NCUA LETTER TO CREDIT UNIONS

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

DATE: **October 2011** **LETTER NO.: 11-CU-16**

TO: **Federally Insured Credit Unions**

SUBJ: **State of the Credit Union Industry**

ENCL: **Financial Trends in Federally Insured Credit Unions**

Dear Board of Directors:

Enclosed for your review is the quarterly report analyzing credit union financial trends for the first half of 2011, using data compiled from June 30, 2011 call reports. We hope you find this report useful in understanding national trends and risks which NCUA will continue to closely monitor and supervise.

The solid financial start to 2011 continues, demonstrating the resilience of credit unions and their progress during the gradual economic recovery. Notably, lending grew for the first time in four quarters, and credit unions increased their return on average assets by 26 basis points – from 51 basis points at year-end 2010 to 77 basis points through the second quarter. As a result of this higher net income, the aggregate net worth ratio bounced back above 10%.

While overall loan growth remains relatively flat, historically low-rate first mortgage real estate loans continue to grow. This trend could impact credit unions' future earnings potential. Accordingly, NCUA is focusing supervisory efforts on credit unions with elevated levels of credit, interest rate, concentration, and strategic risk.

Credit risk continues to constrain the performance of many credit unions and remains a supervisory concern. While overall loan delinquency and net charge-offs declined through mid-year, delinquencies in real estate, business, and participation loans remain high. Moreover, loan modifications are increasing. Modified loans, while offering troubled members an opportunity to avoid default, remain at risk for future delinquency, due to their high re-default rates. NCUA has issued several guidance letters[1] about prudent loan modification policies and procedures. Strong policies and appropriate analysis are needed to ensure each borrower is a suitable candidate for modification or other alternative to foreclosure. We encourage credit unions to modify loans where prudent. At the same time, we urge credit unions to closely monitor the performance of modified loans and ensure policies and procedures appropriately mitigate risk.

[1] See Letters to Credit Unions 09-CU-19, 09-CU-04, 10-CU-07, and 07-CU-06.

Interest rate risk also remains a supervisory concern, as many credit unions hold a significant amount of long-term, fixed-rate loans, in addition to low-rate loan modifications. In an effort to obtain a slightly higher yield, credit unions are also beginning to purchase investments with longer maturities. At the same time, most member shares are in short-term accounts, such as regular shares, share drafts, and money market accounts. Fifty eight percent of credit union share balances are now in rate-sensitive accounts that are less stable funding sources,[2] especially in a rapidly changing interest rate environment.

The interest rate risk present in credit union balance sheets will have a detrimental impact on earnings when rates begin to rise, after such a protracted period of low rates. Proactive structuring of balance sheets, including proper control over loan and share products, remains vital to future success. Credit unions must be cautious about extending maturities and taking on higher risk investment products in this current interest rate environment.

Concentration risk, particularly the high level of real estate loans held by many credit unions during a period of declining real estate values, also remains a concern. Concentrations of risk can occur across product lines when different products have the same market sensitivities. For example, long-term real estate loans combined with mortgage-backed securities with similar risk characteristics as your loan portfolio can compound your credit union's sensitivity to market conditions. Sound risk mitigation and diversification strategies are necessary to effectively manage concentration risk and to prevent concentrations in loans and investments from reaching unsafe levels.

Strategic risk impacts all aspects of credit union operations. Management philosophy, plans, decisions, and actions are among our most forward-looking indicators of potential and emerging risk in a credit union. The ability to plan for the short- and long-term, determine product offerings, perform initial and ongoing due diligence over any third-party relationships, and set appropriate limits through policies and procedures mitigates strategic risk.

We realize that overcoming the effects of the economic downturn continues to present a challenge for most credit unions. For this reason, NCUA examiners are working diligently with credit union management and boards of directors to maintain stable balance sheets. The actions taken by NCUA are designed to protect the safety and soundness of the credit union industry and the 91 million members who put their trust in credit unions.

Sincerely,

/s/

Debbie Matz
Chairman

Enclosure

[2] Interagency guidance on funding and liquidity risk management was issued in August 2010, with Letter to Credit Unions 10-CU-14.