## **NCUA LETTER TO CREDIT UNIONS**

## NATIONAL CREDIT UNION ADMINISTRATION 1775 Duke Street, Alexandria, VA 22314

DATE: June 2008 LETTER NO.: 08-CU-17

TO: Federally Insured Credit Unions

SUBJ: Impact of the Current Mortgage Market on Corporate Credit

**Unions** 

## **Dear Board of Directors:**

The current market for mortgage related investment securities has weakened and the estimated fair value of these securities has recently declined resulting in higher accumulated unrealized losses on available for sale (AFS) securities. The market is impacting the financial statements of some corporate credit unions and several questions have been raised by corporate credit union members. NCUA is keenly aware of the issues faced by the corporate credit union system and the related concerns of natural person credit unions. This Letter provides additional information to consider when evaluating the financial condition of your corporate credit union as part of your due diligence review.

Corporate credit unions have proactively prepared for the downturn in the prime and sub-prime mortgage markets. In the latter half of 2007, most corporates stopped purchasing securities and began investing in very short-term liquid investments. The corporate credit unions have very strong liquidity positions and as such, currently demonstrate the ability to hold the investment securities to maturity while continuing to meet anticipated member liquidity, product, and service demands. It is also important to note that as of June 10, 2008, 85 percent of the securities held in the corporate system received the highest long-term credit rating of triple-A (e.g., AAA). Overall, 98 percent were rated investment grade, which is triple-B or better. Almost every security continues to perform with interest and principle payments being received, as applicable. The combination of strong liquidity positions and the ability to hold these securities to maturity indicate that corporate credit unions are well positioned to continue to meet members' liquidity needs.

The Office of Corporate Credit Unions (OCCU) is focusing its supervision efforts on ensuring corporate credit unions are effectively managing their balance sheets and monitoring their liquidity positions appropriately. OCCU's primary goal is for corporate credit unions to maintain the ability to meet their members' needs in a safe and sound manner. On a daily basis OCCU staff monitors liquidity, operations, and investment

securities performance (on-site presence in the largest institutions) at the corporates holding the vast majority of impacted securities.

While I believe corporate credit unions are taking every reasonable precaution to weather the current market conditions, each credit union board of directors must independently make investment decisions, evaluate risk tolerances, and perform due diligence. It is important to consider the following factors when performing your due diligence of a corporate credit union's balance sheet:

• Corporates are required to comply with generally accepted accounting principles (GAAP) in the Call Reports they file with the NCUA. As such, they must report and disclose accumulated unrealized losses on AFS securities. Corporates reflect the "fair value" of their AFS securities in accordance with Financial Accounting Standards Board Statements Nos. 115, Accounting for Certain Investments in Debt and Equity Securities, and 157, Fair Value Measurement. As the market activity for mortgage related investment securities virtually ceased, pricing indications used to estimate fair value have declined. From a GAAP perspective, this has significantly increased the accumulated unrealized losses on AFS securities.

As the name of the account implies, these "unrealized" losses would only be "realized" through either a sale of the security or recognition of other-than-temporary impairments (OTTI). For example, a corporate may decide to sell or could be forced to sell a security in the event it did not have adequate liquidity to meet its members' needs. Alternately, factors that may indicate an OTTI needs to be recognized include: the length of time and the extent to which the market value has been less than cost; the financial condition and near-term prospects of the issuer; realization of a loss on subsequent disposition of the investment; whether the issuer has defaulted on scheduled interest and principal payments; and downgrade in ratings by rating agencies.

- Credit union members can monitor the capital ratio of corporate credit unions by reviewing the corporates' financial statements or NCUA Call Reports (5310). The monthly 5310 reports can be viewed on NCUA's website at <a href="http://www.ncua.gov/data/5310/5310rpt.html">http://www.ncua.gov/data/5310/5310rpt.html</a>. The three ratios (retained earnings, core capital, and capital) used to monitor corporate credit unions' capital are included in schedule C-1 of the 5310. The capital ratio is defined as the sum of retained earnings, paid-in capital, and membership capital divided by the moving daily average net assets. For the purposes of NCUA Regulation Part 704, retained earnings does not include the allowance for loan and lease losses account, accumulated unrealized gains and losses on available for sale securities, or other comprehensive income items.
- Although the nationally recognized statistical rating organizations (NRSROs)
  downgraded many securities, it is important to review the actual performance of
  the securities in the AFS portfolio. In almost every case, the downgraded

securities held by corporate credit unions continue to perform and interest and principal payments continue to be received, as applicable. While the NRSROs and credit ratings have come under public criticism, they still remain the market convention. As mentioned above, 98 percent of the securities held in the corporate system were recently rated investment grade.

 Additionally, a number of corporate credit unions obtain NRSROs institutional ratings in order to participate in the commercial paper and medium term notes markets as additional sources of liquidity. In comparison to other financial institutions, corporate credit unions continue to be highly rated.

Credit union officials should not hesitate to contact their respective corporate(s) for additional information or clarification regarding the performance of their investment securities. A number of the larger corporate credit unions holding the majority of the securities impacted by current market conditions are conducting webinars on a regular basis to keep their members apprised of the fluid economic situation. I encourage you to participate in those events.

If you have any additional questions or concerns, please contact OCCU, your regional office, or your State Supervisory Authority.

Sincerely,

JoAnn M. Johnson Chairman