***68%***	***$3.225 billion***	***527%***

Table 4: Below Prime Quality Composition of Southwest's RMBS Portfolio

As discussed in the "Background" section of this report, NCUA issued guidance in 2005 and 2006 warning FICUs about the increasing risks in mortgage and home equity lending. NCUA also expressed concerns to corporate credit unions regarding securities backed by these mortgages. Specifically, in April 2007, OCCU issued a Corporate Credit Union Guidance Letter[51] addressing its concerns with: (1) the credit quality and market value of MBS collateralized by sub-prime or nontraditional mortgages; and (2) the corporate credit union system's more than 75 percent exposure to securities collateralized by real estate.[52] NCUA indicated that it expected corporate management, at a minimum, to require pre-purchase analysis to identify risks and also to monitor closely the MBS to control material exposures.

Regarding the overall quality of its RMBS portfolio, we believe Southwest management performed an appropriate and reasonable level of due diligence. Specifically, although

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[47] We used the December 2007 ALCO package because it was the first ALCO meeting at which Southwest management presented this data.
[48] Although the exact definition may vary, the Alt-B category falls between Alt-A and sub-prime loans; it is a classification for loans that don't quite qualify for Alt-A.
[49] Sub-Prime and Alt-A mortgages are addressed in the Background section on page 8 of this report.
[50] We used the amount of capital from Southwest's November 2007 Statement of Financial Condition (5310 report)
[51] NCUA OCCU. *Credit and Market Value Risks of Mortgage-Backed Securities (MBS)*, April 18, 2007 (Corporate Credit Union Guidance Letter No. 2007-02)
[52] The overall 75.34 percent exposure was as of December 31, 2006.

Southwest's privately-issued RMBS portfolio was largely comprised of RMBS backed by higher risk collateral, the portfolio was comprised of high investment grade securities based on NRSRO standards (see Table 1 on page 14). In addition, Southwest management:

- Conducted pre-purchase analysis rather than relying solely on NRSRO credit ratings of the RMBS as required by NCUA regulation.
- Conducted semiannual non-standard shock tests to assess the impact of shifts in model[53] assumptions (e.g., prepayments, credit spreads, etc.) on the corporate's NEV.
- Conducted additional non-standard tests to assess the impact of a confluence of simulated "economic shocks" (i.e., non-traditional changes in economic policy) and the resulting changes in multiple model assumptions on Southwest's NEV.
- Monitored and analyzed the performance of individual RMBS on a monthly basis.

While Southwest management clearly conducted due diligence, we believe management erred in building a significantly large portfolio of privately-issued RMBS, especially those comprised of lower quality/higher risk collateral (i.e., sub-prime, Alt-A, Alt-B)--despite the high credit ratings of the individual securities. In addition, we learned Southwest--not unlike other entities at the time--did not have the tools available or processes in place to adequately correlate and assess concentration risk. Specifically, we learned that Southwest's: (1) credit risk management processes almost exclusively focused on each investment deal; (2) risk management models or decision making processes did not adequately capture the growing concentrations and exposure to the housing market; and (3) stress tests--in hindsight--were not severe enough.[54]

Concentration of Privately-Issued RMBS Collateralized with Mortgages in a Single Residential Real Estate Market

We determined the underlying mortgage collateral within Southwest's RMBS portfolio was more heavily concentrated in one state. Specifically--based on data Southwest management presented at its July 2007 ALCO meeting--approximately $1.9 billion (43 percent) of Southwest's $4.4 billion RMBS exposure had at least 40 percent of the mortgage collateral in California. The California concentration represented 319 percent of Southwest's capital.[55]

[53] Southwest used the Kamakura Risk Manager Software (KRM) for its NEV and Net Interest Income analysis. The founder, Kamakura Corporation, has been a provider of daily default probabilities and default correlations since November 2002.
[54] Southwest engaged ALM Model Metrics to conduct a detailed and independent assessment of the risks of its funds management business. ALM Model Metrics issued its report – Southwest Corporate Federal Credit Union Comprehensive Risk Assessment - on September 22, 2008.
[55] We used Southwest's level of capital from the June 2007 Statement of Financial Condition (5310 report).

If the underlying mortgage collateral of an investor's RMBS portfolio is more heavily concentrated in one geographic locale, the health of the residential mortgage market in that locale would have a more significant impact on the performance of that portfolio. Specifically, if that locale had a high delinquency and foreclosure rate, the performance (i.e., cash flows) of that RMBS portfolio could be severely and negatively impacted. We learned that leading up to the credit market dislocation, several cities in the California residential real estate market were reportedly overpriced and--during the credit market dislocation--the state experienced high foreclosure rates. The following statistics pertaining to the California residential real estate market highlight that a higher concentration of underlying mortgage collateral in California created the potential for increased credit and market risks within Southwest's RMBS portfolio:

- On August 16, 2005, USA Today published an article regarding extremely overvalued home prices. The article indicated 53 cities were at "high risk of price declines," including 25 cities in California where the author indicated the overvaluations ranged from 30 percent to 69 percent.[56]

- A February 26, 2008 article in CNN Money indicated California was one of three states that: (1) recorded big price run-ups during the housing boom; and (2) currently had the highest foreclosure rates in the nation.[57]

- A February 27, 2008 article in Property Wire--a global property news service--indicated California foreclosures for January 2008 had increased more than 120 percent over what they had been in January 2007.[58]

We determined Southwest management's policy and procedures were not adequate to appropriately mitigate potential risks associated with geographic concentrations. However, absent more specific regulatory restrictions, Southwest management acted within the scope of its authority in not setting a specific limit or in establishing whatever limit it wanted, so long as its policy *addressed* geographic concentrations. Specifically:

- Southwest's *2003 ALCO Operating Policy (Policy)* indicated that geographic concentrations would typically be *reviewed for investments such as MBS and ABS*, adding that *for each ABS*, the geographic concentration should generally be less than 50 percent. Effective August 2005, Southwest changed the *Policy* to only indicate that *for ABS and MBS*, due consideration would be given to geographic concentrations and on an aggregate basis Southwest would diligently monitor and manage overall exposure levels. We believe both versions of Southwest's *Policy* complied with NCUA's regulation.

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[56] USA Today, "Home prices 'extremely overvalued' in 53 cities." August 16, 2005. <http://www.usatoday.com/money/economy/housing/2005-08-16-home-prices-usat_x.htm>. The article addressed the results of a study of 299 metropolitan areas that comprised 80 percent of the U.S. housing market.
[57] CNNMoney, "January foreclosures up 57%". Money.CNN.com, February 26, 2008. <http://money.cnn.com/2008/02/26/real_estate/foreclosures_rise_again/index.htm>
[58] Property Wire, "Foreclosure rates increase substantially in California" PropertyWire.com, February 27, 2008. <http://www.propertywire.com/news/north-america/foreclosure-rates-increase-substantially-in-california-20080227544.html>

- Early on, Southwest's *Investment Credit Analysis Department Procedures* (Procedures) indicated only that analysis of collateral pools may include evaluating an investment's geographic concentration. However, in response to OCCU's February 2005 examination, Southwest included in its *Procedures* a per investment transaction limit of 85 percent per state, effective June 1, 2005. Again, we believe both versions of Southwest's *Procedures* complied with NCUA's regulation.

As a result of Southwest's significant concentration of privately-issued RMBS with a high concentration of underlying mortgage collateral in California, management left its balance sheet highly vulnerable to economic conditions in that state. Ultimately, Southwest management increased its vulnerability to credit, market, and liquidity risks.

Overall, despite the credit enhancements designed to mitigate the risk of potential losses to an investor on individual securities, Southwest's credit risk management policy and practices were not comprehensive enough and did not place appropriate limits on concentrations, whether in investment type, sector, or geography. Therefore, when there was a national mortgage meltdown, in which California foreclosure rates were among the top three in the nation, and the credit market collapsed, Southwest was left holding a significant portfolio of securities it could not sell. Ultimately, Southwest's high concentration of RMBS had a significant adverse impact on Southwest and its balance sheet after the credit market dislocation began. Specifically, NCUA determined that:

- As of March 31, 2009, only 44 percent ($2.26 billion) of Southwest's $5.12 billion security portfolio (face value) was rated investment grade. Fifty two percent of the portfolio ($2.67 billion) had been downgraded to non-investment grade.[59]

- By July 28, 2010, 77.28 percent ($2.8 billion) of Southwest's $3.6 billion securities portfolio was rated non-investment grade.

- Southwest's capacity to fund liquidity needs was diminished:

  - Upon NCUA placing U.S. Central (Southwest's primary lender) into conservatorship on March 20, 2009, Southwest's lines of credit with U.S. Central were cut.

  - As of early 2009, the S&P and Fitch rating services downgraded Southwest's long-term and short-term credit ratings, which adversely impacted Southwest's capacity to borrow funds [to meet liquidity needs].

  - As of June 30, 2010, $2.38 billion of Southwest's marketable securities were not liquid and, consequently, were not a reliable source for Southwest's liquidity needs.

[59] The ratings were as of mid-April 2009 and were based on the lowest published ratings by Standard and Poor's, Moody's, or Fitch.

- As a result of other than temporary impairments (OTTI) charges and U.S. Central membership capital depletions, Southwest depleted a total of $776 million of its membership capital by July 30, 2010.[60]

- As of August 31, 2010, Southwest was insolvent with a solvency ratio of 91.88 percent[61] and economically insolvent with a NEV ratio of -9.10 percent. NCUA officials indicated there was no reasonable prospect of Southwest returning to solvency.

NCUA regulations did not provide corporates with specific limits for concentrations of credit risk. Essentially, NCUA left it entirely up to each corporate to determine their own respective risk levels and limits. To address this and other issues, the NCUA Board took several actions, on September 24, 2010, to reform the corporate credit union system under a stronger regulatory framework. One of those actions was to finalize major revisions to Part 704, NCUA's rule governing corporate credit unions. The final rule includes new limitations on corporate credit union investments and credit risks, as well as asset-liability management controls, so that high concentrations of the types of investments that caused the corporate crisis are no longer permitted. Specifically, the final rule includes the following provisions:

- Prohibits investments in private label RMBS and subordinated securities.

- Imposes specific concentration limits by investment sector.[62]

The final rule also requires that all investments, other than in another depository institution, must have an applicable credit rating from at least one NRSRO. In addition, at a minimum, 90 percent of all such investments, by book value, must have a rating by at least two NRSROs. However, NCUA subsequently proposed to delete references to NRSRO credit ratings from Part 704. This proposal was published in the Federal Register on March 1, 2011.[63]

[60] Under Financial Accounting Statements No. 115 (Accounting for Certain Investments in Debt and Equity Securities) and No. 157 (Fair Value Assessments), securities must be classified as OTTI when it is not probable the holder [of the security] will collect all contractual principal and interest due on the security. Reductions in fair value must then be recorded as OTTI charges, which pursuant to NCUA regulations (12 C.F.R Section 704.2), deplete – in order - retained earnings, paid-in capital, and membership capital.
[61] A credit union is determined to be insolvent when the total amount of its shares exceeds the present cash value of its assets after providing for liabilities unless: (a) it is determined by the NCUA Board that the facts that caused the deficient share-asset ratio no longer exist; (b) the likelihood of further depreciation of the share-asset ratio is not probable; (c) the return of the share-asset ratio to its normal limits within a reasonable time for the credit union concerned is probable; and (d) the probability of a further potential loss to the insurance fund is negligible.
[62] Sectors are defined as residential mortgage-backed securities, commercial mortgage-backed securities, student loan asset-backed securities, automobile loan/lease assets-backed securities, credit card asset-backed securities, other asset-backed securities, corporate debt obligations, municipal securities, money market mutual funds, and an "all others" category to account for the development of new investment types. Sector limits are, generally, 1) the lower of 500 percent of capital/25 percent of assets, or 2) the lower of 1000 percent of capital/50 percent of assets (for less risky sectors).
[63] This requirement is in accordance with provisions of the Dodd-Frank Act. Dodd-Frank requires every federal agency to review existing regulations that require the use of an assessment of the credit-worthiness of the security or money market instrument and any references to credit ratings in such regulations. In addition, Dodd-Frank requires

Based on this revision to Part 704, we are not making any recommendations to address concentration limits, credit analysis, or credit risks related to investments in privately-issued RMBS.

B. NCUA Supervision of Southwest Corporate Federal Credit Union

We determined that OCCU staff did not adequately and timely identify or address the risks associated with Southwest's direct concentration of and indirect exposure to privately-issued RMBS. Specifically, we determined OCCU staff did not:

- Take exception with Southwest's increasing and significant concentrations of RMBS early on;[64]

- Take exception with the larger geographic concentration of the underlying collateral in Southwest's privately-issued RMBS.

- Adequately address Southwest's indirect exposure to privately-issued RMBS investments through U.S. Central in its assessment of Southwest's risk exposure.

We believe this occurred in part because OCCU staff did not appropriately aggregate or correlate all components of Southwest's concentrations of privately-issued RMBS. In addition:

- OCCU staff did not have the appropriate regulatory support in the form of specific investment concentration limits to address the growing concentrations of privately-issued RMBS; and

- NCUA regulations: (1) did not place any limits on corporate investments with other corporates as obligors; and (2) did not indicate that any special emphasis should be placed on monitoring investments with other corporates, considering there were no regulatory restrictions on the level of such deposits.

We also determined OCCU staff's efforts at assessing the credit risk associated with Southwest's RMBS portfolio was not adequate. Specifically, we did not find that OCCU staff conducted additional independent *analysis* of the credit risk within Southwest's RMBS portfolio beyond what Southwest management had already conducted.

As a result of these issues, OCCU staff did not have an accurate and comprehensive picture of Southwest's: (1) concentration of privately-issued residential mortgage-backed securities; or (2) true credit, market and liquidity risks.

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agencies to modify such regulations identified in the review to remove any reference to, or requirement of, reliance on credit ratings; and substitute with a standard of credit worthiness, as the agency shall determine as appropriate, for such regulations.

[64] As discussed previously in Section A of this report, for the purposes of this review, we will refer to the portfolio of MBS and home equity ABS collectively as RMBS unless otherwise indicated.

NCUA regulations required that:

- Corporates operate according to a credit risk management policy that was commensurate with the investment risks and activities it undertook. At a minimum, corporates were required to implement a credit risk management policy that addressed concentrations of credit risk (e.g., originator of receivables, insurer, industry type, sector type, and geographic).

- The aggregate of all investments in any single obligor be limited to 50 percent of capital or $5 million, whichever was greater. However, this restriction did not include aggregate investments in corporate credit unions.

Effective May 2006, Southwest's investment policy and procedures provided for the following concentration limits:

- Up to 500 percent of Southwest's capital could be invested in private-label securities backed by residential mortgages.

- Up to 400 percent of Southwest's capital could be invested in any one collateral type of ABS (e.g., home equity loans, credit cards, student loans, etc.) and Asset Backed Mortgage Paper.[65]

In addition, NCUA regulations provided that: (1) all investments, other than in a corporate credit union or CUSO, required an applicable credit rating from at least one NRSRO; and (2) investments with long-term ratings had to be rated no lower than AA– (or equivalent), and investments with short-term ratings had to be rated no lower than A–1 (or equivalent) at the time of purchase.

The NCUA Corporate Examiner's Guide advised examiners that:

- A credit rating is not a substitute for prudent due diligence and should only be considered as one factor in an investment decision. The ratings and other opinions issued by rating agencies are not recommendations to buy securities and there is not a warranty on the accuracy, timeliness, completeness or fitness of the information provided. It is simply one tool to assist an investor in making investment decisions. Analysts are expected to understand the implications and conclusions of a rating agency's research and form an independent judgment.

- Credit risk managers must be mindful that credit ratings are generally a lagging indicator.

- There is a danger corporates may focus upon high credit ratings and simply consider the improbability of default. Corporates need to consider how concentrations of credit risk will change when market or credit conditions change.

[65] Up to a total of 600 percent of capital could be invested in all ABS collateral types and Asset Backed Mortgage Paper.

Failing to recognize the impact of credit events other than an event of default ignores a major component of risk.

- Failure to manage concentration risk or adequately diversify the portfolio may give rise to excessive liquidity risk. Corporates must be especially mindful of liquidity when making investment decisions since investment portfolio(s) are the primary source of funds to meet ongoing and contingent liquidity demands.

- The credit analysis and approval process should involve substantive and timely information. The more complex the credit or the greater the potential exposure, the more analysis required. Examiners should sample credit files to determine the resources used in the analysis.

- The credit exposures inherent in corporates' investment activities have multiplied and become more complex as new instruments and debt structures have come to market. Financial products are increasingly complex in part because of the proliferation of credit enhancement mechanisms supporting these instruments. With this growth there is an increasing need for more sophisticated risk measurement techniques.

- Examiners should: (1) ensure corporates "have programs and processes to manage the market, credit, liquidity, legal, operational, and other risks" of investment securities; and (2) evaluate the adequacy of a corporate's monitoring and reporting of risks, returns, and overall performance of investment and derivative activities to senior management and the board of directors.

Direct Concentrations of Privately-Issued RMBS Not Adequately Addressed

We determined that OCCU staff did not include Home Equity ABS early on in its assessment of Southwest's direct concentration of privately-issued RMBS. Therefore, OCCU staff did not have a comprehensive or accurate picture of Southwest's concentration risk prior to the credit market dislocation that occurred starting in July 2007. In addition, we determined OCCU staff did not take exception with Southwest's increasing and eventually significant direct concentrations of RMBS until after the credit market dislocation began. As stated previously, NCUA regulations did not impose specific concentrations limits. Nevertheless, we believe that had OCCU staff made an accurate assessment of Southwest's RMBS concentration risks early on, they might have raised legitimate concerns with Southwest about its increasing concentrations based on sector and investment type (i.e., privately-issued securities linked to the residential real estate market).

Between the March 2004 examination and June 2007 (just prior to the start of the credit market dislocation), Southwest's total concentration of privately-issued RMBS increased from 272 percent to 817 percent of capital.[66] Chart 3 below illustrates Southwest's

[66] Until the March 2007 examination, OCCU staff did not include the Home-Equity ABS in its assessment of Southwest's concentration of privately-issued RMBS.

increasing concentrations of privately-issued MBS and Home Equity ABS (i.e., RMBS) as a percentage of Southwest's capital from March 2004 through July 2007 when the credit market dislocation began.

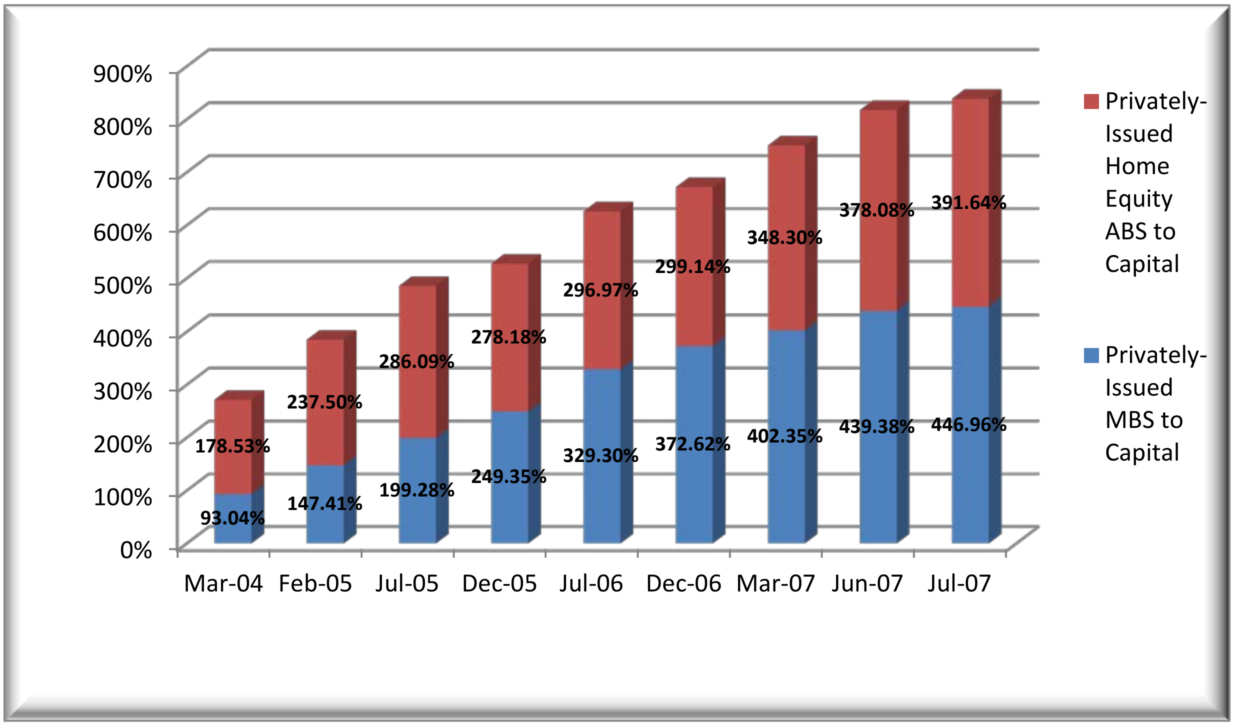

Chart 3: Southwest's Increasing Direct Concentrations of Privately-Issued RMBS

Based on our review of Southwest's examinations, we determined that:

- During the March 2004 examination, OCCU staff noted that Southwest's investment portfolio was adequately diversified by investment type and sector. OCCU staff indicated Southwest's investment in privately-issued mortgages (i.e., Mortgage-Backed Securities (MBS)) was less than six percent (approximately $473 million) of Southwest's total portfolio. However, while OCCU staff noted that Southwest's total investment in ABS was approximately 27 percent ($2.3 billion) of the portfolio, we determined that the Home Equity ABS was nearly 11 percent of the total portfolio. Consequently, Southwest's concentration in privately-issued RMBS was nearly 17 percent[67] of the total investment portfolio (and 272 percent of total capital). We agree that at the time, Southwest's direct investments were adequately diversified by investment type and sector overall. However, when we also took into consideration Southwest's indirect exposure to privately-issued securities in the residential real estate market through U.S. Central, we disagree with OCCU staff's assessment. We address Southwest's indirect exposure through U.S. Central starting on page 36 of this report.

[67] This represents the nearly 6 percent MRS plus the 11 percent of Home Equity ABS.

- As of the February 2005 examination, OCCU staff indicated that in terms of investment type, there was reasonable diversification in Southwest's portfolio. When taking into consideration only privately-issued MBS as a concentration, the concentration by investment type and by sector was only 147 percent of capital. However, we determined that as of February 2005--when appropriately including Home Equity ABS--Southwest's total direct concentration of privately-issued RMBS was 385 percent of total capital, representing a more significant concentration in terms of not only investment type, but also sector. We found no evidence in the examination documentation that OCCU staff: (1) aggregated the privately-issued Home Equity ABS with the privately-issued MBS to adequately assess Southwest's total RMBS concentration; or (2) took exception with the total direct concentration of privately-issued securities (i.e., concentration by investment type) linked to the residential real estate market (i.e., sector concentration).

- During the July 2006 examination, OCCU staff indicated that: (1) overall, the investment portfolio was well diversified by instrument type; and (2) credit risk was limited. OCCU staff also noted that Southwest had increased its exposure to the mortgage backed securities market. We determined that as of July 2006, Southwest's concentration of privately-issued MBS had grown to 329 percent of total capital. However, when including the privately-issued Home Equity ABS, the actual concentration of privately-issued RMBS was 626 percent of total capital. We found no evidence in the examination documentation that the staff took exception with the increasing concentration of privately-issued RMBS.

- The March 2007 examination was the first examination in which OCCU staff included Home Equity ABS in its calculation of RMBS. OCCU staff indicated Southwest's investment portfolio remained comprised of highly rated, reasonably diversified financial instruments as required by policy, regulation, and *sound practice*. In addition, OCCU staff indicated the credit process was being well-managed within acceptable risk tolerances. We determined that as of the examination date, Southwest had a total direct concentration of privately-issued RMBS of just over 750 percent of capital. However, we still found no evidence that OCCU staff took exception with this significant concentration of privately-issued RMBS.

- During the March 2008 examination, OCCU staff noted the negative and unprecedented impact of the credit market dislocation on mortgage-backed security values and their related liquidity. This examination was the first instance in which we found evidence OCCU staff took exception with the concentration of privately-issued RMBS. Specifically, the staff indicated that:

  - "The severity of the impact of the ongoing credit market dislocation has been worsened by inadequate sector diversification. Current and allowable residential mortgage-backed securities (RMBS) exposures are significant given the unprecedented market dislocation and the contagion that has impacted most fixed income sectors. Previously viewed as acceptable, Southwest's exposure to the mortgage sector is clearly excessive."

- o "Unquestionably, the size of Southwest's mortgage-backed security holdings in relation to the overall portfolio heightened the severity of the credit market dislocation's impact on the corporate."

We agree with OCCU staff who, during the March 2008 examination, stated clearly and succinctly that: "Events of the current period highlight the importance of prudent sector diversification." As a result of Southwest's excessive concentration in privately-issued RMBS, Southwest faced significant credit, market, and liquidity risks, which ultimately resulted in significant losses to NCUA and the agency's eventual conservatorship and liquidation of Southwest.

Credit Risk of Privately-Issued RMBS Not Adequately or Timely Assessed

We determined that NCUA staff evaluated the reasonableness of Southwest's credit risk management methodologies and processes in accordance with existing examination procedures. However, NCUA corporate examination guidelines do not suggest or advise that NCUA staff independently analyze a corporate's credit risk. We believe NCUA's assessment of Southwest's credit risk would have been improved had NCUA's policies or procedures required independent analysis of Southwest's credit exposure and potential risk.

We found that NCUA staff appropriately sampled Southwest's investment summaries during examinations and addressed weaknesses in the summaries early on. However, beyond that, we found that OCCU staff assessments of the samples prior to the March 2007 examination were generally limited to determining that the investment summaries contained sufficient financial data to support the investment decisions.

We also found that up to and including the March 2007 examination, OCCU staff indicated Southwest's credit risk was reasonably undertaken and diligently monitored and controlled. OCCU staff noted that Southwest was monitoring the collateral composition of its structured mortgage-backed securities on a monthly basis as part of its monthly ALCO Package. Furthermore, although we found OCCU staff reviewed Southwest management's data regarding the individual collateral characteristics of its RMBS portfolio during the March 2007 examination, we found no evidence that OCCU staff did any *analysis* of the RMBS portfolio's underlying collateral characteristics:

- During the March 2007 examination, OCCU staff *summarized* "significant characteristics of Southwest's portfolio of structured, mortgage-backed securities" that Southwest management presented in its May 2007 ALCO Meeting package. OCCU staff provided such highlights as the following regarding the MBS:

- o 74 percent were composed of loans to borrowers with average FICO scores greater than 680;
- o 64 percent were at least 50 percent composed of interest only loans;
- o Approximately 38 percent were at least 50 percent "full documentation" loans; and
- o Just over 22 percent were at least 50 percent "stated documentation" loans.

We conducted analysis of the data Southwest presented by comparing data from two of its ALCO packets (May 2006 and April 2007), which included stratifications regarding FICO scores in combination with other individual characteristics within the RMBS portfolio. Specifically, we reviewed data pertaining to the underlying RMBS collateral in which at least 50 percent of the borrowers were approved based on stated documentation. Table 5 summarizes this data as it relates within FICO pools:

RMBS: FICO Pools	**Collateral with at least 50 percent of borrowers approved under Stated Documentation Requirements**			
	May 2006 ALCO Data		**April 2007 ALCO Data**	
	Percent	***Value***	***Percent***	***Value***
< 620	3.06%	$6 million	0%	$0
620 - 649	7.28%	$56 million	10.37%	$89 million
650 - 679	13.63%	$22 million	19.53%	$20 million
680 - 719	8.33%	$61 million	38.13%	$590 million
720+	7.36%	$85 million	11.37%	$157 million
Not Reported	0%	$0	0%	$0
Total		$230 million		$856 million

Table 5: Summary of Underlying RMBS Collateral in which At Least 50 percent of The Borrowers Were Approved Based on Stated Documentation

Based on this analysis, we determined that overall, borrowers in the underlying mortgage collateral of the Southwest RMBS portfolio were increasingly approved for 'Stated Documentation' loans over time. For example--as a percentage of the selected FICO pool--the 'Stated Documentation' characteristic within the four credit score pools ('620 – 649', '650 – 679', '680 – 719', and the 720 plus) had increased. The most significant was a 358 percent increase in the percentage of 'Stated Documentation' loans in the '680 – 719' pool, which correlated to an 867 percent increase in the dollar value of securities in that pool. This is a potentially significant credit risk issue regarding mortgage collateral in that:

- In May 2007, the then Comptroller of the Currency stated that “the use of a borrower's stated income, without verification, had helped increase mortgage delinquencies and foreclosures in combination with other lax underwriting standards.”[68]

- In a speech in May 2007, the Chairman of the Federal Reserve indicated *"Mortgage applications with little documentation were vulnerable to misrepresentation or overestimation of repayment capacity by both lenders and borrowers, perhaps with the expectation that rising house prices would come to the rescue of otherwise unsound loans. Some borrowers may have been misled about the feasibility of paying back their mortgages, and others may simply have not understood the sometimes complex terms of the contracts they signed."*[69]

We believe these revelations support that it would have been much more revealing if OCCU staff had assessed multiple collateral characteristics of Southwest RMBS in combination such as the composition of interest only/exotic mortgage loans, Stated Documentation loans, and (Combined) Loan To Values in each FICO pool. Had OCCU staff done so, it is possible that, ultimately, they would have assessed Southwest's credit risk differently.

We also determined that during the March 2007 examination, OCCU staff had summarized Southwest management's estimates of the First Loss Constant Default Rate[70] (CDR).[71] For example, OCCU staff's review of Southwest management's First Loss CDR analysis indicated that Southwest's sub-prime and Alt-B securities had significant credit support. OCCU staff also indicated Southwest management believed the corporate would be minimally impacted by the housing downturn because of the appreciable credit enhancement structures supporting the corporate's senior positions, continued high credit quality, well-known issuers and servicers, and the insurance wraps enhancing most second lien deals.

Overall, we found that NCUA's *analysis* of Southwest's credit risk was limited to reflecting what Southwest management had determined about its credit risk, which we learned was in turn limited by Southwest's tools and decision processes. As we addressed in Section ‘A’, although we determined Southwest management conducted appropriate and reasonable due diligence in its credit risk management effort, the third-party Asset/Liability Management report that Southwest had sponsored in 2008

[68] Reuters. “Regulator sees stated income subprime problem.” Reuters.com, May 23, 2007 <http://www.reuters.com/article/2007/05/23/us-usa-subprime-income-idUSN2334957320070523>
[69] Federal Reserve Board, Chairman Bernanke Speech at the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois. “The Subprime Mortgage Market.” Federal Reserve Board.gov, May 17, 2007 <http://www.federalreserve.gov/newsevents/speech/bernanke20070517a.htm>
[70] The Constant Default Rate (CDR) is the security industry's accepted method of stating the rate at which loans can be expected to default during the life of a pool. CDR is a critical variable used by investors to structure the expected cash flows for a pool of loans.
[71] The First Loss CDR is the constant default rate necessary to expose specific Southwest securities to their first principal loss.

indicated the corporate did not have the tools available or processes in place to adequately correlate and assess concentration risk (see page 23).

We learned from OCCU management and staff that OCCU does not have resources to conduct its own analysis. However, OCCU management informed us that it is looking at resources or avenues through which to independently assess corporate credit risk.

Geographic Concentration of Southwest's Investments in Privately-Issued RMBS Not Adequately Addressed

We determined OCCU staff did not take exception with the potential risk associated with Southwest's geographic concentration. Specifically, although OCCU staff: (1) prompted Southwest to implement geographic concentration limits in 2005; and (2) mentioned the composition of loans in California associated with MBS during the March 2007 examination, we found no evidence that OCCU staff took issue with Southwest's geographic concentration levels despite what we believe was--in terms of Southwest's capital--a significant and increasing concentration of collateral located in California. For example, based on data Southwest presented in July 2007, the percentage of the RMBS portfolio that had at least 40 percent of the underlying collateral located in California represented 319 percent ($1.9 billion) of Southwest's capital ($598 million). Table 6 illustrates the significant concentration of Southwest's privately-issued RMBS with collateral located in California:[72]

ALCO Packet Date	% of RMBS Portfolio with California Concentration >= 40%	
	Percentage of RMBS	*Percentage of Capital*[73]
April 2006	46.54%	*243%*
July 2006	44.79%	*247%*
December 2006	39.68%	*251%*
July 2007	43.31%	*319%*

Table 6: Significant Concentration of Underlying RMBS Collateral Located in California

As we stated previously in Section A, a high delinquency and foreclosure rate could have a severe impact on the performance (i.e., cash flows) of the RMBS. Therefore, if the RMBS' underlying collateral is more heavily concentrated in one geographic locale, the health of the residential mortgage market in that locale would have a direct impact on the performance of the RMBS. (See discussion of geographic concentrations starting on page 23 of this report)

Indirect Exposure to Privately-Issued RMBS Not Adequately Addressed

[72] The table is based on data from selected ALCO packets as of the dates specified.
[73] To determine the percentage of capital the California concentration represented, we used the amount of capital as presented in Southwest's Statements of Financial Condition (5310 report) from the month preceding the date of the ALCO packet.

We determined OCCU staff did not adequately or timely address the potential concentration risk and resulting potential credit, market and liquidity risks Southwest faced with the corporate's significant indirect exposure to privately-issued RMBS through its deposits with U.S. Central. Specifically, although OCCU staff noted early on that Southwest's deposits with U. S. Central represented Southwest's largest portfolio concentration and that Southwest needed to gain more insight into this concentration, OCCU staff did not independently address the potential risks of this concentration**.**

As previously discussed on page 19, we reported in October 2010 that U.S. Central had significant investments in private label sub-prime and ALT-A MBS, which exposed it to excessive financial risks. Therefore, Southwest was inherently and indirectly exposed to these risks through its deposits with U.S. Central. Ultimately, U.S. Central's investment portfolio incurred substantial losses. As a result, NCUA conserved U.S. Central in March 2009 and began liquidation of the corporate in October 2010.

We believe OCCU staff should have addressed the extent of Southwest's potential credit, market and liquidity risks resulting from its indirect exposure to the residential real estate market through U.S. Central's privately-issued RMBS. However, while OCCU staff clearly urged Southwest management to better understand U.S. Central's investments, there is no evidence that OCCU staff addressed – from NCUA's position as supervision authority - the risks to Southwest associated with its deposits with U.S. Central.

Ultimately, by failing to ascertain and correlate the composition of U.S. Central's investment portfolio as it pertained to Southwest's portfolio, OCCU staff continually underestimated Southwest's potential concentration risks. Southwest's concentration risks by investment type (i.e., privately-issued MBS) and by sector (residential real estate market) were much worse when its privately-issued RMBS was correlated with U.S. Central's RMBS portfolio. For example, as a percentage of investments and capital, Southwest's direct exposure to privately-issued RMBS as of March 2007 was 36 percent and 751 percent respectively. However, Southwest's potential total exposure (when including its deposits with U.S. Central) dramatically increased to 86 percent and 1783 percent respectively. Table 7 below presents Southwest's direct, indirect and total exposures to privately-issued RMBS for examinations effective from March 2004 through March 2007:

Southwest Investment:	March 2004	February 2005	July 2006	March 2007
- Privately-Issued MBS (a. Direct)	$476 Million	$795 Million	$1.875 Billion	$2.363 Billion
- Privately-Issued Home-Equity ABS (b. Direct)	$913 Million	$1.281 Billion	$1.69 Billion	$2.046 Billion
- U.S. Central Obligations (c. Indirect)[74]	$4.289 Billion	$4.45 Billion	$3.7 Billion	$6.054 Billion
Direct Exposure (a. + b.)				
% of Investments	16%	25%	40%	36%
% of Capital	272%	385%	627%	751%
Total Exposure (a. + b. +c.)				
% of Investments	67%	78%	81%	86%
% of Capital	1111%	1211%	1277%	1783%

Table 7: Southwest's Direct Concentrations of and Indirect Exposure to Privately-Issued RMBS

The following information summarizes OCCU staff's general and overall discussion or concerns regarding Southwest's exposure to U.S. Central's investment portfolio prior to the credit market dislocation:

- During the March 2004 examination, OCCU staff:
  - Noted that at $4.3 billion, Southwest's concentration of investments with U.S. Central represented nearly half (49.56 percent) of Southwest's investment portfolio.
  - Indicated that given Southwest's diligent, ongoing monitoring of U.S. Central's operational safety and soundness, Southwest's portfolio remained adequately diversified by investment type and sector.
- During the February 2005 examination OCCU staff:
  - Indicated (1) [investment] credit summary information provided by U.S. Central to Southwest did not adequately summarize all pertinent information; and (2) management was "attempting, *though unsuccessfully*, to obtain more granular information from U.S. Central for purposes of credit analysis".
  - Highlighted the need for Southwest management to "upgrade the depth of analysis and frequency of performance of credit review summaries related to U.S. Central Credit Union commensurate with the level of exposure to this counterparty."

[74] This data for U.S. Central Obligations excludes Southwest's Paid-In Capital and Member Capital Assets which were not protected under the Share Guarantee Program.

    - o Indicated Southwest's credit risk was adequately controlled and monitored.

- During the July 2006 examination, OCCU staff:

    - o Indicated Southwest had reduced its exposure to U.S. Central – from approximately 55 percent ($4.6 billion) of the total investment portfolio as of February 2005 to less than 43 percent ($3.9 billion).

    - o Indicated that, except for U.S. Central, the investment portfolio was well diversified.

- During the March 2007 examination – just prior to the credit market dislocation - OCCU staff:

    - o Noted U.S. Central obligations increased to $6.3 billion, just over half of Southwest's $12.2 billion investment portfolio.

    - o Indicated (1) Southwest continued to maintain a well-diversified investment portfolio; and (2) that overall, the investment process was being well-managed within acceptable risk tolerances.

    - o Indicated Southwest remained financially safe and sound.

    - o Indicated credit risk was reasonably undertaken and diligently monitored and controlled.

    - o Indicated Southwest's investment portfolio remained composed of reasonably diversified financial instruments as required by policy, regulation, and *sound practice*.

Despite the OCCU staff's inadequate response to Southwest's indirect exposure to potentially significant risks through its deposits with U.S. Central, NCUA's efforts through the Share Guarantee mitigated the impact of any losses from Southwest's deposits with U.S. Central. As previously discussed, NCUA created the Share Guarantee to protect member shares deposited with corporates. While Southwest's combined direct and indirect exposure to privately-issued RMBS represented significantly increased concentrations in credit and market risks, this program nearly eliminated Southwest's losses from its deposits with U.S. Central.[75] Therefore, we are merely raising this indirect exposure issue with the expectation that it will be used as a lesson learned, *viz.,* that even investments among corporates should be thoroughly vetted when NCUA assesses potential risks within corporates.

[75] Southwest's deposits at U.S. Central that were ultimately lost included only Paid-In-Capital and Member Capital Assets.

NCUA regulations focused on investment ratings and only required corporates to *address* concentrations of credit risk in their respective policies, leaving it up to each corporate to determine its risk levels/limits. This loosely worded requirement limited OCCU staff's options in taking exception with Southwest's investment strategy and significant concentrations of privately-issued securities linked to the residential real estate market and more heavily in a single state. We believe if NCUA had had definitive (and reasonable) concentration limits in place, OCCU staff would have likely been able to mitigate the conditions that led to Southwest's high concentrations of privately-issued RMBS, the conservatorship and liquidation of Southwest, and ultimately, the expected loss to the Stabilization Fund.

To address these issues, the NCUA Board took several actions, on September 24, 2010, to reform the corporate credit union system under a stronger regulatory framework. One of those actions was to finalize major revisions to Part 704, NCUA's rule governing corporate credit unions. The final rule includes new limitations on corporate credit union investments and credit risks, as well as asset-liability management controls, so that high concentrations of the types of investments that caused the corporate crisis are no longer permitted. Specifically, the final rule includes the following provisions:

- Prohibits investments in private label RMBS and subordinated securities.
- Imposes specific concentration limits by investment sector.[76]

The final rule also requires that all investments, other than in another depository institution, must have an applicable credit rating from at least one NRSRO. In addition, at a minimum, 90 percent of all such investments, by book value, must have a rating by at least two NRSROs. However, NCUA subsequently proposed to delete references to NRSRO credit ratings from Part 704. This proposal was published in the Federal Register on March 1, 2011.[77]

Based on these revisions to Part 704, we are not making any recommendations to address NCUA's assessment of concentration limits, credit analysis, or credit risks related to investments in privately-issued RMBS.

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

[77] This requirement is in accordance with provisions of the Dodd-Frank Act. Dodd-Frank requires every federal agency to review existing regulations that require the use of an assessment of the credit-worthiness of the security or money market instrument and any references to credit ratings in such regulations. In addition, Dodd-Frank requires agencies to modify such regulations identified in the review to remove any reference to, or requirement of, reliance on credit ratings; and substitute with a standard of credit worthiness, as the agency shall determine as appropriate, for such regulations.

Recommendation:

We recommend NCUA management identify and determine the best use of available resources to independently assess risks within corporate credit unions and other complex credit unions.

Management Response:

Management agreed with the recommendation. Management indicated NCUA has an active working group identifying elevated risk posed by large, complex institutions and developing appropriate strategies to supervise those institutions.

OIG Response:

We concur with management's actions.

Appendix A – Management Response

National Credit Union Administration

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SSIC1920

SENT VIA E-MAIL

TO:	Inspector General William DeSarno Office of the Inspector General
FROM:	Executive Director David M. Marquis Office of Executive Director
SUBJ:	Material Loss Review (MLR) of Southwest Corporate Federal Credit Union
DATE:	September 21, 2011

This memorandum responds to your request for review and comments on the *Material Loss Review of Southwest Corporate Federal Credit Union* provided on August 31, 2011. Pursuant to Section 206(j) of the Federal Credit Union Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the National Credit Union Administration's Office of Inspector (OIG) conducted a material loss review of Southwest Corporate Federal Credit Union (Southwest), Plano, Texas. Southwest was placed under NCUA conservatorship on September 24, 2010 and liquidated on November 1, 2010, with certain assets, liabilities, and shares transferred to Southwest Bridge Corporate Federal Credit Union through a purchase and assumption agreement.

Southwest failed due to losses associated with an excessive concentration of privately-issued residential mortgage-backed securities (RMBS). In addition, Southwest's investments at U.S. Central Credit Union (US Central) were also backed by similar privately-issued RMBS, which magnified their exposure to credit risk. Southwest's board of directors and management failed to employ appropriate enterprise-wide risk management practices to identify the nature and extent of the concentration and other risks present in the RMBS portfolio.

Third parties who originated, securitized and rated the underlying residential mortgages and securities were a material contributing factor to Southwest's losses and the subsequent losses to the Temporary Corporate Credit Union Stabilization Fund. Southwest over-relied on the credit ratings assigned by the Nationally Recognized Statistical Rating Organizations (NRSROs). At the time of purchase, the RMBS securities received AAA or AA ratings.

The MLR Report refers to the lack of independent analysis of credit risk during regular corporate credit union examinations, which was not a standard examination procedure during the period leading up to the credit market dislocation. NCUA recognizes that independent analysis may have mitigated losses resulting from the recently failed corporate credit unions. NCUA is taking steps to revise the corporate credit union examination guidelines and exploring potential contracts with outside vendors to provide thorough analysis of large, complex investment and loan portfolios. In addition, the revised Corporate Credit Union Rule, approved in September 2010, provides regulatory support to mitigate risk by prohibiting the purchase of privately-issued RMBS and imposes stronger concentration limits.

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The MLR Report repeats the recommendation made in the report titled *Material Loss Review of Constitution Corporate Federal Credit Union (OIG-11-09)* and recognizes that management has already taken or agreed to take action to resolve the concern. Specifically, the Report recommends NCUA determine the best use of available resources to independently assess risk within corporate credit unions and other significant/complex institutions. NCUA agrees and already has an active working group identifying elevated risk posed by large, complex institutions and developing appropriate strategies to supervise those institutions. NCUA remains committed to taking all necessary steps to ensure the continued safety and soundness of all federally-insured credit unions.

Thank you for the opportunity to comment.