NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: March 1996
LETTER NO.: 96-CU-2

DEAR BOARD OF DIRECTORS:

Enclosed is a report highlighting credit union financial trends during 1995. The analysis is based on data compiled from the yearend 1995 call reports submitted by all federally insured credit unions. We are providing this information to keep you informed of current conditions and trends in the credit union industry.

Credit unions have enjoyed another very successful year. Credit union capital is at a record level, while loan delinquency and related losses remain very low. As we review this outstanding financial performance, I feel that it is also important for each credit union to evaluate its success at serving its members' needs.

I ask each of you to evaluate your business plan and capital structure with respect to member service. Determining an appropriate level of capital is a very complex issue which must be addressed based on the unique circumstances of each individual credit union. The availability of credit union resources to meet the financial service needs of all members should be a primary consideration in the capital structure. This orientation should also be reflected within each credit union's business plan.

I urge each of you to continually strive for new and improved ways to serve your members' needs.

Keep up the good work!

For the National Credit Union Administration Board,

NORMAN E. D'AMOURS
Chairman

FINANCIAL TRENDS IN FEDERALLY INSURED CREDIT UNIONS

January 1, 1995 to December 31, 1995

HIGHLIGHTS

An analysis of the consolidated financial statements of federally insured credit unions for yearend 1995 reveals a robust and sound industry. The following summarizes the most significant trends during 1995:

Assets
: of federally insured credit unions increased 5.9% during 1995.

Capital
: accumulation continued, increasing 13.7%. The capital to asset ratio at yearend 1995 equals 11.0%.

Loans
: increased 9.2%, the third consecutive year of strong loan growth.

Shares
: expanded 5.9%. The loan to share ratio now stands at 71.1%.

Investments
: declined 0.9%.

Profitability
: declined very slightly, as measured by the net income (before reserve transfers) to average assets ratio, which moved from 1.2% at the end of last year to 1.1%.

Delinquency
: edged slightly higher, and is now 1.0%, compared to 0.9% during 1994.

CAPITAL

Capital [1] increased 13.7% during 1995 and now totals $33.7 billion. At the same time, assets grew at a slower pace increasing 5.9%. Capital now equates to 11.0% of total assets, compared to 10.4% at the end of last year. The net capital [2] to asset ratio is 10.3%, compared to 9.5% at yearend 1994.

The full implementation of SFAS 115 [3] this year had little impact on overall capital levels. The new equity account for accumulated unrealized gains and losses on available for sale securities, which became an additional component of capital during 1995, was -$6.1 million, a figure so small that it represents less than 0.1% of total capital. Exclusion of this account from the capital to asset ratio would not even affect the ratio.

ASSET QUALITY

LOAN TRENDS:

During 1995, loans expanded 9.2%, compared to 15.6% during 1994.

Until last year, unsecured loans comprised the largest percentage of the total loan portfolio. During 1994, the composition of the loan portfolio shifted so that new auto loans comprised the largest single type of loan. This trend continued during 1995. New auto loans were 24.2% of total loans at the end of 1995, compared to 23.5% at the end of 1994. New auto loans contributed the largest amount to the growth in outstanding loans during 1995 in terms of dollar volume. Of the $16.3 billion added to total loans outstanding, $5.2 billion were in new auto loans, a 12.7% increase. The second largest dollar volume increase was in used auto loans, which expanded nearly $4.0 billion or 14.9%. Total auto lending (new and used) now comprises over 40% of the loan portfolio.

Total unsecured loans outstanding increased $2.7 billion, or 7.5%. Most of the increase in unsecured loans was due to an increase in credit card loans, which increased $2.1 billion, or 16.1%. At yearend 1995, credit card loan balances comprised 39.0% of total unsecured loans, compared to 36.1% at yearend 1994. Credit card loan balances at yearend 1995 constituted 7.8% of the total loan portfolio, compared to 7.4% at yearend 1994.

The ratio of loans to shares continues to increase. At the end of 1995 the loan to share ratio was 71.1%, compared to 69.0% at yearend 1994, and 61.7% at the end of 1993.

Loans are also increasing as a percentage of total assets. Loans currently comprise 62.7% of total assets, compared to 60.8% at yearend 1994 and 54.9% at yearend 1993.

While real estate loans outstanding increased 7.0% during 1995, their relative contribution to the total loan portfolio continues to decline slowly but steadily. Real estate loans as a percentage of total loans declined from 33.9% at yearend 1993, to 32.8% at yearend 1994, to 32.2% at yearend 1995. The total for all mortgage loan originations have slowed considerably, down 14.8% from 1994. With the exception of home equity lines of credit, originations for each type of real estate loan are below levels at one year ago.

Real Estate Loans Granted and Secondary Market Activity

(Billions of Dollars)	Dec. 1994	Dec. 1995
1st Mortgage Loans Granted	$13.0	$9.9
Other Real Estate Loans Granted	$7.0	$7.3
1st Mortgages Sold on Secondary Market	$3.7	$3.1

DELINQUENCY TRENDS:

The ratio of delinquent loans to total loans edged slightly up during 1995. Delinquency currently equals 1.0%, compared to 0.9% during 1994. The year ending 1995 marks the first time the delinquency ratio has increased since 1986. The net charge-off ratio remained unchanged at 0.4%.

The slight increase in the delinquency rate during 1995 is attributable to the unusually high rate of loan growth (15.6%) during 1994. Because the loans originating during 1994 are beginning to age, and because loan growth in 1995 slowed by comparison (9.2%), the 1995 delinquency rates increased. If loan growth for 1996 approximates the rate of increase during 1995, we can expect delinquency rates to continue to rise. However, no sudden or large increases in delinquency are anticipated, primarily because of the types of loans which were made in 1994 and 1995. The significant increase in auto lending will exert downward pressure on overall delinquency, since these types of loans are becoming a larger percentage of the total loan portfolio, and because they typically have lower rates of delinquency.

The number of credit union members filing for bankruptcy declined during 1995, from 174 million to 165 million, or -5.5%. The amount of outstanding loan balances for these members increased from $600 million to $802 million, or 33.6%. The actual amount of losses that credit unions will incur will be less, however, since many of these loans will be reaffirmed and repaid.

INVESTMENT TRENDS:

Total investments declined 0.9% during 1995. This follows a 10.0% decrease during 1994. Investments as a percentage of assets declined from 35.0% at yearend 1994 to 32.8% at yearend 1995. The decline of investments as a percentage of total assets is primarily attributable to the acceleration in loan growth.

Of the individual types of investments making up the investment portfolio, investments in U.S. government obligations registered the only decline, but the decline was significant enough to cause the overall decline in investments of 0.9%. Investments in U.S. government obligations declined nearly $3.8 billion, or -21.3%. The largest dollar volume increase was in federal agency securities which increased $1.1 billion, or 3.0%.

The overall composition of the investment portfolio is shifting toward investments with shorter maturities and repricing intervals:

Investment Maturity or Repricing Interval	**% of Total Investments Dec. 1994**	**% of Total Investments Dec. 1995**
Less than 1 year	52.2%	61.4%
1 to 3 years	30.2%	26.0%
3 or more years	17.6%	12.6%

Credit unions are investing more in the short term for two reasons. First, they are anticipating liquidity needs in the near future to sustain loan growth. Secondly, the yield curve has flattened, narrowing the interest margins between longer and shorter term investments. At the end of 1994, the interest rate spread between 3-month and 30-year government securities was slightly over 200 basis points. By the end of 1995, the spread had narrowed to slightly less than 100 basis points.

During 1995, all credit unions were required to report their investments according to the classification system set forth under SFAS 115. The following pie chart shows the break out of investments according to this new classification system for yearend 1995.

EARNINGS

Gross income increased 12.8% during 1995, compared to an increase of 3.2% during 1994. Gross income increased as a percentage of average assets, registering 8.1% at yearend 1995, compared with 7.6% at the end of 1994. The increase was driven by an increase in interest income from loans, a result of accelerated loan growth during 1994 and 1995. This is a favorable trend because yields on loans are generally higher than those earned on investments.

Although credit unions were able to maintain a stable ratio of operating expenses to average assets, an increase in the cost of funds exerted a downward pressure on the bottom line. Net operating expenses as a percentage of average assets remained unchanged from the yearend 1994 level of 2.6%. Before adjusting for the cost of funds, net income increased 16.7% during 1995. However, in an effort to attract member deposits, credit unions raised dividend rates. The increase in dividend rates was particularly notable for share certificates. As a result, the cost of funds to average assets ratio [4] increased from 3.0% at yearend 1994 to 3.5%, and the net income to average assets ratio moved down slightly, from 1.2% to 1.1%.

LIQUIDITY

LONG TERM ASSET TRENDS:

The percentage of assets with maturities exceeding three years declined during 1995. At the end of 1995, 17.5% of total assets are considered long term, compared to 19.6% at the end of 1994. Contributing to this shift is the trend favoring shorter term investments, and the trend in shorter term lending.

SHARE TRENDS:

Shares increased 5.9% during 1995. For the second consecutive year, growth in share certificates contributed the largest amount to total share growth. During 1994, share certificates expanded nearly $6.9 billion, or 22.7%. During 1995, share certificates increased $20.4 billion, or 54.8%. During 1994 and 1995, regular shares experienced a net outflow, declining nearly $0.5 billion (-0.4%) during 1994 and down $8.8 billion (-6.8%) during 1995.

Growth rates for the various share categories are as follows:

- Share drafts, +7.5%
- Regular shares, -6.8%
- Money market shares, +0.4%
- **Share certificates, +54.8%**
- IRA/Keogh accounts, +3.8%
- All other shares and deposits, +1.1 %

The total of all shares maturing in under one year increased $6.9 billion, or 2.9%, while shares maturing between one and three years increased $6.6 billion, or 50.1%. Shares maturing in more than three years increased $1.6 billion, or 36.3%. This shift in the share maturity structure is principally due to the substantial increase in share certificates.

OVERALL LIQUIDITY TRENDS:

Because of the disparity between loan growth and share growth during 1994 (15.6% and 3.3%, respectively), liquidity tightened, and borrowed funds increased over 300%. During 1995, however, the disparity between loan growth and share growth lessened, with loans increasing 9.2% and shares expanding 5.9%. Credit unions were able to fund their members' loan demand with the increase in additional share deposits, coupled with a modest decrease in the investment portfolio. As a result, during 1995 borrowings have declined to more normal levels.

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1 Capital is defined as the sum of regular reserves, accumulated unrealized gains and losses on available for sale securities, other reserves, undivided earnings, allowance for loan losses, allowance for investment losses, and the net income of credit unions which did not close their books.

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2 Net capital is defined as capital less classified assets. Classified assets are estimated by summing the allowance for investment losses, allowance for loan losses, and the investment valuation reserve for state chartered credit unions.

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3 Statement of Financial Accounting Standard (SFAS) 115, *Accounting for Certain Investments in Debt and Equity Securities.*

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4 The ratio of net income to average assets measures the return on assets after operating expenses, non-operating expenses or income, and cost of funds, but before transfers to reserves.