Distressed Securities Held by Corporate Credit Unions
Summary of NCUA Analysis
April 10, 2009

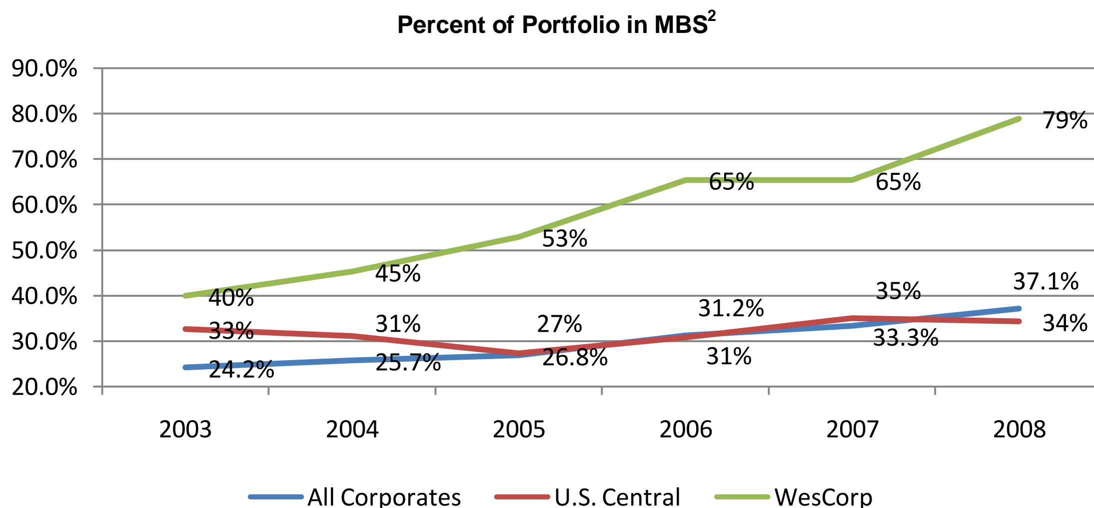
Introduction

As part of NCUA's ongoing communication efforts for the corporate stabilization program, this document is intended to provide federally-insured credit unions with background on the distressed non-agency mortgage backed securities (non-agency MBS) held by corporate credit unions and a portfolio-level analysis of the holdings of Western Corporate Federal Credit Union (WesCorp) and U.S. Central Federal Credit Union (U.S. Central).

Background

Corporate credit unions have traditionally used securities to meet both earnings and liquidity needs. While providing a source of earnings, marketable securities also serve as source of liquidity by either selling the securities or pledging them as collateral on loans. The types of securities purchased by corporate credit unions include highly rated asset-backed securities (automobile, credit cards, etc.) and mortgage related securities.

As the yield on other traditional sectors decreased, several large corporate credit unions began to purchase more non-agency MBS. As a result, the investment portfolios of these corporate credit unions became more concentrated in mortgage related securities. As of December 31, 2003, total MBS comprised 24 percent of all corporate credit union investments. The level rose to 35% in 2007. NCUA issued supervisory directives in mid-2007 to cease purchasing non-agency MBS.[1]



[1] In April 2007, NCUA issued a Letter to Corporate Credit Unions noting credit quality and market value concerns with mortgage related securities having underlying sub-prime or nontraditional mortgages. From mid-2007 to early-2008, corporate credit unions (including WesCorp and U.S. Central) were issued supervisory directives to cease purchasing these types of securities. The increases in percentage of MBS in 2008 are due primarily to a decline in the size of the investment portfolio, not additional purchases of securities.
[2] Source: As reported on the 5310.

During the time frame in which corporate credit unions were investing more heavily in mortgage related securities, significant changes were taking place in the mortgage industry. The use of sub-prime, Alt-A, and interest only mortgage loan products grew at a very rapid rate. These loan products were packaged into the private label MBS that were being marketed at an increasing magnitude in 2006 and 2007.

The securities purchased by corporate credit unions during this time frame were all permissible under NCUA's Rules and Regulations. Almost all had very high ratings (AAA and AA) as assigned by the nationally recognized statistical rating organizations (NRSROs). NRSRO ratings were the norm in the financial markets for determining the quality of a security. However, NRSROs relied primarily on historical data of the performance of a security's underlying assets in making rating determinations. No reliable historical data existed relating to the performance of the sub-prime and other types of loans that were originated in a period of rapid home price increases and relaxed underwriting criteria. As such, NRSRO ratings did not prove to be a reliable means of determining the quality of these securities. Since late-2007, analysis of these securities has been based on actual performance of the underlying assets and projected future performance. This has led to very significant downgrades in the NRSRO ratings of many of the securities held by corporate credit unions. The downgrades had the most severe impact on the portfolios of WesCorp and U.S. Central.

Beginning in mid-2007, credit and liquidity issues associated with sub-prime mortgages began to surface. By the end of 2007 and into early 2008, what started out as a sub-prime mortgage problem spread to Alt-A loans, Option ARM loans, and finally to prime mortgage loans. Additionally, mortgage delinquencies were increasing, foreclosures rates began to rise, housing prices were declining leading to lower recoveries, and confidence in the markets dropped significantly. As a result, the market for mortgage related securities became inactive. Corporate credit unions with significant levels of investments in mortgage related securities faced two critical issues as a result of the inactive market:

(1) Impact on liquidity. Mortgage related securities had traditionally been used by corporates to meet liquidity needs. As the markets became more distressed and illiquid, the margin requirements set by lenders increased, making borrowing sources limited and, if available, prohibitively expensive.[3]

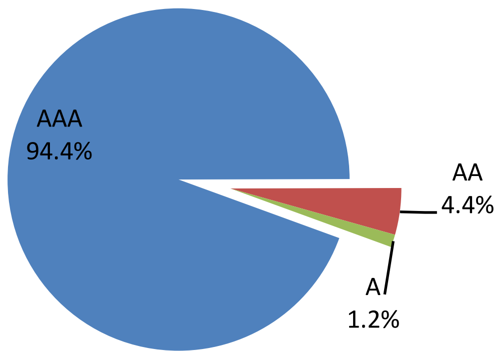
(2) Impact on financial statements. Generally accepted accounting principles (GAAP) requires the difference between book value and fair value of securities classified as available-for-sale be recorded on the balance sheet as Accumulated Unrealized Gains or Losses on Available for Sale Securities.

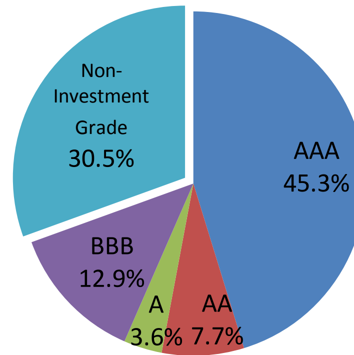
[3] Selling securities in the distressed market would have forced corporate credit unions to "realize" the unrealized losses.

GAAP also requires that if a decline in fair value is determined to be other than temporary, an other-than-temporary impairment (OTTI) charge must be realized via the income statement (earnings). OTTI is resulting in corporate credit unions recognizing losses, having an immediate impact on capital and the capital instruments held by the member credit unions.

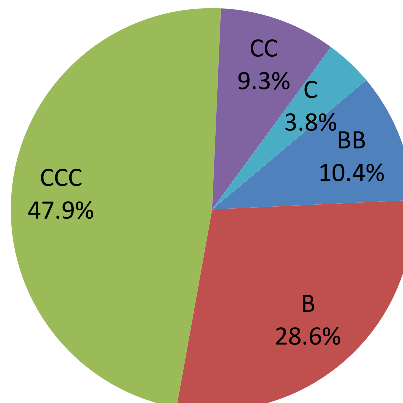
U.S. Central Portfolio Overview

The charts below depict the breakdown of credit ratings for U.S. Central's total investment portfolio at the time of purchase and as of February 23, 2009, using year-end par values (total of just under $35 billion) and the lowest rating provided by S&P, Moody's, and Fitch. The lowest credit rating is used because credit ratings changes (i.e., downgrades) have been lagging and this is regarded as a more conservative approach.





The chart below further breaks down U.S. Central's non-investment grade (below BBB-, or equivalent) security holdings.



Moody's Investors Service provides a quantification of expected recoveries for residential mortgage-backed securities (RMBS) from which the following corresponding expected losses were derived:

Moody's Rating	Estimated Loss[4]
B or higher	0%
CCC	5% to 25%
CC	25% to 75%
C	Above 75%

Of the approximately 750 individual securities within its total investment portfolio, U.S. Central holds 525 non-agency MBS. U.S. Central had a process for determining securities subject to OTTI. This process involves an initial determination, using prior external analyses and internal projections, on whether a security will be subject to an enhanced review. From this process U.S. Central identified 106 securities, with an approximate par value of $4.1 billion, for an enhanced analysis consisting of internal and external analyses. Approximately half of the 106 securities subjected to the enhanced analysis were determined to have OTTI as of December 31, 2008.

Subsequent to the December 2008 analysis for OTTI, U.S. Central had an expanded external independent credit analysis performed on 420 non-agency MBS with a par value of $14.2 billion. The resulting credit loss estimate produced a loss projection within the current range provided by the NCUA's outside vendor. U.S. Central's conservatorship management team is in process of obtaining an expanded credit analysis by one of their external vendors for its residential mortgage-backed holdings. Results of this expanded review are expected to be available in mid-April.

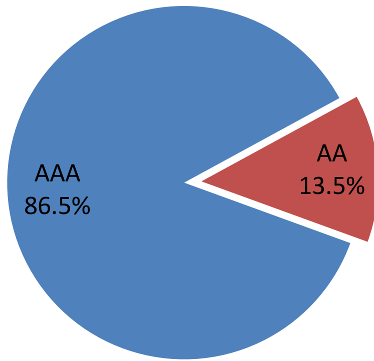
The vast majority of U.S. Central's risk and projected losses are from such securities originated in 2006 and 2007. Of the 2006 and 2007 originated securities, the risk is concentrated in securities backed by subprime, Alt-A, and Option ARM (negative amortization) loans. Actual loan losses and increased loss projections, relative to subordination, have affected the subordinate, mezzanine, and senior securities within US Central's portfolio. Contemporary NRSRO ratings and external vendor loss projections support the portfolio risk assessment.[5]

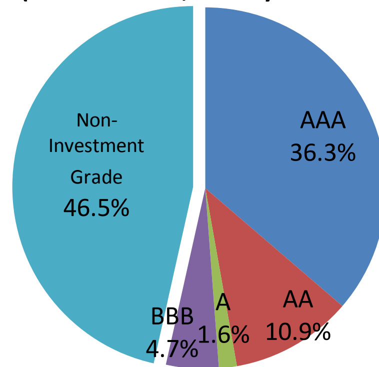
[4] These figures are broad estimates for credit losses and are not based on a loan level analysis. In addition, credit rating downgrades lag actual performance. As such, these broad estimates are not a substitute for a security level credit analysis, but are indicative of increasing credit losses.

[5] U.S. Central's total investment portfolio also contains exposure to commercial mortgage backed securities, securities wrapped by insurers demonstrating signs of credit deterioration, the domestic auto industry, unsecured corporate debt, as well as securitized student loans. While these exposures are small relative to those in U.S. central's non-agency MBS portfolio, they are being actively monitored and managed.

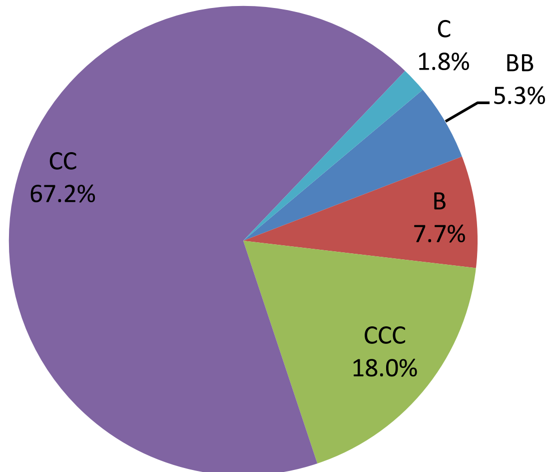
WesCorp Portfolio Overview

The charts below depict the credit ratings' breakdown for WesCorp's portfolio at the time of purchase and as of February 23, 2009, using year-end par values (total of almost $23 billion) and the lowest rating provided by S&P, Moody's and Fitch. The lowest credit rating is used because credit ratings changes (i.e., downgrades) have been lagging and this is regarded as a more conservative approach.





The chart below further breaks down WesCorp's non-investment grade (below BBB-, or equivalent) security holdings.



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Moody's Rating	Estimated Loss[6]
B of higher	0%
CCC	5% to 25%
CC	25% to 75%
C	Above 75%

WesCorp has approximately 950 individual securities within its investment portfolio. WesCorp had a process for determining securities subject to Other Than Temporary Impairment (OTTI). This process involves running securities through a series of filters that drive the depth of analysis and whether analysis is done internally or externally. From this filtering process WesCorp identified 253 securities for advanced analysis, indicating a possibility of OTTI. Of these 253 securities, 44 were subjected to external vendor analysis. Between the internal and external analysis performed, ultimately 47 of these 253 securities were determined to have OTTI as of December 31, 2008.

Comparison of results between WesCorp's internal analysis and the external, independent analysis implies that had WesCorp externally modeled a greater portion of its investment portfolio, credit loss projections would have been greater resulting in greater OTTI charges. There are 37 ALT-A securities, with an approximate par value of $1.25 billion, which were all modeled for credit losses by the following three sources:

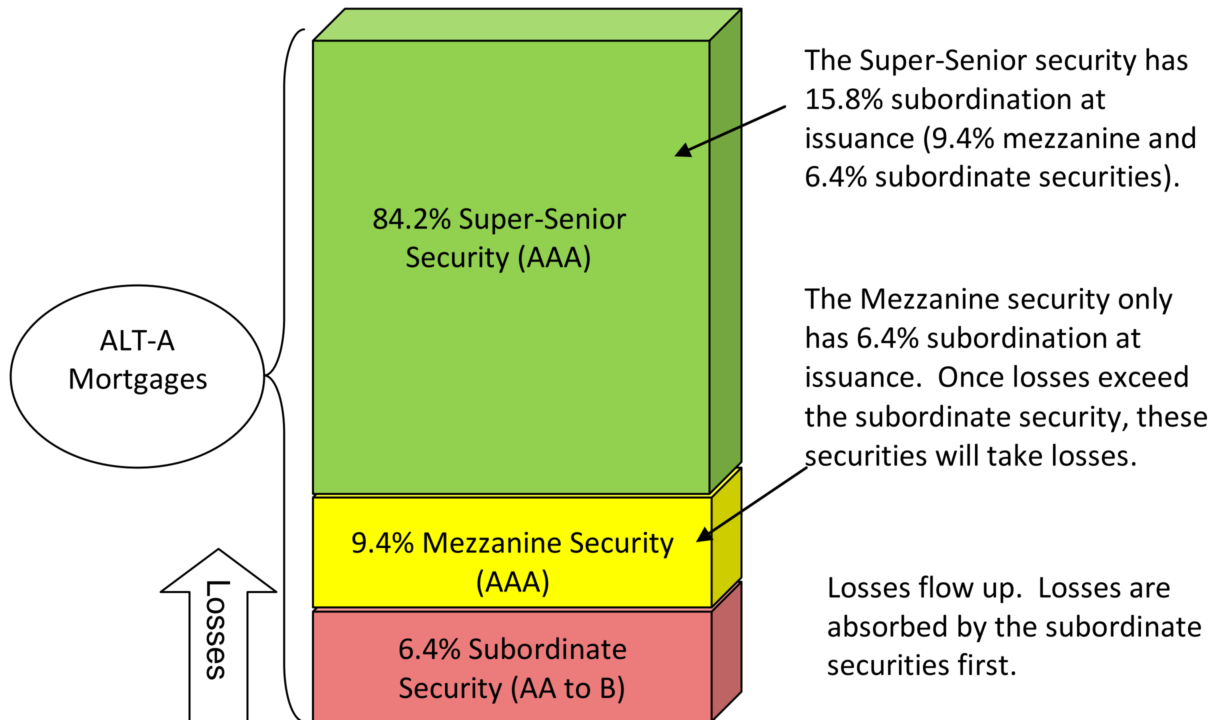
1. WesCorp using their internal model;
2. WesCorp's external vendor; and
3. NCUA's external vendor.

For these securities, WesCorp's own external vendor analysis resulted in a credit loss estimate more than $500 million greater than WesCorp's internal estimates. Furthermore, the credit loss projections for these securities made by WesCorp's external vendor were within a range of $175 million of the credit loss projections made by NCUA's outside vendor. WesCorp's senior management was prepared to report an OTTI number based on the lower internal analysis estimate. WesCorp conservatorship management team is in process of obtaining an expanded credit analysis by an external vendor for its residential mortgage-backed holdings. Results of this expanded review are expected to be available in mid-April.

WesCorp has a large concentration of mezzanine securities ("Senior/Support" is another term used to describe these securities) backed by Alt-A and Option ARM (negative amortization) loans. In simplistic terms, mezzanine securities act as insulation to absorb losses before more senior securities within the bond structure. Despite this support role, these securities were rated AAA (or equivalent) at issuance. Below is an illustration of a bond with a mezzanine security.

[6] See footnote 4.

Illustration of a Simple Alt-A Backed Bond with a Mezzanine Tranche



The average amount of subordination to protect against losses for AAA securities with underlying Alt-A and Option ARM mortgages issued in 2006 and 2007 were as follows:

Alt-A: 6.4%[7]
Option ARM: 13.7%[8]

To understand the relevance of these subordination percentages, one needs to compare them to the current projected losses of the loans supporting these securities. Losses for Alt-A and Option ARM loans are projected to exceed the initial AAA subordination in many deals. Below are S&P and Moody's most recent loss projections for 2006 and 2007 Alt-A and Option ARM securitized loans:

[7] *Alt-A RMBS Loss Projection Update: January 2009*. Moody's Investor Service, January 22, 2009.
[8] *Option ARMs RMBS Loss Projection Update: February 2009*. Moody's Investor Service, February 5, 2009.

Average Loss Projection, Percent of Original Balance[9]				
	ALT-A (Average 6.4% subordination for AAA's at new issue)		**Option ARM (Average 13.7% subordination for AAA's at new issue)**	
	2006	2007	2006	2007
Moody's	19.8%	24.2%	26.7%	29.7%
S&P	17.8%	24.0%	21.8%	27.8%

Based on average projected losses and current subordination levels, some Alt-A and Option ARM securities rated AAA at issuance are expected to lose principal in the near future. Furthermore, many mezzanine securities are expected to take losses in excess of 50% of remaining principal due to their first loss position within the AAA portion of the bond.

Over one-third of the securities owned by WesCorp are mezzanine securities backed by Alt-A and Option ARM loans. Furthermore, of these holdings, a vast majority of the securities are backed by loans originated in 2006 and 2007. This portion of WesCorp's portfolio accounts for a vast majority of the risk and projected losses on their balance sheet. A smaller portion of WesCorp's relative portfolio risk and projected losses, albeit still a large absolute number, come from collateralized debt obligations (CDO) and the subprime sector.

[9] Individual bonds may have higher or lower projections due to numerous factors, e.g. quality of underwriting, geographic distribution, and loan-to-values.