CORPORATE CREDIT UNION GUIDANCE LETTER

No. 2003-01 DATE: January 16, 2003

SUBJ: Credit Concentrations and Credit Monitoring

TO: The Corporate Credit Union Addressed

NCUA Rules and Regulations Section 704.6(a) requires corporate credit unions to "operate according to a credit risk management policy that is commensurate with the investment risks and activities that it undertakes." Additionally, Section 704.6(a)(4) requires the policy to address concentrations of credit risk. The revised rule has expanded the examples of potential credit concentrations to include "originator of receivables" and "insurer" to supplement "industry type, sector type, and geographic."

The Office of Corporate Credit Unions (OCCU) strongly urges corporate credit union boards to evaluate whether credit exposures are being prudently limited to guard against excessive losses. OCCU encourages boards to ensure the corporate has appropriate and timely processes to identify, measure, monitor and control investment credit risks.

Recent events in the health care sector of the financial markets highlight the importance of carefully setting and monitoring obligor credit limits and credit concentration limits. As recently as October 2002, senior classes of asset-backed securities issued by two trusts (NPF XII and NPF VI), funding vehicles affiliated with National Century Financial Enterprises (NCFE), carried Aaa ratings from Moody's. On October 25 Moody's downgraded these securities for the first time. Subsequent credit downgrades brought the senior classes of both securities below investment grade to Caa3 by November 22. NCFE is also the holding company for the trusts master servicer, National Premier.

NCFE, which filed bankruptcy on November 18, is a corporation that purchased health care receivables. These receivables were used to collateralize the NPF XII and NPF VI securities. The speed with which the downgrades took place, unprecedented in the asset backed securities market, should prompt corporates to consider carefully the credit exposures they are willing to tolerate.

Sector Risk

There have been further indications of risk in the health care sector. On October 4, Standard & Poor's raised its credit ratings to BBB for Tenet Healthcare Corp., the second-largest U. S. hospital chain. On October 28, UBS Warburg cut its stock rating for Tenet, noting excessive Medicare outlier payments. Standard and Poor's subsequently downgraded Tenet to BBB-, negative watch. On December 3, Medicare announced that it would scrutinize all hospitals receiving large Medicare payments and revise its reimbursement policy.

The description of recent credit events is not intended to paint a negative picture of the entire health care sector, since there may be sound investment opportunities in this sector. However, the events do heighten awareness of obligor credit risks and the risks associated with credit concentrations, including servicer risk.

Credit Risk Exposures

Corporate credit unions should carefully review the latest financial reports, industry analyses, internal and external analyst evaluations and rating agency information as required to be maintained by Section 704.6(e)(iii). Credit risk management requires due diligence to developments related to parties with whom they have investment transactions. This includes attention to early warning signs and red flags of potential weakness. In the case of NCFE, Fitch downgraded its ratings on July 12, 2002, and withdrew them entirely on October 28 citing "inconsistent communication between NCFE and Fitch." Investors that continue to hold securities after the rating status or material circumstances have changed would be expected to have made this decision only after a full review of the investment involved. Clear reasoning would be expected for retaining the security, demonstrating that credit quality still meets prudent corporate credit union standards, and does not pose a threat to safety and soundness.

Credit Risk Management

Corporate credit union boards and management should be clearly aware of the potentially serious risks presented by credit quality. Interruptions of cash flows from receivables associated with NPF XII and NPF VI led to bankruptcy filings by a number of companies in the health care industry. Holders of these securities meanwhile should expect writedowns in the same order as the underwriter, Credit Suisse First Boston.

The issues related to credit concentration risks are growing more and more complex. Investments involve increasingly sophisticated structures and contractual agreements that are difficult to discern and analyze. In such an evolving environment it is imperative that boards of corporate credit unions carefully examine their credit risk management policies. Additionally, corporate management should review their credit risk practices, and actively monitor emerging credit risks in their investments, to ensure the continued safety and soundness of their institutions.

Sincerely,

Kent Buckham
Director
Office of Corporate Credit Unions

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