NCUA LETTER TO CREDIT UNIONS

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

DATE: **January 2012** **LETTER NO.: 12-CU-01**

TO: **Federally Insured Credit Unions**

SUBJ: **Supervisory Focus for 2012**

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

Dear Board of Directors:

As we begin the New Year, federally insured credit unions appear to be turning the corner. Credit unions' financial health continues to improve during this protracted economic recovery. Many key financial indicators are trending in the right direction.

Net income during the first nine months of 2011 exceeded net income for all of 2010. Deposits, loans, assets, and net worth all rose again during the third quarter. As a result, the aggregate net worth ratio continued to inch upward to 10.15%.

Enclosed is a report analyzing these and other trends in credit unions for the first three quarters of 2011.

In order to ensure that the positive financial trends continue in 2012, NCUA plans to closely monitor and supervise emerging risks which are evident in several lending and investment trends.

The rest of this letter outlines specific risks based on the most recent trends, and describes actions that credit unions should take to mitigate those risks.

Lending Trends

Further examination of recent lending trends reveals several areas of concern. New auto loans continued to decline, while riskier types of loans weighed more heavily on credit union books. Unsecured loans, non-federally guaranteed student loans, and first mortgages all increased for consecutive quarters.

Of particular concern: Growth in low-rate first mortgages continues to far exceed growth in overall loans. Credit unions holding high concentrations of long-term fixed-rate loans will be subject to negative margins when interest rates rise and short-term funding costs exceed income from fixed-rate mortgages.

Although overall delinquency and net charge-offs were relatively stable through the third quarter, the percentage of loans with delinquencies 12 months or longer increased. This increase in long-term delinquencies indicates that charge-offs may spike in the near future.

Supervisory Focus

Accordingly, NCUA will focus supervisory efforts on credit unions with elevated levels of credit risks, interest rate risks, liquidity risks, and concentration risks.

Below is further information on each of these risks, as well as strategies to mitigate them.

- **Credit Risks**

Credit risks persist in constraining the performance of many credit unions. Delinquencies and charge-offs in real estate, business, and participation loans remain historically high. Each credit union must regularly evaluate the adequacy of its Allowance for Loan and Lease Loss[1] (ALLL) account and fund the ALLL fully.

Modified loans also carry a high risk of re-default. Credit unions need prudent loan modification policies and procedures to ensure that each borrower is a suitable candidate for modification or other alternatives to foreclosure. While the NCUA Board intends to propose regulatory relief from the requirement to manually track Troubled Debt Restructurings in 2012, credit unions will still need to monitor performance of modified loans on an ongoing basis to properly mitigate credit risks.

New and outsourced loan programs carry additional risks. For example, non-federally guaranteed student loans have grown at an annualized rate of 49% since NCUA began collecting data on these loans in the first quarter of 2011. Non-federally guaranteed student loans are essentially unsecured loans that may not begin to pay down for several years. As with any new loan program, credit unions should establish appropriate policies, underwriting criteria, risk measurement, monitoring, and control processes prior to granting the first loan. Your credit union's policy should contain suitable limits in relation to net worth and total loans or total assets.

Third-party indirect loan programs call for an added level of monitoring over vendors and other parties affiliated with the transaction, such as insurance companies. Refer to NCUA guidance letters regarding such lending arrangements.[2]

- **Interest Rate and Liquidity Risks**

A majority of credit union member balances are in rate-sensitive accounts[3], which are less stable funding sources than regular shares or share drafts. Higher levels of interest rate risk will have a negative impact on earnings when rates rise. It is vital for credit unions with

[1] See Letters to Credit Unions 02-CU-09 and 03-CU-01.
[2] See Letters to Credit Unions 10-CU-15, 07-CU-13, and 04-CU-13.
[3] Rate-sensitive accounts may include money market shares, uninsured shares, non-member shares (for low income designated credit unions), above-market share certificates, deposits by other credit unions, and brokered shares/deposits. These accounts are generally attracted to yield and tend to be less permanent in nature.

high exposure to interest rate risk to proactively re-structure their balance sheets, sell off excessive concentrations of long-term loans, and re-price share products before rates begin to rise.

Growing portfolios of long-term, fixed-rate loans also pose liquidity risks. Compounding those risks, some credit unions are beginning to purchase investments with longer maturities to obtain slightly higher yields. Such calculated risks negatively impact short-term liquidity.

Another strain on liquidity is due to elevated real estate foreclosures, which increase the level of non-earning assets.

The NCUA Board this month issued an advance notice of proposed rulemaking which suggests several options for credit unions to access federal sources of emergency liquidity. In addition, credit unions should be securing sources of operational liquidity.

- **Concentration Risks**

Concentration risks are compounded when credit unions holding high levels of mortgages also hold mortgage-backed securities with similar risk characteristics.

Credit unions must employ sound risk mitigation and diversification strategies to effectively manage concentration risks and prevent concentrations from reaching unsafe levels.

Responsible Lending

While ensuring that credit unions mitigate all of these risks, NCUA will continue to encourage responsible lending. The best service that credit unions can offer consumers and businesses to promote economic recovery is access to sound and affordable loans through a healthy financial institution.

As credit unions overcome the effects of the economic downturn, NCUA examiners will continue to work diligently with credit union directors and management to maintain stable balance sheets.

NCUA's actions are designed to protect the safety and soundness of America's credit unions and the 91 million members who put their trust in you.

Sincerely,

/s/

Debbie Matz
Chairman

Enclosure