

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

**MATERIAL LOSS REVIEW
OF
CONSTITUTION CORPORATE
FEDERAL CREDIT UNION**

**Report #OIG-11-09
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William A. DeSarno

*William A. DeSarno
Inspector General*

Released by:

James W. Hagen

*James W. Hagen
Deputy Inspector General*

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Acronyms and Abbreviations

ALCO	Asset/Liability Committee
ABS	Asset-Backed Securities
CCFCU	Constitution Corporate Federal Credit Union
CLF	Central Liquidity Facility
CMO	Collateralized Mortgage Obligations
Constitution	Constitution Corporate Federal Credit Union
CRIS	Corporate Risk Information System
Crowe	Crowe Horwath LLP
DOR	Document of Resolution
FCU	Federal Credit Union
FICO	Fair Isaac Corporation
GAAP	Generally Accepted Accounting Principles
Guide	NCUA Corporate Examiner's Guide
LSC	League Services Corporation
LUA	Letter of Understanding and Agreement
MLR	Material Loss Review
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NEV	Net Economic Value
NPCU	Natural Person Credit Union
NRSRO	Nationally Recognized Statistical Rating
OCCU	Office of Corporate Credit Unions
OCM	Office of Capital Markets
OEF	Other Examiner Findings
OIG	Office of Inspector General
OTTI	Other-than-temporary Impairment
TCCUSF	Temporary Corporate Credit Union Stabilization Fund
TCCUSGP	Temporary Corporate Credit Union Share Guarantee Program
U.S. Central	U.S. Central Federal Credit Union

Executive Summary

The National Credit Union Administration (NCUA) Office of Inspector General (OIG) contracted with Crowe Horwath LLP (Crowe) to conduct a Material Loss Review (MLR) of Constitution Corporate Federal Credit Union (Constitution), a federally chartered corporate credit union. We reviewed Constitution to: (1) determine why NCUA placed Constitution under federal conservatorship; (2) assess NCUA's supervision of the corporate credit union, and (3) make appropriate recommendations to prevent future losses. To achieve these objectives, we analyzed NCUA examination and supervision reports and related correspondence; interviewed management and staff from the NCUA Office of Corporate Credit Unions (OCCU) and Office of Capital Markets (OCM); reviewed NCUA guides, policies and procedures, and NCUA Call Reports (Corporate 5310 Reports).¹

Our review determined Constitution's management and Board of Directors (Board) contributed to the conservatorship of Constitution and resulting material loss to the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). Specifically, management and the Board's inadequate oversight resulted in Constitution purchasing significant holdings of private-label mortgage-backed securities, many of which were later downgraded to below investment grade, which exposed the credit union to excessive amounts of financial risk. Constitution's management and the Board failed to identify and manage this risk exposure prior to the mortgage-backed securities market dislocation that occurred in mid-2007². Specifically, in regards to managing the investment portfolio, Constitution's management:

- Relied heavily on ratings assigned to the securities by Nationally Recognized Statistical Rating Organizations (NRSRO) when purchasing securities for the portfolio and when monitoring the amount of credit risk in the investment portfolio;
- Did not establish prudent sector concentration limits to reduce the credit risk exposure related to the underlying assets of the mortgage-backed securities;
- Did not properly identify and monitor credit risk exposure in the underlying mortgage loan collateral of the mortgage-backed securities held in the investment portfolio; and

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

² The market dislocation refers to events, which began in 2007 and continued into 2009, when securities collateralized by mortgages, typically considered sub-prime, began to lose value due to high borrower defaults in the underlying mortgages and declines in value of the property securing those mortgages. Because of this market dislocation, mortgage-backed securities, which were initially high rated, were downgraded to reflect the greater risk in the underlying mortgages. The value of the securities declined due to the downgrades and trading in these securities eventually halted in mid-2007. The problems in the subprime mortgage market were largely blamed on loose lending practices, low interest rates, a housing bubble, and excessive risk taking by lenders and investors.

- Failed to recognize the substantial risk they were undertaking with significant investments in complex mortgage-backed securities, with a substantial portion of these securities backed by subprime assets.

Management allowed the investments in mortgage-backed products to represent a significant concentration compared to net worth and they failed to impose reasonable limits on these securities. Management and the Board also did not adequately recognize the credit risk associated with the underlying collateral, much of which was subprime loans, including home equity loans. Underlying collateral weaknesses ultimately led to performance issues and credit rating downgrades which severely depressed the market value of the major portion of Constitution's investment portfolio. Once the investments deteriorated in value, Constitution management had no course of action for divestiture of the securities other than to sell the securities at extreme discounts.

Constitution suffered substantial losses due to other-than-temporary market value impairment on their holdings of mortgage-backed securities in 2008, 2009, and early 2010, which quickly eroded the credit union's net worth and net economic value (NEV)³ and eventually led to conservatorship.

Constitution recorded Other Than Temporary Impairment (OTTI)⁴ charges of \$122 million from 2008 through July 2010. These charges resulted in an undivided earnings deficit. In accordance with Part 704.2 of NCUA's rules and Regulations, Constitution had to deplete its member-contributed capital to offset the undivided earnings deficit. As of July 31, 2010, undivided earnings had a deficit of \$24 million and the capital ratio⁵ declined to -1.88 percent. Net Economic Value (NEV) was negative \$162 million or negative 13.55 percent. Constitution posted a net loss of \$84 million in 2008 and \$100 million in 2009 due to the OTTI charges and the write-off of \$34 million related to its capital investment in U.S. Central.

NCUA Supervision of Constitution

We determined NCUA failed to adequately assess or timely identify key risks related to Constitution's investment portfolio related to the concentration of mortgage-backed securities, until it was too late. We also determined the lack of adequate and timely oversight of Constitution was partially attributable to corporate examiners not having the appropriate regulatory support, such as more specific investment concentration limits, to adequately address Constitution's concentration risk and the exposure to credit, market, and liquidity risks.

³ Net Economic Value measures the economic solvency of a corporate credit union. It is defined as "the fair value of assets minus the fair value of liabilities" (12 C.F.R 704.2).

⁴ OTTI is an accounting requirement under GAAP. The premise for OTTI is that certain price declines are not temporary, but reflect fundamental losses in a security that are considered to impair the security's long-term value.

⁵ The capital ratio includes retained earnings and membership capital accounts.

Examiners commented on Constitution's concentration in mortgage-backed securities, including sub-prime issues, prior to the market dislocation. NCUA examination reports issued in 2006 and 2007 discussed investment portfolio concentrations in mortgage-backed securities and Constitution's increased credit risk exposure to lower rated securities, including sub-prime mortgage-backed securities. Although investment concentrations and increased credit risk exposure were discussed, no significant concerns were noted and no supervisory actions recommended.

As a result of the August 2008 examination, examiners cited serious concerns regarding Constitution's significant concentration in mortgage-backed securities and issued several Documents of Resolution (DORs). These DORs, which were a result of the effects of the significant market-dislocation, addressed concerns related to credit concentration limits that did not adequately reflect market sector risks from direct and indirect investments, inadequate capital planning, inadequate liquidity planning, and inadequate policies and procedures addressing significant deposit concentrations. At this time, a Letter of Understanding and Agreement (LUA) was issued to Constitution which contained several provisions pertaining to policies and strategies to address liquidity, credit concentrations, and capital adequacy concerns.

We believe stronger and timelier supervisory action regarding Constitution's concentration in mortgage-backed securities could have resulted in a reduced loss to the TCCUSF. NCUA regulations did not provide corporates with specific limits for concentrations of credit risk. We believe NCUA examiners should have recognized the risk exposure that Constitution's significant concentration in mortgage-backed securities represented earlier than August 2008. Similar to Constitution's management, NCUA also placed significant reliance on the high ratings assigned by the NRSRO on the purchased mortgage-backed securities, and failed to recognize Constitution's exposure to significant concentration risk due to the lack of diversification in their investments.

Introduction and Background

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

History of Constitution Corporate Federal Credit Union

In October 1967, Constitution received a charter from the state of Connecticut to organize as a credit union under Connecticut General Statutes. Initially the credit union was known as First Connecticut Credit Union from 1967 to 1979 and essentially operated as a natural person credit union (NPCU); i.e., making consumer loans and taking passbook deposits. In October 1979, First Connecticut changed its name to Constitution State Corporate Credit Union, Inc., and transferred the retail consumer business to another credit union.

Prior to 1986, Constitution operated under the management of League Services Corporation (LSC), a management company contracted to provide payroll and management services. In January 1986, Constitution's Board of Directors terminated the LSC contract and designated the position of president to oversee the organization.

Once operational, Constitution used aggregated surplus funds of Connecticut credit unions for investment. Initially, the objective was to provide credit unions with low-cost liquidity from surplus credit union funds recycled to those credit unions experiencing shortfalls in their funding due to a variety of reasons. The aggregating of resources also resulted in investor credit unions receiving market yields on investments made through Constitution. The guiding investment philosophy involved a commitment to a matched investment strategy in which sources of funds (credit union deposits at Constitution) were, for the most part, matched by dollar, rate, and maturity with uses of funds (Constitution's investments). Constitution employed this matched portfolio management strategy for reasons of prudence and safety and incorporated early withdrawal penalties to insure commitments. In late 1980, Constitution began focusing on developing a full range of financial and payment services for member credit unions.

In July 2005, members voted to convert to a federal charter. Effective September 16, 2005, NCUA issued the credit union a federal charter and it became known as Constitution Corporate Federal Credit Union.

Although Constitution had a national field of membership, it primarily delivered support, investment, and correspondent services to natural person credit unions located in Connecticut. As of July 31, 2010, Constitution managed approximately \$1.2 billion in assets for its members.

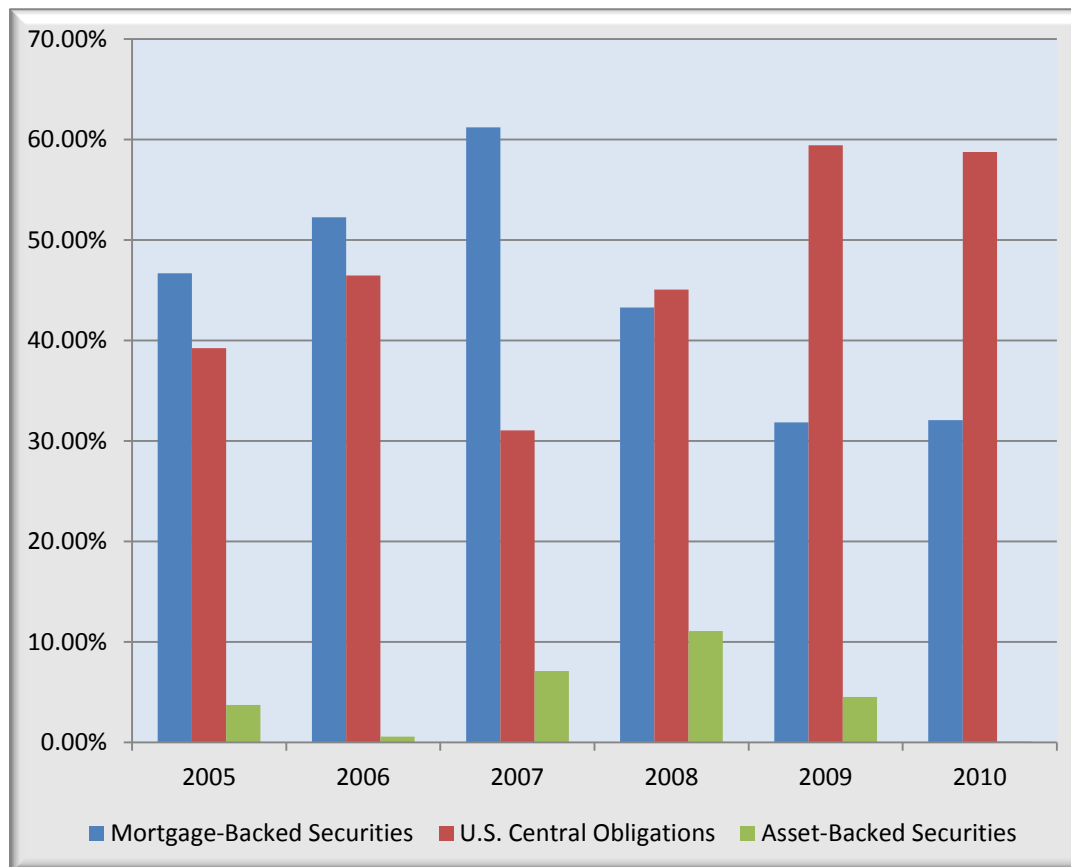
Constitution was a mid-tier corporate credit union within a three-tiered structure of the Nation’s credit union system. The mid-tier corporate credit unions provide liquidity, as well as a range of transactional products and services to the bottom tier, which consists of the NPCUs. The NPCUs invest their excess funds in a corporate credit union. The invested funds are drawn down to meet increasing liquidity demands due to member loan demand and share withdrawals.

NCUA’s Evaluation of Investment Activities

Constitution invested its members’ liquid funds primarily in securities and interest-earning deposits at U. S. Central. The investment portfolio represented, on average, 97 percent of Constitution’s total assets from December 31, 2005, through September 30, 2010.

The composition of Constitution’s investment portfolio was primarily mortgage- and asset-backed securities and deposits at U.S. Central as illustrated in Chart 1 (below).

Chart 1: Constitution’s Investment Portfolio Composition



Source: NCUA 5310 Reports as of December 31, 2005, 2006, 2007, 2008 and 2009; and as of September 30, 2010

Mortgage-backed securities represented a significant concentration in Constitution's investment portfolio. Mortgage-backed securities were approximately 47 percent of total investments as of December 31, 2005, and increased to a high of 61 percent as of December 31, 2007. Mortgage-backed securities declined to approximately 32 percent of total investments in 2009 and 2010 due to the continued devaluation of mortgage-backed securities held in the portfolio, reinvestment of securities' proceeds as they matured into other products, and greater retention of cash to meet members' liquidity needs.

Constitution also invested a significant amount of funds with U.S. Central for purposes of meeting the short-term liquidity needs of their members. Deposits at U.S. Central ranged from a low of 31 percent of the investment portfolio as of December 31, 2007 to a high of 59 percent as of December 31, 2009.

Beginning mid-2007, the mortgage-backed securities market experienced a significant dislocation, which resulted in severe declines in the market value of these types of structured securities. Trading of mortgage-backed securities was substantially restricted later that year due to investors' uncertainty regarding the quality and value of the underlying loans. Due to the market deterioration, Constitution's investments in mortgage-backed securities experienced significant declines in credit ratings and market value.

As of December 31, 2007, Constitution reported net unrealized losses on securities of \$59 million, compared with the prior year in which a small unrealized loss was recorded. Constitution's management determined the unrealized losses were temporary at that time. As stated in the December 31, 2007, audited financial statements:

“Due to the underlying credit support of these securities and Constitution's available sources of liquidity, management concluded that none of the unrealized losses on these securities represent other-than-temporary impairment as of December 31, 2007.”

As of July 31, 2010, Constitution held marketable securities with a book value of \$1.2 billion. Of this \$1.2 billion, \$238 million was comprised of private label mortgage-backed securities, \$21 million was comprised of commercial mortgage-backed securities, and \$93 million was comprised of asset-backed securities. The Office of Corporate Credit Unions (OCCU) determined that at this time at least \$352 million or approximately 30 percent of the investment portfolio was illiquid in the current markets.

Constitution recorded OTTI charges of \$122 million from 2008 through July 2010. These charges resulted in a net deficit to undivided earnings in July 2010. Constitution had to deplete its member-contributed capital in an attempt to eliminate the undivided earnings deficit. As of July 31, 2010, undivided earnings had a deficit of \$24 million and the capital ratio declined to -1.88 percent. NEV was negative

\$162 million or negative 13.55 percent. Constitution posted a net loss of \$84 million in 2008 and \$100 million in 2009 due primarily to the OTTI charges and the write-off of \$34 million related to U.S. Central Membership Capital.

Due to the illiquidity of the mortgage and asset backed securities markets, it was difficult for Constitution to sell these securities or use them as collateral for borrowings, which therefore limited sources for Constitution and its members' liquidity needs. This impeded management's ability to reposition the balance sheet through sales of securities without incurring irrecoverable losses.

Constitution's liquidity concerns were compounded by a deposit concentration of a member credit union, which represented 55.7 percent of Constitution's total shares and certificates as of July 31, 2010. The vast majority of these deposits were term deposits maturing within a two year window; however, early withdrawal by the member credit union could have created a liquidity crisis for Constitution.

Constitution experienced further restrictions in its liquidity sources as U.S. Central also realized losses resulting from the declining value of their own mortgage-backed securities portfolio and could not meet the liquidity demands of its retail corporate credit union members.

In October 2008, NCUA implemented the Corporate Stabilization Plan, which included several liquidity programs designed to provide funding to the corporate credit unions through the Central Liquidity Fund. The Temporary Corporate Credit Union Liquidity Guarantee Program stabilized Constitution's remaining unsecured borrowing sources. NCUA stabilization efforts continued with the Temporary Corporate Credit Union Share Guarantee Program (TCCUSGP), which constructively increased deposit insurance on all member share accounts beyond the statutory minimum. This program provided some assurance to members, in particular the member credit union who as previously mentioned, represented a large deposit concentration at Constitution.

On September 24, 2010, the NCUA Board placed Constitution into conservatorship and appointed itself Conservator. On November 30, 2010, NCUA placed Constitution into liquidation and through a purchase and assumption agreement transferred certain assets, liabilities and shares to Members United Bridge Corporate Federal Credit Union.⁶

⁶ On September 28, 2010 the NCUA Board chartered Members United Bridge Corporate Federal Credit Union and immediately placed it into conservatorship.

Objectives, Scope and Methodology

We performed this material loss review to satisfy the requirements of the FCU Act, which requires the NCUA OIG to conduct a material loss review of an insured credit union if the loss to the NCUSIF⁷ exceeds \$25 million.⁸ NCUA confirmed that as of July 2011, the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) had recorded a loss of \$145 million for Constitution. Consequently, in accordance with the FCU Act and Chapter 3 of the NCUA Special Assistance Manual, NCUA OIG contracted with Crowe to conduct a material loss review of Constitution.

Our audit objectives were to: (1) determine the cause(s) of Constitution's conservatorship, (2) assess NCUA's supervision of the corporate credit union, and (3) make appropriate recommendations to prevent future losses.

We conducted this review from January 2011 to August 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 as described in the Scope and Methodology section, provides a reasonable basis for our findings and conclusions based on our audit objectives.

The scope of this review included an analysis of Constitution from November 30, 2004, to September 24, 2010, the date the NCUA placed the credit union in conservatorship. Our review also included an assessment of NCUA regulatory supervision of the institution during the same period. In determining why NCUA placed Constitution in conservatorship, we did not analyze any potential impact from the actions of third-party providers. This included, but was not limited to underwriters, issuers, or NRSROs that may have impacted the losses sustained by Constitution or the TCCUSF.

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

⁷ 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 (TCCUSF). The TCCUSF 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 corporate credit unions. The payment of the insured amounts in a liquidating corporate credit union is primarily a liability of the NCUSIF. However, the TCCUSF legislation allows the NCUA Board to use the TCCUSF to make the payment.

⁸ The FCU Act, 12 U.S.C. § 1790d, §216(j) requires that the OIG conduct a review when the NCUSIF has incurred a material loss with respect to a credit union. A material loss is defined as (1) exceeding the sum of \$25 million and (2) an amount equal to 10 percent of the total assets of the credit union at the time at which the Board initiated assistance or was appointed liquidating agent.

- We analyzed NCUA examination and supervision contact reports and related correspondence and workpapers contained within the examination databases.
- We interviewed management and/or staff from NCUA's OCCU and Office of Capital Markets (OCM) and reviewed NCUA guides, policies and procedures, as well as NCUA Call Reports (Corporate 5310 Reports).
- We reviewed Constitution data and correspondence maintained at the NCUA in Alexandria, VA as provided to Crowe by NCUA.

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

Results in Detail

We determined that Constitution's management and Board of Directors (Board) contributed to the conservatorship and liquidation as well as the resulting material loss. Further, we determined that the NCUA⁹ could have reduced the loss to the TCCUSF had they more aggressively pursued resolution to issues related to Constitution's high credit risk and concentration in its investment portfolio.

A. Why NCUA Conserved Constitution Corporate Federal Credit Union

Inadequate Management and Board Oversight

We determined NCUA conserved Constitution, in part, because of inadequate management and Board oversight that exposed the credit union to excessive amounts of financial risk due to significant holdings of private label mortgage-backed securities including subprime and Alt-A mortgage-backed securities. Constitution's management and Board failed to identify and manage this risk prior to the severe market value decline that occurred starting in mid-2007 and became more severe in 2008 and 2009. Specifically, in regards to managing the investment portfolio, Constitution management:

- Relied heavily on ratings assigned to the securities by Nationally Recognized Statistical Rating Organizations (NRSRO) when purchasing securities for the portfolio and when monitoring the amount of credit risk in the investment portfolio;
- Did not establish prudent sector concentration limits to reduce the credit risk exposure related to the underlying assets of the mortgage-backed securities;
- Did not properly identify and monitor credit risk exposure in the underlying mortgage loan collateral of the mortgage-backed securities held in the investment portfolio; and
- Failed to recognize the substantial risk they were undertaking with significant investments in complex mortgage-backed securities, with a substantial portion of these securities backed by subprime assets.

These factors led to increased exposure to higher risk investments largely secured by subprime mortgage loan collateral, including exposure at U. S. Central due to its

⁹ Primary supervisory responsibility of corporate credit unions lies with OCCU. In addition, OCM develops agency policies and procedures related to credit union investments and asset liability management. OCM also assists OCCU examiners in evaluating investment and asset liability management issues in credit unions. We reviewed OCM's role in the examination of Constitution during the November 2004 through June 2009 examinations and determined that prior to the June 2009 examination, OCM's assistance was not used. During the June 2009 examination, an OCM specialist was used for reviewing Asset/Liability Management and Liquidity. The June 2009 examination marked the first involvement of OCM staff in reviews and these specialists were not used to evaluate the investment portfolio.

significant concentration of mortgage-backed securities. The concentration in mortgage-backed securities left Constitution vulnerable to downturns in national and local economic conditions and the decline in the residential real estate market. Constitution's Board and management failed to adequately diversify the investment portfolio and secure other sources of liquidity outside of the credit union structure. The consequences of Constitution's management and Board's inadequate oversight were:

- Substantial unrealized losses recorded to capital related to the deterioration of the market value of mortgage-backed securities held in Constitution's investment portfolio. As of December 31, 2008, Constitution management recognized substantial OTTI losses related to further deterioration of the credit quality of the mortgage-backed securities.
- Market value declines and ratings downgrades severely limited Constitution's ability to sell mortgage-backed securities in the marketplace, hampering liquidity sources necessary to meet member credit union needs. Constitution's ability to obtain funding sources on reasonable terms and costs became difficult due to the declining value of the securities portfolio which restricted them from having securities available to pledge against borrowings, leading to an unsatisfactory liquidity position.
- Due to Constitution's weakened financial condition, the increased cost related to the issuance of commercial paper in the marketplace was no longer a viable option, impeding efforts to issue debt to fund liquidity.
- Economic insolvency as Constitution's NEV deteriorated due to the market value declines in the investment portfolio.
- Constitution was placed into conservatorship on September 24, 2010. On November 30, 2010, Constitution was liquidated and certain assets and liabilities were purchased and assumed by Members United Bridge Corporate Federal Credit Union.

Table 1 (below) summarizes selected financial information for Constitution.

Table 1

	Key Financial Data and Ratios (\$000's)				
	12/31/06	12/31/07	12/31/08	12/31/09	07/31/10
Total Assets	1,763,399	1,678,357	1,311,827	1,291,542	1,219,575
Deposits With Other Financial Institutions	793,765	504,137	576,561	795,367	802,065
Investments (amortized cost)	900,351	1,164,500	979,616	640,687	382,964
Accumulated Unrealized Gains (Losses) from Available for Sales Securities	(504)	(59,474)	(284,553)	(184,195)	(137,758)
Members' Share Accounts	1,668,286	1,569,580	1,502,677	1,494,350	1,345,795
Short-term Borrowings	35,895	103,474	114,999	-	-
Total Member's Equity (Deficit)	47,692	(7,657)	(317,021)	(209,297)	(161,695)
Net Economic Value	116,803	54,028	(230,021)	(217,506)	(161,695)
Regulatory Capital Ratio	7.10%	6.46%	2.07%	(1.81)	(1.88)
Retained Earnings Ratio	3.0%	2.85%	(2.01%)	(1.81)	(1.88)
Net Income (loss)	2,476	3,621	(84,285)	(100,082)	1,165

Source: Audited financial statements and July 31, 2010 NCUA 5310 report

Constitution's Investment Strategy

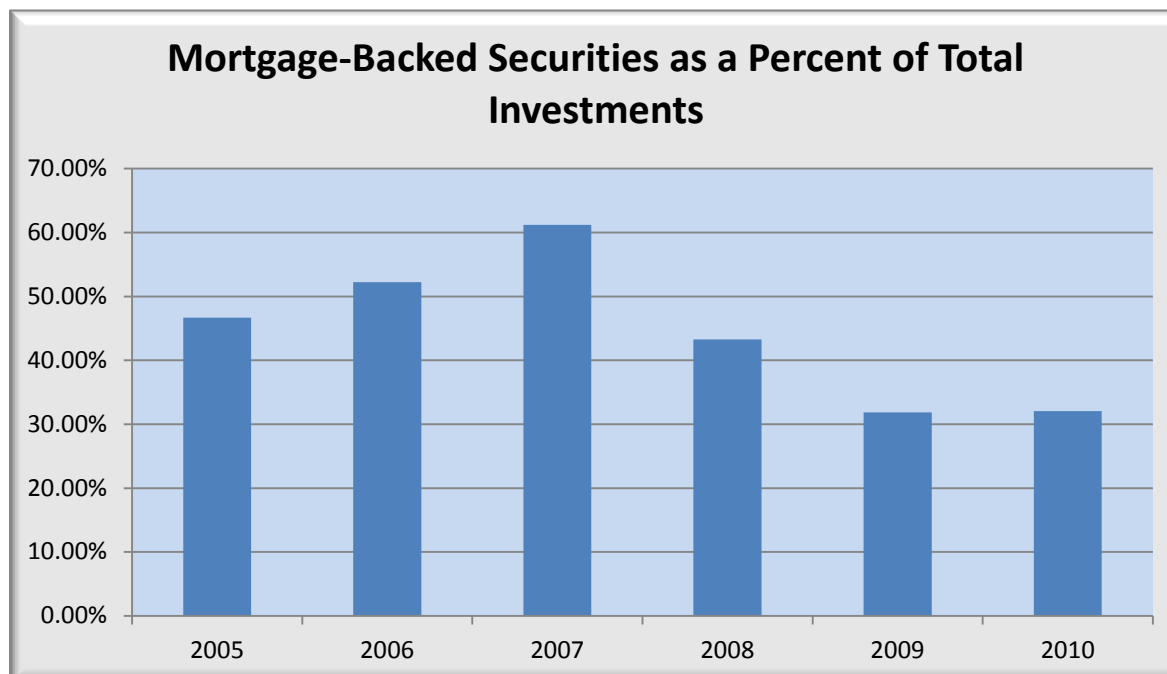
The majority of the investment portfolio consisted of asset-backed securities and privately issued mortgage-backed issues along with smaller amounts of government agency mortgage-backed securities, commercial mortgage-backed securities, and commercial debt obligations.

Mortgage-Backed Securities

During the period from 2005 through September 2010, mortgage-backed securities represented a significant concentration within Constitution's investment portfolio. Mortgage-backed securities represented 47 to 52 percent of the investment portfolio as of December 31, 2005, and 2006, respectively. In 2007, mortgage-

backed securities represented a larger percentage of the portfolio, increasing to 61 percent of the total portfolio. In 2008 through 2010, mortgage-backed securities declined to a low of 32 percent of the investment portfolio due to the devaluation of the securities and reinvestment of maturities and repayments into cash and deposits at U.S. Central. Chart 2 (below) provides mortgage-backed securities as a percentage of total investments.

Chart 2:



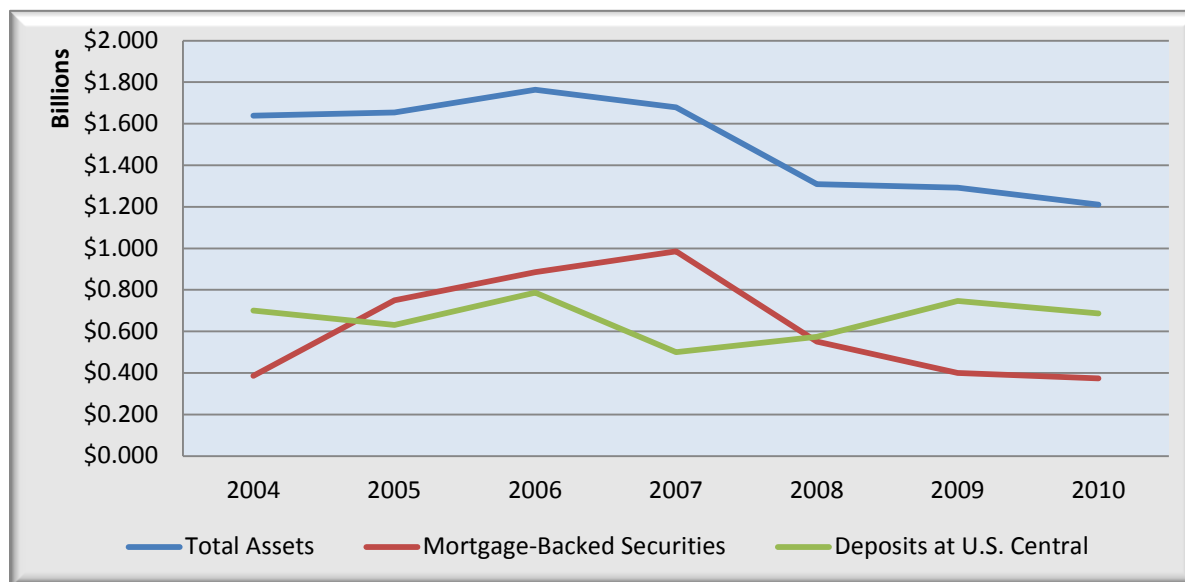
Source: NCUA 5310 Report as of December 31st and September 30, 2010

In 2004, Constitution applied for and received conditional approval for Part I Expanded Authority.¹⁰ On May 16, 2005, Constitution was granted Part I Expanded Authority allowing them to migrate further down the investment credit curve in an effort to enhance yields and remain competitive with other corporates in providing attractive rates for member deposits.

¹⁰ Part I Expanded Authority allows a corporate credit union maintaining a minimum capital ratio of at least six percent, to: (1) purchase investments with long-term ratings no lower than A- (or equivalent); (2) purchase investments with short-term ratings no lower than A-2 (or equivalent), provided the issuer has a long-term rating no lower than A- (or equivalent), or the investment is a domestically-issued asset-backed security; (3) engage in short sales of permissible investments to reduce interest rate risk; (4) purchase principal only (PO) stripped mortgage-backed securities to reduce interest rate risk; and (5) enter into a dollar roll transaction. Corporate credit unions under Part I Expanded Authority must perform rate stress tests. Under these stress tests, their NEV may decline as much as: (1) 20 percent if the corporate credit union has a six percent minimum capital ratio; (2) 28 percent if the corporate credit union has a seven percent minimum capital ratio and is specifically approved by NCUA; or (3) 35 percent if the corporate credit union has an eight percent minimum capital ratio and is specifically approved by NCUA.

Constitution management began to add lower rated securities (AA and A-) to the portfolio which were primarily private label residential mortgage-backed securities and second lien home equity mortgage-backed securities. Chart 3 (below) illustrates the increase in mortgage-backed securities in the investment portfolio in relation to changes in total assets and deposits at U.S. Central. According to the March 31, 2007, Examination Report, the exposure related to mortgage-backed securities peaked at slightly over \$1 billion or 50 percent of total assets.

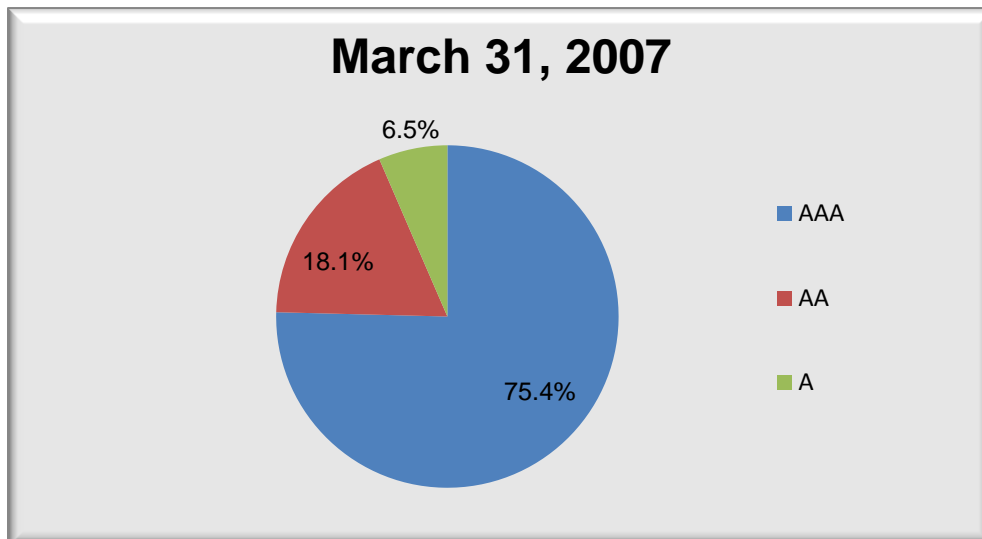
Chart 3: Mortgage-Backed Securities Growth



Source: NCUA 5310 Report as of December 31st and September 30, 2010

Prior to 2007, Constitution's investment securities portfolio showed evidence of a shift from AAA rated securities to higher-yielding, AA and A-rated securities, as mortgage-backed securities were added to the investment portfolio. The March 31, 2007, Examination Report indicated that Constitution's investment portfolio consisted of 75.4 percent AAA rated securities, 18.1 percent AA rated securities, and 6.5 percent A rated securities, as illustrated in Chart 4 (below), compared with 89.5 percent AAA rated securities, 10.4 percent AA rated securities, and 8.0 percent A rated securities as of November 30, 2004.

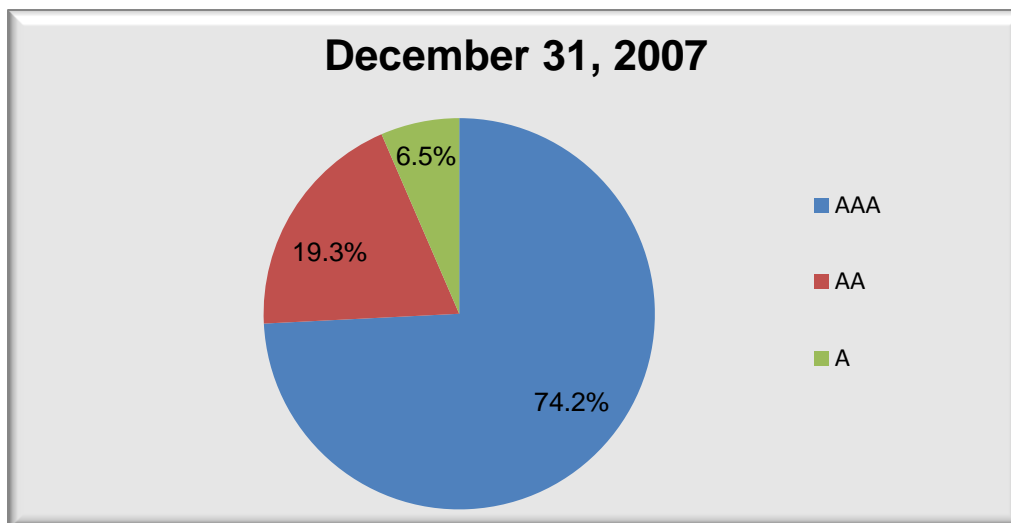
Chart 4: Investment Portfolio Mix by Rating as of March 31, 2007



Source: Audited Financial Statements

Due to the market dislocation, Constitution's securities, primarily mortgage-backed, began to show signs of deterioration in market value; though the ratings remained consistent with their March 2007 designations. As of December 31, 2007, investments carrying a rating of AAA declined to 74 percent while AA and A rated investments increased to 19.3 and 6.5 percent of the portfolio, respectively, as illustrated in Chart 5 (below).

Chart 5: Investment Portfolio Mix by Rating as of December 31, 2007



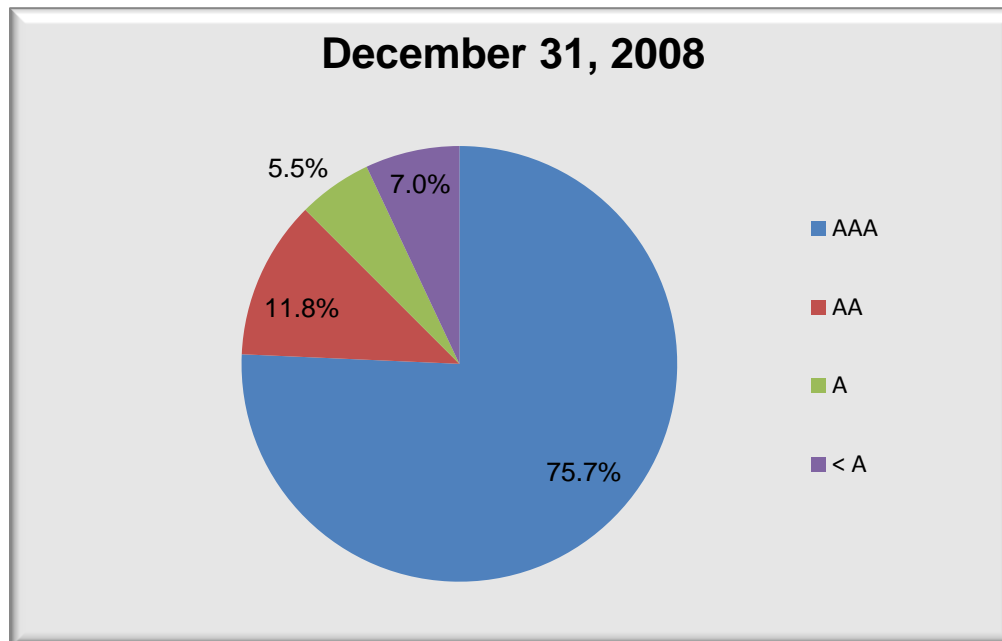
Source: Audited Financial Statements

As of December 31, 2007, Constitution reported net unrealized losses on securities of \$59 million, compared with the prior year in which a small unrealized loss was recorded. Constitution’s management determined that these losses were temporary at that time. Per the December 31, 2007, audited financial statements:

“...it was determined that sufficient credit support currently exists to ensure continued payment of principal and interest. In addition, Constitution has the intent and ability to hold these securities until prices recover or principal is repaid. Constitution believes the decline in market value of these investments is due to the combination of unique market conditions including: (1) the general credit spread widening caused by market concern over the credit quality of residential mortgage-backed securities and (2) an imbalance between market supply and demand for these securities. Due to the underlying credit support of these securities and Constitution’s available sources of liquidity, management concluded that none of the unrealized losses on these securities represent other-than-temporary impairment as of December 31, 2007.”

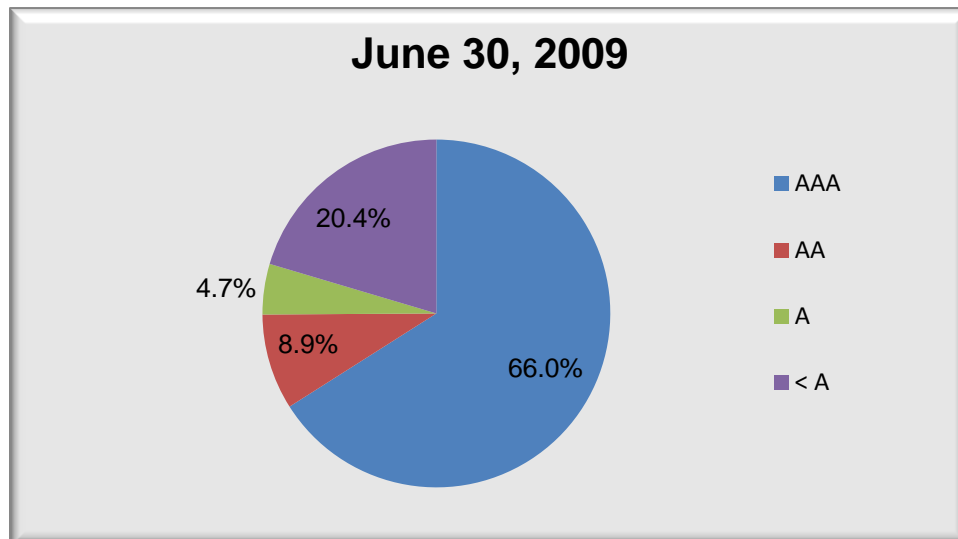
As of December 31, 2008, and June 30, 2009, Constitution experienced further downgrades to its credit ratings with 7 percent of the securities held in the investment portfolio dropping below a rating of A. Investments rated below A increased to 20 percent of the portfolio as of June 30, 2009, as illustrated in Charts 6 and 7 (below).

Chart 6: Investment Portfolio Mix by Rating as of December 31, 2008



Source: Audited Financial Statements

Chart 7: Investment Portfolio Mix by Rating as of June 30, 2009



Source: NCUA Examination Report as of June 30, 2009

Table 2 (below) illustrates the composition of Constitution’s private label mortgage-backed securities as of December 31, 2007, 2008, and 2009.

Table 2:

Composition of Private Label Mortgage-Backed Securities			
(in \$000's)	December 31, 2007	December 31, 2008	December 31, 2009
Private label, mortgage-backed securities	\$870,497	\$476,098	\$344,884
Prime (FICO >719)	55%	59%	54%
Near-prime (FICO 620 – 719)	24%	21%	23%
Sub-prime (FICO <620)	21%	20%	23%

Source: Audited Financial Statements

The composition of the private label mortgage-backed securities remained fairly consistent after December 31, 2007. In the audited financial statements, auditors described the quality of the mortgage-backed securities as follows:

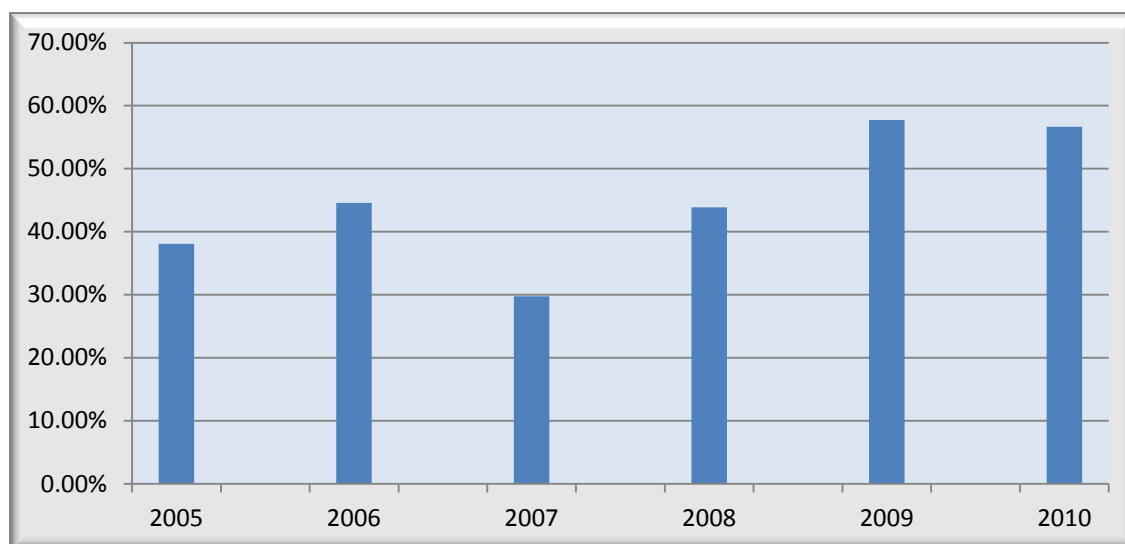
“Residential mortgage-backed security structures are comprised of many classes of securities, with various levels of subordinated classes being first to absorb losses experienced on the underlying mortgage loan collateral and thus providing credit enhancement to the senior classes. Constitution’s residential mortgage-backed securities are generally classes which are

senior to the subordinate classes. A small amount of Constitution’s securities have insurance coverage to further support the senior classes in the event of deteriorating collateral performance.”

Deposits at U.S. Central

Constitution had a significant amount of funds invested at U.S. Central. Chart 8 (below) indicates the percentage of total assets represented by funds deposited at U.S. Central.

Chart 8: Deposits at U.S. Central as a Percent of Total Assets



Source: NCUA 5310 Report as of December 31st and September 30, 2010

Because U.S. Central had a significant amount of funds invested in mortgage-backed securities, Constitution’s investments held at U.S. Central represented indirect credit exposure related to investments in mortgage-backed securities. Constitution, when determining concentration limits in mortgage-backed securities, did not consider this indirect exposure. Due to the securities losses experienced by U.S. Central which depleted their capital, Constitution recorded losses from capital investments at U.S. Central which, as of July 2011, totaled approximately \$34 million.

Although, investments at U.S. Central added to the overall mortgage-backed securities exposure at Constitution, the Share Guarantee put in place by the NCUA mitigated the impact of this exposure. The Share Guarantee extended the existing Insurance Fund coverage for corporate credit unions’ member share accounts beyond the \$250,000 statutory limit to cover the entire balance of each such account.

Diminished Liquidity

To meet its short-term liquidity needs, Constitution relied primarily on funds invested and borrowed from U.S. Central. From December 31, 2005, through September 30, 2009, funds invested at U.S. Central ranged from approximately 30 to 60 percent of total assets.

In 2007, U.S. Central increased Constitution's line of credit to \$450 million. Access to the line of credit was not guaranteed by U.S. Central. This line of credit with U.S. Central was increased in 2008 and 2009 to \$500 and \$650 million, respectively.

In July 2002, Constitution management authorized the issuance of up to \$130 million in commercial paper. Constitution issued commercial paper periodically over the years to meet short-term liquidity needs. As of August 31, 2009, Constitution discontinued its commercial paper program after determining the commercial paper market was no longer a viable source of funding as cost of issuance increased due to Constitution's weakened financial condition.

As of December 31, 2008, Constitution maintained reverse repurchase agreement lines with various brokers totaling \$950 million as an additional source of liquidity. These reverse repurchase agreement lines required pledging investment securities as collateral against the amount borrowed. Collateral available for pledging against these lines deteriorated not only with the declines in the market values of Constitution's securities, but also with the further discounting of the collateral value applied by the lender. The value of the securities available to pledge as collateral against borrowings was approximately \$200 million as of December 31, 2008.

Constitution was also an agent member of the Central Liquidity Facility (CLF), which is a mixed-ownership government corporation established as an additional liquidity facility for credit unions in the United States. As an agent member of the facility, Constitution could request the facility to assist them in obtaining funds to meet the liquidity needs of its members.

As U.S. Central began to experience liquidity constraints due to losses resulting from the declining value of their own mortgage-backed securities portfolio, Constitution looked for additional sources of liquidity. During 2008, Constitution established Fed Funds lines with several financial institutions including Wachovia Bank (\$15 million), Bank of America (\$30 million), and Pacific Coast Bankers' Bank (\$67 million). Wachovia suspended their line as of April 14, 2009. Bank of America did not guarantee the availability of their line, which they could reduce without notice, and the Pacific Coast Bankers' Bank line increased to \$100 million in February 2009 and was reliant on the NCUA Guarantee of unsecured debt.

In December 2008, in an effort to expand its sources of available liquidity, Constitution obtained access to the Federal Reserve Bank of Boston discount window. Constitution intended to access the discount window only as a last resort

after all other sources of available credit were utilized. The Federal Reserve Bank of Boston notified Constitution in September 2009 that access to the discount window was inconsistent with its financial condition and that access would only be granted after consultation with the NCUA. In 2009, Constitution did obtain a \$350 million secondary line of credit with the Federal Reserve Bank that would be used only as a last resort.

Liquidity concerns were compounded by a deposit concentration. One member credit union consistently represented over 50 percent of Constitution's total shares and certificates between 2008 and into 2010. Although the relationship between Constitution and this member credit union was strong and the level of their deposits appeared consistent, Constitution would not have been able to fund a significant and immediate withdrawal by this member without realizing losses that would prevent Constitution from being able to meet the normal liquidity needs of the remaining membership.

Given the unique situation of this single large depositor, we determined Constitution management and examiners continuously monitored the deposit concentration. The market dislocation and increased liquidity demands made the deposit concentration a greater risk. However, we found in the March 2007 examination report (effective March 31, 2007) that examiners had noted the following:

“... a worst case scenario has been added where 100 percent of the term liabilities of the two largest depositors and 75 percent of overnight liabilities are withdrawn. This worst-case scenario shows the corporate still having an excess of \$303 million in borrowing capacity. However, there would be a significant impact on earnings if this event occurs. CCFCU has sufficient options available to meet projected liquidity needs. Staff also prepares daily and monthly cash flow analysis and projections documenting adequate sources of funds exist.”

It was not until the August 31, 2008, report of examination that examiners noted Constitution could not fully fund a significant immediate withdrawal by the member credit union with the deposit concentration without realizing losses that would render the corporate unable to meet even normal liquidity needs of the remaining membership.

Through interviews with examiners and review of examination reports, we learned the CEO of the member credit union with the deposit concentration was on the Board of Constitution and that he provided assurances to both Constitution management and NCUA examiners that the credit union would not withdraw deposits from Constitution.

As previously noted, in October 2008, NCUA implemented the Corporate Stabilization Plan¹¹, which included several liquidity programs designed to provide funding to the corporate credit unions. The Corporation Stabilization Program included the following efforts by the NCUA:

- Established a Temporary Corporate Credit Union Liquidity Guarantee Program by which the Insurance Fund guaranteed repayments of unsecured debt issued between October 16, 2008 and June 30, 2009, which was later extended to debt issued prior to June 30, 2010.
- Established a Temporary Corporate Credit Union Share Guarantee Program to build member confidence in the credit union system. The Share Guarantee extended the existing Insurance Fund coverage for corporate credit union's member share accounts beyond the \$250,000 statutory limit to cover the entire balance of each such account.

The Temporary Corporate Credit Union Liquidity Guarantee Program stabilized Constitution's remaining unsecured borrowing sources. The Temporary Corporate Credit Union Share Guarantee Program provided assurance to members, in particular the member credit union, which held a large deposit concentration at Constitution.

Management and Board Oversight of Constitution's Investment Strategy

We determined Constitution's management and Board did not practice sound risk management principles. Specifically, based on our review of Constitution's policies, Asset/Liability Committee (ALCO) reports and meeting minutes, and discussions with examiners, we believe management focused primarily on obtaining yield in order to compete with larger corporate credit unions. As a result, Constitution's management permitted significant holdings of mortgage-backed securities without fully understanding the credit risks associated with such complex investments and the related risk this concentration posed on the ability of Constitution to serve its primary purpose of being a liquidity source for its members.

We also determined Constitution's investment portfolio had a significant level of credit risk associated with the large concentration of mortgage-backed securities and was not adequately identified and managed by its management and Board. In addition, management was slow to react to the market dislocation to ensure the credit union had sufficient liquidity.

Constitution's ALCO minutes indicated management focused on yields to allow them to service natural person credit unions. Constitution's August 2006 ALCO minutes reflected management's focus as follows:

¹¹ The NCUA's Corporate Stabilization Program, approved in January 2009, consisted of a series of actions designed to add stability to and strengthen corporate credit unions. The purpose of these actions was to maintain liquidity, strengthen capital, and restructure the corporate system.

“Mr. _____ presented the Rate Comparison, as well as the one-month and three-month averages as of 8/17/06... Discussion followed regarding Constitution’s rates as compared to the competition, EasCorp & Members United. Mr. _____ stated that we are trying to be as competitive as possible...”

Additionally, our review of Constitution’s 2006 Board-approved Strategic Plan noted the following:

“Constitution Corporate management remains committed to the premise that members receive the optimal return for their investment dollars placed with the corporate. The pursuit and attainment of additional expanded investment authorities is considered intertwined with the interest of its membership. From an investment perspective, the ability to serve the membership remains firmly grounded in the level of competitiveness of its investment offerings. The degree of rate competitiveness is directly related to levels of investment authority. Additional authorities will enable Constitution to provide competitive investment product without compromising the organization’s net interest margin. Without these authorities, margin compression and sub-optimal return on asset performance will result. As the competition for member deposits intensifies and the corporate landscape changes, growth of average net asset balances will reflect the degree of rate competitiveness associated with Constitution’s investment offerings. Our membership is currently being actively solicited by various corporate credit unions both within and outside of the New England marketplace. Commoditization of investment products mandates the rate competitiveness as a prerequisite competitive weapon...”

The 2007 Strategic Plan noted the following as well:

“...Constitution should be able to compete more successfully within the national marketplace against the ‘tier one’ corporates (WesCorp, Southwest/Southeast, Members United).”

Constitution’s management did not establish prudent sector concentration limits to limit exposure to the underlying assets related to mortgage-backed securities; rather management and the Board modified the Credit Risk Management policy to allow further concentrations of mortgage-backed securities. Our review of the February 1, 2007, ALCO meeting minutes noted the committee approved changes to policy sector limits as follows:

- Concentration limits on private label mortgage-backed securities and Collateralized Mortgage Obligations (CMO) increased from 35 percent to 60 percent of total net assets.

- Limits on home equity asset-backed securities increased from 25 percent to 40 percent of total net assets.
- Agency CMO limits increased from 40 percent to 75 percent of total net assets.

The above changes were approved by six (6) Directors, with two (2) Directors voting in opposition of the changes.

The August 31, 2008, report of examination noted the following:

“Credit concentration limits do not adequately reflect market sector risks from direct and indirect investments... Current overly-generous investment limits increase the potential of loss during systemic events. Also, the application of the existing limits allowed management to concentrate purchases in mezzanine tranches representing greater credit risk.”

Examiners instructed management to revise and implement concentration limits to ensure prudent investment portfolio diversification and appropriately minimize correlation risk.

Effective June 4, 2008, Constitution’s chief investment officer elected to resign. This resignation left the primary and secondary investment positions vacant as the director of investments had left the credit union several months earlier. Constitution management did proactively suspend its use of Part I expanded authority during the search for replacements for both vacant positions.

The high concentration of mortgage-backed securities impacted Constitution’s liquidity and management did not proactively seek to secure liquidity sources as the market dislocation continued. The liquidity issues at Constitution were compounded by a deposit concentration that represented over 50 percent of Constitution’s total shares and certificates between 2008 and into 2010. During our review of the 2008 report of examination, we noted the following significant issues with liquidity:

“Management has been slow to react to the current market dislocation in garnering and ensuring sufficient liquidity. While current liquidity sources and experience demonstrate the ability to serve membership, the corporate’s ability to manage a significant liquidity demand beyond normal levels is highly questionable. With significant liquidity issues experienced at financial institutions such as Lehman Brothers, Washington Mutual Savings, and Merrill Lynch, the corporate needs to become more proactive and aggressive in ensuring available liquidity beyond normal levels. Although management has explored other sources of liquidity, in the two months since the end of original field work, the corporate has secured only one new liquidity source. High unrealized mark-to-market investment losses, due primarily to

overconcentration in investment mezzanine tranches collateralized by subprime mortgage debt, have deteriorated the corporate's ability to provide adequate liquidity to membership under all but normal liquidity conditions. This results in a capital level that, while continuing to meet regulatory capital requirements, is insufficient to survive a significant liquidity event and is not adequate in relation to the excessive investment portfolio concentration risk."

Additionally, examiners issued two DORs regarding liquidity issues, as follows:

"1) Liquidity Management - Corporate liquidity exhibits the following weaknesses: (A) Contingency testing does not adequately determine market acceptance of credit-impaired securities; (B) Liquidity sources are not adequately diverse or guaranteed; and (C) The liquidity plan overstates the corporate's true borrowing capacity.

2) Liquidity Concentration - Liquidity policies and procedures do not provide sufficient guidance for significant deposit concentrations. Specifically lacking are: (A) Procedures to provide sufficient liquidity in case a large depositor withdraws significant funds; and (B) Procedures ensuring appropriate communications with significant depositors."

The 2009 Report of Examination showed further evidence that management was slow to respond or react to liquidity needs, as follows:

"Only after significant demands by NCUA following the last examination did management intensify its efforts to garner additional sources of external liquidity. ...CCFCU's Available Lines Report shows \$2.225 billion in total approved lines outstanding. The availability column in the same report, when calculated by the examiner indicated the amount currently available based on testing and internal assessments of \$1.58 billion, instead of the \$2.225 billion reported by management. The difference of \$650 million is due to a calculation error in the total amount of the Available Lines Report. This liquidity availability report needs to more clearly portray the actual status of the external sources of liquidity."

Additionally, although not specifically noted in a report of examination, the Chief Executive Officer of Constitution was also on the Board at U.S. Central. Although this was in line with how corporate credit unions and the Boards were structured, there are governance issues and inherent conflicts of interest with this practice, as evidenced by Constitution's investments in U.S. Central, discussed above.

B. NCUA Supervision of Constitution Corporate Federal Credit Union

Examiners Could Have Mitigated the Loss to the TCCUSF

We determined a contributing factor in the conservatorship of Constitution was NCUA's failure to adequately assess or timely identify key risks related to Constitution's investment portfolio related to the concentration of mortgage-backed securities, until it was too late. We also determined the lack of adequate and timely oversight of Constitution was partially attributable to corporate examiners not having the appropriate regulatory support, such as more specific investment concentration limits, to adequately address Constitution's concentration risk and the exposure to credit, market, and liquidity risks. As a result, examiners missed opportunities to reduce the loss to the TCCUSF.

Supervisory Background

Constitution received Corporate Risk Information System (CRIS)¹² Composite Risk Ratings of 2 for both Composite Financial Risk and Composite Risk Management during the 2004, 2006, and 2007 annual examinations. The examination reports noted improved capital and earnings but noted that Constitution needed to continue to build and maintain strong capital to offset the additional risks of Expanded Authorities and strategic plans. Credit risk was increasing with the migration from AAA rated securities to AA and A-rated securities; however, examiners determined Constitution management had a handle on this increasing risk through close monitoring and comprehensive analysis and reporting procedures.

Prior to 2008, examiners also noted share concentration risk was present but indicated that the risk was mitigated with the large volume of term shares and continued monitoring of liquidity risk including worst-case scenarios related to a 100 percent withdrawal of the two largest depositors' term balances. Examiners noted Constitution had comprehensive strategic planning, capital planning, and budgeting processes in place. Examiners also noted management closely monitored, managed, and adequately reported on interest rate, credit, and liquidity/concentration risks for Board review and analysis.

During the November 30, 2004, examination, examiners verbally communicated to management the following related to investment concentrations:

¹² The Corporate Risk Information System (CRIS) is used to measure and report risk in the corporate credit union system. As such, CRIS separates the assessment and communication of quantitative financial risk from qualitative operational and managerial risks and assign individual Financial Risk and Risk Management Composite and Component ratings. The Composite Financial Risk rating and its components represent the degree of risk to Capital and Earnings. The ratings are defined as follows: 1 – Low Risk; 2 – Moderate (Managed) Risk; 3 - High Risk; 4 – Excessive Risk; and 5 – Critical Risk. The Composite Risk Management rating and its components represent the Quality of Policy or Risk Management Process. The ratings are defined as follows: 1 – Exceptional; 2 – Acceptable; 3 – Minimally Acceptable; 4 – Inadequate; and 5 – Seriously Deficient.

“The credit matrix and accompanying footnotes do not adequately address regulatory requirements regarding reasonable and supportable concentration limits for limited liquidity investments.”

“The credit policy does not address ‘concentrations of credit risk’ by industry type and sector type.”

Although investment concentration limits had not been established by Constitution’s management, as of the March 31, 2006, subsequent examination, examiners did not note these repeat findings in the examination report or communicate them verbally to management.

As a result of the 2007 examination, two Documents of Resolution (DORs) were issued regarding management’s digression from established agreed-upon procedures relating to investment pre-purchase credit analysis required for granting Part I Expanded Authorities. Examiners cited insufficient management oversight as the cause for this digression away from the established procedures. The August 2008 examination report indicated that management took action to correct these issues.

Significant downgrades were made to both the Composite Financial Risk and Composite Risk Management ratings as a result of the August 2008 examination. The Composite Financial Risk rating was downgraded from 2 to 4 based on downgrades to each of the five components of the composite rating. The most significant of these downgrades were made to Empirical Capital Level and Credit Risk components which were both downgraded from 2 to 4. The Liquidity Risk Component was also significantly downgraded from 1 to 4 during this examination.

Examiners cited the following as reasons for the downgrades:

“High unrealized mark-to-market investment losses, due primarily to overconcentration in investment mezzanine tranches collateralized by subprime mortgage debt, have deteriorated the corporate’s ability to provide adequate liquidity to membership under all but normal liquidity conditions. This results in a capital level that, while continuing to meet regulatory capital requirements, is insufficient to survive a significant liquidity event and is not adequate in relation to the excessive investment portfolio concentration risk. While earnings are historically appropriate for the corporate, they are currently unable to augment capital sufficiently to overcome unrealized mark-to-market losses. Additionally, standard interest rate risk measurements show a corporate currently excessively sensitive to interest rate changes. However, much of the volatility is due to enhanced credit risk, and a dollar interest rate risk volatility measure shows manageable interest rate risk. While market security prices are depressed, investment and cash flow analyses and projections continue to show a portfolio performing as

expected. However, the risk of ultimate principal loss is elevated from prior periods as the credit weakness spreads from subprime to prime borrowers.”

During the August 2008 examination, examiners downgraded the Composite Risk Management rating from 2 to 3 based on downgrades to five of the seven rating components including Liquidity Risk Management and Board Oversight and Compliance, which were both downgraded from 2 to 4. Capital Accumulation Planning, Credit Risk Management, and Operating Risk were also downgraded from 2 to 3. Examiners cited the following reasons for the downgrades:

“As we approach the market contagion’s one year anniversary, the board and management have been slow to react in evaluating alternative strategies to ensure adequate sources of liquidity. This slowness is also evident in capital planning that does not address capital adequacy in relation to the level of risk. While appropriately reviewing individual investment securities credit risk, concentration limits do not adequately address sector or tranche priority factors, resulting in the excessive concentration discussed throughout this report.”

As a result of the August 2008 examination, examiners issued several DORs related to inadequate liquidity planning, inadequate policies and procedures addressing significant deposit concentrations, credit concentration limits that did not adequately reflect market sector risks from direct and indirect investments, and inadequate capital planning.

The DORs called for the following action from management:

- 1.) *“Enhance the corporate’s liquidity position and planning to enhance the corporate’s access to sufficient liquidity in case of a significant liquidity event.*
- 2.) *Prepare, adopt, and enact procedures to provide appropriate liquidity to a large depositor’s potential liquidity needs, and ensure appropriate communication to foster confidence.*
- 3.) *Revise and implement concentration limits to ensure prudent investment portfolio diversification and appropriately minimize correlation risk.*
- 4.) *Develop capital goals sufficient to meet current and projected risk exposures of the institution.”*

As a result of the August 31, 2008, examination, a Letter of Understanding and Agreement (LUA) was issued. The LUA contained several provisions pertaining to policies and strategies to address liquidity, credit concentration limits, and capital adequacy concerns.

NCUA performed an on-site follow-up contact at Constitution in February 2009 to review the status of the LUA, DOR, and material Other Examiner Findings (OEF) issued as a result of the August 2008 examination. As a result of this follow up contact, examiners noted:

“Overall, management has been successful in addressing the 16 LUA provisions, 4 DORs, and the 20 OEFs documented in the August 31, 2008, examination report. The capital and liquidity issues continue to evolve as market and financial conditions have changed during the examination period.”

In addition to the follow up contact in February 2009, NCUA executed a TCCUSGP supervisory agreement with Constitution. This agreement was further amended in May 2009 and prohibited Constitution from engaging in any new activity pursuant to the expanded authorities previously granted, unless approved in writing by the Director of OCCU. Constitution management submitted the required cost reduction and capital restoration plans to NCUA on February 27, 2009. NCUA sent back a response on April 23, 2009, requesting additional information. On May 26, 2009, NCUA sent a letter granting an extension to the cost reduction and capital restoration plans. Constitution management submitted the plans on June 30, 2009, and they were under review by OCCU staff and management as of the June 30, 2009, examination. OCCU staff provided no further information about the status of the plans; therefore, we could not determine whether they were eventually approved by the NCUA.

Examiners made further downgrades as a result of the June 2009 examination. The Financial Risk Composite was downgraded from 4 to 5 and the Risk Management Composite rating was downgraded from 3 to 5. These downgrades were due to the depletion of Constitution’s capital caused by the continued deterioration in the value of its mortgage-backed securities resulting in significant losses recognized due to OTTI charges recorded against earnings, as well as management and the Board’s inability to implement strategies to manage the risks related to the mortgage-backed securities concentration during the market dislocation. As a result of this examination, examiners issued additional DORs relating to financial reporting and capital adequacy plans. The DORs stated Constitution did not provide full and fair disclosure of their financial statements to the NCUA and Constitution’s membership. Specifically, Constitution failed to timely and accurately record and report losses from the write-off of their membership capital at U.S. Central and OTTI charges relating to losses in the investment portfolio in accordance with Generally Accepted Accounting Principles (GAAP). In addition, Constitution did not incorporate current OTTI charges into their capital restoration plan, as a result, examiners considered the plan no longer valid.

Examiners issued additional DORs regarding weak supervisory oversight that did not prevent delayed financial postings and misleading financial reporting, inaccurate reporting of available lines of credit for liquidity purposes, and the practice of paying

higher rates to a large member credit union depositor on shares guaranteed by NCUA as part of the Corporate Stabilization Plan.

Examiners also identified and reported on 31 significant Other Examiner Findings related to issues such as funds transfer, information systems, business continuity planning, item processing, supervisory committee, compliance, liquidity, and management.

Table 3 (below) provides the history of NCUA examinations and resulting CRIS Composite ratings from November 2004 through June 2009.

Table 3:

NCUA Examination History					
Report Issuance Date	03/23/05	06/27/06	06/27/07	10/30/08	09/10/09
Exam As of Date	11/30/04	03/31/06	03/31/07	08/31/08	06/30/09
Exam Type	Annual	Annual	Annual	Annual	Annual
Composite Financial Risk	2	2	2	4	5
Component:					
Empirical Capital Level	3	2	2	4	5
Earnings Risk	2	2	2	3	4
Interest Rate Risk	2	2	2	3	3
Liquidity Risk	2	2	1	4	5
Credit Risk	2	2	2	4	5
Composite Risk Management	3	2	2	3	5
Component:					
Capital Accumulation Planning	2	2	2	3	4
Profit Planning and Control	2	1	2	2	3
Interest Rate Risk Management	2	2	2	2	2
Liquidity Risk Management	2	2	2	4	5
Credit Risk Management	2	2	2	3	4
Operating Risk	3	2	2	3	5
Board Oversight, Audit & Compliance	3	2	2	4	5

Source: Reports of Examination

Supervisory Efforts to Identify and Correct Key Risks Were Not Adequate

We determined NCUA did not timely communicate key risks related to Constitution’s investment portfolio even though they had identified credit and concentration risks in the 2004, 2006, and 2007 exam workpapers. Specifically, NCUA failed to require corrective action on the credit risk in Constitution’s investment portfolio related to the concentration of mortgage-backed securities until

August 2008. By that time, severe market dislocation had occurred and Constitution's significant holdings of mortgage-backed securities experienced rapid declines in value and were increasingly illiquid. We believe stronger, more-timely supervisory actions and restrictions on concentrations could have provided opportunities for reasonable divestiture of investment securities without incurring significant realized losses, which eventually caused the NCUA to conserve and liquidate Constitution.

We also determined the lack of adequate oversight of Constitution is partially attributable to NCUA not having appropriate regulatory support, such as specific investment concentration limits, to adequately address Constitution's concentration risk and increasing exposure to credit, market, and liquidity risks. This type of regulatory support would have likely mitigated the rapid deterioration of Constitution's financial condition and mounting investment losses as a result of the extended credit market dislocation.

Prior to the August 2008 examination, NCUA examination reports discussed investment portfolio concentrations in mortgage-backed securities and Constitution's increased credit risk exposure to lower rated securities, including sub-prime mortgage-backed securities. Although investment concentrations and increased credit risk exposure were discussed, no significant concerns were noted and no supervisory actions recommended. Examiners cited the following conclusion in both the 2005 and 2006 Reports of Examination reports:

“Risk exposures, while increasing with the additional volume of lower-rated securities, are adequately analyzed prior to purchase, monitored after purchase, and remain within both regulatory and policy parameters.”

The 2007 examination report contained the following conclusion regarding the credit risk in the investment portfolio:

“The investment portfolio, while heavily focused in structured mortgage-backed investments, is well managed by both the Investments and Risk Management departments.”

After the market dislocation in mid-2007, NCUA examiners noted the following regarding Constitution's investment concentration in mortgage-backed securities and sub-prime holdings of these securities in their August 2008 examination report:

“Due to concentrated investment in residential securities, Constitution currently faces significant unrealized mark-to-market losses. While the exact amount the corporate will ultimately experience is not known, the magnitude and breadth of the unrealized mark-to-market losses is extensive. As of August 31, 2008, unrealized mark-to-market losses totaled \$199,168,543, or 18 percent of the total non-U.S. Central portfolio. These losses are concentrated in mezzanine tranches, which, though totaling 31.4 percent of

the non-U.S. Central investments, account for 66.2 percent of the unrealized mark-to-market losses. The percentage attributed to mezzanine tranches declined from May 31, indicating unrealized mark-to-market losses are spreading across other investment classes. Adding to credit risk, the mezzanine classes were concentrated in the residential-related investments backed by B/C subprime and home equity asset-backed securities (ABS). These factors combined to magnify and concentrate credit risk by combining lower quality collateral with lower priority tranches which remain closer to the first loss position.

Board-approved policies and management actions resulted in significant sector and structure concentrations. Policies allow management to invest up to 75 percent of assets in private issue securities backed by residential mortgages. Combined with a lack of tranche/priority concentration limitations, policies permit compounding credit risk exposure of lower quality collateral with lower priority tranches. It is imperative for corporate management and the board to review and revise investment limitations to reduce the potential of future excessive concentrations. Limitations should consider not only ratings, but also collateral type, collateral loss potential, and priority in the structure, at a minimum. Properly implemented, more comprehensive investment limitations could have muted the large unrealized mark-to-market losses currently experienced.”

We believe examiners should have communicated to Constitution management in a more timely fashion and required corrective action regarding the substantial concentration risk posed by Constitution’s significant holdings in private label mortgage-backed securities. Although the limits outlined in Constitution’s policies were in compliance with NCUA Regulation Parts 704.5(c) and 704.6 - Credit Risk Management, we determined the regulations do not provide specific guidance regarding concentration limits other than for investments in any single obligor, as follows:

- (4) Concentrations of credit risk (e.g., originator of receivables, insurer, industry type, sector type, and geographic).*
- (c) Concentration limits—(1) General rule. The aggregate of all investments in any single obligor is limited to 50 percent of capital or \$5 million, whichever is greater.*

NCUA’s Corporate Examiner’s Guide (Guide)¹³ discusses the varying degrees of credit risk in the investment portfolio including the risk of the obligor or counterparty and the structure of the transaction (i.e., quality of the underlying collateral, level of subordination and/or credit enhancements). The Guide encourages examiners to ensure that corporate credit unions are properly measuring, monitoring, reporting, and controlling credit risk; particularly complex structured securities such as

¹³ NCUA updated the Corporate Examiner’s Guide in March 2008.

mortgage-backed securities, which may have numerous components of credit exposure.

The Guide also discusses the effect of credit risk in the investment portfolio on NEV and liquidity. For example, the Guide states in part,

“...it is important for corporate credit unions to understand and monitor the impact to NEV of potential volatility in the market value of the investment portfolio. As NEV declines, the ability to meet members’ potential liquidity demands diminishes...”

The Guide further warns examiners of the danger of focusing on high credit ratings and the probability of default (i.e., the higher the rating the less the probability of default) stating in part:

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

Based on our review, we believe examiners, as well as Constitution management, relied too heavily on credit ratings to determine credit risk in the portfolio. Through interviews, we determined that examiners did not perform further analysis on the potential credit and liquidity risks associated with Constitution’s significant holdings and concentrations of mortgage-backed securities prior to 2008 because most were AAA rated. In addition, we believe examiners’ failure to further assess these risks prevented them from recognizing earlier in the process, the inadequacy of management’s assessment and monitoring of credit risk in the investment portfolio due to the large concentrations of private issue mortgage-backed securities.

We determined increased supervisory oversight was warranted, in the form of:

- More timely supervisory action related to the credit risk in Constitution’s significant concentration in mortgage-backed securities. By the time examiners issued the DOR in October 2008 (Effective August 31, 2008), the mortgage-backed securities market had deteriorated to the point where these securities were no longer being actively traded. We believe had NCUA required Constitution to perform more extensive evaluation on its securities concentrations and credit risk exposure prior to the market dislocation in 2007, Constitution may have had the opportunity to divest some of these securities or limit additional purchases of these securities.
- More authoritative guidance related to sector concentrations and identifying and monitoring risk related to the market value of securities through the NEV may have allowed NCUA to more effectively encourage Constitution’s management to more proactively address the significant risks associated with Constitution’s investment portfolio.

As stated earlier in this report, we believe NCUA's over-reliance on investment ratings prevented them from performing further evaluation on the significant risks that the large holdings of private label mortgage-backed securities posed to the safety and soundness of Constitution and the credit union system as a whole. We also believe substantial purchases of these investments by Constitution and other corporate credit unions should have prompted NCUA to review examiner guidance and training to enhance on the ability of its examiners and analysts to evaluate risks associated with the complex assets, and the underlying assets securing the collateral. Accordingly, we are making the following recommendations:

Recommendations

Based on the conditions and findings described in this report, we recommend NCUA management:

1. Provide corporate credit unions with more definitive guidance on limiting investment portfolio concentrations by security type (agency-backed versus private label backed securities), sector type (residential real estate versus non-residential real estate), and by supporting collateral (private label sub-prime, Alt-A, prime, exotic mortgage, etc.).
2. Institute requirements for corporate credit union board membership to eliminate conflicts of interest. Specifically, the NCUA should determine whether it is appropriate for retail corporate credit union board members to sit on the boards of the top-tier corporate credit unions.
3. Provide NCUA examiners training to identify higher risk assets, especially if those assets are higher yielding products that involve a higher level of sophistication and several counterparties. Additionally, outside of previously raised recommendations for sector limit concentrations and diversification, NCUA should consider off-site monitoring enhancements of Call Report data to identify rapidly increasing holdings of certain types of assets and ensure that examiners and credit union management fully understand the risks posed by the products. NCUA should require credit unions to perform stress testing or scenario analysis to evaluate potential losses in the event of market dislocations or adjustments to other economic conditions.

We made these same recommendations to NCUA management in our report entitled: *Material Loss Review of Members United Corporate Federal Credit Union* (OIG-11-01), issued May 4, 2011, and management has already taken or agreed to take corrective action to resolve these recommendations, therefore, it not necessary for management to respond to the three recommendations specified above. However, we are making one new recommendation to NCUA Management to correct a deficiency identified in this report related to credit risk.

We recommend NCUA management:

1. Determine the best use of available resources to independently assess risk within corporate credit unions and other significant/complex institutions.

Management Response

Management agrees with the recommendation and has formed a working group to identify enhanced risk posed by large, complex institutions and develop appropriate strategies to supervise those institutions.

OIG Response

We concur with management's planned actions.

Appendix A - Management Response




National Credit Union Administration

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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 Constitution Corporate Federal Credit Union

DATE: August 29, 2011

This memorandum responds to your request for review and comments on the *Material Loss Review of Constitution Corporate Federal Credit Union* provided on August 15, 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) contracted with Crowe Horwath, LLP to conduct a material loss review of Constitution Corporate Federal Credit Union (Constitution), Wallingford, Connecticut. Constitution was placed under NCUA conservatorship on September 24, 2010 and liquidated on November 30, 2010, with certain assets, liabilities, and shares transferred to Members United Bridge Corporate Federal Credit Union through a purchase and assumption agreement.

Constitution failed due to losses associated with an excessive concentration of privately-issued residential mortgage-backed securities (RMBS), particularly in mezzanine tranche level RMBS. In addition, Constitution'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 and ultimately resulted in high losses. Constitution'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 factor in contributing to Constitution's losses and the subsequent losses to the Temporary Corporate Credit Union Stabilization Fund. Constitution 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 states that while NCUA examination reports commented on the RMBS concentrations and credit risk exposure prior to the market dislocation, NCUA did not note significant concerns or require corrective action until it was too late. The Report further states that had stronger supervisory actions and restrictions on concentrations been in place, Constitution may have had opportunities to divest of their portfolio without incurring significant losses. NCUA recognizes that the severity of the market dislocation was unprecedented, and timing the withdrawal from the market at a more opportune time would have been difficult. The revised Corporate Credit Union Rule, approved in September 2010, provides regulatory support

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to mitigate risk by prohibiting the purchase of privately-issued RMBS and imposes stronger concentration limits.

The MLR Report repeats three recommendations made in the report titled *Material Loss Review of Members United Corporate Federal Credit Union (OIG-11-01)* and recognizes that management has already taken or agreed to take action to resolve those concerns. The Report also identifies a fourth recommendation: "Determine the best use of available resources to independently assess risk within corporate credit unions and other significant/complex institutions." NCUA agrees and has formed a working group to identify enhanced risk posed by large, complex institutions and develop 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.