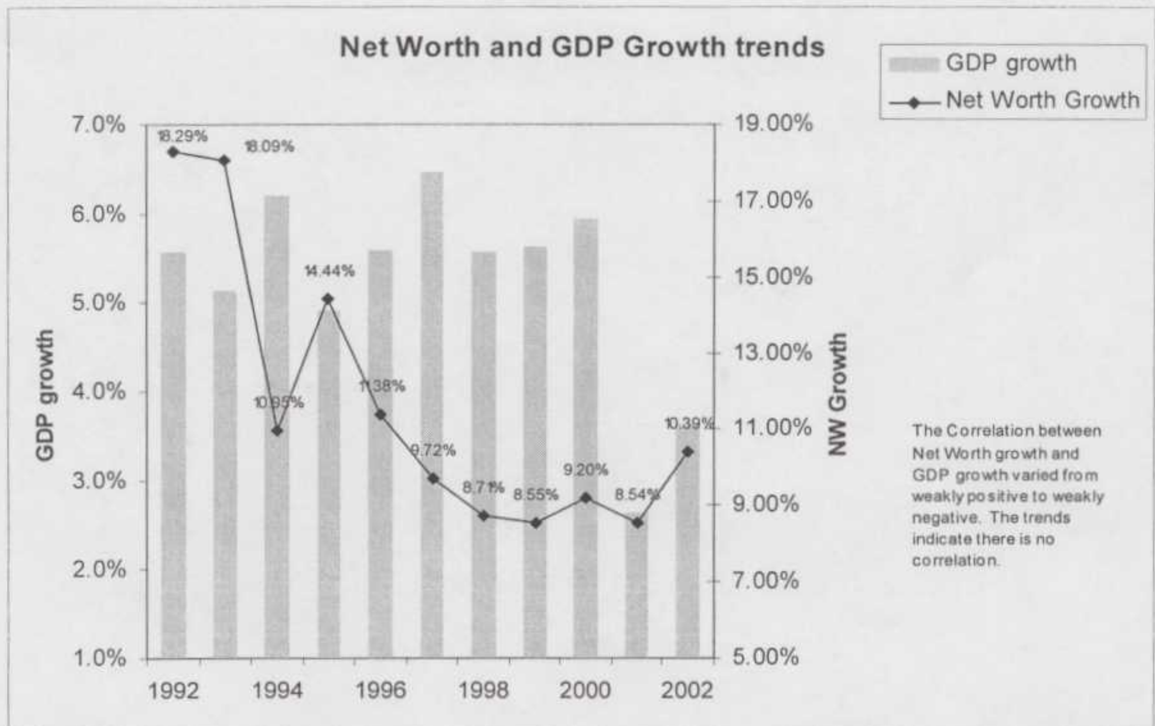
Responses to questions from the U.S. House of Representatives Committee on Financial Services

Question 1: From 1992 to 2002, at what rate did credit unions increase their capital (net worth) both in actual dollars and as a percentage of assets?

From 1992 to 2002, net worth at credit unions grew from $21.1 billion to $59.7 billion, representing an increase of 182.9 percent. During that same time, the net worth to total asset ratio increased from 8.09 percent to 10.72 percent, representing an increase of 32.5 percent. The net worth ratio did not grow at the same pace as net worth dollars due to the high level of asset growth (113.6 percent) during this period.

Question 2: Has the rate of growth differed during times of strong economic growth and times of weak economic growth?

To evaluate this we compared the growth in the level of net worth dollars to the growth in the level of Gross Domestic Product over the period 1992-2002. The correlation varied from weakly positive to weakly negative. The changes in Net Worth and GDP appear to have no correlation. It is important to note that over the past 10 years, we have not truly experienced a time of weak economic growth. What is interesting about the change in Net Worth is the shift from very high levels of growth to more moderate levels of growth. In 1992, the Net Worth Ratio was 8.09 percent. By 1997, this had increased to 10.82 percent, and at the end of 2002 is 10.72 percent. Credit unions were able to manage their net income, first, to grow net worth and, secondly, to maintain the level of net worth as a percentage of assets.



Question 3: In the last three years, what has been the relationship between the decline in the stock market and the growth of credit union shares (deposits) and net worth?

To evaluate this relationship we compared the year-end changes in the S&P 500 Index, generally considered a broad market index, to the changes in the level of shares (deposits) and net worth. We also expanded this scenario beyond 3 years. If the S&P 500 Index is considered a leading indicator, meaning the change in the index will impact shares and/or net worth in the following year, then there is a strong statistical correlation over the last three years between the decline in the S&P 500 Index and the growth in shares.

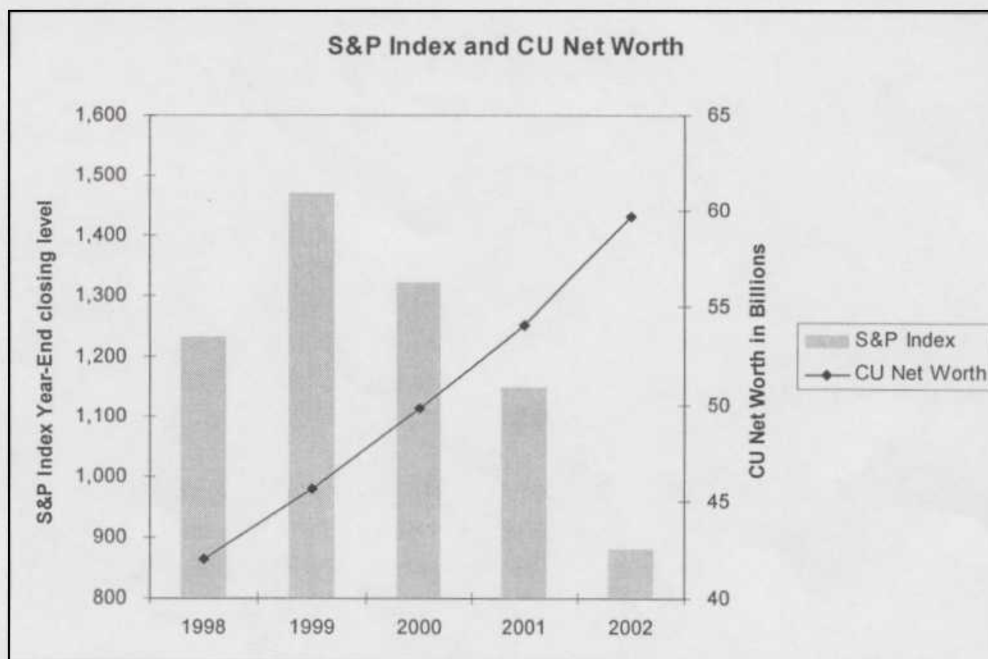
Regarding net worth, the correlation is much less conclusive. The table shows the rate of growth in net worth, although continuing at an impressive rate of 9.38% during the three years from 2000 through 2002 when the S&P 500 Index declined, slowed slightly from the 11.69% average annual growth rate which had occurred during the period of 1993 to 1999. However, the decrease in the rate of growth in net worth appears to have only minimal statistical correlations to the decrease in the rate of growth for the S&P 500 Index. As shown in the table on page 2, although the S&P 500 performance changed dramatically from positive returns to a significant loss, net worth continued to grow at credit unions, just at a slightly slower pace.

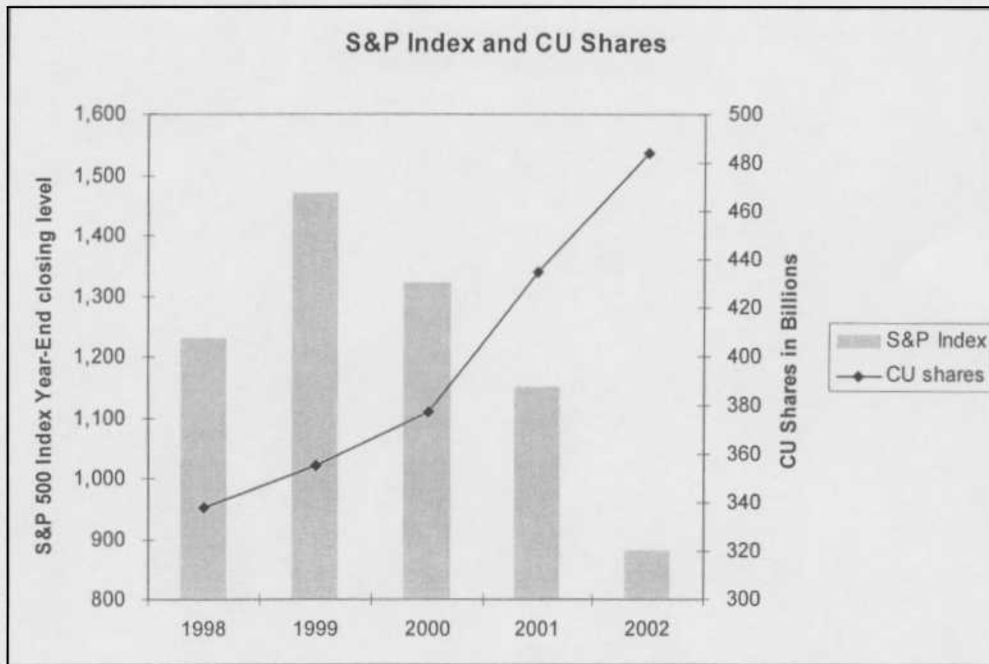
It is important to recognize that there are other issues that existed over the past three years that very likely impacted the level of share growth at credit unions as well as the decline in the S&P 500 Index. Credit unions experienced increased

shares in 1998 and 1999 as the industry prepared for the century roll over (Y2K). After this milestone passed with no discernable negative ramifications, the stock market very shortly thereafter began its descent. The result was that many of the increased shares accumulated during the pre-Y2K period remained at the credit unions where they had been deposited. In addition, the events of 9/11/01 and the wars in Afghanistan and Iraq have affected consumer behavior. These events also are likely to have contributed to the increase in consumer saving at federally insured financial institutions as often occurs during such times of consumer uncertainty.

The two graphs which follow show the level of shares and net worth compared to the level of the S&P 500 index. These show that shares and net worth continued to grow while the stock market decreased. These charts are provided for informational purposes. There were multiple, complex factors that led to this relationship. Using a time-line analysis such as this does not look at growth, but merely shows the trend in different data sets. Future relationships of the S&P 500 Index and share and asset growth will likely be dependent on another set of complex variables.

Average Annual Change	1993-1999	2000-2002
S&P	22.15%	-14.36%
Shares	6.07%	10.96%
Net Worth	11.69%	9.38%





4. Has the Agency performed any studies or internal reports on capital for credit unions? If so, can you please forward them to us?

We are aware of three studies, one internal and two external, that have included a review of capital in corporate credit unions.

Enclosed are:

- *Corporate Credit Union Network Investments: Risks and Risk Management* (The Black Study) completed in 1994 for NCUA by Harold A. Black, Albert E. DePrince, Jr., William F. Ford, James R. Kudlinski, and Robert L. Schweitzer. Tab 1.
- Chapter 6 "Corporate Credit Unions and U.S. Central" from GAO's 1991 *Credit Unions: Reforms for Ensuring Future Safety.* Tab 2.
- Chapter IV "Corporate Credit Unions" from the Department of the Treasury's December 1997 *Credit Unions.* Tab 3.

Also, the Filene Research Institute has published a study "Subordinated Debt for Credit Unions" prepared by Professor James A. Wilcox of the University of California, Berkeley. A copy of that study is enclosed at Tab 4.

5. What has been the Agency's experience with credit unions that have obtained supplemental capital (either low-income credit unions or credit unions in a net worth restoration plan)?

There are fifty-eight low-income credit unions that have secondary capital today. These credit unions range in size from $537,000 to $172 million in assets. The ability to receive secondary capital has enabled many of these credit unions to remain in operation in the face of PCA minimal capital requirements. Twenty-one of these credit unions would have less than 7% net worth had they not issued secondary capital. Although there are increased institutional management responsibilities and agency supervisory requirements associated with credit unions receiving secondary capital, there have been few problems that we have not been able to manage through the supervision process. We have encountered one significant dispute concerning the use of secondary capital in a now liquidated low-income credit union. The credit union is alleged to have used secondary capital of an institutional investor to absorb operating losses, and the investor raised questions about whether the capital was actually used to absorb losses, or to pay an improper dividend. This matter is currently part of a broader investigation involving the failed credit union, and we would be happy to provide further information once the investigation is concluded.

With respect to credit unions under a net worth restoration plan, other than low-income credit unions, the only possible use of secondary capital would be as a justification for a more prolonged net worth restoration period, and NCUA has not yet found it necessary to issue implementing regulations authorizing this use.

6. What has been the Agency's experience with corporate credit unions that have obtained supplemental capital from natural person credit unions? In that experience has the supplemental capital been beneficial to the operations of corporate credit unions in terms of expanding services or protections against losses?

Our experience with supplemental capital in corporate credit unions has been very successful. The membership capital (MC) and paid-in capital (PIC) accounts have served as intended in providing additional protection against losses, introducing an increased awareness of the importance of risk management, and expanding services to members.

As a result of the failure of Capital Corporate Federal Credit Union (CapCorp) in 1995, membership capital absorbed approximately $26 million in losses. The National Credit Union Share Insurance Fund did not suffer any losses from CapCorp. For a summary of the causes behind the failure of CapCorp, please review the enclosed GAO Testimony for Charles A. Bowsher, Comptroller General of the United States, *The Failure of Capital Corporate Federal Credit Union*, February 28, 1995. Tab 5.

MC and PIC have introduced an added measure of awareness to the risk management process in corporate credit unions. The officials are aware that any losses as a result of their decisions will be absorbed by their members' capital accounts before hitting the Share Insurance Fund. As the CEO's of their member credit unions serve on the board of directors they are actively involved in the risk profile of the corporate's balance sheet.

The supplemental capital introduced into the corporate credit union system has been a key factor in providing a level of stability. The added capital provides corporates a cushion to absorb any initial losses associated with start-up cost of new products and services. Over the past few years, corporate credit unions have introduced numerous innovative services ranging from share draft imaging to e-commerce. These services are essential for corporates to remain relevant in serving the financial needs of their members. The supplemental capital introduced into the corporate system has helped make it possible for the corporates to develop and implement these new services.

7. In approving forms of supplemental capital for low-income and corporate credit unions, did the Agency look at different vehicles for obtaining the capital? If so, which forms did the Agency review and why were they rejected?

When secondary capital was first authorized for low-income credit unions in 1996, NCUA considered the scope of permissible investors and concluded that secondary capital should be limited to institutional investors. Given the often limited resources of a low-income credit union's membership and the always-present potential for confusion when uninsured instruments are issued to natural-person investors, it was NCUA's judgment that secondary capital should not be issued to either the public or the general membership.

With respect to corporate credit unions, in response to the various studies noted in #4 above that recommended stronger capital for corporate credit unions and the failure of Capital Corporate Federal Credit Union in 1995, the Agency reviewed options for infusing capital into the corporate credit union system. The only three readily available options for increasing capital in corporate credit unions were determined to be:

1. Contributions to capital from net income of the corporate credit union's operations;

2. Contributions to capital from the corporate credit union's members; and

3. Contributions to capital from outside entities

Option #1. Corporate credit unions operate on a very thin margin. It would take a considerable number of years for corporate credit unions to accumulate any significant amount of capital solely from earnings. Additionally, in order to

operate effectively as liquidity providers, corporate credit unions must be able to expand and contract as the market dictates. Limiting capital to just contributions from earnings would cause capital ratios to fall below the minimum regulatory requirements during periods of excess liquidity, as is currently the case. An unintended consequence might be corporate credit unions shrinking their balance sheets and natural person credit unions placing their funds in more risky investments – resulting in an increased risk to the Share Insurance Fund.

Option #2. Membership capital in corporate credit unions has been around for many years. As a result of the membership capital losses at CapCorp in 1995, the 1998 and 2002 revisions to the corporate credit union regulation introduced additional requirements on membership capital accounts to ensure members are fully aware of the associated risks as well as ensure membership capital cannot be withdrawn in the event of a downturn in a corporate credit union's financial or operational condition.

Option #3. The option of obtaining capital from outside entitles was also considered in the regulatory revision in 1998. The Agency determined this might be a reasonable option for some corporate credit unions in strengthening their capital position. At that time, nonmember paid-in capital was introduced in the corporate regulation. Corporate credit unions have not found it necessary to utilize nonmember paid-in capital, but it does remain an option.

8) To your knowledge has a lack of capital caused any credit union not to participate in the "Access Across America" initiative bringing affordable financial services to low-income and underserved communities?

As you know, with the "Access Across America" initiative we have encouraged federal credit unions to consider expansion into underserved areas as part of their strategic planning. Through the success of this program, federal credit unions added, during the period January 2001 through May 2003, 771 underserved areas with a population total of nearly 50 million. Recognizing that there is some duplication as a result of more than one credit union adding the same or overlapping areas, we nonetheless believe these figures demonstrate the clear success of the Access Across America program in bringing access to credit union services to needy areas. Moreover, the average membership growth rate in credit unions adding underserved areas is almost twice as fast as the overall credit union average for the relevant time frames, demonstrating the commitment of these credit unions to soliciting new members from their expansion areas.

Federal credit unions cannot expand, however, if their net worth to assets ratio is less than "Adequately Capitalized" as defined in the Federal Credit Union Act. Thus, only credit unions that have at least 6% net worth and meet any risk-based net worth requirement would apply for expansion. NCUA has denied a total of 21 requests by 11 federal credit unions to expand into underserved areas. There are a number of critical factors taken into consideration when evaluating an

expansion request. Of these, net worth adequacy is certainly a primary consideration. However, of the eleven affected credit unions, only one had net worth of less than 7%, specifically 6.84%. Thus, it would appear that net worth was not the primary reason for denial in any case. It is also possible there are credit unions that have independently concluded they should not seek to expand services to low-income and underserved communities due to capital constraints and in turn declined to submit a proposal to NCUA.