STATEMENT

OF

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"EXAMINING THE STATE OF THE BANKING INDUSTRY"

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

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I. Introduction

The National Credit Union Administration (NCUA) appreciates the opportunity to provide views on "Examining the State of the Banking Industry." Federally-insured credit unions comprise a relatively small but important part of the financial institution community. However, some 90 million members belong to credit unions so the asset size of the industry is not proportional to its importance to consumers.[1]

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, participating in the supervision of federally-insured state chartered credit unions in coordination with state regulators, and insuring federally-insured credit union members' accounts. In its statutory role as the administrator for the National Credit Union Share Insurance Fund (NCUSIF), NCUA provides oversight and supervision to 7,691 federally-insured credit unions, representing 98 percent of all credit unions and approximately 90 million members.[2]

While credit unions were not active participants in the non-traditional and subprime mortgage lending activities which facilitated much of the financial crisis over the last 18

[1] June 30, 2009 total assets for credit unions equaled $870.13 billion, while total assets for federally-insured banks equaled $11.9 trillion. Based on June 30, 2009 Call Report (NCUA Form 5300) data and *on information available at the FDIC website: http://www2.fdic.gov/SDI.*

[2] Approximately 156 state-chartered credit unions are privately insured and are not subject to NCUA oversight. The term "credit union" is used throughout this statement to refer to federally insured credit unions.

months, they have nonetheless been adversely impacted by the ripple effects of these market dislocations. Although the majority of credit unions heeded NCUA's repeated warnings about the risks of certain lending programs, some corporate credit unions, including the two largest, invested in pools of securitized subprime, Alt-A, and other non-traditional mortgage loans. The current projected credit losses on the underlying mortgages are far beyond those expected at the time of investment, resulting in significant losses to these corporate credit unions. This has had far reaching effects, impeding liquidity and capital throughout the credit union industry.

II. Status of Corporate Credit Unions

The downturn in the residential mortgage-backed securities market had a devastating impact on the twenty-eight corporate credit unions.[3] As stated earlier, a number of corporate credit unions invested in mortgage-backed products. While the majority of the investments were AAA or AA rated, even highly rated securities were not immune to the market contagion. In 2005 and 2006, significant levels of non-agency residential mortgage-backed positions in the ALT-A sector, with mezzanine ALT-A tranches, were added to the portfolios of the two largest corporate credit unions – Western Corporate Federal Credit Union (WesCorp) and U.S. Central Federal Credit Union (U.S. Central). The subsequent market downturn which began in 2007 forced both WesCorp and U.S.

[3] Corporate credit unions operate primarily for the purpose of serving credit unions. There are currently twenty-seven retail corporate credit unions that primarily serve natural person credit unions. Additionally, there is one wholesale corporate credit union (U.S. Central Federal Credit Union) that is a corporate credit union serving the retail corporates. As of August 31, 2009, total corporate credit union network assets were $93.7 billion and total shares and deposits of $94.8 billion.

Central to reflect significant losses when performing a valuation of their investment portfolios in accordance with Generally Accepted Accounting Principles.

The immediate impact of the market downturn was a critical global liquidity crisis and credit unions were also affected. Traditionally, credit unions relied heavily on corporate credit unions for liquidity needs. However, corporate credit unions were not able to liquidate the mortgage-backed securities in their investment portfolios without recognizing significant losses. NCUA took decisive action to utilize its resources to ensure adequate liquidity in the credit union system. The NCUSIF and the Central Liquidity Facility (CLF),[4] in its role of improving general financial stability by meeting the liquidity needs of credit unions, served as major catalysts to the NCUA's liquidity stabilization efforts in developing numerous programs. Some of the key actions include:

1. The Temporary Corporate Credit Union Liquidity Guarantee Program was introduced in October 2008.[5] Under this program, the NCUSIF guarantees the timely payment of principal and interest on certain unsecured debt of participating corporate credit unions.

2. The Credit Union Homeowners Affordability Relief Program (CU HARP) was adopted in December 2008.[6] Under the program credit unions were able to help

[4] The Central Liquidity Facility was created by Congress in 1979 to improve the general financial stability of the credit union industry by meeting the liquidity needs of individual credit unions.
[5] Information on the Temporary Corporate Credit Union Liquidity Guarantee Program can be found at http://www.ncua.gov/Resources/CLF/Index.aspx.
[6] Information on the Credit Union Homeowners Affordability Relief Program (CU HARP) can be found at http://www.ncua.gov/Resources/CLF/Index.aspx.

eligible members hold onto their homes while also maintaining liquidity in the credit union system. Credit unions receiving a CU HARP advance through the CLF were required to invest the proceeds in a CU HARP Note, which is a NCUSIF guaranteed senior debt of a corporate credit union. The participating credit unions receive the benefit of passing on a rate break to their members in the form of a 1 percent bonus coupon to assist in making their mortgage loan more affordable.

3. The Credit Union System Investment Program (CU SIP) was also adopted in December 2008.[7] Credit unions receiving a CU SIP advance through the CLF were required to invest the proceeds in a CU SIP Note, which is a NCUSIF guaranteed senior debt of a corporate credit union. CU SIP funds provided a source of liquidity to corporate credit unions within the credit union system.

4. The Temporary Corporate Credit Union Share Guarantee Program was adopted in January 2009.[8] Under this program, the NCUSIF was utilized to guarantee all shares (excluding paid-in capital and membership capital accounts) in corporate credit unions.[9]

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[7] Information on the Credit Union System Investment Program (CU SIP) can be found at http://www.ncua.gov/Resources/CLF/Index.aspx.

[8] Information on the Temporary Corporate Credit Union Share Guarantee Program can be found at http://www.ncua.gov/Resources/CLF/Index.aspx.

[9] Paid-in capital accounts are perpetual, non-cumulative dividend accounts; are available to cover losses that exceed retained earnings; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings. Membership capital accounts are funds contributed by members that are adjustable balance with a minimum withdrawal notice of 3 years or are term certificates with a minimum term of 3 years; are available to cover losses that exceed retained earnings and paid-in capital; are not insured by the NCUSIF or other share or deposit insurers; and cannot be pledged against borrowings.

These efforts were critical in stabilizing the liquidity situation throughout the credit union system. Combined, credit union participation in CU HARP and CU SIP provided approximately $8.4 billion in funding to the corporate credit union system. The Temporary Corporate Credit Union Share Guarantee Program reduced an outflow of credit union funds from corporate credit unions and allowed corporate credit unions to maintain a presence in the marketplace. Without these efforts, it is highly likely that a liquidity crisis would have devastated the credit union system, and would have forced some corporate credit unions to liquidate their mortgage-backed securities at depressed market prices and incur significant losses.

NCUA contracted for an independent third-party valuation beginning in January 2009 to evaluate the credit risk in mortgage-backed securities held by the corporate credit unions. It was imperative that NCUA have an independent means of testing the veracity of the corporate credit union modeling results before committing the NCUSIF as a means of resolving the issues. The corporate credit unions maintained internal processes for pricing investment portfolios, and also obtained independent third-party credit analyses. As the condition of the portfolios of WesCorp and U.S. Central continued to deteriorate, NCUA determined it was necessary to take action to protect the members of those corporates and to safeguard the NCUSIF. On March 20, 2009, WesCorp and U.S. Central were placed into conservatorship.

The impact of the losses at U.S. Central reverberated through the rest of the corporate credit unions. Twenty-six of the twenty-seven retail corporates are members of U.S. Central. As the losses at U.S. Central exceeded retained earnings, the paid-in capital and membership capital accounts held by the retail corporates were depleted to absorb the losses. Retail corporate credit unions' paid-in capital at U.S. Central was depleted by 100 percent and retail corporate credit unions' membership capital was depleted by 63.7 percent. The losses flowed through to natural person credit unions. Where losses exceeded retained earnings at the retail corporate credit union, than the paid-in capital and membership capital accounts invested by natural person credit unions were depleted.

Over the past year, each quarterly modeling performed by the corporate credit unions on their investment portfolios reflected increasingly negative economic information which resulted in additional losses in the portfolios. Although, the rate of change in the amount of losses is slowing, as conditions continue to deteriorate in the real estate markets, there may be additional investment losses.

NCUA is in the process of drafting significant revisions to its corporate credit union rule, Part 704. NCUA issued an Advanced Notice of Proposed Rulemaking (ANPR) in January 2009 to solicit comments on reforming the corporate credit union system. Over 400 comment letters on the ANPR were received and NCUA is currently developing a proposed rule for public comment. To supplement the comments received on the ANPR, NCUA has also been hosting a series of town hall meetings across the nation to

foster face-to-face dialogue about the proposed rule. In addition to looking at those issues that may have directly led to the current problems facing corporate credit unions, NCUA is conducting a comprehensive review of the entire corporate regulatory framework. The key areas under review are:

- Capital and Prompt Corrective Action requirements;
- Investment concentration and sector limits;
- Asset-Liability Management requirements; and,
- Corporate Governance.

It is NCUA's goal to issue the proposed rule for comment in November 2009 and have in place a new regulatory framework for the corporate credit union system by mid-2010. As the industry moves through the regulatory transition period, continued support by the NCUSIF and the CLF will be critical to natural person credit unions' ability to meet the financial needs of the 90 million credit union members.

WesCorp and U.S. Central are preparing to utilize external sources of funding through offering issuances guaranteed by the NCUSIF for terms of two to three years. This action will provide liquidity within the credit union system during the regulatory transition period, and enable NCUA to consider alternatives in the disposition of the distressed assets on the corporate credit union balance sheets.

NCUA has taken very concrete action to protect the credit union system by stabilizing the corporate credit unions and providing options for a resolution that would be the least costly to the NCUSIF. It should be noted that regardless of the final regulatory framework established, corporate credit unions will only be viable if their natural person credit union members are willing to recapitalize them.

III. NCUA's Actions to Stabilize the Credit Union Industry

Since the summer of 2008, NCUA implemented actions in addition to those already discussed to help stabilize the credit union industry in the wake of the mortgage and housing crisis. One crucial step taken was to pursue Congressional action to lift the appropriated lending limit for the CLF from $1.5 billion to its full statutory limit of $41.5 billion. NCUA appreciates the support provided by Congressional leaders in granting this request, as it has played a key role in maintaining sufficient liquidity within the credit union system.

Following the passage of the Emergency Economic Stabilization Act, NCUA intensified its share insurance public awareness campaign, through television, radio, and print advertisements, to highlight the increased insurance amount of $250,000 as well as the overall strength of federal insurance. An electronic Consumer Share Insurance Tool Kit was developed and posted to NCUA's website. The Tool Kit contains useful consumer brochures, a share insurance estimator, and other insurance-related publications.[10]

[10] Available at http://www.ncua.gov/Resources/ShareInsuranceToolkit.aspx.

NCUA also petitioned the Department of Treasury and the Board of Governors of the Federal Reserve System to allow the agency to expand the lending authority of the CLF for other than liquidity purposes. With their concurrence, NCUA was able to move forward with the CU SIP and CU HARP initiatives addressed above.

On May 20, 2009, the Helping Families Save Their Homes Act was signed into law. Among other things, this crucial piece of legislation established the Temporary Corporate Credit Union Stabilization Fund (TCCUSF) to mitigate near-term stabilization costs by allowing costs to be spread over a 7-year period instead of being assessed in a lump sum. Within a month of the legislation, NCUA acted decisively to establish the necessary corporate governance structure of this separate stabilization fund. On June 18, 2009, the Board approved actions to legally obligate the TCCUSF for the costs of stabilizing the corporate system.

IV. Status of Natural Person Credit Unions

The credit union industry has been challenged over the last 18 months. Unprecedented high rates have been recorded for many key financial ratios, including real estate delinquency, aggregate delinquency, and net losses. During this same timeframe, however, credit unions also received large amounts of member deposits and continued lending when many other financial institutions were scaling back lending efforts. The following discussion highlights some key operating trends.

Credit Unions Provide Members with a Full Range of Loan Products

As often happens during economic downturns, a savings flight to quality drove an annualized increase in member deposits of nearly 16 percent through the first six months of 2009. This provided funds for credit unions to continue to lend during the economic downturn. Loans continue to be the largest credit union balance sheet item, representing an industry-wide commitment to meeting the lending needs of members with a full range of lending products and services. At the mid-point of 2009, net loans represented 65 percent of aggregate credit union assets. Loans increased $4 billion in the first half of 2009 and increased $37 billion during 2008. Consistent with the last few years, real estate loans accounted for the majority of all loan growth through the first half of 2009, and represent 54 percent of total loans. During this same timeframe, fixed rate first mortgages increased $6.95 billion, or 5.66 percent, and adjustable rate first mortgages increased $650 million, or 2.10 percent.

Delinquency and Net Loan Losses Have Increased in the Current Environment

The credit union industry is not immune to the macro economic impact of increasing credit risk exposure created by the current housing market. Since the end of 2006, the aggregate delinquent loan ratio has been steadily increasing, from 0.68 percent to a high of 1.58 percent of total loans as of June 2009. The aggregate net charge-off ratio for all loans also increased during the first half of 2009, from 0.85 percent to 1.15 percent of average loans.

Another key indicator of credit risk is the combined delinquency and net charge-off ratio. This ratio highlights an adverse cycle of delinquency despite aggressive charge-offs. The combined delinquency and net charge-off ratio has been increasing each quarter over the last 24 months to a high of 2.74 percent of average loans as of June 2009, compared to 1.14 percent in June 2007.

Higher Provision for Loan and Lease Losses and NCUA Corporate Stabilization Efforts Impacted Earnings

Aggregate credit union earnings through the first half of 2009 reflect actions taken by NCUA, through the NCUSIF, to stabilize the corporate credit union system and prevent interruption of services to natural person credit unions and their members. Through the first half of 2009, credit unions reported an annualized return on average assets of 0.28 percent.

Notwithstanding the NCUSIF stabilization efforts, credit union income levels were largely impacted by high levels of provision for loan and lease loss expense needed to fund reserves allocated for credit deteriorations in loan portfolios. The level of provisioning for loan losses may continue as the industry works through the current economic environment.

Credit Unions Still Have Strong Net Worth

Aggregate net worth increased $1.11 billion, or 1.29 percent through the first six months of 2009, to $87.34 billion, representing the highest dollar level in credit union history.

Although asset growth outpaced net worth growth during this same time period, thereby diluting the industry net worth ratio to 10.03 percent of total assets, the overwhelming majority of credit unions remain well capitalized. As of June 30, 2009, 98.35 percent of all credit unions were at least "adequately capitalized" or better, with 96.09 percent of all credit unions "well capitalized."[11] It is important to note, however, the influx of member shares coupled with declining net interest margins and high provision for loan and lease losses has slightly eroded the industry's net worth ratio to 2002 levels.

Emerging Trends

As mentioned earlier, the majority of credit unions have demonstrated sufficient restraint in avoiding the types of mortgage products which helped facilitate this financial downturn. As this downturn grew into an economic recession, even the most conservative credit unions faced unparalleled challenges resulting from declining home values and rising unemployment. NCUA will continue to monitor adverse trends stemming from this crisis. NCUA will be focusing on the following potential areas of concern:

1) *Interest Rate Risk*

Given the refinancing activity that typically occurs during a period of low interest rates, NCUA has observed an increasing level of fixed rate real estate loans, presently 64 percent of all mortgage loans. While NCUA recognizes the benefit to consumers of refinancing higher rate real estate loans into lower fixed rate

[11] See 12 C.F.R. Part 702

loans, NCUA is concerned with the increasing interest rate risk associated with a high level of fixed rate, long-term assets should rates rise rapidly.

2) Member Business Lending

Subject to established regulations and a statutory lending limit, credit unions are permitted to maintain a member business loan portfolio.[12] NCUA supports a proper balance of serving members' business lending needs with a prudent regulatory framework to protect the NCUSIF. NCUA has been monitoring the increasing level of member business loans within the credit union community, presently at $27.1 billion. While this figure represents only 3.11 percent of total credit union industry assets, NCUA is concerned with the increasing levels of delinquent member business loans, as well as an increasing concentration of large credit unions with supervisory concerns which are holding member business loans. As an example, a review of 71 credit unions with identified supervisory concerns was conducted as of June 30, 2009. These credit unions averaged $1.1 billion in assets and 62 of them reported member business loans. By way of contrast, in 2005, only 50 of these same credit unions held member business loans. These credit unions hold higher levels of member business loans than the industry as a whole, both in 2005 and today. For these credit unions, the past due and charged off member business loans were lower than the credit union industry in 2005, but in the current environment the level increased to several multiples of the credit union industry aggregate levels.

[12] See 12 C.F.R. Part 723.

For this group, delinquent member business loans increased from 0.17 percent to 8.34 percent in the last 42-month period, compared to the credit union trend of 0.47 percent to 3.19 percent during this same timeframe. A similar trend during this period was noted in net charge-offs, as the percent for this group increased from 0.04 percent to 0.33 percent compared to the credit union trend of 0.07 percent to 0.40 percent. Although member business lending was not identified as the primary area of concern in all of the large credit unions in this group, NCUA is concerned with the additional risks to operations member business loans can pose when coupled with other operational concerns. NCUA will be proactively monitoring member business loan exposure and plans to issue additional guidance in the near future.

3) Increasing Number of Troubled Credit Unions

NCUA has been adjusting our supervision programs and staffing given the increasing number of troubled credit unions as the industry moves through this stage of the economic cycle.[13] There are currently 326 troubled credit unions holding $42.2 billion in assets, representing 4.2 percent of all credit unions and 4.9 percent of all credit union assets. While the number of troubled credit unions increased in the current year, the pace of that growth was slightly lower than in 2008. Troubled credit unions with over $100 million in assets have grown at a faster rate than those with assets under $100 million.

[13] NCUA defines a troubled credit union as rated either a CAMEL Code 4 or 5.

As of September 30, 2009, 66 credit unions with assets over $100 million were considered troubled credit unions, compared to 12 in 2007. NCUA anticipates the overall number of troubled credit unions is likely to increase through the end of 2010 and into 2011. It is also likely that the rate of growth in the number and assets of troubled credit unions will decelerate as the economy recovers. Regardless, NCUA has enhanced the examination program and dedicated additional resources to help manage the risks with troubled credit unions. These measures also include allocating appropriate on-site examination and supervision time at state chartered credit unions given their risk profile.

The NCUSIF has experienced increased losses during the past two years. In 2008 there were 18 credit union failures at a cost of $233 million. Through September 30, 2009 there have been 21 failures at a cost of $95 million.

Stress Testing the NCUSIF

The NCUSIF was created by Public Law 91-468 (Title II of the Federal Credit Union Act), which was amended in 1984 by Public Law 98-369. The Fund was established as a revolving fund in the United States Treasury under the NCUA Board for the purpose of insuring member share deposits in all federal credit unions and in qualifying state credit unions that request insurance. The NCUSIF is comprised of the 1 percent insured share deposit that credit unions contribute to the NCUSIF and the retained earnings of the fund. The NCUA Board is required to maintain the fund's equity ratio between 1.20

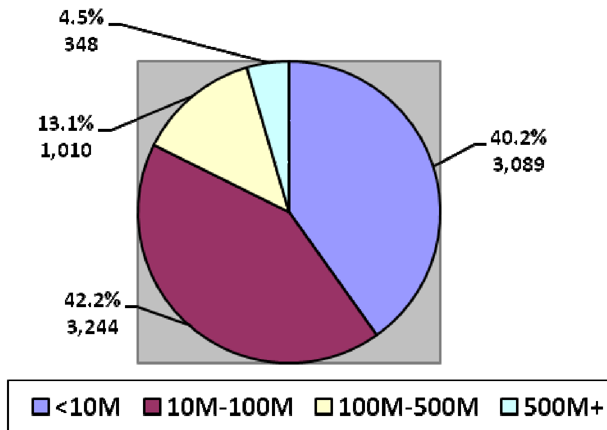
percent and 1.50 percent of insured shares. The Normal Operating Level has been maintained at 1.30 percent since December 1999.

As of December 31, 2008, the NCUSIF's equity ratio was 1.27 percent. However, the increased limit on share insurance, high levels of share growth, and increased levels of real and potential losses resulted in a reduction in the NCUSIF's equity ratio during 2009. In September, the NCUA took action to assess a 10 basis point premium on all credit unions' insured shares to restore the equity ratio to 1.30 percent.

To measure the robustness of the NCUSIF, NCUA performed a series of stress tests. The tests included analyzing the impact of further declines in real estate conditions, the impact of potential exposure to losses in the corporate credit union system, and the impact of the layering of these two stress events. NCUA also performed stress tests using the economic scenarios and the related loss rates utilized by the Department of Treasury in the Supervisory Capital Assessment Program. The result of these stress tests disclosed a wide range of losses. The amount of losses at baseline stress levels are well within the ability of the NCUSIF to absorb, but the number of credit unions that would be subject to additional supervision would create resource challenges. Should economic conditions significantly deteriorate, it is possible that losses could be greater than the level of the NCUSIF's current retained earnings, resulting in the need for credit unions having to expense and fund part of the 1 percent contributed capital deposit. NCUA will continue to assess the robustness of the fund as economic conditions change and take appropriate actions based on the results.

V. LARGE AND SMALL CREDIT UNION CONSIDERATIONS

When comparing the size and complexity of credit unions to banks, even the largest credit unions are small in comparison to most banks. As shown in the graph below, small credit unions make up the majority of the institutions which the NCUA insures.



Eighty-two percent of credit unions have less than $100 million in assets as opposed to thirty-eight percent of the institutions that the Federal Deposit Insurance Corporation (FDIC) insures with the same asset size.[14] Total assets in the entire credit union industry are less than the individual total assets of some of the nation's largest banks.

As of June 30, 2009, the credit union industry is well capitalized at 10.03 percent; however, small credit unions (less than $10 million in assets) tend to be better capitalized than the larger credit unions. As of June 2009, small credit unions had an

[14] *Based on information available at the FDIC website: http://www2.fdic.gov/SDI.*

average net worth of 17 percent as compared to an average net worth of larger credit unions (more than $10 million in assets) of 9.95 percent.

As of June 2009, there were 3,089 small credit unions as compared to 4,602 larger credit unions. These small credit unions represent 40 percent of total credit unions serving approximately 3 million members, or 3 percent of the 89 million members served by credit unions.

The impact of current economic conditions appears to weigh more heavily on small credit unions than larger credit unions. During the first six months of this year, small credit unions' net worth declined $196 million while larger credit unions' net worth increased by $1.3 billion. Also during this period, small credit unions reported a negative net income while large credit unions reported positive net income.

The highest share and loan growth was reported in larger credit unions; however, the larger credit unions are reporting the highest charge-offs and provision for loan and lease losses. The larger credit unions have the ability to provide a wider array of member services, including, but not limited to, electronic banking, real estate loans, and member business loans.

NCUA's Office of Small Credit Union Initiatives

In 1993, NCUA created the Office of Community Development Credit Unions dedicated to ensuring the long-term viability of small and low-income designated credit unions.

Today this activity is handled by the Office of Small Credit Union Initiatives (OSCUI), which has expanded from a staff of six and a budget of $756,000 in 2004, to 27 staff and a $4.7 million budget in 2009.

OSCUI conducts regional and national training workshops on a variety of topics to help small and low-income designated credit unions succeed. For example, in 2008, OSCUI conducted 20 national workshops, 10 roundtables, and 22 clinics offering topics that will assist credit unions in product development, planning, and operational and compliance issues. In attendance at OSCUI's 2008 training events were 2,494 credit union representatives representing 1,490 credit unions. NCUA scheduled another 20 workshops in 2009. Topics for these events included regulatory hot topics, collections and workout plans, and allowance for loan and lease loss funding. The 2009 workshops also included an outreach panel of representatives from various community organizations and federal agencies to discuss financial and fraudulent matters facing consumers.

OSCUI's 15 economic development specialists (specialists) provide one-on-one direct assistance and training to officials of small and low-income designated credit unions around the country. The specialists assist with areas such as strategic planning, adding new products and services, board and supervisory committee training, policy development, and grant writing.

In addition, NCUA has administered the CDRLF since 1987. This program, which is available only to low-income designated credit unions, provides Technical Assistance Grants (TAGs) and low-cost loans to those low-income designated credit unions interested in enhancing service to their membership. Since inception, the CDRLF has revolved its loan fund 4 times. With 13.4 million appropriated for loans, the CDRLF has made loans totaling $52 million to more than 300 credit unions. Lending and relending CDRLF monies have effectively quadruped the impact of the $13.4 million in appropriation

In 2008, NCUA approved $1.15 million in grants to 240 credit unions. These low-income designated credit unions used the grant and loan funds to touch the lives of the members of their communities by:

- ✓ Overcoming the language barrier with translated financial service materials;
- ✓ Offering free income tax return services;
- ✓ Opening offices to better serve their members;
- ✓ Providing financial education opportunities; and
- ✓ Providing loans to develop alternative loan programs to combat predatory lending.

Specialized Supervision

NCUA's mission includes serving and maintaining a safe, sound credit union community. To accomplish this, NCUA has developed specialized programs including

the National Examination Team to supervise credit unions showing a higher risk to the NCUSIF; Subject Matter Examiners to address specific areas of risk; and Economic Development Specialists to provide hands-on assistance to small credit unions.

Last fall, NCUA modified its examination program to shorten the examination cycle from 18 to 12 months, to better identify and assess emerging trends. In conjunction, NCUA also increased examination staff to address rising levels of risk within the credit union industry. In 2009 NCUA added 50 examiners to our field staff, and plans to add another 57 in 2010. Additionally, risk monitoring systems have been enhanced to facilitate more relevant and timely management reports.

In an effort to resolve problems before they become insoluble, NCUA is proactively monitoring adverse trends associated with CAMEL 3 rated credit unions,[15] particularly those with assets in excess of $100 million. NCUA is concerned that the number and size of CAMEL 3 credit unions is increasing. The number of CAMEL 3 credit unions with assets greater than $100 million represented only 7.30 percent of total credit unions as of year-end 2007; however, this ratio increased to 13.48 percent as of September 30, 2009. Similarly, total assets for this group of credit unions increased to 10.43 percent of aggregate industry assets as of September 30, 2009, up from only 3.97 percent in 2007. While credit unions rated a CAMEL 3 have not quite reached the

[15] A CAMEL 3 credit union exhibits some degree of supervisory concern. These credit unions exhibit a combination of weaknesses that may range from moderate to severe. Credit unions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences. These credit unions require more than normal supervision.

threshold of a troubled credit union, discussed earlier, they require enhanced and timely supervision to ensure corrective measures are implemented.

VI. Mortgage Lending in the Credit Union Industry

Current State of Credit Union Mortgage Lending

Through the first half of 2009, the Mortgage Bankers Association estimated first mortgage loan originations in the marketplace of over $1.05 trillion, of which credit unions originated only 2.53 percent or $55 billion in first mortgage loans.[16] First mortgage loans in credit unions represent less than 8 percent of first mortgage loans outstanding in all FDIC-insured depository institutions.[17]

In considering trends related to all mortgage loans, 69 percent of credit unions offer mortgage loans to their members. Those not offering mortgage loans are generally smaller credit unions that cannot afford the expertise or infrastructure to grant mortgages or manage mortgage portfolios. Additionally, smaller federal credit unions have difficulty implementing a wide range of mortgage products since loans to a single member are statutorily limited to 10 percent of a federal credit union's total unimpaired capital and surplus.[18] Consequently, the majority of credit union mortgage lending occurs in larger credit unions, as the following chart illustrates:

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[16] Based on information available at the Mortgage Bankers Association website for 2007 Purchase and Refinance Originations http://www.mbaa.org/files/Bulletin/InternalResource/70290_.pdf.

[17] NCUA data and *FDIC- Statistics on Depository Institutions Report, 1-4 Family Residential Net Loans and Leases for all depository insured institutions as of 6/30/2009.* Federal Deposit Insurance Corporation. <http://www2.fdic.gov/SDI/SOB>.

[18] 12 C.F.R. 701.21(c)(5). Unimpaired capital and surplus equals shares plus post-closing, undivided earnings.

Credit Unions by Asset Size	Number of Mortgage Loans Originated Jan 1 – June 30, 2009	% of Credit Union Mortgage Loan Portfolio as of 6/30/2009
Greater than $1 billion	301,449	51.5%
$500 million-$1 billion	117,440	15.9%
$50 million-$500 million	227,790	28.3%
$10 million-$50 million	34,976	4.0%
Less than $10 million	2,556	0.3%

Demand for mortgage loans in credit unions has tapered somewhat, but remains high for certain mortgage categories. As mentioned earlier, mortgage loans led all loan types in growth; this trend dates to 2002. In the first six months of 2009 alone, total mortgage loans increased $3.7 billion, 90 percent of all loan growth, to a new high of 54 percent of total loans.

As the following chart demonstrates, the majority of mortgage loans in credit unions are fixed rate, with almost all of the remainder being standard adjustable rate mortgages. Nontraditional mortgages are offered by less than 6 percent of credit unions and represent 2.3 percent of mortgage loans outstanding.

Type of Mortgage	Dollar Amount of Mortgage Loan Portfolio (billions) 6/30/2009	% of Credit Union Mortgage Loan Portfolio as of 6/30/2009
Fixed Rate	$197.0	64.0%
Adjustable Rate	$111.1	36.0%
Interest Only or Payment Option 1st Mortgage[19]	$7.2	2.3%

Fixed rate mortgage loans accounted for 78.5 percent of the increase in mortgage loans during the first half of 2009. The growth of fixed rate mortgages in credit unions slowed during the first half of 2009 to an annualized rate of just under 3 percent. Adjustable rate mortgage loans accounted for 21.5 percent of the increase in mortgage loans during this same period, and grew at an annualized rate of 1.42 percent. This indicates a clear preference by credit union members for fixed rate mortgage loans in the current economic environment, likely including a significant degree of refinancing of adjustable rate mortgages, and could impact credit unions' liquidity if interest rates rise rapidly.

Nontraditional Mortgage Lending in Credit Unions

Recognizing the increase in nontraditional mortgage products in the broader market (also referred to as "exotic," or "alternative" mortgage products), NCUA amended the 5300 Call Report in 2007 to collect data on certain nontraditional first mortgage loans.[20] Call Report data indicates that these mortgage products (specifically "Interest-Only" or

[19] 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.
[20] NCUA's 5300 Call Report is the data collection tool used to collect required financial statement reports from credit unions on a quarterly basis.

“Payment Option” mortgages) are only offered in a small number of credit unions and comprise a very small portion of the industry’s total mortgage portfolio.

There are several reasons why these riskier mortgage loans are not prevalent in credit unions. As addressed earlier, many 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, 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.[21] 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 these loans more tenable to other types of institutions. NCUA was also proactively issuing guidance on the increasing risks in real estate lending as early as 2005,[22] and since then has consistently issued guidance on this issue (see Appendix A) followed-up with numerous warnings leading up to the current economic downturn.

[21] 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 per annum. 12 U.S.C. §§1757(5)(A)(vii) and 1757(5)(A)(viii).
[22] See NCUA Letter to Credit Unions 05-CU-15, Increasing Risks in Mortgage Lending, October 2005; NCUA Letter to Credit Unions 06-CU-16, Interagency Guidance on Nontraditional Mortgage Product Risk, October 2006; and NCUA Letter to Credit Unions 07-CU-09, Subprime Mortgage Lending, July 2007.

Mortgage Loan Performance

Over the last decade, and certainly prior to the start of the present housing crisis, aggregate mortgage delinquency as been very low, averaging only 0.38 percent; mortgage loan losses have been equally low at 0.04 percent.

As the following table illustrates, however, real estate delinquency has been increasing as the economic crisis has unfolded:

Real Estate Loan Delinquency > 2 Months					
Quarter End:	**Jun-08**	**Sep-08**	**Dec-08**	**Mar-09**	**Jun-09**
1st Mortgage Fixed/Total 1st Mortgage Fixed Loans	0.48%	0.59%	0.75%	0.90%	1.06%
1st Mortgage Adjustable Rate/Total 1st Mortgage Adjustable Rate Loans	1.14%	1.54%	1.92%	2.19%	2.57%
Interest Only & Payment Option First Mortgage/Total Interest Only and Pmt Opt First Mortgage Loans	2.02%	2.46%	3.72%	4.86%	5.73%
Aggregate Del RE Loans / Total RE Loans	0.78%	0.96%	1.20%	1.38%	1.62%
RE Loan Net Charge-Offs	0.22%	0.24%	0.29%	0.42%	0.47%

Going back even further, credit union real estate delinquency more than quadrupled from early 2007 through mid-year 2009; increasing from 0.34 percent to 1.62 percent of total loans. These mortgage delinquency rates are unprecedented in the last 13 years, and present a challenge for credit unions weathering this economic storm.

The most significant concern with real estate loans is the 32.5 percent dollar increase in 2009 in delinquent first mortgage adjustable rate loans, making up 31.5 percent of the total increase in real estate loan delinquency for this same time period. NCUA noted an increase in real estate net charge-offs over this same time period from 0.29 percent to 0.47 percent of average loans.

To facilitate better risk identification and monitoring, NCUA began collecting data on foreclosed real estate in June 2006. Call Report data shows foreclosure trends have been increasing each quarter to a high of $930 million as of mid-year 2009. Foreclosed real estate has exhibited double-digit growth each quarter, as demonstrated in the following table.

Foreclosed Real Estate					
Quarter Ending:	**Jun-08**	**Sep-08**	**Dec-08**	**Mar-09**	**Jun-09**
Amount (in Millions)	$471.4	$549.4	$684.5	$826.3	$928.7
Percentage Increase	16.6%	16.5%	24.6%	20.7%	12.4%
Percentage of Total Real Estate Loans Outstanding	0.16%	0.18%	0.22%	0.27%	0.30%

Although there has been a significant percentage increase in total real estate foreclosures during this time period, the actual dollar amount of $930 million represents only a small fraction, 0.30 percent, of the $308 billion in total real estate loans outstanding in credit unions. While this amount does not presently represent a threat to the safety and soundness of the credit union industry, NCUA will continue to monitor and respond to this adverse trend.

NCUA recognizes that prudent workout arrangements and loan modifications with mortgage borrowers experiencing financial difficulties may be in the best interest of credit unions and their members. NCUA began collecting data on real estate loan modifications in September 2008. Credit unions modified a total of $3.6 billion in real estate loans at mid-year 2009, up 52 percent from the previous quarter. Modified loans reported as delinquent represent 19.78 percent of all modified loans. While the dollar value of delinquent loan modifications has been increasing each quarter, NCUA has also observed a noteworthy trend regarding delinquent loan modifications. Since peaking at a high of 21.63 percent at the end of 2008, the delinquency rate of modified loans has declined, albeit slightly, each of the last two quarters. However, over this same time period, NCUA observed a corresponding increase in losses of modified loans. NCUA will continue to review and assess delinquent modified real estate loans to ensure credit unions are not taking undue risk in meeting the financial hardship needs of members. Last month, a supervisory guidance paper on evaluating loan modification programs was issued to NCUA's examiner staff and was also provided to all credit unions.[23]

NCUA's Longstanding History of Mortgage Lending Guidance

In the late 1970s, legislation expanded services to 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. For more than thirty years, mortgage lending in credit unions has been considered a relatively safe product, subject more to interest rate risk exposure than the credit risk typically

[23] Available at http://www.ncua.gov/Resources/RegulationsOpinionsLaws/OpinionLetters/2009/09-CU-19_encl.pdf.

associated with lending products. As emerging risks have been identified, NCUA has provided written guidance to credit unions, in the form of Letters to Credit Unions. In recognition of the potential safety and soundness concerns stemming from poor mortgage lending controls, NCUA provided credit unions detailed real estate lending guidance, dating back as far as 1991. A table containing the title, summary, and date the relevant guidance was issued to the industry is provided in Appendix A of this testimony.

VII. Conclusion

Credit unions have been adversely impacted by the financial downturn of the last 18 months. Fortunately, the disciplines and member-centric focus instilled by the industry over the years have built a strong net worth position to help credit unions continue working through this crisis. Credit unions are not-for-profit, member-owned cooperatives that exist to provide their members with the best possible rates and service. Credit unions are chartered to serve a field of membership that shares a common bond such as the employees of a company, members of an association, or a local community. Therefore, credit unions may not serve the general public like other financial institutions and the credit unions' activities are largely limited to domestic activities, which has minimized the impact of globalization on the credit union industry. However, the severity and length of the economic downturn is being felt throughout the credit union industry. It is anticipated that the effects of the downturn will result in

increased losses to the NCUSIF in 2010 and into 2011. NCUA believes the NCUSIF is poised to withstand the challenges it will face in the next several years.

APPENDIX A – SUMMARY OF RELEVANT GUIDANCE ISSUED BY NCUA

The following table details specific mortgage lending guidance issued by NCUA to the credit union industry:

Date	Title	Summary
June 1991	Letter to Credit Unions #124, "Real Estate Secured Credit by Credit Union Members"	Provides guidelines for developing and maintaining an effective real estate lending portfolio, and addressing both interest rate and credit risk associated with real estate lending.
August 1995	Letter to Credit Unions #174, "Risk-Based Loans"	Discusses potential advantages and disadvantages to credit unions of risk-based lending[24] programs or programs where subprime credit could be offered. The letter also included a whitepaper discussing the importance of consumer compliance issues related to risk-based lending and the credit unions' obligations under the Equal Credit Opportunity Act, Fair Housing Act, and the Fair Credit Reporting Act.
June 1999	Letter to Credit Unions 99-CU-05, "Risk-Based Lending"	Restates that soundly managed risk-based lending programs are a way to reach out to all members. Explained a credit union's capital adequacy would be evaluated considering the volume and type of risk-based lending pursued and the adequacy of the credit union's risk management program.
August 1999	Letter to Credit Unions 99-CU-12, "Real Estate Lending and Balance Sheet Management"	Stresses the importance of proper balance sheet risk management for real estate loan products and formally introduced such tools as GAP analysis, income simulation models, Net Economic Value, and other Asset Liability Management concepts.

[24] Risk-based lending involves setting a tiered pricing structure that assigns loan rates based upon an individual's credit risk. A tiered pricing structure enables credit unions to make more loans to disadvantaged, lower income, or credit-challenged individuals.

Date	Title	Summary
September 2003	Letter to Credit Unions 03-CU-15, “Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios”	Reemphasizes the importance of properly monitoring and managing an increasing portfolio of fixed-rate mortgage products.
September 2004	Letter to Credit Unions 04-CU-13, “Specialized Lending Activities”	Refocuses the industry’s attention to proper credit risk management of lending, including real estate lending, in the wake of alternative lending arrangements to increase lending opportunities. Outlines the NCUA’s underwriting expectations for credit unions engaged in subprime lending, noting the need to focus on borrowers’ ability to repay loans as structured.
May 2005	Letter to Credit Unions 05-CU-07, “Risks Associated with Home Equity Lending”	Focuses industry attention to an increasing concentration of Home Equity Lines of Credit (HELOCs) and closed-end home equity loans. This guidance was issued jointly with the other banking agencies.
October 2005	Letter to Credit Unions 05-CU-15, “Increasing Risks in Mortgage Lending”	Addresses the use of alternative or exotic mortgage products to afford housing in areas of high housing value appreciation, as well as an apparent transition to more liberal mortgage credit standards in general. The NCUA developed guidance for staff focusing on the evolution of products in the mortgage market, the unusual volume of originations of variable rate mortgage products in a low interest rate environment, and the market trend toward liberalization of underwriting standards was included as an attachment.

Date	Title	Summary
October 2006	Letter to Credit Unions 06-CU-16, "Interagency Guidance on Nontraditional Mortgage Product Risk"	Addresses risks associated with the growing use of mortgage products that allow borrowers to defer payment of principal and, sometimes, interest. While nontraditional and subprime mortgage lending were not major components of credit union lending portfolios, the letter cautions credit unions on the potential "ripple effect" to their asset quality if some of their members have these types of loans at other financial institutions. Also, discusses prudent underwriting and risk management practices for nontraditional mortgage loans. Issued jointly with the Federal Financial Institutions Examination Council (FFIEC).[25]
April 2007	Letter to Credit Unions 07-CU-06, "Working with Residential Mortgage Borrowers"	Encourages financial institutions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations. Explains that prudent workout arrangements consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. Issued jointly with the FFIEC.
July 2007	Letter to Credit Unions 07-CU-09, "Subprime Mortgage Lending"	Addresses emerging risks and lending practices associated with certain subprime adjustable rate mortgage products that can cause payment shock to consumers. While these types of loans did not appear prevalent in the credit union industry, the letter again cautions credit unions on the potential "ripple effect" to their asset quality. Issued jointly with the FFIEC.

[25] The FFIEC includes the Board of Governors of the Federal Reserve (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the State Liaison Committee (SLC).

Date	Title	Summary
March 2008	Letter to Credit Unions 08-CU-05, "Statement on Reporting Loss Mitigation Efforts of Securitized Subprime Residential Mortgages"	Encourages credit unions servicing securitized subprime adjustable rate residential mortgages to utilize the HOPE NOW[26] alliance's loan modification standards to report foreclosure prevention efforts.
June 2008	Letter to Credit Unions 08-CU-14, "Consumer Information for Hybrid Adjustable Rate Mortgage Products"	Provides all credit unions with the final *Interagency Illustrations of Consumer Information for Hybrid Adjustable Rate Mortgage Products*, particularly those products that offer a low introductory "teaser" rate that could lead to payment shock when associated interest rates reset. Issued jointly with the FFIEC.
August 2008	Letter to Credit Unions 08-CU-19, "Third – Party Relationships: Mortgage Brokers and Correspondents"	Re-emphasizes the importance of proper due diligence over third-party relationships, specifically as they relate to the use of mortgage brokers and correspondents.
August 2008	Letter to Credit Unions 08-CU-20, "Evaluating Current Risks to Credit Unions"	Shares guidance with credit unions that was released to the NCUA examiners. Guidance discusses several of the current risks facing the credit union industry, provides guidance for assessing mortgage portfolio risk management, and recommends best practices for conducting risk focused supervision and monitoring.
November 2008	NCUA Letter to Credit Unions 08-CU-26, "Evaluating Loan Participation Programs"	Documents due diligence considerations for credit union officials to evaluate before entering a loan participation arrangement with another credit union.
December 2008	Letter to Credit Unions 08-CU-25	Provides guidance related to holding foreclosed properties as Foreclosed and Repossessed Assets and encourages credit unions to work constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

[26] HOPE NOW is an alliance between counselors, servicers, investors, and others formed under the direction of the Department of Treasury and the Department of Housing and Urban Affairs in 2007, which serves to maximize outreach efforts to homeowners in distress to help them stay in their homes.

Date	Title	Summary
March 2009	Letter to Credit Unions 09-CU-04, "Making Home Affordable: A Program for Mortgage Loan Refinancing and Modifications"	Announces availability of the U.S. Department of Treasury's Making Home Affordable program designed to mitigate foreclosures to the extent possible through refinancings or loan modifications.
September 2009	Letter to Credit Unions 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Programs"	Provides credit union officials with guidance NCUA provided to the field staff to encourage working constructively with residential mortgage borrowers who may be unable to meet their contractual payment obligations.

NCUA's Guidance Regarding Corporate Stabilization Efforts

Since the onset of the economic events challenging the stability of the corporate credit union system, NCUA has provided timely guidance to the potentially affected stakeholders. The table below summarizes the key guidance NCUA issued throughout 2009.

Date	Title	Summary
January 2009	Informational Letter to Credit Union Members	Template letter designed to assist credit unions in discussing cost impact of Corporate Stabilization Program in general terms with their members. Letter reinforces continuance of federal share insurance coverage and provides key NCUA contact information for members desiring additional information.

Date	Title	Summary
January 2009	Letter to Credit Unions, "Corporate Credit Union System Strategy"	Provided credit union officials with an overview of key economic factors affecting corporate credit unions, including weak liquidity and unrealized losses on investments. Letter discusses NCUA's efforts to support corporate system's immediate liquidity needs, advocates continued support from natural person credit unions, and announces a new guarantee program to supplement existing NCUSIF coverage. Letter also provides an initial assessment of costs and encourages active stakeholder participation in commenting on proposed changes to NCUA's corporate credit union regulation.
January 2009	Advance Notice of Proposed Rulemaking	Request for comments from interested parties relative to changes the NCUA Board is considering to Part 704 of the NCUA Rules and Regulations. NCUA requests general comments regarding the structure corporate credit unions should have and specific comments about capital requirements, permissible investments, risk management, membership requirements, and corporate governance.
February 2009	Supervisory Letter 09-01, "Supervision Considerations for Natural Person Credit Unions and the Announced Corporate Stabilization Efforts"	Letter to NCUA field staff reinforcing importance of considering economic events when assessing supervisory ratings. Letter also advises the field staff to take the objectives of the Corporate Stabilization Program into consideration during contacts at individual natural person credit unions.
February 2009	Accounting Bulletin 09-1	Guidance to credit unions not subject to Generally Accepted Accounting Principles on regulatory reporting matters related to the Corporate Stabilization Program. Provides accounting entries appropriate to reflect NCUA's initial assessment of the impairment to the NCUSIF deposits held by credit unions.

Date	Title	Summary
April 2009	Accounting Bulletin 09-2	Guidance to credit unions not subject to Generally Accepted Accounting Principles on regulatory reporting matters related to the Corporate Stabilization Program. Bulletin incorporates actions NCUA Board initiated during the first quarter of 2009 into the accounting guidance.
May 2009	Letter to Credit Unions 09-CU-10, "Matters Related to 'Paid-in Capital' and 'Membership Capital' of Corporate Credit Unions"	Informs shareholders of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union of the exhaustion of member capital shares. Also informs shareholders of the 23 percent and 100 percent depletion of the paid in capital of US Central Federal Credit Union and Western Corporate Federal Credit Union, respectively.
May 2009	Letter Addressed to Corporate Credit Unions	Provides general information about the Temporary Corporate Credit Union Share Guarantee Program, a program in which NCUA provides coverage of certain unsecured debt obligations issued by corporate credit unions participating in the program.
June 2009	NCUA Letter to Credit Unions 09-CU-14, "Corporate Stabilization Fund Implementation"	Discussion of new legislation enabling NCUSIF to defer costs associated with corporate stabilization over a seven year period. New law also extends the temporary increase in NCUSIF coverage to $250,000 until the end of 2013 and provides NCUA additional emergency borrowing authority.

In addition to formal guidance issued, NCUA has also used other methods of communication to provide timely information to stakeholders. For example, NCUA issued numerous timely updates in the form of Media Advisories during the period between March 27, 2009 and August 7, 2009. The updates explained NCUA's rationale for initiating the corporate credit union conservatorships, provided resources for additional information, and encouraged credit union input during the development of a

long-term corporate credit union strategy. In addition, NCUA also hosted five webcasts to discuss the progress of the Corporate Stabilization Program, developed Fact Sheets and Frequently Asked Questions documents for related topics, and established a dedicated location on the Internet to provide information about the program in one location.