



STATEMENT

OF

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“STATE OF THE BANKING INDUSTRY: PART II”

BEFORE THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN  
AFFAIRS

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## I. Introduction

The National Credit Union Administration (NCUA) appreciates this opportunity to provide an update to the March 4, 2008, testimony concerning "The State of the Banking Industry." The federally insured credit union industry continues to comprise a relatively small but important part of the financial institution community, and NCUA's perspective on the financial performance of the institutions the agency regulates and insures will hopefully add to the overall understanding of a wide range of issues. Despite the continued downturn in the credit markets, and the resultant effect on the mortgage industry and now the broader economy, the federally insured credit union industry continues to be financially strong and vibrant. NCUA takes seriously the responsibility for close and diligent regulatory oversight in the context of this difficult environment.

NCUA's primary mission is to ensure the safety and soundness of federally insured credit unions. It performs this important public function by examining all federal credit unions, and participating in the supervision of federally insured state chartered credit unions in coordination with state regulators. In its statutory role as the administrator for the National Credit Union Share Insurance Fund, NCUA provides oversight and supervision to 8,049 federally insured credit unions, representing 98 percent of all credit unions and approximately 87.5 million members.<sup>1</sup>

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<sup>1</sup> Approximately 166 state-chartered credit unions are privately insured and are not subject to NCUA oversight.

## II. Financial Status of the Credit Union Industry

The financial state of the federally insured credit union industry remains strong and healthy with financial trends indicating continued margins of safe and sound growth. As with the previous testimony, the following discussion highlights key operating trends and supports the conclusion that federally insured credit unions have followed NCUA's guidance issued to date, particularly related to the risks associated with real estate lending, and continue to be well positioned to successfully address the current downturn in the economy.

### Federally Insured Credit Unions Experience Continued Growth in Assets and Shares

Through the first quarter of 2008, aggregate assets of federally insured credit unions increased \$39 billion (annualized rate of 20.57 percent) to a new high of \$792.16 billion. Federally insured credit unions continue to place a priority on meeting the lending needs of the membership as total loans comprise 67 percent of total assets. This percentage has diluted somewhat since December 2007 due largely to asset growth outpacing loan growth by a margin of five to one.

Not surprisingly, given the trend cited above, total shares grew at an annualized rate of 22.35 percent through the first three months of 2008 to \$668 billion. Nearly all share categories demonstrated strong growth in the first quarter of 2008, with a notable increase in money market and share certificates; these two categories combined for 53

percent of the quarterly dollar increase in total shares. Share certificates continue to represent the largest category of shares.

### Federally Insured Credit Unions Continue to Provide Members with a Full Range of Loan Products

Loans continue to be the largest federally insured credit union balance sheet item, representing an industry-wide commitment to providing members with a full range of lending products and services. At the end of the first quarter of 2008, net loans represented 67 percent of aggregate credit union assets. As with 2007, real estate loans accounted for the majority of all loan growth through March 2008, and represented 52.47 percent of total loans. During the first quarter of 2008, fixed rate first mortgages increased \$6.3 billion (annualized rate of 24.21 percent), and adjustable rate first mortgages increased \$2.3 billion (annualized rate of 12.04 percent).

### While Delinquency is Down Slightly, Net Loan Losses Have Increased in the Current Environment

Federally insured credit unions have appropriately positioned themselves to withstand the current economic cycle and related mortgage lending crisis. However, the federally insured credit union industry is not immune to the macroeconomic impact of increasing credit risk exposure created by the current housing market. Aggregate delinquency remained somewhat consistent in the first quarter of 2008, decreasing slightly from 0.93 percent to 0.91 percent of total loans outstanding. In comparing the various categories of delinquent loans (2-6 months, 6-12 months, and greater than 12 months), NCUA

noted an increase in the dollar amount of delinquent loans in longer-term categories (6-12 months and greater than 12 months) in the first quarter, even with an overall increase in net charge-offs during this same time period.

Delinquent real estate loans in federally insured credit unions increased from 0.67 at year-end 2007 to 0.70 percent through the first quarter of 2008. While this represents the highest mortgage delinquency in the last 13 years, it is important to note that federally insured credit unions have demonstrated an ability to manage economic downturns, as they did when mortgage delinquency hit a high of 0.56 percent in 1995.

The largest area of concern within the category of real estate loans continues to be with the category of Other Real Estate Adjustable Rate Loans, consisting primarily of Home Equity Lines of Credit (HELOCs). Delinquency for this category increased from .80 percent as of year-end 2007 to 0.96 percent as of March 31, 2008.

The aggregate net charge-off ratio for all loans also increased 17 basis points during the first three months of 2008, to 0.67 percent of average loans. This trend, coupled with the increasing delinquency with 6-12 months and greater than 12 months cited above, seem to indicate concerns remain in the credit quality of loan portfolios. Looking more closely at the category of real estate loans, NCUA noted an increase in net charge-offs from 0.08 percent at the end of 2007, to 0.19 percent as of March 31, 2008, with the majority of the increase identified as Other Real Estate Loans (HELOCs/Second Deed of Trust).

## Federally Insured Credit Unions Reporting Continued Increase in Real Estate

### Foreclosures

To facilitate better risk identification and monitoring, NCUA began collecting data on foreclosed real estate with the June 2006 Call Report cycle.<sup>2</sup> Call Report data shows foreclosure trends have been increasing each quarter to a high of \$407 million as of March 31, 2008. However, this represents a small portion (0.15 percent) of total real estate loans outstanding.

### Higher Provision for Loan and Lease Losses Continue to Impact Earnings in the first quarter of 2008

The level of earnings for federally insured credit unions declined further in the first quarter of 2008, to 0.60 percent of average assets. As with the time period covered by the previous testimony, this decline was largely due to an increased Provision for Loan and Lease Losses expense needed to adequately fund for estimated losses in the lending portfolio. This level of return, however, was more than sufficient to cover the cost of operations and to contribute to the already solid level of net worth. This is consistent with NCUA's commitment to focus examination and supervision efforts on a federally insured credit union's ability to build capital to meet members' needs, and not just obtain an arbitrary level of return which may sacrifice service to the membership. This philosophy on evaluating earnings was presented to examiners and federal credit unions in Letter to Credit Unions 06-FCU-04 in August of 2006.

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<sup>2</sup> NCUA's 5300 Call Report is the data collection tool used to collect required financial statement reports from federally insured credit unions on a quarterly basis.

## Federally Insured Credit Unions Continue to Have Strong Net Worth

Aggregate net worth increased \$1.54 billion (annualized rate of 7.13 percent) through the first three months of 2008 to \$87.72 billion, representing a new high dollar level in credit union history and a strong 11.07 percent of total assets. The overwhelming majority of federally insured credit unions remain well capitalized despite a slight dilution in the net worth ratio. This dilution resulted from asset growth exceeding capital growth through the first three months of the year. As of March 31, 2008, 99.09 percent of all federally insured credit unions were at least “adequately capitalized” or better, with 98.3 percent of all federally insured credit unions “well capitalized”.<sup>3</sup>

## Looking Forward

As reported during the previous state of the banking industry testimony, NCUA is aware of an increasing trend in the activity of consumer credit card loans as well as delinquent credit card loans. This could be an indicator of consumers facing financial difficulties and needing funds, particularly now that access to additional credit through HELOCs has been significantly reduced or eliminated. As of March 2008, credit card loan delinquency was 1.36 percent, representing a high-point since 2003. In addition, annualized credit card net charges-offs through March 31, 2008, represent 2.37 percent of average credit card loans outstanding. NCUA will continue to monitor this trend over

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<sup>3</sup> NCUA’s Prompt Corrective Action (PCA) framework utilizes a statutory net worth category classification to include: “Well Capitalized” for credit unions with a total net worth ratio of 7 percent or above, “Adequately Capitalized” for credit unions with a total net worth ratio of 6 – 6.99 percent, “Undercapitalized” for credit unions with a total net worth ratio of 4 – 5.99 percent, “Significantly Undercapitalized” for credit unions with a total net worth ratio of 2 – 3.99 percent, and “Critically Undercapitalized” for credit unions with a total net worth ratio of less than 2 percent. NCUA utilizes a modified version of this matrix for newly-chartered credit unions.

the next several Call Report cycles and provide relevant guidance to the industry and agency staff if warranted.

### **III. Mortgage Lending in the Federally Insured Credit Union Industry**

#### A Closer Look at the Current State of Federally Insured Credit Union Mortgage Lending

As a point of reference, through the first quarter of 2008, first mortgage loan originations throughout the entire mortgage industry were estimated at \$558 billion, of which federally insured credit unions originated only 3.26 percent or \$18 billion first mortgage loans.<sup>4</sup> First mortgage loans held in federally insured credit unions represent only 6.62 percent of mortgage loans outstanding in all federally insured depository institutions.<sup>5</sup>

Seventy percent of federally insured credit unions offer mortgage loans to their members. As reported during the previous testimony in March, those credit unions not offering mortgage loans are generally smaller in asset size and cannot afford the expertise or infrastructure to grant mortgages or manage mortgage portfolios.<sup>6</sup>

Consequently, the majority of federally insured credit union mortgage lending occurs in larger federally insured credit unions, as the following chart illustrates:

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<sup>4</sup> Based on information available at the Mortgage Bankers Association website for 2007 Purchase and Refinance Originations [http://www.mbaa.org/files/Bulletin/InternalResource/62590\\_.pdf](http://www.mbaa.org/files/Bulletin/InternalResource/62590_.pdf).

<sup>5</sup> NCUA data and *FDIC- Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 3/31/2008*. 31 March 2008. Federal Deposit Insurance Corporation. <<http://www2.fdic.gov/SDI/SOB>>.

<sup>6</sup> In addition, for federal credit unions, loans to a single member are statutorily limited to 10 percent of a federal credit union's total unimpaired capital and surplus (shares plus post-closing undivided earnings). See 12 C.F.R. 701.21(c)(5).



<b>Federally Insured Credit Unions by Asset Size</b>	<b>Number of Mortgage Loans Originated Jan 1 – Mar 31, 2008</b>	<b>% of Federally Insured Credit Union Mortgage Loan Portfolio as of 3/31/2008</b>
Greater than \$1 billion	128,301	48.05%
\$500 million-\$1 billion	51,271	17.33%
\$50 million-\$500 million	109,401	29.61%
\$10 million-\$50 million	17,610	4.64%
Less than \$10 million	1,319	0.37%

Demand for mortgage loans in federally insured credit unions remains high. As mentioned earlier, mortgage loans led all loan types in growth through the first three months of 2008, increasing \$8.49 billion to a new high of 52 percent of total loans. In fact, in the absence of mortgage loan growth, aggregate loan growth for federally insured credit unions would have been negative in 2007 as well as through the first three months of the this year. NCUA continues to closely watch performance indicators in the mortgage lending area through data collection and the examination and supervision process.

As the following chart demonstrates, the majority of mortgage loans in federally insured credit unions are fixed rate, with almost all of the remainder being standard adjustable rate mortgages. Nontraditional mortgages<sup>7</sup> are offered by less than 6 percent of

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<sup>7</sup> Consistent with guidance issued by NCUA and the other FFIEC member agencies, the term “nontraditional mortgage” covers a broad category of “exotic” or “alternative” mortgage products, including interest only and payment option loans.

federally insured credit unions and represent only 2.4 percent of mortgage loans outstanding.

<b>Type of Mortgage</b>	<b>Dollar Amount of Mortgage Loan Portfolio (billions) as of 3/31/2008</b>	<b>% of Federally Insured Credit Union Mortgage Loan Portfolio as of 3/31/2008</b>
Fixed Rate	\$163	58.2%
Adjustable Rate	\$117	41.8%
Interest Only or Payment Option <sup>8</sup>	\$6.7	2.4%

Fixed rate mortgage loans accounted for 67.1 percent of the increase in mortgage loans during the first quarter of 2008. Fixed rate mortgages in federally insured credit unions grew at a rate of 14.6 percent (annualized) through March 2008. Adjustable rate mortgage loans accounted for 32.9 percent of the increase in mortgage loans during the first quarter of 2008, and grew at a rate of 9.71 percent (annualized). This data indicates a clear preference by federally insured credit union members for fixed rate mortgage loans in the current economic environment, and likely includes a significant degree of refinancing of adjustable rate mortgages.

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<sup>8</sup> NCUA does not capture information relating to the type (fixed or adjustable) of “interest-only” or “payment-option” loans, just the dollar amount outstanding for these loan products. This amount is reflected in the totals for both fixed and adjustable rate mortgage loans outstanding.

### Nontraditional Mortgage Lending in Federally Insured Credit Unions

Recognizing the increase in nontraditional mortgage products in the broader market, NCUA amended the 5300 Call Report to collect data on certain nontraditional first mortgage loans. Results for these mortgage products became available with the March 2007 reporting cycle. The data indicates that these mortgage products (specifically “Interest-Only” or “Payment Option” mortgages) are only offered in a small number of federally insured credit unions and comprise a very small portion of the total mortgage portfolio.

As the following table indicates, federally insured credit unions typically grant traditional mortgage loans:

<b>Types of Federally Insured Credit Union Real Estate Loans<sup>9</sup></b>					
<b>Quarter Ending:</b>	<b>Mar-07</b>	<b>Jun-07</b>	<b>Sep-07</b>	<b>Dec-07</b>	<b>Mar-08</b>
<b>Total Fixed Rate First Mortgages</b>	37.6%	38.3%	38.2%	38.3%	39.4%
<b>Total Balloon/Hybrid First Mortgages</b>	17.1%	16.9%	17.1%	17.2%	17.4%
<b>Total Adjustable First Mortgages</b>	11.1%	11.0%	10.8%	10.6%	10.4%
<b>Total Other Real Estate</b>	34.2%	33.8%	33.9%	33.8%	32.8%
<b>Total Real Estate Loans</b>	100.0%	100.0%	100.0%	100.0%	100.0%
<b>Non-Traditional: Interest Only/Optional Payment Loans<sup>10</sup></b>	1.9%	1.8%	2.1%	2.3%	2.4%

The non-traditional loans (Interest Only/Optional Payment Loans) account for only 2.4 percent of total real estate loans outstanding and 0.85 percent of total assets. There

<sup>9</sup> The table reflects the percentage of each real estate loan type to total outstanding real estate loans.

<sup>10</sup> NCUA only captures the balance of Interest Only/Optional Payment Loans and does not distinguish the type of such loans. Therefore, the Interest Only/Optional Payment Loans dollars are intermixed into the various types of loans listed in the table.

are several reasons why these riskier mortgage loans are not prevalent in federally insured credit unions. As earlier addressed, many federally insured credit unions are smaller institutions that lack the sophistication or resources to underwrite these types of loans. Also, as member-owned not-for-profit cooperatives, federally insured credit unions lending motivation is designed to be member-oriented, appropriately concerned with the suitability and impact on the member. In addition, the Federal Credit Union Act prohibits prepayment penalties and establishes a statutory limit for interest rates.<sup>11</sup> Because of these statutory provisions, the regulatory environment for federal credit unions is not conducive to some of the features that make the cost of underwriting non-traditional loans more tenable to other types of institutions.

### Mortgage Loan Performance

Over the last decade, aggregate federally insured credit union mortgage delinquency has been very low, averaging approximately 0.38 percent. Mortgage loan losses have been equally low at 0.05 percent even with the increased numbers associated with these trends throughout 2007 and the first three months of 2008. Real estate delinquency continued to increase to 0.70 percent during the first quarter of 2008; however, it still remains at a very manageable level.

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<sup>11</sup> The Federal Credit Union Act establishes a limit of 15% per annum inclusive of all service charges, with authority for the NCUA Board to establish a higher ceiling when certain economic conditions are met. The ceiling is currently set at 18%. 12 U.S.C. §§1757(5)(A)(vii) and 1757(5)(A)(viii).

<b>Real Estate Loan Delinquency &gt; 2 Months</b>					
<b>Quarter End:</b>	<b>Mar-07</b>	<b>Jun-07</b>	<b>Sep-07</b>	<b>Dec-07</b>	<b>Mar-08</b>
<b>1st Mortgage Fixed/Total 1st Mtg Fixed Loans</b>	0.28%	0.36%	0.44%	0.48%	0.46%
<b>1st Mortgage Adjustable Rate/Total 1st Mtg Adjustable Rate Loans</b>	0.31%	0.33%	0.46%	0.69%	0.87%
<b>Interest Only &amp; Payment Option First Mortgage/Total Int Only and Pmt Opt First Mtg Loans</b>	0.34%	0.34%	0.88%	1.66%	1.98%

As noted in the table above, nontraditional loans experienced an increase in delinquency. NCUA will continue to monitor the levels of delinquency and losses associated with these loans to ensure the additional risks are being properly measured and controlled. These levels, however, do not represent a threat to the safety and soundness of the federally insured credit union industry.

Federally insured credit unions typically continue to experience low real estate foreclosure rates as demonstrated in following table:

<b>Foreclosed Real Estate (By Quarter)</b>					
<b>Quarter Ending:</b>	<b>Mar-07</b>	<b>Jun-07</b>	<b>Sep-07</b>	<b>Dec-07</b>	<b>Mar-08</b>
<b>Amount (in Millions)</b>	190.2	213.4	271.8	331.9	406.9
<b>Percentage Increase</b>	15.93%	12.17%	27.40%	22.11%	21.65%
<b>Percentage of Total Real Estate Loans Outstanding</b>	0.08%	0.08%	0.10%	0.12%	0.15%

Over the last 12 month period (March 2007 – March 2008), foreclosed real estate held by federally insured credit unions has more than doubled. A state-by-state breakdown of foreclosed real estate based on credit union location shows three states alone (California, Michigan, and Virginia) account for over a third of total foreclosure dollars

and nearly a quarter of the number of credit unions reporting foreclosures. Further analysis, however, shows that the actual dollar amount of \$407 million in foreclosed real estate continues to represent only a small fraction, 0.15 percent, of the \$280 billion in total real estate loans outstanding in federally insured credit unions, and does not represent a threat to the safety and soundness of the credit union industry. NCUA has also identified other geographical areas which warrant enhanced supervisory oversight, and has reallocated resources to ensure a proper level of staff are available to monitor credit unions' efforts through this particularly distressed economy.

#### NCUA's Demonstrated History of Mortgage Lending Guidance to the Industry

In the late 1970s, legislation expanded services to federally insured credit union members to include mortgage lending. This added another option for consumers who found it difficult to obtain real estate loans from commercial banks and savings institutions. Over the last thirty years or so, mortgage lending by federally insured credit unions has been considered a relatively safe product, subject more to interest rate risk exposure than the credit risk typically associated with lending products. As emerging risks have been identified, NCUA has provided written guidance to federally insured credit unions in the form of Letters to Credit Unions. Many of these pieces of guidance, some dating back to the 1970s, have been either cancelled or superseded by more relevant guidance to address emerging risks.

The written statement submitted for the previous testimony illustrated an established history of guidance related to mortgage lending dating back to 1991. Further, since the

previous testimony NCUA has issued additional guidance to the industry on this important issue.

Shortly after the last testimony, NCUA issued Letter to Credit Unions 08-CU-05 to encourage federally insured credit unions servicing subprime adjustable rate residential mortgages to utilize the HOPE NOW Alliance's loan modification standards to report foreclosure prevention efforts. The message conveyed in this letter built on previous statements issued by NCUA and the other FFIEC member agencies; working constructively with residential borrowers who are financially unable to make contractual payments on their home loans can be in the best interest of both the credit union and the borrower when done prudently.

Just last month, NCUA and the other FFIEC member agencies jointly released finalized Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products to assist credit unions with implementing the guidance contained in the Interagency Statement on Subprime Mortgage Lending issued last July.

#### **IV. CONCLUSION**

The federally insured credit union system remains financially sound. These institutions have effectively implemented guidance issued by NCUA related to real estate lending and have positioned the industry to weather this current economic downturn. Since the last "state of the industry" testimony in March, federally insured credit unions have

continued to demonstrate sound financial performance. While the data shows the industry is not entirely insulated from the adverse impact of the real estate lending crisis, it also supports the strong risk management principles effectively implemented by federally insured credit unions nationwide.