The NCUA REPORT

NATIONAL CREDIT UNION ADMINISTRATION

APRIL 2011 NUMBER 4 WWW.NCUA.GOV

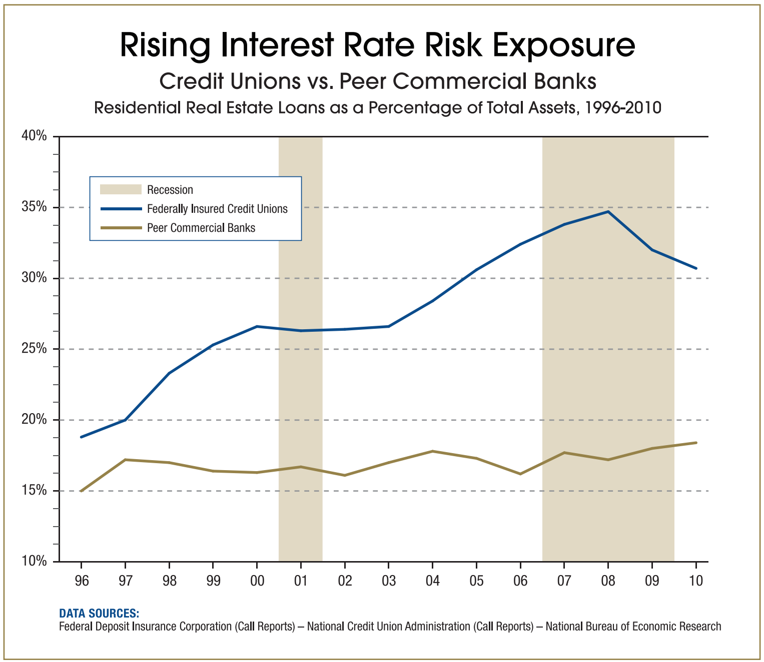
HIGHLIGHTS

Office of Capital Markets Report

INTEREST RATE RISK PROPOSAL GETS AHEAD OF THE CURVE

Interest rates will eventually rise from today's historic lows. In order to stay ahead of the curve and remain profitable, credit unions need to plan for this inevitability.

In March, the NCUA Board issued for public comment a new regulation on managing interest rate risk (IRR). The comment period will end on May 23, 2011.



The proposal's key requirements include the development of a written policy identifying appropriate risk measures and setting limits in terms of those measures. The proposal also specifies remedial steps for written policy violations.

Why require a written IRR policy?

Most credit unions borrow short and lend long. That is, they use short-term liabilities like share certificates to fund long-term assets like fixed-rate mortgages. This strategy typically boosts earnings and net worth, which can be thought of as the present value of future earnings. Rising interest rates, however, pose a threat to this strategy.

Since deposit-interest ceilings ended in January 1986, the interest spread between 30-year mortgages and 6-month certificates of deposit has averaged

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Chairman's Corner

FOUR TIPS FOR EFFECTIVE COMMENT LETTERS

Debbie Matz
Chairman

Public Feedback Really Can Alter Regulatory Proposals

Whenever I speak about regulations, stakeholders regularly ask me: *Does NCUA really read all comment letters on every proposed rule?*

My answer is always "Yes!" If you write a comment letter, we will read it.

Then I'm often asked another question: *Do comment letters really lead to rule changes?*

Again, my answer is "Yes!" It may not happen in every case, but when comment letters on a proposed rule are particularly effective, they can ultimately influence the content of a final rule.

> *"Do comment letters really lead to rule changes? Yes!"*

In fact, it may happen again this month. At our next open meeting on April 21, the NCUA Board will consider a new final rule on corporate credit unions. Based on thorough reviews of the 227 comment letters received on that proposal, NCUA's policy staff are now working diligently to draft potentially significant changes from the proposed rule that we released for comment last November.

So the most important question is: *How can comment letters be most effective?*

Here are four tips to make the comment process more productive for you and for us.

Do Your Research

Before you begin writing, visit **www.ncua.gov** to find information about each NCUA proposed rule and the deadline for comments. You can also use our website to view already submitted comment letters written by other stakeholders.

Consider Unintended Consequences

Read the preamble of each proposed rule to understand NCUA's intent. Think about changes that credit unions might have to implement in order to comply with the proposal. Then let us know about any unintended consequences you think the rule would create.

State Your Position Clearly

Consider each provision of a proposed rule and whether you support or oppose it. You may choose to support certain provisions and oppose others; you may also choose to support or oppose the entire proposal. Go on record either way.

Suggest Alternatives

If you oppose a proposed rule in whole or in part, let us know why. We will consider better ways to achieve the rule's intent. In fact, the most effective comment letters propose reasonable alternatives. **I assure you: NCUA is open-minded about workable solutions consistent with sound public policy.**

Once a comment period closes, we tally the number of credit unions and other stakeholders who support and oppose each provision of the proposed rule. We read each letter very carefully.

Before we finalize any rule, we then deliberate internally. We consider changes based on the comments. And we talk through different scenarios about how a revised rule might play out over time.

The federal rulemaking process seeks to strike the fairest possible balance — between the requirements of applicable law, our mission to protect safety and soundness, and our effort to minimize any adverse impact on credit unions. It's not always popular, but it's our job — and we take it very seriously. It's more difficult, if not impossible, to reach that fair balance without getting direct input from affected credit unions and other stakeholders.

So we hope you view the comment process as an opportunity to proactively shape your credit union's future.

We currently have several proposed rules, including interest rate risk management, incentive-based compensation, and credit ratings. Do your research, and write us about each proposal. You can change your future.

We look forward to reading your comment letters!

Debbie Matz

BOARD ACTIONS March 17, 2011

In March, the National Credit Union Administration Board convened its third open meeting in 2011 to consider:

- a proposed rule on interest rate risk policy to strengthen the long-term viability of credit unions;
- a proposed rule updating definitions of "net worth" and "equity ratio" to lower costs associated with the resolution of failed credit unions;
- a final rule broadening the definition of "low-risk assets" to facilitate the ability of credit unions to purchase NCUA Guaranteed Notes; and
- final changes related to delegations of authority and technical corrections to complete a cleanup of the agency's existing corporate credit union rule.

The Board unanimously approved all agenda items presented. The Board also received updates on the operations of the National Credit Union Share Insurance Fund (NCUSIF) and the Temporary Corporate Credit Union Stabilization Fund (TCCUSF).

Proposal prepares for interest rate increases

To prepare for inevitable increases in interest rates, federally insured credit unions (FICUs) ought to adopt written interest rate risk (IRR) policies. Such policies explicitly express a credit union's IRR tolerance and guide management decisions. An effective IRR program identifies, measures, monitors, and controls IRR. An IRR plan is also an essential component of safe and sound credit union operations. In today's financial environment, long-term fixed-rate assets especially require careful IRR management.

To address these matters, the NCUA Board issued a proposed amendment to the agency's insurance requirements. The proposed rule would require affected FICUs to have a written policy to address IRR management and maintain an effective IRR program for asset liability management. The Board also approved draft guidance, as an appendix to the proposed rule, to assist credit unions in meeting the proposed regulatory requirements. Together, the IRR proposed rule and draft guidance will address an important element of credit union operations.

The proposed rule would exempt credit unions with less than $10 million in assets. FICUs with assets between $10 million and $50 million would need to develop a written policy if their total of first mortgage loans plus total investments longer than five years equals or exceeds net worth. All FICUs with assets above $50 million would need to have written IRR policies under the proposed rule.

Stakeholders have 60 days to comment on the IRR proposal. For additional information about IRR management, see the story on page 1.

Proposed "net worth" and "equity ratio" changes save money

On January 4, 2011, President Obama signed into law (P.L. 111-382) the NCUA-recommended "toolbox" legislation. When implemented, the new law will save credit unions hundreds of millions of dollars. Specifically, this statute gives NCUA several new tools to reduce the costs of managing the NCUSIF and the TCCUSF. The bill's enactment occurred after the U.S. Senate and the U.S. House unanimously passed S. 4036 last December.

As a result of the new toolbox law, the NCUA Board issued a proposed rule to amend the definition of "net worth" in the agency's rule on Prompt Corrective Action (PCA). Specifically, the proposed rule would allow for the inclusion of NCUA-provided Section 208 assistance that contains minimum elements of equity in a credit union's net worth for PCA purposes. This change will facilitate NCUA's ability to conduct assisted mergers of credit unions.

The proposed rule also makes an additional technical change to the definition of net worth outside of the scope of the new law. This proposed fix would eliminate the double counting of net worth in a combination resulting in a bargain purchase gain.

Finally, the proposal would revise the definition of "equity ratio" as it appears in NCUA's regulation on insurance requirements. Under the proposed rule, NCUA would calculate the NCUSIF's equity ratio using the financial statements of the NCUSIF alone, without consolidation or combination with the financial statements of any other fund or entity.

Stakeholders have 60 days to comment on the proposed rule. For more information about writing an effective comment letter, see page 2.

Rule adds NCUA guaranteed debt instruments as low-risk assets

Until recently, NCUA Guaranteed Notes (NGNs) received a risk weighting of three percent. Because of the backing of the full faith and credit of the United States, NGNs, however, have no credit risk. NCUA's rules therefore discouraged credit unions from investing in NGNs due to the adverse effect on net worth. In October 2010, the NCUA Board first acted to fix this problem by issuing an interim final rule.

The Board has now issued a final rule expanding the definition of "low-risk assets" to include debt instruments unconditionally guaranteed by NCUA. This final rule expands the definition of "low-risk assets" for PCA purposes. As a result, debt instruments guaranteed by NCUA will permanently have a zero percent risk-weighting.

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All Aboard the *NCUA Express*!

FROM GIGI HYLAND, NCUA BOARD MEMBER

At a recent credit union conference, some attendees expressed their frustration that they never receive *NCUA Express*, NCUA's electronic system to deliver NCUA news electronically to those who subscribe.

What is *NCUA Express*?

The *NCUA Express* subscription service allows credit unions to receive NCUA communications via e-mail. Within hours of publication, press releases, Letters to Credit Unions, Regulatory Alerts, and various other communications will be sent to your e-mail. Credit unions will receive an e-mail message containing a brief description of the publication along with a link to download the publication from *NCUA Express'* file server. There is no cost for this service and it's available to all federally-insured credit unions.

Who can get *NCUA Express*?

Any volunteer, executive or staff member at a federally insured credit union can sign up to receive materials from NCUA via e-mail. Some credit unions that have already subscribed to *NCUA Express* have appointed an administrator who can add more email addresses to the distribution list. Officials at those credit unions can now subscribe to *NCUA Express* directly, or ask their manager who is the administrator and add their e-mail addresses to the distribution list.

In addition, there is an *NCUA Express* Users' Guide on **www.ncua.gov** if you need additional information on how to manage your credit union's account. You can also e-mail questions or comments about this service to **Express@ncua.gov**.

The Choice Is Still Yours

FROM MICHAEL E. FRYZEL, NCUA BOARD MEMBER

In 2008, when we found the corporate credit union system was not working the way it should, NCUA stepped in to eliminate the problems. With comments, input and help from credit unions across the country, new rules were developed to improve the corporate operating system and ensure current events never reoccur.

From the beginning through today, NCUA has reached out to the industry for input and ideas on how to improve the corporates. We asked and you responded with letters, committees, focus groups and papers.

Credit unions created the corporate system, lived with it through good times, were there to prop it up when it faltered, and credit unions are now being called on to help restructure and make the corporate system what they want it to be for years to come.

The task is not easy. As expected, ideas and opinions vary about tactics. While everyone cannot always agree on the means, the final product will, hopefully, reach a consensus.

We are not there yet. Much work still needs to be done and questions remain. Who will be able to recapitalize? Who will merge? Who will provide what services? Will there be alternatives to the corporates? In time, those questions will be answered and a new system will be established.

At this point, NCUA's work is not done and neither is yours. Until a working structure is in place, you must continue to remember, the choice is yours. You will be the ones supporting the new system and you must determine what it will look like.

Rest assured we will accomplish the task. We will overcome the obstacles, and together we will put in place a corporate system that will benefit natural person credit unions for decades to come.

The NCUA Report is published by the National Credit Union Administration, the federal agency that supervises and insures most credit unions.

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Examination & Insurance Report

DETERMINING THE OVERHEAD TRANSFER RATE — PART 2

Editor's Note: An article in the December 2010 NCUA Report generally discusses NCUA's Overhead Transfer Rate (OTR). This second article in the series aims to clarify the process and methodology for calculating the OTR.

OTR is one of the primary funding sources for NCUA's budget. The calculation of OTR seeks to provide an equitable distribution of the costs associated with the agency's dual role as an insurer and as a regulator.

A key factor in determining OTR is the evaluation of how much of NCUA's work relates to insurance and how much of it relates to regulatory activities. The process of setting OTR aims to allocate NCUA costs as fairly as possible.

To validate the methodology for setting OTR, NCUA, in 2010, conducted an independent review. The review also addressed the NCUA Board's desire for greater transparency.

This independent study examined the methodology used to compute OTR and evaluated the appropriateness of NCUA's calculation. Recommendations to better define what constitutes "insurance related" and "regulatory related" items came out of the review. A full review of these definitions is underway and NCUA will be soliciting public input.

The starting point in the calculation of OTR is the classification of NCUA's activities into two categories:

- "Insurance-related" activities include those tasks associated with NCUA's role as an insurer of all federally insured credit unions. These activities address safety and soundness issues.
- "Non-insurance" (regulatory) activities incorporate those tasks driven by NCUA's role as a regulator and charterer of credit unions. These activities address compliance with the laws and regulations that NCUA enforces.

The table below provides examples of each category and comes directly from NCUA training material for examiners.

Examples of Insurance and Regulatory Activities

Insurance Related Activities	Non-Insurance (Regulatory) Activities
Evaluating financial trends.	Review of actions taken related to regulatory violations.
Reviewing risk management reports.	Ensuring policies comply with regulations.
Evaluating financial risk exposure.	Compliance with the Bank Secrecy Act.
Determining whether management has adequate controls in place.	Documenting supervision plans for monitoring regulatory violations noted.
Reviewing loan underwriting to ensure that the level of risk is consistent with the credit union's net worth position.	Reviewing loan underwriting to ensure management is complying with applicable consumer laws and regulations.
Reviewing appropriateness of the investment portfolio and practices.	Reviewing compliance with the Gramm-Leach-Bliley Act.
Reviewing management's planning and general business practices for overall soundness.	Fair Lending exams.

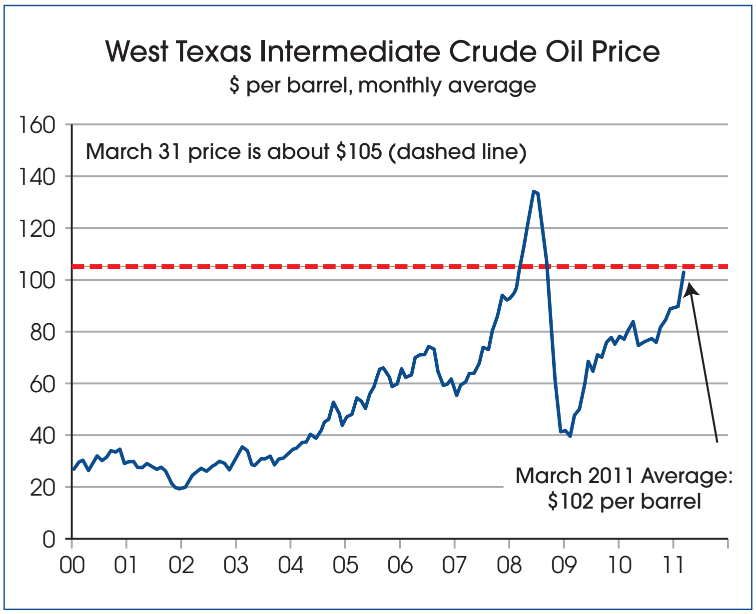
John D. Worth
Chief Economist

Chief Economist Report

OIL PRICES AFFECT THE ECONOMY

The recent rise in oil prices is having an impact on gasoline prices at the pump. While rising oil and gas prices will likely raise the level of consumer prices, they are not likely to induce a wage-price spiral that results in accelerating inflation. They could, however, dampen the economic recovery and result in a slower improvement in the labor market and persistently high unemployment.

Oil prices moved higher in the second half of 2010 and have surged in past two months, lifted by concerns about the instability in oil-supplying countries. Prices jumped as political instability moved to Libya and jumped again when the Allied no-fly zone went into effect.



The price of West Texas Intermediate crude — a U.S. benchmark crude oil — averaged just above $75 per barrel in September 2010, and rose to $89 per barrel in December. During March, prices have averaged over $100 per barrel, up more than 33 percent since last September. In September 2010, the average national price of gasoline was $2.70 per gallon; it rose to just under $3.10 in January. The most recent weekly data puts the average price of gasoline at just under $3.59 per gallon. Gas prices are up about 50 cents from January and up about 80 cents from a year ago.

While energy prices are highly visible to consumers, they do not necessarily result in a sharp near-term run-up in the general level of prices and wages. We believe that the slack labor market will hold down labor costs, keeping overall price levels in check. On average, labor costs roughly account for about two-thirds of the price of all goods and services in the economy. With the unemployment rate just under 9 percent, sharp increases in labor costs — which are necessary for consistently higher inflation — do not appear likely in 2011.

The impact of higher oil prices on the pace of the economic recovery is a more significant risk. Rising oil prices reduce real consumer income and raise the import bill, thereby slowing economic growth. Higher gasoline prices also hurt consumer confidence, resulting in less consumer spending.

Estimates based on past oil price shocks suggest that each 10 percent increase in the price of crude oil, sustained for at least a year, reduces real GDP growth by about 0.2 percentage points. Based on that estimate, if oil prices were to stay at about $100 per barrel through all of 2011 (up from nearly $80 during all of 2010), growth would be lowered by about half a percentage point. With Blue Chip forecasters looking for just above 3 percent growth during 2011, the sustained rise in prices would cut growth to just above 2.5 percent in 2011. Of course these estimates are naturally very rough — oil prices could rise higher, or the rise may not be sustained for very long.

CONTINUED ON NEXT PAGE

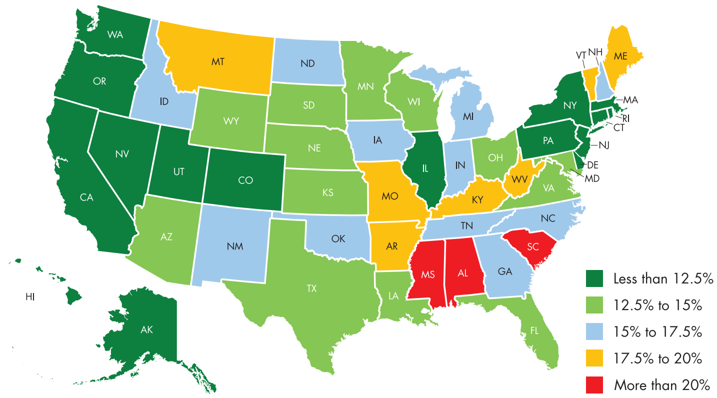
CHIEF ECONOMIST REPORT (FROM PAGE 6)

There is likely to be regional variation in the effects of the oil price shock. The map to the right shows a measure of the gasoline dependency of state economies by comparing motor vehicle fuel consumption per unit of output. Higher fuel prices will have the most impact in states with high consumption per unit of output.

In sum, the rise in oil and other commodity prices seems to pose a larger risk to economic recovery and growth than to inflation. If elevated oil prices dampen consumer spending and confidence, slow the recovery and keep the unemployment rate at high levels, this will depress loan demand and continue to lift delinquency rates.

Motor Fuel Consuption per Unit of Output – 2008

(000's of BTU per $ of Share GDP)



Data Source: Energy Information Administration and Bureau of Economic Analysis

OFFICE OF CAPITAL MARKETS REPORT (FROM PAGE 1)

2.88 percentage points. Mortgage rates are low by historical standards, but CD rates are even lower, so the February 2011 spread averaged an attractive 4.57 percentage points. The problem is funding costs will not stay this low, and fixed-rate mortgages booked today will generate the same interest income when rates return to historical norms.

A simple example demonstrates the danger. Imagine a credit union with $30 million in assets, including $5.5 million in long-term fixed-rate mortgages and $3 million in net worth. Suppose the credit union funds the mortgages with short-term share certificates, and, to get more precise, average duration is ten years for the mortgages and six months for the certificates. If mortgage and CD rates reverted to November 2007 (pre-recession) levels, net worth would tumble by about $538,000 or nearly 18 percent.

Year-end call report data show this example is not far-fetched. As shown in the chart on page 1, residential mortgages accounted for 30.7 percent of credit union assets; at peer commercial banks the ratio was only 18.4 percent. Even more worrisome, credit union holdings were longer term. Home loans with rates adjusting in more than five years came to 18.2 percent of credit union assets; all bank loans with rates adjusting in more than five years came to only 12.6 percent of assets. Over the last 15 years, the exposure of federally insured credit unions to IRR has risen absolutely and relatively to banks.

Underscoring the likelihood of IRR exposure is the comparable scale of mortgage lending by credit unions and thrifts. At year-end, first mortgages were 24.4 percent of credit union assets and 26.5 percent of peer thrift assets. Bank and thrift officials have had to have written policies on IRR management for more than a decade. NCUA's proposed rule reflects, in part, the notion that credit unions face an exposure similar to thrifts and banks, so they should be required to take similar steps to manage their risk.

Would the proposed rule extend to all federally insured credit unions?

Generally, the proposed rule classifies credit unions based on size and risk exposure to determine the need to adopt a written policy on IRR.

Understanding why the NCUA Board created a tiered system requires a peek behind the averages, which can mislead because most small credit unions do little mortgage lending. Half the industry holds fewer than $17.6 million in assets, and 71.3 percent of these credit unions carry no first mortgages at all.

Accordingly, the proposed rule exempts from the written-policy requirements all credit unions under $10 million in assets. The proposal also excludes institutions between $10 million to $50 million with modest risk exposures — where "modest" means first mortgages and investments with maturities more than five years total less than net worth. Credit unions greater than $50 million in assets would need to develop written policies regardless of their risk exposures.

The size and exposure criteria exempt most credit unions — particularly small ones — while protecting the Share Insurance Fund through expansive coverage of industry assets. Year-end figures indicate that roughly 57 percent of all credit unions and 93 percent of credit unions below $17.6 million in assets would be exempt from the written-policy requirement. Nonetheless, written IRR policies would cover nearly 96 percent of industry assets.

In sum, the proposed rule addresses a material threat to credit union safety and soundness — with the focus on institutions whose size and complexity put them most at risk. Taking action to control IRR now will also help credit unions to get ahead of the curve and prevent future problems.

Office of Consumer Protection Report

NCUA LAUNCHES MYCREDITUNION.GOV

To enhance consumer protection and better equip individuals of all ages with the tools they need to make smarter financial decisions, NCUA unveiled **MyCreditUnion.gov** during National Consumer Protection Week.

Created by NCUA's Office of Consumer Protection, **MyCreditUnion.gov** provides consumers with important material that complements the information for credit unions found at **www.ncua.gov**. For example, the free website offers financial literacy advice to help consumers make better choices for their money.

With multiple interactive features, **MyCreditUnion.gov** allows consumers to access educational topics such as keeping your money safe, managing credit, protecting savings and learning how to resolve complaints about a federal credit union.

What's more, the website offers general information and guidance about how to plan for and manage an array of life events with financial implications, such as purchasing a home, buying a car, and fighting identity theft.

MyCreditUnion.gov also allows individuals to obtain information on share insurance protection and calculate share insurance coverage on their accounts.

The credit union community has responded very favorably to the release of **MyCreditUnion.gov** in Tweets and on Facebook. Some referred to the website as "a great consumer tool" and others described the initiative as "a great resource for tips on making smart financial decisions."

MyCreditUnion.gov seeks to improve financial literacy, too. Not only does the website provide educational information for adults, it includes a section focused on youth. Young adults benefit from financial education that teaches the importance of making wise financial decisions, developing effective saving habits, and protecting against predatory credit offers.

Finally, through **MyCreditUnion.gov** consumers can decide if a credit union is right for them, locate a credit union in their area, or learn how to start a federal credit union.

NCUA intends to regularly improve and update **MyCreditUnion.gov**, found on NCUA's homepage, **www.ncua.gov**, under information *For Consumers*. Credit unions can place a link to **MyCreditUnion.gov** on their websites to provide members with quick access to financial advice. Please contact the Office of Consumer Protection at 703.518.1140, or email **ocpmail@ncua.gov** if you have comments about or suggestions for the new website.

FINANCIAL EDUCATION AND FINANCIAL LITERACY INITIATIVE TAKES OFF

As part of the agency's activities during Financial Literacy Month, the NCUA Board has started a new grant — the Financial Education and Financial Literacy Initiative. The program operates as part of the NCUA Community Development Revolving Loan Fund Technical Assistance Grant Program.

The Financial Education and Financial Literacy Initiative provides funding opportunities for designated low-income credit unions. The initiative seeks to improve financial literacy within the general population, particularly students. Specifically, the grants encourage credit unions to deliver training in collaboration with schools, community organizations, and other financial institutions.

NCUA will accept grant applications from April 18 through May 20. Applicants can learn more details about the initiative at **www.ncua.gov** under ***Resources & Publications/Resources for Credit Unions/Credit Union Development.***

In November 2010, NCUA Board Chairman Debbie Matz announced the agency's partnership agreement with the U.S. Department of Education and the Federal Deposit Insurance Corporation. The partnership aims to help more students to learn the basics of handling their finances appropriately and to develop habits that lead to strong financial futures, including saving.

Through the partnership, the agencies promote financial education, financial access, and asset building for students and families. NCUA's 2011 credit union training workshops, conducted by the Office of Small Credit Union Initiatives, also include a joint session with the Education Department covering financial education, loan access strategies, and dedicated saving habits.

NCUA looks for opportunities to encourage financial literacy and financial education for the nation's children and young adults. Teaching future credit union members about saving, investing, and borrowing will positively contribute to the long-term economic viability for credit unions and members.

Another new initiative geared to support financial education and literacy is NCUA's **MyCreditUnion.gov**. Designed to offer educational information and personal finance tips, the website seeks to assist consumers in making smarter financial decisions and better choices for their money. For more information about **MyCreditUnion.gov**, see the article on page 8.

BOARD ACTIONS (FROM PAGE 3)

Corporate credit union delegations of authority modified and technical corrections finalized

As part of a spring cleaning of the agency's rules, the NCUA Board approved several minor changes to the authorities delegated to the director of the Office of Corporate Credit Unions. Recent revisions to NCUA's rule for corporate credit unions required these fixes.

The Board also approved in final form several technical corrections to the agency's rule on corporate credit unions. The Board initially issued these technical fixes as an interim final rule on November 18, 2010. The changes became effective on January 18, 2011.

NCUSIF projects 1.29 percent equity ratio

The NCUSIF equity ratio remains at 1.29 percent, based on projected collections in insured shares as the end of 2010. NCUSIF ended February with a $1.19 billion reserve balance. NCUA mailed invoices related to collections during March. Payments are due by April 15, 2011.

The NCUSIF reported net income of $7.6 million for February. Three credit unions failed in February — all liquidations. The cost of failures for the first two months of 2011 totaled $34.1 million. The NCUSIF insurance loss reserve has remained constant during the current calendar year.

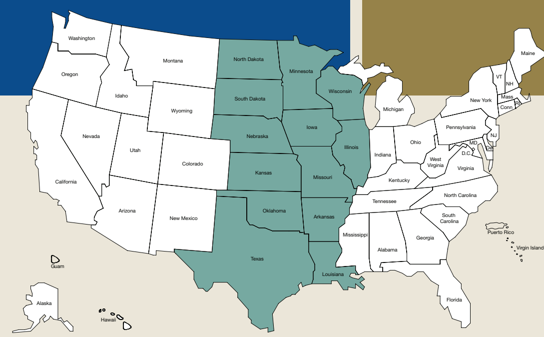
In February, 360 federally insured credit unions, with assets of $42.5 billion and shares of $37.7 billion, had CAMEL code 4 or 5 designations. Additionally, 1,803 CAMEL code 3 credit unions had assets of $151.5 billion and shares of $133.9 billion. Overall, CAMEL code 3, 4 or 5 credit unions held 21.21 percent of all credit union assets.

The TCCUSF total liabilities and net position stood at $385 million.

Financial data reported for both the NCUSIF and the TCCUSF are preliminary and unaudited.

All Board Action Memorandums are available online at www.ncua.gov under *Agency Leadership/NCUA Board and Actions/Draft Board Actions.* NCUA rule changes are posted online at www.ncua.gov under *Resources & Publications/Legal/Regulations, Legal Opinions and Laws.*

FIXED ASSETS AND THE BOTTOM LINE



REGION IV

In recent years, many credit unions have experienced excessive growth in their fixed assets: items like buildings, branches, computers and furniture. Each dollar invested by a credit union in a fixed asset results in one less dollar to generate earnings for the credit union.

A review of regional trends reveals the majority of fixed-asset growth over the last three years occurred in 'land and building' investments, while 'other fixed assets' have remained flat or declined. The amount of land and buildings on credit union balance sheets has increased quarter over quarter.

This trend indicates that growth in traditional 'brick and mortar' branches has outpaced growth in technology. Between 2009 and 2010, Region IV also experienced a decrease of 59 credit unions, but simultaneously encountered an increase of 43 credit union branches.

Additionally, credit unions have changed the way they fund increases in fixed assets. During a time of record low interest rates, many have used low-cost, short-term deposits to fund long-term fixed-asset investments. Excessive investing in fixed assets, especially in land and buildings, can place pressure on a credit union's net interest margin as interest rates rise. The additional pressure on earnings, coupled with increased operating expenses, may ultimately prove problematic for some credit unions.

While fixed-asset expansion can play a viable part of a credit union's strategic plan and expand service to members, a correlation between profitability and fixed-asset levels exists. Credit unions with higher fixed-asset ratios are more likely to have negative returns on average assets. Weaker earnings often result from higher operating expenses, but they also may indicate that a credit union has failed to meet growth and income projections developed when adding new branches.

Financial trends indicate credit unions in Region IV have grown membership and share deposits, but have struggled with loan growth even with the increase in branches. Additional branches often increase membership and shares as projected. Credit unions, however, regularly struggle to meet loan growth projections. Share growth will only contribute to the dilution of net worth if not offset by increased earnings.

Institutions that continue to show positive returns on average assets and grow net worth, even during weak economic climates, historically have lower fixed-asset ratios and operate more efficiently. Credit unions considering increasing fixed assets should therefore undertake significant analysis to determine the long-term benefits of an expansion.

Successful expansions increase both shares and loans. Management should also ensure projections for any fixed-asset expansion provide for a positive effect on the strategic position of the credit union and the membership.

In October 2010, the NCUA Board rescinded the exemption on the 5 percent fixed-asset limitation for RegFlex credit unions. Credit unions operating above the 5 percent limitation therefore should remain mindful of this recent change and any waiver requirements subsequent fixed-asset growth may generate.

The NCUA
REPORT
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