SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF EXAMINATION AND INSURANCE
1775 DUKE STREET, ALEXANDRIA, VA 22314

DATE: **February 2009** **Supervisory Letter No.: 09-01**

TO: **All Field Staff**

SUBJECT: Supervision Considerations for Natural Person Credit Unions and the Announced Corporate Stabilization Efforts

Recent NCUA Board actions to stabilize the corporate credit union system will impact individual credit union earnings and net worth ratios. We are fully aware of the potential concerns and outcomes from such actions. When examining and supervising credit unions, evaluating financial trends, and assigning CAMEL codes and risk ratings, examiners must clearly distinguish between the impact of the actions taken by the NCUA Board and the decisions made by the credit union's management. The attached letter provides guidance to consider when supervising your assigned credit unions.

Credit unions participating in the Credit Union System Investment Program (CU SIP) may experience temporary reduction in their return on average assets ratio and dilution in their net worth ratio due to the additional funds on their balance sheet. Examiners should recognize these institutions are voluntarily participating in an NCUA Board initiative to assist with our efforts to address the larger market liquidity needs present in the credit union system.

If you have any questions on this issue, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

John Kutchey,
Acting Director, Office of Examination and Insurance

Supervision Considerations for Natural Person Credit Unions and the Announced Corporate Stabilization Efforts

Background

Actions recently taken by the NCUA Board will have a financial impact on all natural person credit unions. This Supervisory Letter provides guidance to staff on the evaluation of earnings, net worth, and overall CAMEL and risk ratings of credit unions given the special circumstances of the actions taken. It is imperative staff differentiate between the impact of the actions taken by the NCUA Board versus actions and operational results produced by credit union management and the overall risk of the financial institution.

Corporate Stabilization Efforts

On January 28, 2009, the NCUA Board approved a series of actions designed to enhance and support the corporate credit union system.[1] The corporate credit union system is facing unprecedented strains on liquidity and capital due to extraordinary market disruptions and the current economic climate. To counter the effects of these conditions, the NCUA Board approved the following actions which impair the National Credit Union Share Insurance Fund (NCUSIF) Deposit and necessitate a premium to return the NCUSIF's equity ratio to 1.30 percent:

- Guaranteed uninsured shares at all corporate credit unions through February 2009, and established a voluntary guarantee program for uninsured shares of all corporate credit unions through December 31, 2010;
- Issued a $1 billion capital note to U.S. Central Corporate Federal Credit Union; and
- Declared a premium assessment to be collected in 2009 to restore the NCUSIF equity ratio to 1.30 percent.

The impact of these actions on individual credit union financial statements will be:

[1] See NCUA Letter to Credit Unions 09-CU-02, January 2009, *Corporate Credit Union System Strategy*.

- An impairment of the NCUSIF deposit requiring a write-down (expense) of a portion, presently estimated at 51 percent, of the credit union's NCUSIF Deposit, and
- An assessment of a premium equal to 0.30 percent of insured shares.

The current estimate for the write-down of the NCUSIF deposit and the premium assessment will, on average, produce a 62 basis point reduction in the return on assets for 2009 and reduce the net worth by 56 basis points.[2] These figures are estimates and may change in either direction as economic conditions change. Additional guidance will be issued to credit unions as we determine the actual amounts which will affect credit union financial statements.

The actions taken by the NCUA Board allow natural person credit unions to continue safely supporting the corporate system by maintaining their current deposits and placing any excess liquidity in their corporate credit union. Success of the credit union system in weathering the current economic cycle hinges on the cooperative foundation of the credit union system.

The Credit Union System Investment Program (CU SIP)

On December 9, 2008, the NCUA Board announced a new initiative to address system-wide liquidity challenges, the CU SIP.[3] Under this program, the Central Liquidity Facility (CLF) will lend funds to credit unions (a CU SIP advance) to invest in fixed-rate, matched-term NCUSIF guaranteed notes at a corporate credit union, the proceeds of which are then used to retire the corporate credit union's external system debt. This program was designed to improve system-wide liquidity positions by freeing corporate credit union collateral and providing corporate credit unions with increased contingent borrowing capacity.

A credit union receiving a CU SIP advance must invest the proceeds in CU SIP Notes, which are NCUSIF guaranteed senior debt of a corporate credit union. A credit union will earn ¼ of 1 percent on the difference between the CLF advance and the CU SIP Note. CU SIP advances have a maximum one-year term, are fully secured by collateral of the borrowing credit union, and have interest payable semi-annually. Credit unions interested in participating can request to participate through their corporate credit union by the last Friday of the month. Funding and required investment transactions will occur simultaneously on the second Friday of each month through June 2009, unless the NCUA Board extends the Temporary Corporate Credit Union Liquidity Guarantee Program.

[2] Based on information available at the time the actions were taken and is subject to change as economic conditions change. The figures were an average for all credit unions and could be materially different for each credit union.
[3] Examiners can find program materials posted on: http://www.ncua.gov/CLF/index.htm.

Examiner Responsibilities

Assessment of Earnings

Examiners must consider the above actions when evaluating a credit union's earnings. Although the return on average assets will decline over the short-term, most natural person credit unions have the net worth to absorb the charge and retain sufficient levels of capital. Examiners are encouraged to fully evaluate the earnings level and not take exception to the amount of earnings resulting from these NCUA Board actions. However, other business decisions made by credit union management and the impact of those decisions on current and future earnings must be reflected in the CAMEL earnings component code. Examiners must evaluate each credit union's earnings level relative to net worth needs, financial and operational risk exposures, the current economic climate, and the credit union's strategic plans.

Credit unions investing in the CU SIP will receive a net ¼ of 1 percent return on the asset. The infusion of funds may reduce the overall return on assets by increasing the amount of assets. Examiners should not take exception to the planned, reduced return, attributable to CU SIP participation. However, examiners should address any unsafe and unsound risks or practices affecting earnings through discussions with management, documenting concerns in the examination or supervision contact, and assigning appropriate CAMEL and risk ratings.

Assessment of Net Worth

When evaluating a credit union's net worth level, as in the evaluation of earnings, examiners must consider the NCUA Board actions. Although the net worth ratio may decline over the short-term, most natural person credit unions have adequate net worth levels to withstand the current economic environment. Examiners are encouraged to fully evaluate the net worth level and not take exceptions to the reduction due to the actions taken by the NCUA Board. In addition, the CU SIP program is an NCUA initiative, and examiners should not take exception to planned capital dilution directly attributed to the program.

Net worth evaluations must include both immediate as well as strategic considerations related to risk and future plans. Examiners should reflect the impact of any action the credit union management takes to increase risk in the CAMEL capital component and related risk ratings. Examiners should continue to address any negative capital trends or increased risk from unsafe and unsound practices.

Prompt Corrective Action and Net Worth Restoration Plans

Credit unions whose net worth ratio falls below 7 percent are subject to Prompt Corrective Action requirements per NCUA Regulation Part 702. Net worth categories are established by statute and cannot be changed or temporarily adjusted by the NCUA Board.

NCUA does have flexibility when reviewing a Net Worth Restoration Plan. NCUA takes into account why the net worth ratio fell below 6 percent and how long it will take to increase the ratio to the "adequately capitalized" level. Examiners and regional office analysts are instructed to be flexible when reviewing credit union plans and to consider the impact of any action taken by the NCUA Board, specifically if that action alone triggers mandatory Prompt Corrective Action. Approval of the plan should consider the credit union's overall financial condition and the ability to withstand the current economic environment. The overall net worth ratio and restoration plans must be evaluated based on the risks present in the current balance sheet, the credit union's historical performance, and future strategic plans of the credit union.

Due Diligence

It is essential credit unions continue to support the corporate credit union system. It has been NCUA's practice for examiners not to take exception to credit unions which have invested exclusively in the corporate system, unless warranted. However, examiners should expect each credit union to continue performing due diligence on any third party, including their corporate credit union.[4] When reviewing the credit union's due diligence process, the examiner should acknowledge the credit union's commitment to support the credit union system by participating in the NCUA Board initiatives. In addition, the due diligence process will be limited if the credit union deposits funds in a corporate credit union participating in the uninsured share guarantee.

Since CU SIP reduces the potential borrowing capacity for participating credit unions, CU SIP investments have been limited (maximum exposure of 37.5 percent of borrowings plus CU SIP advance as a percentage of paid in and unimpaired capital and surplus), leaving a potential liquidity cushion should the need arise during the term of the investment. A credit union should manage its risk of exposure for alternative borrowing capacity to meet its liquidity needs accordingly. Examiners should expect sound liquidity management strategies and practices on an ongoing basis.

CAMEL Rating System

Examiners will continue to use the principles of the Risk Focused Exam program set forth in Letter to Federal Credit Unions 02-FCU-09 when evaluating the impact of NCUA Board actions. Examiners are reminded the CAMEL ratings are based on risk and not determined by a matrix.[5] NCUA uses the internal rating system to evaluate the safety and soundness of credit unions based on the degree of risk to the NCUSIF and for identifying those credit unions that require additional supervision. Credit unions still using benchmarks based upon the old matrix system without adequate risk management processes could lead to unsafe and unsound business decisions.

Examiners must assign the CAMEL ratings based on the examiner's qualification of the impact material risk(s) has on the credit union's soundness and established strategic plans. The risk focused examinations' seven risk indicator ratings are a forward-looking assessment. Any program approved by the NCUA Board should be a separate consideration from the actual risk of the credit union and should not be an automatic adjustment in CAMEL ratings. Each credit union's earnings and net worth level must be based on the credit union's unique risk characteristics, as well as taking into

[4] NCUA Letter to Credit Unions 08-CU-17 states: "each credit union board of directors must independently make investment decisions, evaluate risk tolerances, and perform due diligence."

[5] CAMEL Rating System was modified by the matrix being eliminated in 2007. NCUA Letter to Credit Unions 07-CU-12, December 2007, *CAMEL Rating System.*

consideration the overall economic trends. Examiners should continue to document CAMEL ratings and any material adjustments based on risk within the Scope Workbook.

Conclusion

The determination of the CAMEL composite and component ratings, as well as the seven risk ratings is a judgmental process and requires the examiner to take into account all of the subjective and objective variables that affect a credit union's financial and operational condition, as well as their interrelationships.

It continues to be incumbent on credit unions to proactively develop and document sound strategic plans. A variety of factors, such as the contemporary decisions affecting the direction of the risk in a credit union's balance sheet, require examiners to exercise a high degree of professional judgment when evaluating the adequacy of earnings and net worth levels.

Participation in CU SIP should not adversely affect examiner perspective, recognizing the temporary reduction in earnings and diluted net worth ratio will be just that, temporary

It is essential credit union management and examiners maintain an open and ongoing dialogue on the strategic direction of the credit union in relation to earnings and net worth and not be overly focused on the financial impact of the actions taken by the NCUA Board.

If you have any questions on this issue, please direct them to your immediate supervisor.

References

1. NCUA Letter to Credit Unions 09-CU-02, January 2009, *Corporate Credit Union System Strategy*

2. NCUA Letter to Credit Unions 08-CU-20, August 2008, *Evaluating Current Risks to Credit Unions*

3. NCUA Letter to Credit Unions 08-CU-17, June 2008, *Impact of the Current Mortgage Market on Corporate Credit Unions*

4. NCUA Letter to Credit Unions 07-CU-12, December 2007, *CAMEL Rating System*

5. NCUA Letter to Federal Credit Unions 06-FCU-04, *Evaluation of Earnings*

6. Supervisory Letter 05-01, August 2005, *Evaluating Capital Adequacy*

7. NCUA Letter to Federal Credit Unions 02-FCU-09, May 2002, *Risk-Focused Examination Program*