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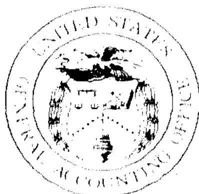
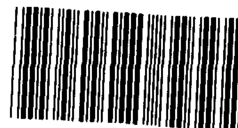
Report to the Congress

July 1991

CREDIT UNIONS

Reforms for Ensuring Future Soundness





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Comptroller General
of the United States

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To the President of the Senate and the
Speaker of the House of Representatives

This report discusses issues related to the financial condition of credit unions, the regulation and supervision of credit unions, the structure of the credit union industry, and the evolving role of credit unions in the financial marketplace. It also includes the results of our review of the certified public accountant's audits of the financial statements of the National Credit Union Administration's Operating and Share Insurance Funds and its Central Liquidity Facility for 1989 and 1990. It was prepared pursuant to section 1201 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (P.L. 101-73).

We are sending copies of this report to all Members of the Banking Committees as well as to other appropriate congressional Committees, federal banking agencies, and other interested parties.

This report was prepared under the direction of Craig A. Simmons, Director, Financial Institutions and Markets Issues, who may be reached on (202) 275-8678 if there are any questions. Other major contributors are listed in appendix XV.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

Two decades ago, almost 24,000 credit unions were operating in the United States. These credit unions had $18 billion in total assets, 23 million members, no federal share (deposit) insurance, asset powers limited to short-term small consumer loans, and restricted membership requirements. Today, 13,100 credit unions have federal share insurance, total assets of almost $200 billion, about 55 million members, the authority to offer a wide range of consumer credit and depository services, and relaxed membership requirements.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) required GAO to make a comprehensive study of the credit union system. Accordingly, this report discusses the financial condition of both credit unions and their federal share insurance fund, regulation and supervision of credit unions, the structure of the credit union industry, and the evolving role of credit unions in the financial marketplace.

Background

A credit union is a not-for-profit cooperative association that offers a variety of financial services. Its member/owners have a "common bond," such as working for the same employer, which is specifically defined in the credit union's charter.

Credit unions are chartered by both the federal and state governments. As of June 30, 1990, 8,659 credit unions were federally chartered and federally insured; 4,443 credit unions were state chartered and federally insured. There were also 1,462 state-chartered credit unions insured by private, cooperative entities.

In addition, there are special credit unions whose members are credit unions, not individuals. These institutions—referred to as corporate credit unions—developed in the 1970s and now play a key role in the industry. They provide credit unions with short-term investment opportunities; payment system and other services; and, should liquidity problems develop, loans and other forms of credit. As of June 30, 1990, corporate credit unions had $20.4 billion—over 10 percent of industry assets—in investments from credit unions.

Corporate credit unions are members of a single, large credit union—U.S. Central Credit Union; most corporate credit union funds are invested in this entity. U.S. Central, in turn, invests these funds primarily in uncollateralized, uninsured loans to major banks (federal funds)

and marketable securities purchased from dealers under agreements that the dealers will repurchase them (reverse repurchase agreements).

The Federal Credit Union Act of 1934 first authorized federal charters as well as federal regulation and supervision of these credit unions. The present federal oversight agency is the National Credit Union Administration (NCUA), which was established in 1970, when Congress authorized federal share insurance. NCUA administers the National Credit Union Share Insurance Fund (NCUSIF).

Results in Brief

The condition of today's federally insured credit unions is better than that of banks and thrifts. Credit union capital averaged 7.3 percent of assets as of mid-1990; the annualized net return on assets for the first half of the year was 0.90 percent. (For the same period, bank capital averaged 6.4 percent of assets, and the annualized net return was 0.69 percent.) NCUSIF reported equity of $1.25 for every $100 in insured accounts, as of December 31, 1990. GAO's preliminary estimate is that the Bank Insurance Fund's equity was no higher than $.26 per $100 in insured deposits as of that date.

Contributing to the industry's present condition are expansions in the type and length of loans and in the types of accounts credit unions may offer, as well as relaxed membership (common bond) restrictions. The credit union industry has grown and remained profitable as bank and thrift industries have slowed in growth and declined in profitability. As the credit union industry has grown, however, it has been exposed to increased risk. The recent sharp decline in the condition of banks and their insurance fund shows how quickly problems can appear.

Difficulties could develop if credit unions are not operated safely and soundly in their new environment, if regulation is not modernized, if supervision and failure resolution are not timely and effective, and if NCUSIF is not adequately overseen and financed. NCUA made some changes in response to the expanded powers. It has, for example, tightened regulation of commercial lending and developed a new examination format and rating system. However, GAO has identified numerous changes related to organization, regulation, supervision, and insurance that would help assure continued safe and sound operations and also protect NCUSIF.

GAO also believes that Congress may wish to provide guidance on what constitutes a common bond for membership. Such action would help define the future role of credit unions in the financial marketplace.

GAO's Analysis

Present Industry and Insurance Fund Condition Is Relatively Good

The assets of federally insured credit unions have grown dramatically, from $12.5 billion in 1971 to $195 billion in mid-1990. In June 1990, there were about 13,100 credit unions. Most of these were small; about half had assets of less than $2 million. However, 375 had assets of at least $100 million, and together they held almost half of the industry's assets.

The greatest recent change in credit unions' asset portfolios, and the one with the greatest risk, has been increased real estate lending, including first mortgages and home equity loans. Such lending rose from 5 percent of assets in December 1985 to 21 percent in June 1990. First mortgages alone rose from 5 to 12 percent of assets during the same period. Real estate loans, which have been increasing in all but the very smallest credit unions, have been riskier than the short-term installment loans traditionally made.

Credit unions may also make "member business" (commercial) loans. Commercial loans totalled $1.4 billion (0.7 percent of assets) in mid-1990. This total excludes those commercial loans that were under $25,000, secured by a primary residence, or that met other criteria; it includes commercial real estate loans, which are not separately reported.

GAO reviewed the recent financial audits of NCUSIF, the Central Liquidity Facility operated by NCUA, and the NCUA Operating Fund that were done by Price Waterhouse, a public accounting firm. The firm reported that the NCUSIF and other financial statements for the years ending September 30, 1988, 1989, and 1990 were fairly presented and in conformity with generally accepted accounting principles.

As of September 30, 1990, NCUA reported that the ratio of NCUSIF's reserve balance as a percent of insured shares was 1.25. The operating range for the fund, set by NCUA, is now 1.25 to 1.3 percent. Since the 1985 recapitalization of NCUSIF by the industry, NCUA has not assessed

the annual insurance premiums, also provided for in the act, because earnings on fund assets have been sufficient to maintain the fund balance.

Because of the new and more risky environment in which credit unions are operating, it would be appropriate for Congress to hold annual oversight hearings on the condition of the industry and NCUSIF at which the NCUA Board would testify.

Changes Needed to Maintain Safe and Sound Insurance Fund Operations

The continued health of NCUSIF can best be assured by a sound organizational structure, straightforward accounting, effective use of enforcement powers, and an adequately capitalized fund. Improvements are needed in each of these elements.

Organizational Structure: NCUA is responsible for credit union chartering, supervision, and insurance. FIRREA asked GAO to study whether the insurance functions should be separated from the other functions of NCUA. The closest parallel to NCUA is the Federal Deposit Insurance Corporation (FDIC), which is responsible for supervision and insurance functions for state-chartered banks that are not Federal Reserve members.

The collapse of the thrift industry's insurance fund is attributed to a number of factors, including certain actions of the Federal Home Loan Bank Board (FHLBB), which had responsibility for that fund. FHLBB did not give sufficient priority to maintaining the fund's soundness; instead, it chose to forbear on weakly capitalized or insolvent institutions in the hope that their condition would improve, thus risking huge insurance fund losses.

GAO did not find at NCUA the built-in conflicts of interest and weak organizational support for supervisory and insurance functions that it found in FHLBB. Nor did GAO find evidence that NCUA was inappropriately delaying the resolution of failing credit unions or taking any other actions that put NCUSIF at risk. GAO notes, however, that neither the industry nor the fund has been under pressure in recent years.

To help assure that the insurance function would be given priority if conditions should deteriorate, GAO believes a number of changes are essential.

- First, because the supervisory and insurance responsibility currently rests in one staff position at NCUA, it is possible that the staff would not

bring to the Board's attention for explicit discussion issues with the potential for increased risk to NCUSIF. This could be corrected by placing staff responsibility for the insurance and regulatory functions in two, co-equal line organizations. The directors of both entities should report individually to the Board.

- Second, NCUA is isolated organizationally from the other federal banking agencies at the Board level and is not directly linked to the administration's views on depository institution regulatory and insurance issues. Expanding NCUA Board membership to include the Chairman of the Federal Reserve Board and the Secretary of the Treasury would provide NCUA with a broader perspective on the role and oversight of financial institutions as well as the administration's thinking on public policy issues affecting insured depository institutions.

If legislation is passed to authorize a single federal regulator to administer all examination and supervision functions, Congress may want to consider including credit unions among the institutions regulated by that entity, once it is operating effectively. The responsibility for the insurance function could then be placed under FDIC or another separate entity.

- Third, in reviewing some credit unions, GAO found that NCUA has sometimes elected to use informal approaches in dealing with troubled institutions, approaches that do not always result in correction of the problems. GAO notes that such informal approaches by bank and thrift regulators have resulted in greater insurance losses than would have occurred following stronger corrective actions. GAO has already recommended that Congress require bank regulators to take specific and more forceful supervisory enforcement actions when they find certain unsafe and unsound conditions or practices ("tripwires").[1] A similar intervention system would strengthen NCUA's regulation of credit unions.

NCUSIF 1-Percent Deposit: Credit unions recapitalized NCUSIF in 1985. Each credit union deposited and subsequently must maintain an amount equal to 1 percent of its insured shares. NCUSIF counts the deposit as capital. Credit unions, however, treat the deposit as an asset rather than an expense, thereby avoiding a reduction in capital. This double-counting produces a misleading picture of the combined strength of NCUSIF and the credit unions. Expensing the deposits over a period of time, which is consistent with conservative accounting, would result in a

[1] Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4, 1991).

truer picture of the overall health of the industry and NCUSIF and provide NCUA with greater control over NCUSIF resources.

Capitalization: NCUA now measures the financial strength of NCUSIF by using a ratio of fund capital to insured shares. As of September 30, 1990, the ratio was at the low end of the range set by NCUA, 1.25 to 1.3 percent. The Federal Credit Union Act requires a minimum capitalization ratio of 1 percent. If the ratio exceeds 1.3 percent, the surplus must be distributed to the credit unions. The act also provides for an insurance premium of one-twelfth of 1 percent of insured shares if needed.

NCUA should be authorized to raise NCUSIF's current equity-to-insured-shares ratio and the insurance premium. This would help NCUA provide for anticipated NCUSIF funding needs, and it would help prevent inappropriate supervisory and resolution decisions based on inadequate funding.

Fund assets are liquid now. However, if NCUA were to acquire considerable illiquid assets from troubled and failed credit unions, it may not have ready assets sufficient for prompt resolution of failing credit unions. A two-tier ratio—with one minimum level based on liquid fund assets that are available to meet future needs and the other based on total capital—would help assure that NCUSIF could continue to promptly resolve failing institutions.

Improvements in Law, Regulation, and Supervision Are Needed

NCUA has made considerable progress coping with the growth and changing operations of the credit union industry. However, a number of weaknesses relating to the regulation, supervision, and oversight of the industry need to be addressed to assure continued safety and soundness.

Regulation and Supervision of State-Chartered Institutions: Federally chartered credit unions operate within the bounds specified by the Federal Credit Union Act and NCUA regulations. State chartered credit unions are subject to some federal regulations, but they operate primarily under state laws and regulations that are sometimes less restrictive than federal law.

Following a 1982 GAO report that cited problems, NCUA improved its relationship with state supervisors and also helped improve the scope and content of state examinations. However, NCUA should set forth explicit policies stating the circumstances under which NCUA will examine state-chartered credit unions and the frequency of such examinations.

Regulatory Improvements: Federal regulation needs to be improved and applied to all insured credit unions. Regulations should specify underwriting standards for real estate loans and maximize conformity with secondary market criteria. Regulations should also set a cap on commercial lending; prohibit credit unions from borrowing funds to grow without regulatory approval; reduce the present limits on loans to or investments in one person or entity to not more than 1 percent of the credit union's total assets, with appropriate exceptions for small credit unions; require credit unions to disclose that dividends cannot be guaranteed in advance; and require credit unions to maintain minimal capital levels. In addition, regulators should require credit unions larger than a minimum size to have annual independent audits and make annual management reports on internal controls.

Off-site Monitoring: In recent years, NCUA significantly improved its off-site monitoring systems, but such oversight should be strengthened further. First, NCUA should specify how federal and state examiners should use some of the off-site monitoring reports. Also, because the annual audit reports that supervisory committees prepare for their credit unions could be valuable off-site monitoring tools, NCUA should require credit unions to promptly provide NCUA with a copy of those reports.

The financial reports credit unions submit must be sufficiently detailed and submitted frequently enough for NCUA to evaluate condition and risk between examinations. This is particularly important in the case of large credit unions, whose operations can be quite complex and whose problems, if not identified early, could pose major risks to the insurance fund. Quarterly filings and more detailed reporting should be required first for credit unions with assets of $50 million or more.

Regulation of Corporate Credit Unions: As of mid-1990, federally insured credit unions had $20.4 billion, or about 10 percent of their assets, invested in corporate credit unions. However, U.S. Central and 13 of the 44 corporate credit unions are outside the full supervisory control of NCUA because they are not federally chartered or insured. As of mid-1990, corporate credit unions generally had capital levels averaging 1.4 percent of assets, net of certain items—a low average that has not improved despite NCUA efforts.

Changes are needed to bring about needed federal regulatory and supervisory authority and to temper the perception that NCUA would not permit any corporate credit union to fail. First, NCUA should allow credit unions it insures to invest only in other credit unions and corporate

credit unions that are federally insured. Second, in the event of a credit union or corporate credit union failure, NCUSIF should be given priority over uninsured shareholders when the failed entity's assets are distributed.

Failure Resolutions: GAO is concerned about NCUA's practices in resolving failing credit unions. NCUA has generally resolved failing credit unions in an appropriate time. However, GAO is troubled by the upward trend in NCUA's use of assistance. Outstanding assistance as of September 30, 1987, was $49 million and had risen to $191 million by June 30, 1990. GAO reviewed NCUA's assistance to credit unions. In four of the five sampled cases, the credit unions did not meet NCUA's preconditions for assistance, such as the presence of good management.

The Federal Credit Union Act does not provide written criteria for NCUA to use in resolving failing credit unions, although NCUA officials say that their policy is to use the least costly method. Legislative guidance on resolution considerations and documentation requirements are needed to strengthen NCUA operations in this area.

Action Regarding Common Bond Is Needed

As providers of personal savings and credit services, credit unions are competing successfully with other depository institutions. Relaxed membership restrictions have helped many credit unions compete, and some survive. Since its enactment in 1934, the Federal Credit Union Act has limited membership in federal credit unions to those with "a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district."

In the past decade, NCUA has significantly loosened the definition of the "common bond." In 1982, NCUA allowed groups of members with different common bonds to join in a single credit union, which has helped increase the number of members, including those who do not share a common bond, in single credit unions.

Congress should consider establishing related guidelines to specify the outer limits of an occupational, associational, or community common bond.

Recommendations[2]

To Congress

GAO recommends that Congress amend the Federal Credit Union Act as follows:

To Maintain Safe and Sound Insurance Fund Operations

- Expand the NCUA Board to five members and provide that the Chairman of the Federal Reserve Board and the Secretary of the Treasury, ex officio, be members. Authorize the two ex officio members to delegate their authority to another person from their agency who is appointed by the President with the advice and consent of the Senate.
- Require NCUA to identify unsafe and unsound conditions or practices and the specific enforcement actions that will be used when such conditions or practices are identified; also, provide in legislation that Congress expects NCUA to take the designated actions.
- Require natural person and corporate credit unions to expense their 1-percent deposit in NCUSIF over a reasonable period of time.
- Establish a two-tier capitalization ratio for NCUSIF, with one ratio based on fund equity and the other on liquid assets available for future resolutions.
- Give NCUA the authority to raise the NCUSIF capitalization level and the premium percentage above the current limits and to borrow additional funds from Treasury on behalf of NCUSIF.

To Improve Regulation and Supervision

- Authorize NCUA to require any state natural person or corporate credit union with unsafe or unsound practices or conditions to follow applicable federal law or regulation.
- Require NCUA to establish minimum, risk-based, capital standards for natural person and corporate credit unions, providing for a phase-in period.
- Revise the natural person and corporate credit union limits on loans to a single borrower or investments in a single obligor to not more than 1 percent of the lender's total assets, with larger limits as appropriate for small credit unions.
- Allow natural person credit unions to borrow only to meet liquidity needs, unless prior regulatory approval has been obtained.

[2]This list of recommendations is not all inclusive. A complete listing of recommendations is provided in appendix XI.

- Require natural person credit unions above a specified minimum size and all federally insured corporate credit unions to obtain an annual audit by an independent public accountant and to make annual management reports on internal controls and compliance with laws and regulations.
- Specify that natural person credit unions may invest only in those credit unions and corporate credit unions that are insured by NCUSIF.

GAO also recommends that Congress hold annual oversight hearings at which the NCUA Board reports on the condition of credit unions and NCUSIF, assesses risk areas, and reports on NCUA's responses to them.

In addition, although GAO is not making specific recommendations, GAO believes Congress should, at a minimum, consider providing guidance on the purpose and limits of the common bond requirement, making it applicable to all federally insured credit unions.

Recommendations to the Chairman, NCUA Board

GAO recommends that NCUA take the following actions:

- Separate responsibility for supervision and insurance into separate line organizations, with each reporting to the Board.
- Identify, in consultation with Congress and the credit union industry, unsafe and unsound conditions or practices with the potential of damaging NCUSIF and set out the appropriate supervisory responses.
- Strengthen regulation of credit unions. Areas to focus on include real estate and commercial lending and disclosure of the fact that dividends cannot be guaranteed in advance.
- Improve aspects of off-site monitoring of credit union condition by issuing guidance on the use of monitoring reports and requiring more frequent and detailed credit union reporting.
- Develop policy goals for examining state-chartered credit unions and invoke its statutory authority to refuse to accept state examinations under certain conditions.

Agency Comments and GAO Response

GAO made about 50 recommendations. NCUA agreed with most of them, saying that they will strengthen the credit union system and enhance NCUA's effectiveness as a federal financial regulator. GAO's response to NCUA's comments is discussed at the close of each chapter. These comments and GAO's detailed response are in appendix XII.

NCUA objected to several recommendations. It indicated that the separation of insurance and supervision functions within NCUA is neither necessary nor desirable and that placing the supervision functions of NCUA in a new consolidated federal supervisor would not serve the public. GAO believes that internal separation is essential and clearly states that incorporation of NCUA's supervision functions in a consolidated supervisor should be considered only if such an entity is established and then after it is operating effectively. (See p. 196.) NCUA also said that GAO's recommendation to expand the NCUA Board and place on it, as ex officio members, the Secretary of the Treasury and the Chairman of the Federal Reserve Board is unworkable, given the frequency of Board meetings. GAO has modified its recommendation to allow these ex officio members to delegate the authority to another Presidential appointee in their agencies. Finally, NCUA argued that the investment and loan limits recommended, 1 percent of assets, are too low for corporate credit unions. GAO disagrees, given the risk to the credit union system from any higher level of concentration.

The Department of the Treasury commented on two recommendations. It agreed that the credit unions' 1-percent deposit in NCUSIF should be expensed. It also said that the administration's current legislative proposal would make the director of the proposed Office of Depository Institutions Supervision an ex officio member of the 3-member NCUA Board. (See app. XIII.) The Federal Reserve Board in its comments said that the Chairman's membership on the NCUA Board could distract the Federal Reserve from its principal responsibilities. (See app. XIV.) As noted above, GAO has modified its recommendation to provide for delegation of the authority.

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Abbreviations

ABA	American Bankers Association
AICPA	American Institute of Certified Public Accountants
BIF	Bank Insurance Fund
CAEL	Capital, assets, earnings and liquidity
CAMEL	Capital, assets, management, earnings and liquidity
CLF	Central Liquidity Facility
CUNA	Credit Union National Association
CURE	Credit Union Risk Evaluation
FCU	Federal credit unions
FCUA	Federal Credit Union Act
FDIC	Federal Deposit Insurance Corporation
FHLBanks	Federal Home Loan District Banks
FHLBB	Federal Home Loan Bank Board
FHLBS	Federal Home Loan Bank System
FHLMC	Federal Home Loan Mortgage Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act
FNMA	Federal National Mortgage Association
FPR	Financial Performance Report
GAAP	Generally accepted accounting principles
GNMA	Government National Mortgage Association
MBS	Mortgage-backed securities
MCSD	Membership Capital Share Deposit
NAFCU	National Association of Federal Credit Unions
NASCUS	National Association of State Credit Union Supervisors
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
OCC	Office of the Comptroller of the Currency
OEI	Office of Examination and Insurance
ROA	Record of Action
SFAC	Statement of Financial Accounting Concepts

Highlights

History

- 1909: First American credit union is incorporated.
- 1934: Federal Credit Union Act provides federal chartering and supervision of credit unions and establishes the predecessor federal organization to the National Credit Union Administration.
- 1970: National Credit Union Share Insurance Fund is created.
- 1977: Federal credit unions can make 30-year mortgage loans.
- 1980: Federal credit unions are permitted to offer transaction (checking) accounts.

Industry Structure

- Credit unions are cooperative depository institutions in which members must share a common bond or one of a group of common bonds. They are overseen by member boards of directors.
- As of mid-1990, 13,102 credit unions serving 55 million members were federally insured. Two-thirds of all credit unions were federally chartered. Another 1,452 state-chartered credit unions were cooperatively insured.
- The 13,102 federally insured credit unions had $195 billion in assets, mostly in installment and residential loans and in investments.
- Forty-four corporate credit unions, owned by their member credit unions, and U.S. Central Credit Union, owned by the corporates, accept for investment a significant portion of the unloaned assets of their members. Corporates and U.S. Central also exist to provide liquidity to their member credit unions.
- The trade associations include: the Credit Union National Association (CUNA), which, with its affiliates, provides a variety of financial services to the industry; 52 state credit union leagues; the National Association of Federal Credit Unions (NAFCU); and the National Federation of Community Development Credit Unions.

Basis for Report

This comprehensive report was mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

Introduction

Credit unions are cooperative not-for-profit associations in which members, who are the owners, share a common bond, deposit funds, and obtain credit. Federally insured credit unions, which numbered 13,102 as of June 30, 1990, had assets of about $195 billion, more than triple their 1980 year-end total of almost $60 billion.

In the past two decades, there have been major changes in the industry. Federal share (deposit) insurance was provided for the first time; limits on loan types, amounts, interest rates, and maturities were raised; and a range of transaction and other accounts was permitted. Further, the membership common bond requirements, such as restricting membership to individuals employed by a specific entity, were relaxed. Insured credit unions reported members of 55 million in mid-1990. Credit unions now offer a wide range of services to members, including residential real estate loans, small business loans, credit cards, transaction accounts, and retirement accounts.

A majority of the credit unions are relatively small and many are managed primarily by volunteers. As of mid 1990, 9,928 had assets of less than $10 million, and 2,375 had assets of less than $500,000. Nevertheless, the majority of the industry's assets are in larger credit unions. The 780 with assets over $50 million held about 60 percent of the industry's assets.

In Section 1201 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Congress asked us to make a comprehensive study of the credit union industry. Topics listed for inclusion in the study fell into three general areas:

- the condition of the credit union industry and its insurance fund,
- the supervision and insurance of credit unions, and
- the present and future role of credit unions.

This report responds to that requirement. Background information on the industry and its regulation and supervision as well as a discussion of the objectives, scope, and methodology of our study are provided in this chapter. Chapter 2 discusses the condition of the industry, the condition of its insurance fund—the National Credit Union Share Insurance Fund (NCUSIF)—and the risks facing the industry. Chapter 3 discusses credit union law and regulation. Chapter 4 discusses supervision by the responsible federal entity—the National Credit Union Administration (NCUA)—and state authorities. Chapter 5 discusses NCUA's resolution of failed credit unions. Chapter 6 discusses corporate credit unions—their

role, regulation, supervision, and insurance status. Chapter 7 discusses issues related to share insurance, including accounting treatment of credit unions' 1-percent deposit in the insurance fund, financing NCUSIF, and the liquidation payout priorities. Chapter 8 discusses issues related to the structure of NCUA, including the organizational placement of NCUSIF within NCUA and the need for the Central Liquidity Facility. Finally, chapter 9 discusses issues associated with the evolution of credit unions' role in the financial marketplace, including expansion of the field of membership criteria, federal share insurance, and tax treatment. Supplementary discussions are provided in the appendixes.

Background

History

Cooperative credit associations had their origins in mid-19th century Europe. An early promoter and organizer of these associations established requirements that members pay entrance fees, purchase shares, and deposit their savings. The members could obtain short-term loans on the basis of their character. At first, all members signed the passbooks and promissory notes.[1] Early cooperatives were focused on urban craftsmen, proprietors, and farmers. The early credit union philosophy was closely connected with moral and humanitarian goals.[2] In the late 1800s, interest in cooperative credit associations began to grow in Canada. The first cooperative there—called a caisse populaire, or credit society—was organized in 1901.

The first credit union in the United States—known as St. Mary's Cooperative Credit Association—was incorporated in 1909 in New Hampshire. A few weeks later Massachusetts became the first state to pass a law providing for credit union charters. It defined credit unions as cooperative associations "formed for the purpose of promoting thrift among its members." By 1934, there were approximately 2,500 credit unions in 38 states and the District of Columbia. Credit unions were not chartered, supervised, or insured at the federal level during these early years.

[1] A detailed history of credit unions is provided in a volume entitled The Credit Union Movement: Origins and Development, 1850 to 1980, supported and copyrighted by the Credit Union National Association. The volume is authored by J. Carroll Moody and Gilbert C. Fite, (2nd Edition, Iowa: Kendall/Hunt Publishing Co., 1984).

[2] NCUA, 1980 Annual Report, Preface.

Interest in providing federal charters to expand the opportunities to establish credit unions grew in the 1930s. In 1934, the Federal Credit Union Act was passed. Its title described its purpose:

"An Act to establish a Federal Credit Union System, to establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States." (The Federal Credit Union Act of 1934, Pub.L. 73-467, 48 Stat. 1216.)

This act provided for federal charters and set out the powers of these federally chartered credit unions. It also stated that membership in a federal credit union was limited to groups sharing "a common bond of occupation, association, or geographical location in a well-defined neighborhood, community, or rural district." (12 U.S.C. 1759) Congress amended the Federal Credit Union Act in 1937 to exempt federal credit unions from federal and state income taxation. State credit unions had been exempt from federal taxation in accordance with an Attorney General ruling in 1917. (See ch. 9 and app. X for background information on credit unions' tax status.)

Credit unions grew steadily in number, rising from 5,241 at year-end 1936 to 9,891 at year-end 1941. By 1956, there were 17,256; by 1969 the total was 23,761. Further growth in the industry occurred in the next two decades, although the total number of credit unions declined as individual credit unions became larger through mergers or expansion, facilitated by broadened common bond membership requirements. At year-end 1980, for example, some 187 federally insured credit unions (slightly more than 1 percent of the total number) had assets of over $50 million; in June 1990, 780 (6 percent) did. The following table, which includes credit unions that do not have federal insurance, shows the trends in both growth and consolidation.

Table 1.1: Growth and Consolidation of Credit Unions (Insured and Uninsured) (December 31)

	1960	1970	1980	(June 30) 1990
Credit unions	20,456	23,688	21,467	14,564
Members	12 million	23 million	44 million	55+ million[a]
Assets	$5.65 billion	$17.95 billion	$69 billion	$216 billion

[a]Excludes members of privately insured credit unions.

Source: CUNA, The Credit Union Report, 1989.

Significant expansions in the types of accounts, asset powers, and membership requirements have taken place in the past two decades. These changes are discussed throughout this report. (See especially ch. 9.) Appendix I provides a chronology of the major events in credit union history.

Structure of the Industry

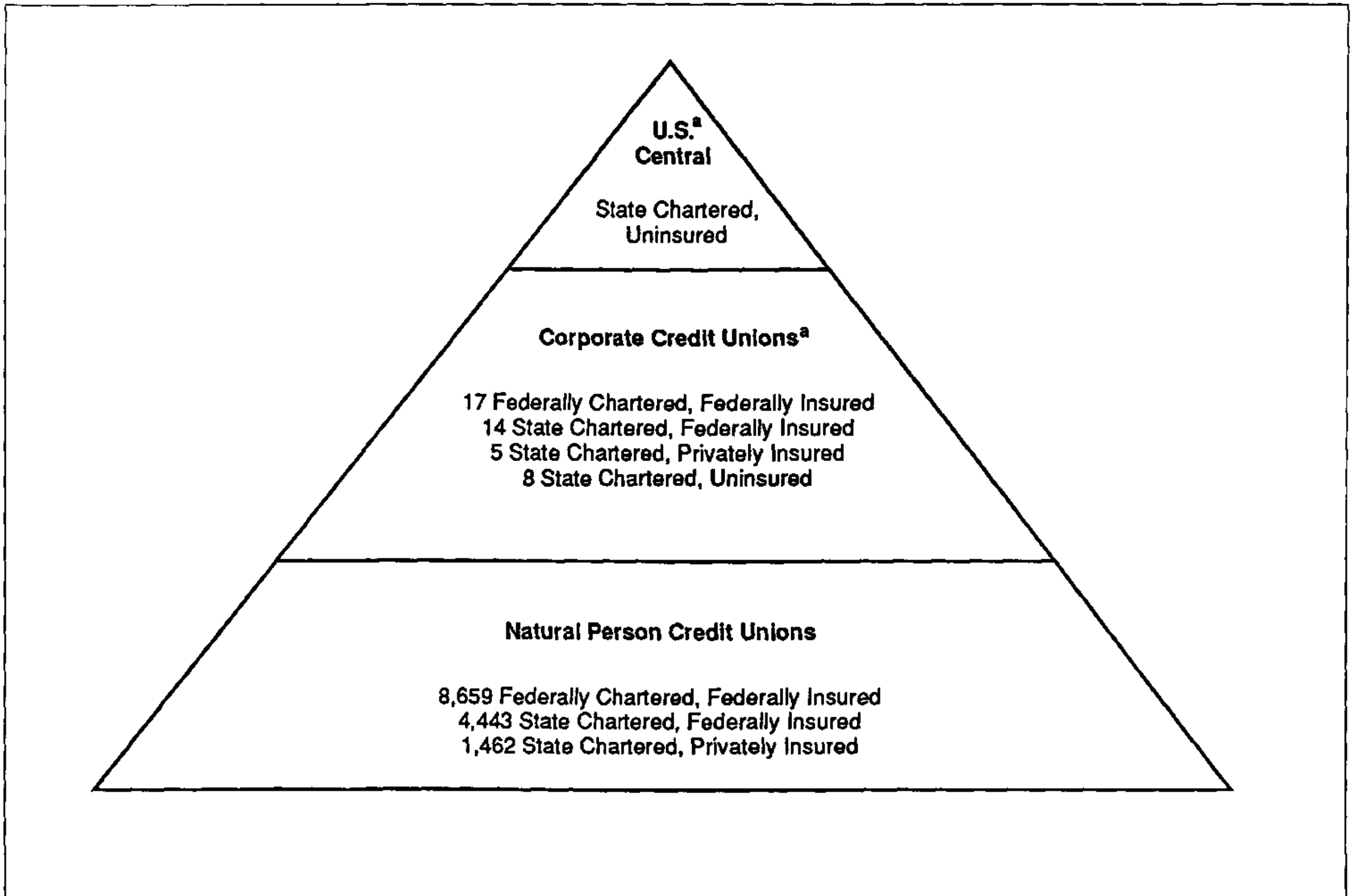
The credit union industry can best be visualized as a triangle: about 14,500 natural person credit unions[3] form the base of the industry structure. These credit unions are in turn the cooperative member-owners of 44 corporate credit unions,[4] into which they invest a portion of their assets and from which they can borrow to meet liquidity needs. The corporate credit unions, in turn, are members of a single very large corporate credit union—U.S. Central Credit Union—into which they currently invest almost all their assets. (See fig. 1.1.)

The term "credit union" as used in this report refers only to federally insured natural person credit unions and excludes corporate credit unions. Federally insured credit unions are referred to in this report as federal credit unions if they have federal charters and state credit unions if they have state charters. State credit unions that are not federally insured are specifically identified as such whenever they are included in the discussion. The terms "thrift" and "savings association" refer to entities insured by the federal Savings Association Insurance Fund. Corporate credit unions are always referred to as such and exclude U.S. Central Credit Union, unless explicitly included.

[3]Natural person credit unions primarily serve individuals, who are their member-owners.

[4]Corporate credit unions are those credit unions operated primarily for the purpose of serving other credit unions and whose total dollar amount of outstanding loans to member credit unions plus shares issued to member credit unions equals or exceeds 75 percent of their total outstanding loans plus shares. (12 C.F.R. 704.2) While this definition applies to federally chartered corporates, state laws—where they provide a definition of a corporate credit union—have similar definitions.

Figure 1.1: Credit Union System Structure (June 30, 1990)



[a]U.S. Central and the Corporate Credit Unions comprise the Corporate Credit Union System, which includes a total of 45 institutions.

Source: Information obtained from NCUA reports and officials.

Natural Person Credit Unions

As is the case with banks and savings associations, credit unions have a dual chartering, regulation, and supervision system in the United States. As of June 30, 1990, about two-thirds (8,659) of the 13,102 federally insured credit unions, with total assets of about $128 billion, had federal charters. One-third (4,443), with $67 billion in assets, were state chartered. While there is a large number of federally insured credit unions, most are quite small, as shown in table 1.2.

Table 1.2: Distribution of Credit Unions by Asset Size, June 30, 1990

Dollars in millions

Asset size	Number of credit unions	Percent of total[a]	Total assets	Percent of total[a]
Less than $.5	2,375	18.1%	$583	0.3%
$.5 to $1.99	3,326	25.4	3,733	1.9
$2 to $9.99	4,227	32.3	20,178	10.3
$10 to $49.99	2,394	18.3	53,456	27.4
$50 to $99.99	405	3.1	28,392	14.5
$100 and over	375	2.9	88,921	45.5

[a]Totals do not add due to rounding.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

The January 1991 collapse of the private insurer in Rhode Island focused attention on the privately insured institutions. NCUA subsequently provided insurance to some of these credit unions. As of June 30, 1990, there were 1,462 state-chartered credit unions, with savings of $18.6 billion, insured by private, cooperative entities.

Corporate Credit Unions

Natural person credit unions invest unloaned funds in credit unions that they themselves are members of—corporate credit unions—and they can borrow funds from them. As of June 30, 1990, federally insured credit unions had invested $20.4 billion, about 10 percent of their total assets, in shares of their corporates, up from $15.8 billion as of December 31, 1989. Twenty-seven corporates are state-chartered and 17 have federal charters. Of the 44, 31 are federally insured, 8 are not insured, and 5 are privately insured. As of June 30, 1990, corporate credit unions had 77 percent of their assets invested in shares and accounts with U.S. Central Credit Union. U.S. Central Credit Union, formed in 1974 to provide financial and payment services for the corporate credit unions, is an uninsured state-chartered entity associated with the credit union industry's principal trade association, the Credit Union National Association (CUNA). As of June 30, 1990, it held about $20.3 billion in credit union shares.[5]

Limited-Income Credit Unions

Within the industry is a subset of institutions designated by NCUA under the Federal Credit Union Act as serving "predominantly low-income members." As of June 30, 1990, according to NCUA, there were 181 of these institutions; all but 11 had federal charters. Most are small; 161

[5]Data from U.S. Central Credit Union's unaudited balance sheet as of June 30, 1990.

had assets of under $2 million and only 4 had assets exceeding $10 million. Unlike other federal credit unions, they may accept deposits from nonmembers. Limited-income credit unions may also receive NCUA designation as credit unions involved in stimulation of economic development activities or community revitalization efforts. These credit unions are commonly referred to as community development credit unions, and they may obtain loans from a special fund administered by NCUA. (See ch. 8.)

Credit Union Related Entities

Several entities are closely associated with credit unions and are an integral part of the industry's overall structure. CUNA, which had its origins in the 1930s, is described by its independent certified public accountant as a tax-exempt organization that serves as a trade association for credit unions. It provides legislative, research, and public relations services/advice as well as educational and service development for the national credit union movement. Its membership comprises 52 credit union leagues. In its 1989 annual report, CUNA described its affiliated entities as follows: CUNA Service Group, which provides a range of financial services for credit unions and their members; U.S. Central Credit Union, the movement's central liquidity and investment facility, serving credit unions through the Corporate Credit Union Network; and CUNA Mortgage Corporation, which is the credit union movement's link to the secondary mortgage market and is owned by CUNA Service Group and CUNA Mutual Insurance Group. The CUNA Mutual Insurance Group provides a variety of services, including benefit plans and fidelity bonds for credit union employees.

Credit union leagues, which are members of CUNA, are active nationwide and provide trade association services at the state level. Most credit unions in a state typically belong to that state's league. The leagues have close relationships with their respective corporate credit unions. The state leagues themselves are members of their corporates, and many have interlocking boards of directors. Included among the corporates' boards of directors are individual officials from their member credit unions.

Other entities associated with credit unions include NAFCU, in which 758 federal credit unions, including the largest federally chartered ones, are members. The National Federation of Community Development Credit Unions represents the community development credit unions. The National Association of State Credit Union Supervisors represents the government regulators of state credit unions.

Oversight and Federal Share Insurance

Credit unions, like banks and thrifts, are chartered by both the federal government and by state governments. Federally chartered credit unions are required to be federally insured. These institutions—8,659 as of June 30, 1990—are regulated and supervised by NCUA. Another 4,443 federally insured state chartered credit unions, referred to as state credit unions in this report, are regulated and supervised by both NCUA and a state authority. (See app. II for data on credit unions by state and charter.) As of mid–1990, there were 15 states and the District of Columbia that required state-chartered credit unions to have federal insurance, 33 states and Puerto Rico that required state-chartered credit unions to have either federal or some other officially approved insurance program, and 2 states that did not have a requirement in law on share insurance.

Since 1934, when Congress passed the Federal Credit Union Act, the organization with responsibility for federal oversight has been changed a number of times.[6] In 1970, it was finally established as an independent government agency—the National Credit Union Administration (NCUA) with a single administrator. In 1978, Congress replaced the single administrator at NCUA with a three-member board. Board members are appointed to 6-year terms with the advice and consent of the Senate. NCUA is now a highly decentralized organization, with over 80 percent of its 900 staff members assigned to 6 regional offices. Appendix III provides an organization chart.

In the preface to its 1989 annual report, NCUA stated that its mission "is to ensure the safety and soundness of credit unions and to provide a flexible regulatory environment that will facilitate sound credit union development, while efficiently and effectively managing the Agency's resources and the Share Insurance Fund." The National Credit Union Share Insurance Fund (NCUSIF), which was established in 1970 to provide federal share insurance for credit unions for the first time, is administered by NCUA. In 1970, NCUA was also given certain regulatory and supervisory power over those state credit unions insured by NCUSIF. It was authorized to examine them and to accept examinations made by state regulatory authorities. In recent years, NCUA has examined federal credit unions annually and a percentage of state credit unions.

[6] In 1934 supervisory responsibility was placed in a new credit union section within the Farm Credit Administration, then an independent agency. The Farm Credit Administration was subsequently moved to the U.S. Department of Agriculture. In 1942, credit union supervision was moved to the Federal Deposit Insurance Corporation. In 1948, it was moved to the Federal Security Administration. In 1953, the Federal Security Administration became part of the Department of Health, Education, and Welfare (predecessor to the Department of Health and Human Services).

The 1970 legislation also authorized NCUA to establish reserve (capital) requirements for all state chartered credit unions that are not less than reserve requirements imposed by statute on federal credit unions. NCUA has exercised this authority by regulation (12 C.F.R. 741.7(a)). In many other instances, however, state laws and regulations govern state credit union activities and in certain instances provide greater powers than those available to federal credit unions. (See ch. 3.) Nevertheless, to protect the insurance fund, NCUA has legal responsibility and authority to require any insured credit union engaging in unsafe and unsound practices, or any such credit union that is in unsafe or unsound condition, or is violating laws or regulations, to make the requested corrections or terminate its insurance. (12 U.S.C. 1786)

Objectives, Scope, and Methodology

The objectives of this review were specified in Section 1201 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. This act required us to examine:

"(1)credit unions' present and future role in the financial marketplace;

(2)the financial condition of credit unions;

(3)credit union capital;

(4)credit union regulation and supervision on both the Federal and State levels;

(5)whether the National Credit Union Administration examinations of credit unions are comparable in frequency and quality to supervisory examinations of insured banks and savings associations;

(6)the structure and financial condition of the National Credit Union Share Insurance Fund, including whether supervision of that Fund should be separated from the other functions of the National Credit Union Administration Board; and

(7)whether the common bond rules regarding credit union membership continue to serve their original purpose."

It also required comparative information on other types of depository institutions.

In addition, the Chair of the Veterans Administration, Housing and Urban Development and Independent Agencies Appropriations Subcommittee of the Senate Committee on Appropriations requested a study of

NCUA's oversight of credit unions. This request, as agreed, was incorporated into the legislatively mandated study.

Our work was done at NCUA headquarters in Washington, D.C.; NCUA regional offices, in Austin, Texas; Itasca, Illinois; and Concord, California. As part of our financial audit responsibilities, we reviewed the independent certified public accountant's audits of NCUSIF, NCUA's Central Liquidity Facility, and the NCUA Operating Fund for fiscal years 1989 and 1990.

To assess NCUA regulation, supervision, and failure resolution, we reviewed the legislation and NCUA regulations, policies, procedures, and techniques and considered potential risks. In analyzing the supervision of problem credit unions, we selected a judgmental sample of 39 problem credit unions. We also made judgmental samples of 10 corporate credit unions and 16 failed credit unions and reviewed them using similar techniques to assess the overall quality of supervision and, where appropriate, the reasons for failure. (See app. VI for a detailed discussion of the sample selections.)

To assess the condition of credit unions, we obtained from NCUA the semiannual Financial and Statistical Reports (call reports) submitted by insured credit unions and analyzed them for the period 1985 through mid-1990. We analyzed the balance sheet and income statement data using a wide range of financial ratios. While NCUA examiners are asked to review the raw numbers submitted by credit unions and NCUA data processing staff also make certain checks to help assure their accuracy, we did not independently verify the accuracy of the data. To assess issues related to common bond, we researched the legislative history of the original Federal Credit Union Act, chartering manuals, and relevant policy statements issued by NCUA from 1972 to 1990.

In addition to interviewing NCUA officials at all levels, we talked with officials of industry-affiliated groups, such as CUNA, NAFCU, the National Association of State Credit Union Supervisors, and others. We also met with state regulatory officials. We sought the views of the bank industry groups, such as the American Bankers Association and the Independent Bankers Association of America. Officials at the Department of the Treasury, Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal National Mortgage Association, and others were consulted on specific matters.

Our work was done during the period April 1989 through December 1990 and in accordance with generally accepted government auditing standards.

Highlights

Background

- The 13,102 federally insured credit unions, as of mid-1990, had about $195.3 billion in assets, $180.7 billion in liabilities, and capital measured according to generally accepted accounting principles (GAAP) of $14.3 billion.
- Most credit unions are small; about half had assets of less than $2 million. But the 375 with assets of $100 million or more held about 46 percent of the industry's assets.
- NCUA reported that, as of September 30, 1990, National Credit Union Share Insurance Fund's (NCUSIF) reserve balance as a percentage of insured shares was 1.25. Fund capitalization totaled $2.05 billion.

Key Findings

- The industry's average capital was 7.3 percent of assets. It earned an annualized net return on assets for the first half of 1990 of 0.90 percent. In comparison, bank capital averaged 6.43 percent of assets, and net return on assets was 0.69 percent. About 1.0 percent of credit union assets were delinquent loans; about 2.46 percent of bank assets were nonperforming.
- Real estate lending has increased significantly, rising from 5 percent of assets in December 1985 to 21 percent in June 1990.
- NCUA contracts with a private accounting firm to audit its financial statements. Price Waterhouse has reported that the NCUSIF, CLF, and the NCUA Operating Fund statements for the years ending September 30, 1989, and September 30, 1990 are fairly presented and conform with GAAP. We found nothing to indicate that the auditor's opinions or reports could not be relied on.
- NCUA relies on the financial and statistical reports submitted by credit unions to monitor conditions between examinations. These reports are submitted only semiannually, which is not frequent enough, and do not contain sufficient data to adequately assess risk.

Key Recommendations

- NCUA should require that credit unions, those with assets of $50 million or more, (1) file financial and statistical reports quarterly and (2) expand the report format for such credit unions to obtain more data.
- Congress should have annual oversight hearings on credit union and NCUSIF condition at which the NCUA Board testifies.

Condition of Credit Unions and NCUSIF

The financial problems facing depository institutions today are well documented. The collapse of the thrift industry and cost to the taxpayers of meeting commitments to insured depositors continue to be of widespread concern. Reports about the financial distress of commercial banks and pressure on its insurance fund are an almost daily occurrence, as are reports of continuing problems in the thrift industry. In contrast, few concerns have been raised about the overall health of the credit union industry. This chapter discusses its condition, that of its insurance fund—NCUSIF—and the risks facing the industry and the Fund.

Credit unions are in a relatively favorable financial position. On average, they are relatively well capitalized, profitable, and liquid. NCUSIF—the fund that guarantees credit union shares—is also healthier than its banking counterpart. As of December 31, 1990, NCUA reported that NCUSIF equity was $1.25 for each $100 in insured accounts. This compares favorably with the Bank Insurance Fund (BIF). GAO's preliminary estimate was that BIF reserves totaled no more than $.26 for $100 in insured deposits. The Federal Savings and Loan Insurance Corporation (FSLIC) became insolvent and was replaced with a new fund (the Savings Association Insurance Fund).[1]

While credit unions are healthier than banks and thrifts, they still face risks common to all depository institutions. And, the recent sharp decline in the condition of banks and their insurance fund highlights how quickly serious problems can appear in depository institutions and, consequently, their insurer. The business of lending and investing members' money is, by its nature, risky, and losses may leave institutions with assets that are insufficient to cover deposits.

Large increases in real estate holdings in recent years leave credit unions more exposed than they had been to interest rate and credit risk, and the more general risk of entering into new product lines. Other risks, common to all depository institutions and their insurance funds, are that regulation will be inadequate, supervision will be lax, failing institutions will not be promptly closed, insurance fund capitalization will be overstated because reserving for anticipated losses is too low, the capitalization of the insurance fund will not be adequate, serious economic problems will have a significant impact on debtors' ability to repay

[1]Savings associations that are placed in receivership or conservatorship between January 1, 1989, and August 9, 1992, are to be resolved by the Resolution Trust Corporation, primarily at taxpayer expense.

loans on schedule, and management will engage in fraud or not be sufficiently competent. Finally, unlike other depository institutions, credit unions have membership requirements. To the extent that a credit union's membership comes from one plant or company or localized members of an occupation, this lack of diversification also increases its vulnerability to economic problems.

After discussing the condition of the industry and its insurance fund, this chapter provides comments on the types of risks facing credit unions. These are discussed in more detail in subsequent chapters. Because NCUA's ability to assess and anticipate the extent of risk in credit union operations is greatly dependent upon credit unions' financial reports, this chapter also recommends annual oversight hearings and more frequent and detailed reporting.

Condition of the Credit Union Industry

Primarily through consolidation within the industry, the number of credit unions in the United States has fallen rather dramatically over the past 20 years, from a peak of 23,688 in 1970, the year federal share insurance was authorized, to 13,102 federally insured and about 1,450 privately insured credit unions in June 1990. Total savings as of June 30, 1990, were $178 billion in federally insured associations and about $19 billion in privately insured credit unions.

The consolidation in the industry has been accompanied by growth in both total industry deposits and changes in types of lending. While credit unions are still, on average, much smaller than commercial banks or thrifts, the average federally insured credit union had grown from $1.8 million in assets as of December 31, 1975, to $14.9 million in assets as of June 1990. The industry is highly concentrated. The 780 credit unions with assets of $50 million or more held, as of mid-1990, about 60 percent of the industry's assets.

In the rest of this chapter, as elsewhere in the report, the term credit union refers only to federally insured credit unions.

Growth of Credit Unions

The credit union industry has grown dramatically in recent years. Assets, which totaled $12.5 billion in 1971, had risen to $61 billion in 17,712 credit unions by the end of 1980. Between December 1985 and June 1990, assets of credit unions increased by 63 percent, from $119.7 billion to $195.3 billion. In 1986, assets and shares grew by 23.4 and 24.1 percent, respectively. Since then growth has continued, but at a

slower rate. In 1989, assets and shares grew by only 4.8 and 4.7 percent, respectively. In the first half of 1990, however, growth rebounded to 6.3 percent for assets and 6.5 percent for shares.

Table 2.1: Credit Union Growth (1985-1990)

Dollars in billions

	Assets		Shares	
Year	**Dollar value**	**Percentage growth**[a]	**Dollar value**	**Percentage growth**[a]
Dec. 1985	$119.7		$108.2	
Dec. 1986	147.7	23.4	134.3	24.1
Dec. 1987	162.2	9.8	148.4	10.5
Dec. 1988	175.3	8.1	159.6	7.5
Dec. 1989	183.7	4.8	167.1	4.7
June 1990	195.3	6.3	178.0	6.5

[a]Changes from end of preceding period.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

In contrast, during the December 1985 to June 1990 period, assets in commercial banks grew by 24 percent and assets at thrifts, which peaked in 1988, grew by 9.4 percent. Total insured deposits in the United States grew by 25.9 percent. Credit unions' share of total deposits in credit unions, banks, and thrifts has increased somewhat from 4.7 percent in 1985 to 6 percent in June 1990.

There were 13,102 credit unions in June 1990, with average assets of $14.9 million. However, as shown in table 2.2, assets in the industry were quite concentrated. The 780 large institutions, those with assets of $50 million or more, held 60 percent of the industry's total assets. The 375 institutions with assets of $100 million or more held 46 percent of industry assets.

Table 2.2: Distribution of Credit Unions by Asset Size, June 30, 1990

Dollars in millions

Asset size	Number of credit unions	Percentage of total[a]	Total assets	Percentage of total[a]
Less than $.5	2,375	18.1	$583	0.3
$.5 to $1.99	3,326	25.4	3,733	1.9
$2 to $9.99	4,227	32.3	20,178	10.3
$10 to $49.99	2,394	18.3	53,456	27.4
$50 to $99.99	405	3.1	28,392	14.5
$100 and over	375	2.9	88,921	45.5

[a]Totals do not add due to rounding.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Capital

Capital provides a cushion against losses. The amount of capital a credit union has is a measure of its capacity to withstand economic adversity and to avoid recourse to NCUSIF. As of June 30, 1990, total capital in federally insured credit unions equalled $14.3 billion, which was 7.3 percent of their $195.3 billion in total assets.[2] Table 2.3 shows that credit union capital ratios have improved in recent years and that smaller credit unions consistently have somewhat higher capital ratios than larger credit unions. Contributing to this difference are the current reserving requirements. A credit union with assets of less than $500,000 (of which there were 2,375) has to reserve until regular reserves equal 10 percent of outstanding loans and risk assets.[3] One with $500,000 or more in assets has to reserve until a 6-percent level is reached. (Years in operation also affects reserving requirements. Ch. 3 discusses the reserving requirement.)

Credit union capitalization of 7.3 percent compares with capital of 6.43 percent of assets for commercial banks. Average thrift capital fell during the 1980s. It was 5.5 percent of assets in 1980, 3.4 percent in 1985, and 2.5 percent on June 30, 1990.

[2]"Capital" is defined in this report as GAAP capital; that is, capital according to generally accepted accounting principles. In the credit union context, it is the sum of regular, investment valuation, and other reserves and undivided earnings. It excludes the allowance for loan and investment losses and also shares. Because credit unions are cooperatives, capital is at times defined by NCUA and the industry as shares plus GAAP capital.

[3]NCUA defines in regulation how regular reserves, outstanding loans, and risk assets are to be calculated. For example, certain investments with maturities of less than 3 years are excluded. (See ch. 3.)

Table 2.3: Capital in Credit Unions as a Percentage of Assets (1985-1990)

Year	Total industry	Large credit unions[a]	Medium credit unions[b]	Small credit unions[c]
Dec. 1985	6.5%	5.7%	6.6%	8.3%
Dec. 1986	6.2	5.7	6.3	7.8
Dec. 1987	6.6	6.2	6.6	7.9
Dec. 1988	6.9	6.4	7.0	8.4
Dec. 1989	7.3	6.8	7.5	9.2
June 1990	7.3	6.8	7.6	9.1

[a]Large credit unions are defined as those with assets of $50 million or more.

[b]Medium sized credit unions are defined as those with assets between $10 million and $50 million.

[c]Small credit unions are defined as those with assets of less than $10 million.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Banks, particularly larger banks, have different asset portfolios—and thus face additional risks. We therefore compared credit unions and banks of similar size. At the same time, it must be recognized that significant differences can exist in asset portfolios between credit unions and these banks because of lending constraints on credit unions. Credit unions with assets equal to or less than $100 million (12,727) had capital-to-asset ratios averaging 7.7 percent; banks in this size category (9,500) had ratios averaging 9.09 percent as of June 30, 1990.

Although 78 percent of credit unions had capital in excess of 6 percent of assets in June 1990, there were 87 institutions that were insolvent; that is, their capital, calculated on the basis of GAAP, was zero or less. These insolvent institutions held $1.8 billion in assets, or 0.9 percent of industry assets. As shown in table 2.4, the number of insolvents and the share of industry assets they held has been stable in recent years. In comparison, in June 1990, there were 35 insolvent commercial banks, which held 0.04 percent of bank assets.

The warehousing of insolvent institutions in the thrift industry, allowing insolvent thrifts to continue operating, increased costs significantly when they ultimately failed. We were therefore concerned about the 87 insolvent credit unions as of mid-1990. We found that 43 of the 87 had reported insolvency for only one prior period and that 30 had reported insolvency for three or more prior reporting periods. Further analysis of the 30 revealed that 18 were small but that 12 had assets of $10 million or more. Twenty-four of the 30, however, and 11 of the 12 with assets of $10 million or more were receiving NCUSIF assistance. Credit unions receiving assistance are reserved for in NCUSIF financial

statements to the extent that any losses are anticipated; such reserving is not counted as part of NCUSIF's capital. (A detailed analysis of NCUA's handling of insolvent credit unions, and also those considered to be in "weak" or "unsatisfactory" condition, is contained in ch. 5.)

Table 2.4: Insolvent and Low Net Worth Credit Unions (1985-1990)

	Insolvent		Low net worth[a]	
Year	Number	Percentage of total assets	Number	Percentage of total assets
Dec. 1985	83	1.0	731	6.4
Dec. 1986	64	1.0	748	6.4
Dec. 1987	73	0.7	714	6.3
Dec. 1988	90	0.7	547	4.5
Dec. 1989	99	0.8	406	3.6
June 1990	87	0.9	415	3.9

[a]Low net worth credit unions are those with GAAP capital greater than 0 and less than 3 percent of assets.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

There has been a significant decline in recent years in the number of low net worth credit unions and in their market share. As of June 30, 1990, 415 institutions were in this category compared with 731 at the end of 1985. These 415 low net worth institutions, with capital greater than 0 but less than 3 percent of assets, held $7.6 billion (3.9 percent) of total credit union assets. The decline in the number and assets of low net worth credit unions probably reflects to a considerable extent the significant consolidation within the industry. Mergers have been high in the past decade, and low net worth credit unions are those most likely to seek or require merger partners. There were 467 mergers in fiscal year 1990, 386 of which were done without NCUSIF assistance. In 1988 and 1989, mergers totaled 514 and 455. Particularly because industry capitalization as a whole has improved (see table 2.3), this percentage decline in the assets held by weakly capitalized credit unions should result in a considerable reduction in aggregate risks to NCUSIF.

Nevertheless, the percentage of industry assets in these institutions remains noteworthy. Accordingly, we analyzed the data to determine how long the December 1989 low net worth credit unions had been in that category. Of the 406, 202 had reported low or no net worth as of both December 1987 and December 1988. It should be noted in this context that credit unions are chartered without capital. They are not required to maintain a specified level of capital but rather to reserve a

percentage of gross income until certain capital levels are met. (This situation, and our recommendations, are discussed in ch. 3.) Newly chartered credit unions thus first appear in the low net worth category and may stay there for several years or more. In 1985, 1986, and 1987, there were 78, 59, and 46 credit unions chartered, respectively.

Analysis of data on commercial banks, which are subject to minimum capital requirements, shows that as of June 1990, 148 low net worth banks held 0.85 percent of the industry's assets.

Industry Profits

Profits are an important source of capital for financial institutions, and thus the profitability of an institution is a key indicator of its financial viability. Profits are an especially important source of capital for mutually owned institutions, such as credit unions, since these institutions cannot raise capital by selling equity.

To survive, credit unions must earn some minimum level of profits. Intuitively, however, one might expect credit unions not to be as profitable as commercial banks or other "for profit" financial institutions that are not member owned. As mutual associations, credit unions are not by reputation profit-maximizers. They are expected to maximize benefits to their members through higher yields on savings and lower rates on loans.

In general, the credit union industry is profitable. On average, credit unions earned a net return on assets of 0.92 percent during 1989 and an annualized rate of 0.90 percent in the first half of 1990. This was down from the 1.2 percent earned in 1985, but nevertheless compares favorably with the net return on assets of commercial banks—0.52 percent in 1989 and the negative return (-1.34 percent) for thrifts in the same year. Bank net return on assets, annualized, was 0.69 percent during the first half of 1990.

Table 2.5 shows that the credit unions with capital of 6 percent or more consistently earned the highest return, and that those with low net worth have trended toward unprofitability as a group. As noted earlier, credit unions' only source of capital—outside of an unassisted merger or NCUSIF assistance—is retained earnings; they are thus more constrained in obtaining capital than nonmutual banks and thrifts. (NCUA's use of assistance, including forbearances from certain reserving and other requirements, is discussed in ch. 5.) Newly chartered credit unions, which must build capital internally, are generally in the low net worth

group. However, on average, only about 40 new charters were issued annually in fiscal years 1985 through 1990; because they are generally small in their early years, they should not have a major effect on aggregate performance of the group.

Table 2.5: Profitability of Credit Unions by Level of Capitalization (Net Income/Average Assets) (1985-1989)

Year	Industry average	Better capitalized (net worth of 6% and over)	Moderately capitalized (net worth of 3 to 6%)	Low net worth (net worth more than 0 but under 3%)	Insolvent (net worth of 0% or less)
Dec. 1985	1.2	1.5	1.1	0.5	1.1
Dec. 1986	1.0	1.4	0.9	0.4	−1.9
Dec. 1987	0.9	1.2	0.7	0.2	−1.3
Dec. 1988	1.0	1.2	0.8	0.1	−1.6
Dec. 1989	0.9	1.2	0.7	−0.5	−4.1

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Liquidity

Credit union liquidity has been relatively high throughout the past decade. Loans as a percentage of shares were over 90 percent in the late 1970s, dropped to under 80 percent in the early 1980s, and continued to decline, reaching about 69 percent of assets in mid-1990. Unloaned funds are generally invested in assets maturing in less than 1 year. In June 1990, for example, $47 billion of the $62 billion of credit union investments—75 percent—would mature in less than 1 year. Commercial banks at that time held $486 billion, 14 percent of their assets, in investments with remaining maturities of 1 year or less and $434 billion in securities maturing in over a year.

Liabilities

As with other types of depository institutions, the major liabilities are deposits, referred to by credit unions as shares.[4] In June 1990, credit union liabilities totalled $180.7 billion. Deposits of various types accounted for $178.2 billion. These accounts include regular share (savings) accounts, share draft (checking) accounts, certificates of deposit, and individual retirement accounts (IRA), as shown in table 2.6.

[4]For consistency of presentation with other depository institutions, liabilities are defined here on the basis of GAAP. Credit unions do not define shares as liabilities.

Table 2.6: Credit Union Shares and Other Liabilities as a Percentage of Total Liabilities (1985-1990)

Figures in percent

Year	Regular and other shares	Share drafts	Money market shares	Share certificates	IRAs	All other liabilities[a]
Dec. 1985	59.7	8.9	[b]	17.1	10.9	2.2
Dec. 1986	61.7	9.1	[b]	13.7	12.5	1.8
Dec. 1987	61.1	9.4	[b]	14.1	13.3	2.1
Dec. 1988	58.3	9.2	[b]	17.0	13.3	2.2
Dec. 1989	45.7	9.5	8.0	21.2	13.8	1.8
June 1990	45.5	9.6	8.2	20.8	13.8	1.9

[a]"All other liabilities" includes promissory notes, reverse repurchase agreements, other notes and interest payable, accrued dividends (declared but not yet posted to accounts), and accounts payable.

[b]Not applicable.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Assets

The majority of credit union assets are loans. In June 1990, credit unions held 63.4 percent of their assets in loans, compared with 61.9 percent at commercial banks. However, law and regulation tend to restrict credit union loans to consumer loans and investments in higher quality issuers. (See ch. 3.) In addition, common bond membership restrictions limit those to whom credit unions can lend and from whom they can accept deposits. (See ch. 9.) These differences, compared to the lending and investing activities of banks and thrifts, have contributed to less risky, and in recent years more profitable, operations for credit unions. Asset losses have been lower and credit unions have avoided the liquidity problems often associated with unduly rapid and expensive growth funded by "hot money," such as brokered deposits. Table 2.7 compares the asset mix in credit unions, commercial banks, and savings associations. Table 2.8 shows the types of credit union investments.

Table 2.7: Comparison of the Loan Portfolios of Credit Unions, Commercial Banks, and Savings Associations as a Percentage of Total Assets (June 1990)

	Credit unions	Commercial banks	Savings associations
Total loans	63.4%	61.9%	77.8%
Personal loans[a]	41.1	11.7	4.6
Real estate loans	21.3	22.7	70.9
Other loans[b]	0.2	7.5	(0.2)
Agriculture and commercial loans	[c]	20.0	2.5[c]
Other assets[d]	36.6	38.1	22.2
Total	**100.0**	**100.0**	**100.0**

[a]"Personal loans" for credit unions include unsecured loans, car loans, and certain other loans to members. It excludes $530 million in loans to nonmembers, which may include personal loans. For commercial banks, personal loans are defined as loans to individuals. For savings associations, personal loans include loans for home improvement, education, and autos.

[b]"Other loans" for credit unions is computed by subtracting real estate and personal loans from total loans. For banks, "other loans" is computed by subtracting personal, agricultural, real estate, and commercial loans from total loans. For thrifts, other loans are "contra" loans.

[c]For credit unions, personal loans, real estate, and other loans may include loans for agricultural and commercial purposes. About 0.7 percent of assets were categorized as commercial loans in reports to NCUA. For savings associations, only commercial loans are included in the 2.5 percent figure.

[d]"Other assets" is computed by subtracting loans from total assets. Thus, for credit unions and banks, other assets includes all investments and assets other than loans.

Source: Data calculated from credit union financial and statistical reports provided by NCUA and from bank reports provided by the Federal Reserve. The Office of Thrift Supervision provided the savings association numbers.

Clearly, credit unions are much more heavily concentrated in personal loans than are other depository institutions. At the same time, commercial lending appears to be, overall, relatively insignificant. Some loans made by credit unions for commercial purposes are not reflected in these statistics, however. NCUA rules do not require any commercial (referred to as business) loans smaller than $25,000 or those loans secured, for example, by first or second homes to be reported as commercial or agricultural even though that may be their purpose. We recommend in chapter 3 that these exclusions be limited. We also recommend that, because of the risks of commercial lending, there should be a limit on the amount of such loans a credit union may hold.

Change in Loan Mix Toward Real Estate Loans

Table 2.8 shows the composition of credit union assets over the past several years. Personal loans made up 42 percent of total credit union assets in June 1990. This is still the largest single category of assets and is the type of loan traditionally made by credit unions. However, in recent years the proportion of personal loans has fallen significantly, from 57 percent of assets in December 1985 to 42 percent in June of

1990, while real-estate-based loans increased from 5 percent to 21 percent.

Table 2.8: Asset Composition of Credit Unions as a Percentage of Total Assets (1985-1990)

Figures in percent

	Dec 1985	Dec. 1986	Dec. 1987	Dec. 1988	Dec. 1989	June 1990
Total loans	**62.2**	**58.3**	**61.4**	**64.9**	**66.8**	**63.4**
Personal	56.9	44.8	43.6	44.1	44.0	41.9
Real estate	4.8	12.4	16.5	19.6	21.7	21.3
Other loans[a]	0.5	1.1	1.3	1.2	1.1	0.2
Cash	2.4	2.4	2.2	2.2	2.3	2.3
Total investments	**33.0**	**36.9**	**33.9**	**30.5**	**28.4**	**31.8**
U.S. government and agencies	8.8	9.3	9.8	9.4	7.9	8.9
Corporate credit unions	7.7	8.5	7.1	6.8	8.6	10.4
Bank & thrift deposits	13.9	15.4	12.5	10.2	9.5	9.9
NCUA insurance deposit	0.8	0.7	0.8	0.8	0.8	0.8
Other investments[b]	1.8	3.0	3.7	3.3	3.9	1.8
Fixed and other assets[c]	2.9	2.8	2.9	3.0	3.1	3.0
Total assets (billions)	**$119.7**	**$147.7**	**$162.2**	**$175.3**	**$183.7**	**$195.3**

[a]"Other loans" includes loans involving repossession of collateral, any note or contract receivable resulting from the sale of assets acquired in liquidation of loans, etc., and loans to nonmembers.

[b]"Other investments" includes credit union service organizations, state and federal funds, local government obligations, shares in NCUA's CLF and privately issued mortgage-backed securities.

[c]"Fixed assets" includes land and buildings and other real estate owned; "other assets" includes leasehold improvements, prepaid expenses, and accrued income.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Real estate lending consists primarily of first mortgage, home equity, and second mortgage loans. Credit unions have moved into real estate lending, as authorized by changed regulations (see ch. 3), for several reasons. First, the Tax Reform Act of 1986 phased out the deductibility of interest payments for consumer loans but not mortgages, making home equity loans and second mortgages more attractive to credit union members who could use the deductions. Second, credit unions have been forced into new markets as membership and share deposits have grown at the same time banks and auto financing companies have increased their consumer lending activities. Third, mortgage lending has been perceived by some to be a relatively safe and lucrative business. Currently, real estate loans comprise nearly one-third of loans outstanding and about one-fifth of credit union assets. Commercial real estate lending is not separately reported.

As shown in table 2.9, real estate first mortgages as a percentage of total loans have risen from 7.8 percent of loans in December 1985 to 19.3 percent in June 1990. Of first mortgages, 43 percent were adjustable-rate loans.

The "other real estate" lending, comprising primarily second mortgages and home equity loans, has also increased dramatically over the last 5 years. Since December 1986, when "other real estate" lending was first reported separately, such lending has increased from 8.6 percent of total loans to 14.3 percent in June 1990. About half of all funds in real estate loans as of June 30, 1990, were in fixed-rate loans.

The increasing reliance on variable—rather than fixed-rate—loans shifts some of the risk of rising interest rates from credit unions to their borrowers. The extent to which risk can be transferred is limited by interest rate caps and the ability of borrowers to make larger payments.

Table 2.9: Types of Real Estate Lending by Credit Unions as a Percentage of Total Loans (1985-1990)

	Percent		Total real estate lending	
Year	First mortgages	Other real estate	Percent	Dollars in billions
Dec. 1985[a]	7.8	[a]	7.8	$5.8
Dec. 1986	12.7	8.6	21.3	18.3
Dec. 1987	16.5	10.4	26.9	26.7
Dec. 1988	18.4	11.8	30.2	34.3
Dec. 1989	18.9	13.5	32.5	39.8
June 1990	19.3	14.3	33.6	41.6

[a]Not applicable.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

As shown in table 2.10, credit union investment in real estate varies regionally. Credit unions in the northeast (Albany) region hold, on average, 45 percent of their loan portfolios in real estate loans. Forty percent of the loans held by west coast (Pacific) region credit unions are real estate loans. In contrast, 24 percent of the southwest (Austin) region and 25 percent of the midwest (Chicago) region loans are real estate based. These differences relate in large part to the powers granted to state-chartered credit unions.

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Table 2.10: Real Estate Lending by Region and Type as of June 1990

	Total real estate lending		Percent			
			First mortgages		Other real estate lending	
NCUA region[a]	Dollar in billions	Percentage of total loans	Fixed rate	Variable rate	Fixed rate	Variable rate
All credit unions[b]	$41.6	33.5	11.0	8.2	5.6	8.7
Albany	8.5	44.6	15.4	11.6	6.2	11.4
Capital	5.3	32.0	11.7	5.3	7.2	7.7
Atlanta	6.3	33.6	10.0	10.2	3.4	10.0
Chicago	5.1	24.8	8.7	6.9	3.0	6.3
Austin	4.8	23.6	9.3	5.0	4.7	4.6
Pacific	11.5	40.4	11.4	9.5	8.2	11.4

[a]A map showing the states in each region is in app. IV.

[b]Totals may not add due to rounding.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

While larger credit unions have higher amounts of real estate lending, such loans are held by credit unions of all sizes. Insolvent or poorly capitalized associations also had significantly higher percentages of real estate loans than those with capital exceeding 6 percent of assets.

In addition to making real estate loans, some credit unions have acquired mortgage-backed securities. These securities do not incur all the risks associated with making and holding real estate loans, but they still depend on the value and repayment of the underlying mortgages for repayment. Credit union holdings of mortgage-backed securities cannot, however, be determined from the semiannual financial and statistical reports credit unions submit to NCUA.

Many credit unions use mortgage banking services provided by others. These services help credit unions to offer mortgage loans to members and provide a continuing source of new funds by the sale of such loans to private investors through the mortgage banker. Providers of these services include CUNA Mortgage Corporation (an affiliate of Credit Union National Association, a trade organization), about 25 credit union service organizations (CUSO), and such government-sponsored enterprises as the Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae). We believe credit unions should benefit from the expertise and the liquidity provided by these arrangements. However, as has been noted by NCUA, most credit unions have been making loans that are permanently held in their own

portfolios; in many or most cases, the loans have terms or documentation that limit their salability in the secondary market. This is a matter of concern because it creates liquidity risks (long-term loan assets that are largely funded by short-term deposits). In our opinion, the rapid growth of real-estate-based lending by credit unions merits continuing and increased attention by NCUA. (In ch. 3, we recommend certain improvements related to real estate lending.)

Credit Quality

Credit unions do not report on the credit quality of real estate loans. However, some information is available on the delinquency status of total loans. Credit unions are only required to report delinquencies that are 2 months or more in arrears. Table 2.11 shows the pattern of delinquent loans for credit unions since 1985. In every category, the delinquency rate for loans has declined. Total delinquent loans fell from 2.1 percent of total loans in December 1985 to 1.6 percent in June 1990. By this measure, the credit problems facing other depository institutions have not—to date—emerged as a factor for credit unions. Credit union real estate lending as a significant percentage of industry assets is relatively new, however, and has not been through a full economic cycle.

Table 2.11: Delinquent Loans (1985-1990)

Dollars in billions

	Percentage of total loans				
Year	2-6 months delinquent	6-12 months delinquent	12 months or more	Total delinquent[a]	Dollar amount delinquent
Dec. 1985	1.2	0.5	0.4	2.1	$1.6
Dec. 1986	1.3	0.6	0.4	2.2	1.9
Dec. 1987	1.1	0.5	0.4	1.9	1.9
Dec. 1988	1.0	0.4	0.3	1.8	2.1
Dec. 1989	1.1	0.4	0.3	1.8	2.2
June 1990	0.9	0.4	0.3	1.6	2.0

[a]Totals may not add because of rounding.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Credit quality is captured differently in bank reports to regulators. They report on assets that are nonperforming.[5] Delinquent loans were about 1 percent of credit union assets; nonperforming loans for all commercial

[5]Nonperforming loans is defined as noncurrent loans and leases (90 days or more past due) and owned real estate.

banks totaled 2.46 percent of assets as of June 1990. For banks with assets of $100 million or less, the total was 1.73 percent.

Condition of the Largest Credit Unions

Because large credit unions represent the greatest risk to NCUSIF, we made a special analysis of their condition. First, we assessed the 375 with assets of $100 million or more. They hold a significant percentage—46 percent—of the industry's assets. Table 2.12 shows that these credit unions, when compared to those with less than $100 million, had somewhat less capital and a higher percentage of assets in both first mortgages and all real estate lending. In the other areas we analyzed, they are roughly comparable.

Table 2.12: Selected Credit Union Statistics by Size of Credit Union, as of June 30, 1990: Over and Under $100 Million in Assets

	All credit unions	Credit unions with $100 million or more in assets	Credit unions with less than $100 million in assets
Number	13,102	375	12,727
Capital-to-asset ratio	7.3%	6.9%	7.7%
Net income as a percentage of assets[a]	0.4	0.5	0.4
Real-estate-based assets as a percentage of assets	21.3	25.7	17.6
First mortgages as a percentage of assets	12.2	15.3	9.7
Commercial loans as a percentage of assets	0.7	0.9	0.6
Loans as a percentage of assets	63.5	62.7	64.1
Investments as a percentage of assets	31.8	32.4	31.3

[a]Data are for the first half of 1990 and are not annualized.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

Data on even larger credit unions—those with assets of $500 million or more and $250 million or more—are shown in table 2.13.

Table 2.13: Selected Credit Union Statistics by Size of Credit Union, as of June 30, 1990: Over $250 Million and Over $500 Million in Assets

	All credit unions	Credit unions with $500 million or more in assets	Credit unions with $250 million or more in assets
Number	13,102	28	100
Capital-to-asset ratio	7.3%	6.7%	6.4%
Net income as a percentage of assets[a]	0.4	0.5	0.5
Real-estate-based assets as a percentage of assets	21.3	25.8	25.9
First mortgages as a percentage of assets	12.2	15.1	15.1
Commercial loans as a percentage of assets	0.7	1.1	0.8
Loans as a percentage of assets	63.5	62.5	62.2
Investments as a percentage of assets	31.8	32.6	32.8
Delinquent loans as a percentage of assets	1.0	0.7	0.6

[a]Data are for the first six months of 1990 and are not annualized.

Source: Data calculated from credit union financial and statistical reports provided by NCUA.

We determined that, of the 28 largest credit unions, 3 had capital of less than 3 percent; NCUA had established reserves for 1 of the 3. Another nine had capital between 4.3 and 5.6 percent of assets. Of those 100 with assets of $250 million or more, 6 had capital-to-asset ratios of less than 3 percent. Another 27 had ratios between 3.6 percent and 5.7 percent of assets. Because NCUSIF sets aside reserves for losses anticipated over the upcoming 2 years, any risks posed by these institutions should be accounted for. (See reserving discussion later in this chapter.)

Regulatory Ratings Remain Constant

Another way to assess the condition of the industry is by looking at trends in regulatory ratings. Credit unions are rated on their condition by NCUA and state regulators using a "CAMEL" system that evaluates their capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and their overall condition. The ratings are 1-excellent, 2-good, 3-fair, 4-weak, and 5-unsatisfactory. Credit unions with an overall rating of 4 or 5 are considered problem credit unions. (Ch. 4 discusses the CAMEL system in detail.) Table 2.14 shows that there has been a downward trend in the number of problem credit unions over the decade. Problem credit unions totaled over 7 percent of the industry in 1983 and again in 1988. In 1990, they totalled 5.2 percent of the industry.

Table 2.14: Distribution of Credit Unions by CAMEL Rating

Date (as of 9/30)	1-excellent and 2-good	3- fair	4- weak	5- unsatisfactory	Total
1983	11,030	3,909	995	129	**16,063**
1984	10,718	3,772	782	90	**15,362**
1985	10,736	3,553	681	61	**15,031**
1986	10,010	3,985	716	78	**14,789**
1987	9,133	4,458	838	91	**14,520**
1988	8,341	4,644	926	96	**14,007**
1989	8,310	4,444	723	71	**13,548**
1990	8,055	4,279	625	53	**13,018**

Note: The Early Warning System was used through September 30, 1987. The ratings mean virtually the same thing, according to NCUA officials.

Source: NCUSIF annual reports for 1983, 1987, and 1990.

The percentage of industry shares in problem credit unions declined earlier in the decade but since 1985 has remained relatively steady, as shown in table 2.15. (Ch. 5 discusses the characteristics of the 4 and 5 rated credit unions, NCUA's policies and practices with respect to them, and the number that are now receiving NCUSIF assistance.)

Table 2.15: Percentage of Shares by CAMEL Rating

Date (as of 9/30)	1-excellent and 2-good	3- fair	4- weak	5- unsatisfactory
1983	81.1	13.0	5.4	.5
1984	81.9	13.4	4.2	.5
1985	82.9	13.2	3.6	.3
1986	79.0	16.1	4.7	.2
1987	76.5	18.6	4.7	.2
1988	73.8	19.9	6.0	.3
1989	75.4	19.8	4.6	.2
1990	73.0	22.1	4.7	.2

Note: The Early Warning System was used through September 30, 1987. The ratings mean virtually the same thing, according to NCUA officials.

Source: NCUSIF annual reports for 1983, 1987, and 1990.

Financial Audits

The Federal Credit Union Act provides that the financial transactions of NCUA and the two funds it manages shall be subject to audit by GAO under such rules and regulations as may be prescribed by GAO (12 U.S.C. 1752a(f), 1789(b), and 1795(h)). NCUA contracts with independent public

accountants to do the audits of NCUSIF, CLF, and the NCUA Operating Fund. To fulfill our audit responsibilities, avoid duplication, and make the most efficient use of our resources, we review the auditor's work and reports.

NCUA has contracted with the public accounting firm Price Waterhouse for these financial audits in recent years. In the opinion of Price Waterhouse, the financial statements have presented fairly the financial positions of these funds as of September 30, 1989 and 1990, and the results of their operations and cash flows for the years then ended, in conformity with GAAP. The audits, which are performed under generally accepted government auditing standards, also include reports to the NCUA Board on internal accounting controls and on compliance with laws and regulations. The reports have not disclosed any material internal control weaknesses or noncompliance with laws and regulations.[6]

We made a review of the auditor's work in accordance with generally accepted government auditing standards. To determine the reasonableness of the auditor's work and the extent to which we could rely on it, we

- reviewed the auditor's approach and planning of the audit;
- evaluated the qualifications and independence of the audit staff;
- reviewed the financial statements and auditor's reports to evaluate compliance with generally accepted accounting principles and generally accepted government auditing standards; and
- reviewed the auditor's working papers to determine (1) the nature, timing, and extent of audit work performed, (2) the extent of the audit quality control methods the auditor used, (3) whether a study and evaluation was conducted of the entity's internal accounting controls, (4) whether the auditor tested transactions for compliance with applicable laws and regulations, and (5) whether the evidence in the working papers supported the auditor's opinion on the financial statements and internal accounting controls and compliance reports.

In addition, in light of deteriorating conditions in other federal deposit insurance funds, we placed additional emphasis on (1) gaining an understanding of NCUA's methodology for establishing a reserve for insurance losses based on information gathered through its regulatory process and (2) reviewing the auditor's testing of the reserve for insurance losses.

[6]Appendix V contains NCUA's financial statements, its auditor's opinions and related reports, and our opinion letter.

However, we did not independently verify all regulatory information provided to us.

We found nothing to indicate that Price Waterhouse's opinions on the fiscal years 1989 and 1990 financial statements are inappropriate or cannot be relied on, nor did we find anything to indicate that the auditor's reports on internal accounting controls and on compliance with laws and regulations are inappropriate or cannot be relied on.

NCUA's Methodology for Determining NCUSIF Reserves

An important aspect of our work in reviewing the NCUSIF financial audit is to ensure that appropriate reserves have been established for anticipated losses. These amounts are thus not counted as part of NCUSIF's capitalization.

NCUSIF establishes reserves for anticipated credit union losses in accordance with GAAP. The cost incurred when establishing reserves is reflected in the Fund's income statement as a loss provision expense for the period when the anticipated loss is recognized, not when funds are actually disbursed. NCUA officials believe that credit unions with composite CAMEL ratings of 4 or 5 pose the greatest risk to the Fund. These credit unions are thus the basis from which the reserve valuation is determined.[7]

NCUA makes reserving projections for a 2-year period. NCUA's Director of Examination and Insurance has told us that he does not think it is feasible to make projections about a credit union's performance further into the future. He also noted that NCUA's policy goal, established in June 1989, is to allow no more than 2 years for a troubled credit union to return to solvency before closing it. In chapter 5 we assess NCUA's progress in reaching its goal.

NCUA uses two methods in calculating its reserve needs. The first method involves all CAMEL-rated 4 and 5 credit unions with insured shares of $20 million or more. Loss estimates for these credit unions are determined and adjusted monthly by the applicable NCUA regional manager and reviewed and adjusted, if necessary, by officials in NCUA headquarters on a case-by-case basis. The financial condition of the credit union and

[7]According to NCUA's Examiner's Guide, the potential for failure is present but not pronounced in credit unions with a composite 4 CAMEL rating, while the probability of failure is high in credit unions with a composite 5 CAMEL rating. See chapter 3 for a discussion of the rating system.

various external factors, such as geographic location, occupational affiliation, and field of membership, are taken into consideration in estimating the loss.

Another method is used for CAMEL-rated 4 and 5 credit unions with insured shares of less than $20 million. The shares of these credit unions are pooled by region, and a percentage of loss is determined on the basis of the historical loss factor of NCUSIF. The loss factor is the ratio of NCUSIF losses to the deposits of all composite CAMEL 4 and 5 credit unions under $20 million. The loss factor, which is recalculated yearly, according to NCUSIF officials, was .64 percent for fiscal year 1989. In June 1989, NCUSIF modified this reserving method, on the basis of a recommendation from its independent auditors, to establish a specific reserve (as is done in the first method, described earlier) when an identifiable loss of greater than $1 million is projected for a credit union with less than $20 million in insured shares.

In both cases, the reserve levels established and the methods used to determine reserve needs are reviewed at fiscal year end by NCUA's independent auditors during the annual audit of NCUSIF.

We have reviewed this work and determined that NCUA's reserving methods appear to be reasonable. The discussions in chapter 4 on the frequency with which CAMEL 4 and 5 ratings preceded failure and in chapter 5 on persistent insolvencies and NCUA's progress in meeting its policy goals with respect to 4- and 5-rated credit unions also indicate that NCUA is not improperly warehousing failing institutions.

Condition and Performance of NCUSIF Has Been Satisfactory Since 1985

As of December 31, 1990, the fund level for NCUSIF was reported by NCUA at $1.25 of reserves for every $100 of insured shares.[8] This fund balance compares very favorably with those of other federal deposit insurance funds, such as the Bank Insurance Fund (BIF), which had $.26 per $100 of insured deposits as of December 31, 1990. Since NCUSIF was recapitalized in 1984, this fund has appeared adequate to meet the insurance needs of the credit union industry.

NCUSIF's capital consists of its retained earnings and a 1-percent deposit, which credit unions are required to maintain with NCUSIF. Operations are

[8]According to NCUA practices, this percentage, as included in the NCUSIF annual reports, is based on insured shares as of the prior June 30. The reserves total included $152 million payable to the fund in January 1991.

financed by annual insurance premiums and by earnings on NCUSIF's investments. The Federal Credit Union Act does not give NCUA the authority to waive the 1-percent deposit—the most essential component of NCUSIF's capital structure—as it does for annual premium payments. If necessary, NCUSIF may use the deposit funds to meet its deposit insurance expenses, in which case the amount used must be replenished by the credit unions.

The Federal Credit Union Act defines the "normal operating level" of the NCUSIF fund balance to be 1.30 percent of insured shares or such lower level as the NCUA Board determines.[9] The act also provides that in any year in which NCUSIF's equity exceeds its normal operating level, NCUA must make distributions to contributing credit unions sufficient to reduce the equity to the normal operating level. (We discuss the financing arrangements for NCUSIF and recommend improvements in ch. 7.)

Since 1985, NCUSIF's earnings on its investments have been sufficient to

- cover operating and loss expenses;
- make additions to its retained earnings;
- maintain its equity in accordance with statutory provisions;
- waive annual premiums; and
- make, in some years, distributions to insured credit unions.

The major expense incurred by NCUSIF is insurance losses. Insurance losses result from the process of resolving failing credit unions. Insurance losses for fiscal year 1989 increased by 56 percent to $93.6 million[10] but declined slightly to $90 million in fiscal year 1990. Losses per every $1,000 of insured shares increased sharply from $.38 in fiscal year 1988 to $.58 in 1989 and declined to $.51 in 1990. NCUSIF losses are recognized when reserves are established for anticipated future losses from specific credit unions that pose the greatest risk to the Fund.

In fiscal year 1989, 65 federally insured credit unions were liquidated, 54 of these involuntarily, resulting in a loss to NCUSIF of $51.4 million. In fiscal year 1990, there were 91 liquidations, 83 of which were involuntary, resulting in a loss to NCUSIF of $24 million. In fiscal year 1989, 455 credit unions were merged; of these, 60 were NCUA-assisted mergers,

[9]NCUA currently defines the normal operating level as a range of 1.25 to 1.30 percent.

[10]Of this amount, $39.2 million was attributed to the failure of Franklin Community Federal Credit Union in Lincoln, Nebraska. This was the single most costly failure in NCUSIF's history.

which cost NCUSIF $7 million. In 1990, there were 467 mergers, 81 of which were assisted at a cost to NCUSIF of $5.8 million. In addition, there were 22 and 25 credit unions in 1989 and 1990, respectively, that failed and were resolved through purchase and assumption transactions at a cost to NCUSIF of $15.7 million and $18.9 million. (In such transactions, some of the assets and, in most cases, all of the shares of an "assumed" credit union are transferred to a "purchasing" credit union.)

Assistance is also provided to open credit unions in the form of cash (loans and cash advances secured by capital notes) and noncash assistance (capital guaranty accounts, which replace a credit union's deficit in undivided earnings.) Outstanding assistance totaled $166 million as of September 30, 1990. In addition, NCUSIF purchased 41 assets from troubled credit unions for $9.6 million. Finally, as of September 30, 1990, NCUSIF was guaranteeing $35.9 million of CLF loans to credit unions, on which there had been no provision for loss. This is down from $61 million in 1989. (An assessment of NCUA's resolution of failing credit unions is contained in ch. 5.)

Risks Facing the Industry and NCUSIF

While the condition of credit unions and their insurance fund is reasonably good, there are nonetheless risks. Most of these risks are common to all depository institutions, but some are unique.

Situation in the Early 1980s

Before discussing the risks, it is useful to recall the condition of credit unions in the early 1980s. NCUA, in its 1981 NCUSIF annual report, said that the industry was "well positioned for the current economic environment." This proved optimistic, because difficulties soon developed. NCUA has attributed the difficulties primarily to the "tremendous upheaval cutting across the U.S. industrial scene." In its 1983 annual report, NCUA reported that 82 percent of credit unions were occupationally based. Noting that many of these were tied to sagging industries, such as steel, lumber, and heavy equipment, NCUA said "The credit union movement was severely impacted as the recession took its toll on one corporation after another and the credit unions they sponsored."

The rapidity of the decline in NCUSIF in this period serves as a reminder that credit unions are not exempt from risk. In its 1985 NCUSIF annual report, NCUA attributed the difficulties to sudden plant closings, a series of poor investment decisions by credit unions, the narrowing of credit unions' interest rate advantage over banks and savings associations, and inflation and recession. Credit union liquidations ranged between 128

and 169 annually in the 1976-1979 period, then rose to 239 in 1980 and a peak of 251 in 1981.

NCUA's response was twofold. It increased its use of cash assistance and guarantees to open credit unions in part to facilitate mergers and, in April 1982, approved a significant broadening of the membership requirement. Rather than restricting membership to people with a single common bond, it authorized multiple common bonds in a single credit union. NCUA's then-chairman called the multiple group policy "the most significant deregulation that has occurred," saying that it enabled "credit unions to take their eggs out of one basket so the credit union won't rise or fall with its sponsoring organization." (Ch. 9 discusses the common bond requirements in detail.)

The costs of these liquidations and mergers in the early 1980s caused capitalization of NCUSIF, which was established with no capital but had grown through premiums and investments to a peak of $.32 per $100 of insured shares, to decline to a low of $.26 in 1982. The industry, however, was able to recapitalize NCUSIF without any taxpayer money. (See ch. 7.)

Present Risks

Intermediation Risks

Most credit unions are profitable and reasonably well capitalized. These desirable attributes reduce but do not eliminate risks generic to financial intermediation, that is, the function of linking savers and borrowers by accepting deposits and making loans and other investments. Lending and investing member funds expose credit unions to asset quality (credit and investment), interest rate, and management risk. Even well capitalized and profitable credit unions can expect to face increased risks in coming years stemming from the increasing volatility in financial markets and growing competition within the financial services industry.

There is always, of course, the general risk that economic conditions will adversely affect the ability of a large number of debtors to meet their commitments as planned.

Credit and Investment Risk

Loans comprise the majority of the assets held by credit unions. The quality of these loans is measured by the probability that they will be paid off, with interest, under the terms of the original loan agreement. This probability is largely determined by two interacting factors: (1) the

underwriting standards used to initially determine whether the loan applicant is able and willing to repay the loan as planned and (2) the possibility that events may occur that will reduce the applicant's ability and willingness to do so. Such events include loss of employment or death of the borrower; the amount of equity held; changes in the local, regional, or national economy that adversely affect the value of the underlying collateral; and, in the case of variable rate loans, increases in interest rates. Changes in the condition of the borrower or of the general economic environment are beyond the control of the lending institution, but the underwriting standards used to originate the loan are not.

By virtue of their common bond of membership credit unions are, in theory, believed to have better information about the credit worthiness of borrowers. Loosening of the common bond requirement has diminished what impact this may traditionally have had. In any event, it does not eliminate the need for prudent underwriting standards. The failed and problem credit unions in our samples generally exhibited poor underwriting practices. (See app. VIII.) Good underwriting standards (for example, a reasonable ratio of loan-to-value) can even provide some protection to the institution from changing conditions that were unforeseen at the origination of the loan. (Ch. 3 discusses needed regulatory changes in this area.)

There is little evidence in credit unions' financial and statistical reports to NCUA that poor loan quality is a major problem now. However, the only information reported is the number and value of delinquent loans, in three rather large categorical breakdowns. Moreover, loans need not be reported as delinquent until they are 2 months or more late. Given that NCUA only receives the financial and statistical reports on a semiannual basis, a surge in delinquencies may not be reported to the regulators for up to 8 or 9 months after it begins.[11] Before enough data are reported to identify an institution with a problem, more than a year may have elapsed.

Potential asset quality problems facing credit unions have changed with increased real estate lending. Short-term personal loans require different and less structured underwriting standards than do larger long-term mortgage loans or long-term, open-ended equity lines of credit. In general, and especially for first mortgage loans, real-estate-based credits are for larger amounts than other types of credit union loans, and the

[11] A time lag of up to 9 months is possible because the report is not due to NCUA until nearly a month after the end of each reporting period.

term is longer. Offsetting these disadvantages is the collateral value of the underlying property. Until recently, strong or rising real estate markets generally ensured that the collateral value of the underlying property would be stable or increasing. However, recent housing market trends in some parts of the country demonstrate that real estate collateral value should not be relied upon to the exclusion of borrowers' ability to repay out of earned income. Because of this increased exposure to credit risk, the regulators need more detailed credit quality information more frequently than may have been true in the past.

Credit union assets other than loans could also be exposed to credit risk. However, the relatively conservative nature of the investments allowed to most credit unions reduces the potential for investment losses due to falling asset quality. Possible exceptions are credit union investments in mutual funds and uninsured loans to (deposits in) banks, savings and loans, and other credit unions. There is no way to identify the approximate potential for such losses from the financial and statistical reports. In the next chapter, we discuss investment regulations and recommend an improvement.

Interest Rate Risk

Another risk that financial institutions face is the risk that the interest rates will change in ways that reduce the value of the institution's portfolio. Any combination of a reduction in the value of assets and an increase in the value of liabilities will result in falling net worth or capital.

The most dramatic example of the negative effect of interest rate changes is provided by the thrift industry's experience in the late 1970s and early 1980s. The rise in interest rates was devastating to savings associations, which had asset portfolios composed primarily of long-term, fixed-rate mortgages funded primarily by liabilities, which were short-term deposits. As interest rates increased, the savings associations had to pay higher rates on their short-term deposits, while most of their assets continued earning the same low rates at which they were originated, thereby narrowing interest margins and cutting profitability. At the same time, the market value of savings association assets, that is, the price for which these long-term, low-yield mortgages could be sold, fell. Since an institution's capital, or net worth, is equal to the value of its assets minus the value of its liabilities, rising interest rates caused many thrifts to become insolvent on a market-value basis, as well as unprofitable. The consequences of this chain of events contributed, together with the risky use of new powers, fraud, and inadequate supervision, to the financial collapse of the thrift industry's insurance fund.

Credit unions' growing share of interest rate-sensitive investments increasingly exposes them to the same kind of risk that devastated the thrift industry. A number of techniques exist to reduce this risk, including use of adjustable-rate mortgages and hedging activities. As shown in table 2.10, about half of credit unions' real estate loans now have adjustable rates. None of these techniques are costless, however. Adjustable-rate mortgages, for example, can reduce, but not eliminate, interest rate risk, but only by shifting part of it to the borrowers. As a result, the risk to the institution that the borrower will be unable to make payments increases.

Assessment of the interest rate risk facing an institution is a complex process. The regulators need considerable information about the maturity structure of both assets and liabilities. At present, this information is not collected by NCUA through the financial and statistical reports. It is thus unlikely that NCUA can adequately assess the exposure of credit unions to interest rate risk on an off-site basis.

Management Risk

Our work in banking has shown that a key cause of bank and thrift, as well as credit union, failure is poor management and inadequate internal controls. To identify such management, and also to detect fraud, the regulator must depend primarily on the examination process. However, regulators of banks have included some data items on the required financial reports that can provide indicators of certain problems. These include information on the number and amount of loans to directors and managers and on loans to one borrower that approach or exceed the regulatory limits on such loans.

The failure of Franklin Community Federal Credit Union in November 1988, NCUSIF's most costly failure, illustrates management risk. According to its financial reports, it was a $2 million credit union. Nevertheless, NCUA estimates that its failure will cost NCUSIF $39.2 million. NCUA believed, until closure, that it was a small credit union that had a central purpose of helping the poor. After closure, massive fraud was uncovered that involved unrecorded share certificate obligations that were not offset by corresponding assets. These certificates were concealed from examiners and outside auditors.[12]

Law and Regulatory Risk

The risky nature of financial intermediation and the potential costs to savers and institutions alike if problems develop is one of the reasons for a strong regulatory system. Moreover, the system must act to limit

[12]For more detail, see NCUA's NCUSIF 1989 Annual Report, p. 10.

the damage that could be caused to the deposit insurer, the financial system, and/or the taxpayers should a regulated institution become impaired or fail. The government must establish a structure for safe and sound operation by promulgating a set of laws and regulations. (The adequacy of current law and regulation for credit unions is discussed in ch. 3. Ch. 6 discusses corporate credit union regulation issues.)

Supervisory and Insurance Risk

This is the risk that regulators will not effectively oversee credit unions to ensure they are following the law and regulations and to close them promptly and at least cost when they fail. The effectiveness of credit union supervision and failure resolution is discussed in chapters 4 and 5. Corporate credit unions are addressed in chapter 6. Chapters 7 and 8 discuss other risks related to supervision and insurance.

Structural Risks

These are risks unique to the credit union industry and its oversight and insurance. They include the special role of the corporate credit union network, in which some 10 percent of credit union assets are invested. Chapter 6 discusses these institutions and recommends changes to improve industry safety and soundness. Risks related to the insurance function are discussed in chapter 7. Chapter 8 discusses the risk that, as a combined charterer, regulator/supervisor, and insurer, NCUA will not promptly resolve failing credit unions. Other structural risks are also discussed in chapter 8. Another risk, unique to credit unions, arises because credit union membership is limited to people sharing a common bond. Credit unions with narrow common bonds are especially vulnerable to the economic distress of their sponsoring or associated entity, such as a plant, local occupational group, or governmental entity. The advent of multiple group charters and other expansions of the common bond requirements in the past decade has, however, given threatened credit unions more of an opportunity to merge, rather than close. (See ch. 9 for a detailed discussion of common bond.)

Reporting Needs

NCUA must be able to monitor at fairly frequent intervals the activities of the institutions it supervises and insures, and estimate the amount of risk to which each institution is actually exposed. Two tools available to NCUA for this purpose are periodic on-site examinations and the financial and statistical reports submitted semiannually by each credit union. (See ch. 3.)

The needs of NCUA for timely and complete data are increasingly important. We have identified a number of potential problems with the data

collected on the credit unions by NCUA. First, the twice-yearly submission of financial and statistical data is too infrequent. Problems that develop quickly may not be noticed by NCUA until a significant amount of time has passed. Admittedly, more frequent filings may pose some hardship for many small credit unions, but in larger credit unions, where the potential losses to the share insurance fund are greater, more frequent reporting is clearly desirable. All banks and savings institutions file reports quarterly. Second, larger credit unions tend to have operations that are too complex to understand adequately in the abbreviated reports that credit unions are required to file. The larger credit unions—those with assets of $50 million or more—should be reporting on a quarterly basis. After experience is gained, quarterly reporting for smaller credit unions as well could be required.

The major operating risks faced by credit unions are (1) credit risk, primarily resulting from bad loans, caused by either poor underwriting or declining economic conditions; (2) interest rate exposure, due to a mismatched maturity structure of assets and liabilities; and (3) management risks. NCUA does not currently collect through the semiannual financial and statistical reports the kind of information necessary to monitor the exposure of individual credit unions to these risks. Other financial institution regulators have reporting requirements to help assess this exposure, and NCUA could build on their experience in tailoring the requirements to the credit union industry. While data collected from individual credit unions can never provide an absolute foreknowledge of future weaknesses and failures, better and more frequent information could improve chances of identifying some problems earlier. Specific items that should be considered for revision or addition to the reports, for example, are data on loan delinquencies, maturity distribution and repricing of assets and liabilities, large loans to one borrower, and loans to officers and directors. Expanded reporting, like quarterly reporting, should be required first only for larger credit unions, those with assets of $50 million or more.

Conclusions

Credit unions currently enjoy a relatively favorable financial condition, particularly when compared with banks and savings and loans. So does their insurance fund. Industry profits are relatively good, and most credit unions have capital of 6 percent or more. At the same time, credit unions are changing. Their activities are becoming more bank-like and the environment in which they operate is increasingly competitive and riskier. The stresses that have led to growing difficulties for other types of depository institutions are likely to confront credit unions as well. For

these reasons, Congress should have annual oversight hearings at which the NCUA Board testifies on the condition of credit unions and NCUSIF and assesses risk areas and reports on NCUA's responses to them.

The information collected by NCUA through the semiannual financial and statistical reports is not as frequent or as detailed as it should be in order for NCUA to fully assess the risk exposure of individual credit unions or the industry.

Recommendation to Congress

We recommend that Congress

- hold annual oversight hearings at which the NCUA Board testifies on the condition of credit unions and NCUSIF and assesses risk areas and reports on NCUA's responses.

Recommendations to NCUA

We recommend that NCUA

- require that credit unions with assets greater than $50 million file financial and statistical reports quarterly; and
- expand the information required from credit unions with assets greater than $50 million on the financial and statistical reports in the areas of asset quality, interest rate sensitivity, management, and common bond.

Smaller credit unions should, in the future, as experience is developed, also be required to file quarterly and in more detail.

Agency Comments and Our Response

In its comments, NCUA agreed with the recommendations concerning better and more frequent reporting and cited actions it has already taken, as well as planned. (See app. XII.)

Highlights

Key Findings

- NCUA has regulatory power over the federally insured credit unions it charters. It has some power over federally insured state-chartered credit unions, but these credit unions operate primarily under state law and regulation, which may be less restrictive.
- Credit unions do not have to maintain a minimum level of capital, unlike all other federally insured depository institutions.
- The legal limits on loans to and investments in single obligors and for borrowing are too high.
- The risks posed by real estate and commercial lending are not adequately limited.
- NCUA does not require approval for branch offices, disclosure that dividends cannot be guaranteed in advance, or annual independent audits.

Key Recommendations

- Give NCUA authority to compel state credit unions to follow federal regulations when state powers constitute a safety and soundness risk.
- Establish minimum capital levels that are not less stringent than those for other insured depositories and provide an appropriate phase-in period.
- Limit the amount, excluding specified exemptions, that can be loaned or invested in a single obligor to not more than 1 percent of the credit union's assets. Unless approved by NCUA, limit borrowing authority for purposes other than liquidity.
- Strengthen regulations on real estate and commercial lending.
- Require NCUA approval to open branches; require credit unions to disclose that dividends on shares and other accounts are not guaranteed.
- Require large credit unions to obtain annual independent certified public accountant audits and to make annual management reports on internal controls and compliance with law and regulations.

Credit Union Law and Regulation

As federally insured credit unions grow and evolve into more diversified financial institutions, it is important that the systems intended to ensure their safety and soundness and minimize the risk to NCUSIF change as well. Regulations that address risks, supervision that detects unsafe and unsound practices and stops them, and prompt resolution of problem and failing credit unions are all essential. This chapter assesses the adequacy of regulation.

NCUA has regulatory power over all federal credit unions. It has some regulatory power over those state-chartered credit unions that it insures. In several areas, federal regulations do not apply to these state-chartered credit unions, and some operate under regulations that give them additional powers or authorize higher levels of participation in certain activities.

We found that federal regulation of all insured credit unions needs improvement. There is not, but should be, a minimum capital requirement; credit unions must only set aside a percentage of gross income. Real estate and commercial lending regulations need to be made tougher. The amount that can be lent to one individual or invested in one entity is much too high. And credit unions do not have to disclose that dividends can not be guaranteed or to get regulatory approval to open a branch.

NCUA Requires Transfers to Reserves but Not a Minimum Capital Level

Credit unions do not have to maintain a minimum level of capital, unlike all other federally insured depository institutions. The Federal Credit Union Act as amended in 1970 and NCUA regulation require only that federal credit unions set aside percentages of gross income until they reach prescribed levels of "regular reserves." This reserving arrangement serves as a capital building requirement. Unlike stock institutions, credit unions—as cooperatives—can generate capital only through retained earnings.

Under the present arrangement, however, there is no assurance that the required annual transfers to regular reserves will ever achieve the stated levels. The requirement also fails to serve as a limit on growth. Growing credit unions must only set aside an amount equal to a portion of their gross income, not maintain a minimum capital amount based on their total assets or risk assets. We recognize that credit unions are now relatively well capitalized. (See ch. 2). Nevertheless, we believe that credit unions should be required to achieve and maintain some minimum level of GAAP capital (regular reserves plus retained earnings) in order to demonstrate and help ensure that they are economically viable and that

their members' money, and ultimately the insurance fund, is as safe as possible.

The percentage of gross annual income that must be transferred annually to regular reserves varies according to the size and age of the credit union and the prescribed amount of regular reserves. As amended in 1977, the act specifies that:

"(1) A credit union in operation for more than four years and having assets of $500,000 or more shall set aside (A) 10 percentum of gross income until the regular reserve shall equal 4 percentum of the total of outstanding loans and risk assets,[1] then (B) 5 percentum of gross income until the regular reserve shall equal 6 percentum of the total of outstanding loans and risk assets.

(2) A credit union in operation less than four years or having assets of less than $500,000 shall set aside (A) 10 percentum of gross income until the regular reserve shall equal 7-1/2 percentum of the total of outstanding loans and risk assets, then (B) 5 percentum of gross income until the regular reserve shall equal 10 percentum of the total of outstanding loans and risk assets.

(3) Whenever the regular reserve falls below the stated percentum of the total of outstanding loans and risk assets, it shall be replenished by regular contributions in such amounts as may be needed to maintain the stated reserve goals." (12 U.S.C. 1762 (a)).

State credit unions are required by NCUA regulation to maintain such regular reserves, which are not less than those required for federal credit unions. (12 C.F.R. 741.7(a))

The absence of minimum capital standards was of concern to the "Credit Union Reserves Study Commission," a group established by the Credit

[1]In October 1987, NCUA requested comments on proposed changes to its definition of "loan and risks assets." At that time NCUA's definition of risk assets was essentially limited to loans to members, which excluded a significant percent of assets. Some 300 comments were received. At an April 1988 meeting, the NCUA Board decided NCUA should work with interested entities to develop a systematic approach to the issue of capital in credit unions. In November 1989, it issued a new regulation that broadened the definition of "risk assets" to include all assets with maturities of over 3 years unless they meet specified exemption criteria. Exempted assets include cash, guaranteed or insured loans, and shares or deposits in a central or corporate credit union with remaining maturities of 3 years or less. In addition, assets with maturities greater than 3 years are exempted if they are carried on the credit union's records at the lower of cost or market, or are marked to market value monthly. (12 C.F.R. 700.1(k)) Thus, for reserving purposes, assets are weighted at either 100 percent or at 0 percent.

The definition of "regular reserves" used in the calculation of the transfer amount was also changed. Totals of the regular reserves plus the allowances for loan and investment losses are to be combined when determining the applicable percentage of gross income to be transferred to the regular reserve. (12 C.F.R. 702.2)

Union National Association and NAFCU to study the issue, after NCUA decided that further study was needed. The commission, which included regulatory liaisons from NCUA and the National Association of State Credit Union Supervisors, concluded that NCUA should replace the existing reserving requirement with a net capital contribution in order to insure the maintenance of minimum capital levels. Under its proposed "net capital contribution" system, law and regulation would set a capital threshold, and credit unions with capital-to-asset ratios below that level would be required to add certain amounts to capital until the threshold was reached. The lower the credit union's net capital-to-assets ratio, the greater its net capital contribution requirement would be.[2]

We recognize that the present required reserving arrangement and absence of minimum capital levels have not resulted in an undercapitalized industry. In fact, as our analysis in chapter 2 shows, most credit unions are relatively well capitalized. In addition, NCUA provided data to us that shows that 7,960 credit unions were not reserving as of December 31, 1989.[3] Nevertheless, credit unions should be required to meet minimum capital standards and those that do not should be required to have approved capital plans and/or be put under operating limits and special oversight, or be closed.

There are two primary problems with the present arrangement. First, there is no guarantee that reserves will ever reach the legislated levels (6 percent or 10 percent of loans and risk assets, depending upon a credit union's length of operation and size). Because the reserving percentages (10 percent and 5 percent) are based on gross income, a credit union can arrange its operations to minimize gross income and reserving. It could operate indefinitely without ever reaching the level at which reserving is not required. As the Credit Union Reserves Study Commission report emphasized, the current arrangement is also vulnerable to swings in interest rates. (For example, in times when interest being charged on loans was declining and a credit union's gross income was declining, the amount added to reserves would decline.) In addition, the reserve requirement does not serve as a check on growth. An undercapitalized credit union may grow, regardless of its capital amount, and not have to add appreciably to capital.

[2]Net capital was defined as total capital (all reserves, allowances, and undivided earnings) less expected loan, investment, and fixed asset losses. The method for calculating expected losses was set out. Report of the Credit Union Reserves Study Commission (Feb. 1989).

[3]Of these credit unions, 2,012 were insolvent or had zero or negative income or regular reserves. The remaining 5,948 credit unions are solvent institutions with positive income and regular reserves.

For these reasons, we believe a capital requirement, as opposed to the present reserving requirement, is prudent. Because credit unions cannot build capital as stock institutions can, such a requirement should be phased in to give those not meeting the new standard an appropriate amount of time to do so. The existence of a minimal capital requirement would also provide the basis for use of the "tripwires" to strengthen supervisory intervention, as discussed in chapter 7.

We are not taking a position in this report as to how the calculation should be made. The Credit Union Reserves Study Commission recommended that the minimum capital amounts assessed be based on "net capital" rather than risk-weighted assets. The latter calculation, it felt, was too complex and the net capital assessment would be equally useful in assessing risk. However, we are concerned that this net capital approach does not provide for the increased risk in certain types of loans. However, we recognize that the net capital approach would be easier for the many small credit unions to use. Whatever standards are set, however, should not be less stringent than those set for other insured depository institutions and should, we believe, appropriately recognize risk.

Limit on Loans to and Investments in Single Obligors Needs to Be Reduced

A widely accepted way of seeking to assure the safety and soundness of financial intermediaries is through diversification of risk. One method is to limit the amount of loans that an institution can make to one borrower, referred to here as a lending limit. For that purpose, state and federal laws and regulations set lending limits for credit unions, banks, and thrifts. The lending limit applicable to credit unions allows them much greater risk-taking because it does not require as much asset diversification. (In another respect, many credit unions already and unavoidably lack the ability to diversify risks because of the constraints imposed by the common bond requirements.) (See ch. 2.) In this discussion, we include as loans all credit union investments in securities other than obligations of the federal government and obligations guaranteed by the federal government and investments in a corporate credit union. For example, we include investments in state and local government obligations, commercial paper, and federal funds (unsecured advances to other depository institutions). Investments in corporates are not subject to the limit because the corporate system is cooperatively owned by its members and is organized in part for the purpose of accepting large amounts of unloaned credit union funds for investment. This role underlines the need for corporates to be managed conservatively and regulated and supervised by NCUA, as discussed in chapter 6. The exemption

from the limit is predicated on implementation of our recommendation that credit unions may invest only in federally insured corporates (and other credit unions) and on other recommendations in chapter 6. Another exemption should be made for the overnight funds kept on deposit with correspondent institutions to meet cash needs, clearing account needs, share draft reserve requirements, etc., as pointed out by NCUA in its comments on a draft of this report. (See app. XII.)

The Federal Credit Union Act limits federal credit union loans and line-of-credit advances to a member to 10 percent of the credit union's unimpaired shares and surplus.[4] (12 U.S.C. 1757 (5)(A)(x)) It does not require that lending be collateralized. This is a far greater percentage than permitted at banks and thrifts because credit unions classify shares as equity, and the limit, therefore, is a percentage of the sum of GAAP capital plus deposit liabilities, not just GAAP capital.

The national bank lending limit, in contrast, states that the total loans and extensions of credit to a person outstanding at one time and not fully secured shall not exceed 15 percent of the unimpaired capital and paid-in surplus of the institution. Another 10 percent may be lent if it is fully secured. (12 U.S.C. 84(a)) FIRREA required that this lending limit, with specified exemptions, also applies to all savings and loan associations. (12 U.S.C. 1461) (Previously, savings and loans had been permitted to lend up to 100 percent of their capital to a single borrower.)

To illustrate the difference, we compared the lending limits for a hypothetical federal credit union and a hypothetical national bank of the same asset size (see table 3.1). In this case, the credit union's lending limit is $9,000. The bank's limit is $750 or, if collateral is provided for additional loans, $1,250. From a viewpoint of asset diversification, the credit union's limit permits it to commit 9 percent of its total assets to a single borrower, whereas the bank can commit a maximum of only 1.25 percent of its assets. The situation is even more risky if we consider the implications for solvency. If the credit union experiences an overall loss on its $9,000 loan, it becomes insolvent by $2,000 and exposes the NCUSIF to a loss. By contrast, the bank should be able to absorb a total loss on its loan with its capital.

[4]Shares in a solvent credit union are unimpaired. The law does not apply to loans to other credit unions; it states that such loans in total shall not exceed 25 percent of a credit union's paid-in and unimpaired capital and surplus. Nor does it apply to loans to credit union service organizations, which are governed by 12 U.S.C. 1757 (7)(c). It imposes a 1-percent limit.

Table 3.1: Comparison of National Bank and Federal Credit Union Lending Limits

	Federal credit union	National bank
Assets	$100,000	$100,000
Liabilities and net worth:		
Shares	83,000	Not applicable
Reserves	7,000	Not applicable
Capital and paid-in surplus[a]	Not applicable	5,000[a]
Other liabilities	10,000	95,000[a]
Lending limit		
unsecured	$9,000	$750
secured		500
Total	**$9,000**	**$1,250**
Lending limit as a percent of assets		
unsecured	9%	0.75%
secured	NA	.50
Total	**9%**	**1.25%**

[a]The bank's earned surplus (undivided profits) is not included in calculating the lending limit, and so is included in other liabilities.

Source: This hypothetical example was developed on the basis of limits set out in 12 U.S.C. 1757(5)(A)(x) and 12 U.S.C. 84(a).

We believe lending limits for credit unions should be developed that will result in a degree of asset diversification similar to that of banks and thrifts. NCUA provided us with data that indicates that while most states have lending limits similar to those applicable to federal credit unions, a significant number have higher limits. Maine, Indiana, Missouri, Wisconsin, Kansas, Nebraska, New Mexico, and Texas, for example, have an overall lending limit of 10 percent of assets. Oklahoma has no general limit.[5]

In setting lending limits, special provision must be made for new credit unions, which begin business with zero reserves because they have accumulated no undivided income. An adjustment could also be needed for credit unions that have experienced losses such that their reserves become very small, causing lending limits based on reserves to be impractically low. Setting the lending limit as a percentage of total assets would accomplish this. We are recommending a lending limit of 1 percent of total assets, which would be roughly comparable to the single obligor exposure permitted for national banks. An exception should be

[5]Loans to insiders fall under stricter limits at federal credit unions. Oklahoma permits such lending up to 20 percent of a credit union's unimpaired capital and surplus.

made to permit continued higher exposure to credit union service organizations, as provided for in the Federal Credit Union Act. (See ch. 9.) Higher exposure—perhaps 2 percent of assets—could be worked out for exposures resulting from fully collateralized and short-term repurchase agreements.

Data are not available to indicate the potential impact of lowered lending limits on the operations of federal credit unions. For credit unions that are engaged exclusively in making traditional consumer loans, the effect would probably be minimal. However, credit unions making commercial or agricultural loans might have to lower the amount they could lend to single borrowers, which seems an appropriate outcome. In addition, as NCUA points out in its comments, a higher limit should be provided by regulation for the secured consumer loans of small credit unions. (See app. XII.)

Asset Powers

Credit union asset powers have expanded significantly in the past decade (see ch. 9) and the amount of real estate loans as a percentage of total loans has increased sharply in recent years. These loans bring new risks to credit unions. Although commercial lending averages a small percent of credit unions loans, it is associated with low net worth credit unions. Tightened regulation in both areas is needed.

Real-Estate-Based Lending Is Increasing and Strengthened NCUA Regulation Is Needed

Real-estate-based lending, a relatively new area for most credit unions, has become a major activity. First mortgage loans constitute about half of this lending. Other loans that take a security interest in the property on some other basis, such as a second mortgage or a property lien related to a home equity line of credit, make up the other half, and the "other loans" share of total credit union real-estate-based lending is rising. As discussed in chapter 2, considerable risks are associated with real-estate-based lending, risks that exceed those associated with traditional credit union lending.

Although federal credit unions were first allowed to make 30-year residential mortgage loans in 1977, the activity became much more important to the industry in the 1987-1989 period. From year-end 1986 to year-end 1989, outstanding real-estate-based loans held by federally insured credit unions more than doubled from $18 billion (12 percent of total industry assets) to $40 billion (22 percent of assets). About $23 billion is in first mortgages, and the remaining $17 billion is in other real-estate-based lending. About $21 billion had adjustable rates. While

larger credit unions have higher percentages of real estate loans, such loans are held by associations of all sizes. Insolvent or less well capitalized credit unions also had significantly higher percentages of real-estate-based loans than those with GAAP capital exceeding 6 percent of assets.

NCUA officials attribute the recent growth in real-estate-based lending to several factors. The Tax Reform Act of 1986 phased out the deductibility of interest paid on loans other than real-estate-based loans. This provided an incentive for consumers who itemize deductions to arrange for second mortgages or home equity lines of credit in situations where they previously would have applied for automobile or other types of personal loans. Mortgage lending can, they said, be a relatively safe and profitable lending area for credit unions with the needed expertise. Finally, officials said, banks and auto financing companies have increased their share of consumer lending and raised competitive pressures.

The safety and soundness of credit union real-estate-based lending is a function of two categories of factors, one relating to the nature of real estate lending itself and the other to the capability of the credit union's staff and the effectiveness of supervision.

The Federal Credit Union Act historically set relatively short limits on the maturities of loans made by federal credit unions. In 1977, however, the act was amended to authorize these credit unions to make 30-year residential mortgage loans for units housing one to four families; in 1981 they were permitted to make variable rate mortgage loans. Legislation the following year removed statutory limits on the size and maturity of mortgage loans, authorized the refinancing of first mortgages, and extended the permitted maturity limits on second mortgages. Current NCUA regulations

- permit residential mortgage loans for periods up to 40 years (and longer with permission of the NCUA Board);
- permit loans for mobile homes, second mortgages, and home improvements for periods up to 20 years (prior to October 1989, the limit was 15 years);
- limit the maximum amount of all loans to a member to 10 percent of the credit union's shares and undivided earnings; and
- require an appraisal of the collateral for real estate loans. (12 C.F.R. 701.21)

The inherent credit, liquidity, and interest rate risks of real-estate-based lending require underwriting knowledge that was not needed or was not nearly so important in making and managing the consumer loans traditionally made by credit unions. The loan amounts are larger and the transactions themselves are more complex. These characteristics, together with the growing amount of real-estate-based lending, create a situation that calls for NCUA to ensure that regulation of such lending is adequate.

With the exception of a new FIRREA-mandated requirement for appraisals, NCUA real estate regulations do not apply to state credit unions.[6] State laws and regulations are, however, rarely more liberal, according to information provided by NCUA. A few states have more restrictive regulations. For example:

- Pennsylvania limits total mortgage loans to 50 percent of a credit union's paid-in capital.
- North Dakota sets the limit on mortgage loans at 30 percent of assets.

NCUA's only guidance on the maximum amount of real-estate-based lending any insured credit union should have was issued in October 1989. It stated that credit unions could "expect additional time and attention during the regular examination" if loans secured by real estate exceed 25 percent of total assets. This guidance was sent to the board of directors of federal and state credit unions. A total of 1,514 credit unions—1,012 with federal charters and 512 with state charters—exceeded the 25-percent limit as of June 30, 1990. (At that time there were 13,102 credit unions, of which 8,659 had federal charters.)

NCUA's regulation of real-estate-based lending gives federal credit unions and most state credit unions a high degree of latitude, considering the risks. We believe that the risks associated with real-estate-based lending, the relative newness of the credit union industry as a whole to this area of business, and the small size of certain credit unions increasingly participating in it combine to call for increased regulation.

We recognize that the Tax Reform Act of 1986 has made real-estate-based lending for consumer purposes more desirable to many individuals, including credit union members. We do not seek changes that

[6]FIRREA required that real-estate-related loans over a specified amount must be preceded by obtaining a current appraisal by a licensed or certified appraiser. NCUA has adopted $50,000 as the amount over which a real-estate-based loan must be preceded by an appraisal.

would hinder credit unions from meeting the legitimate borrowing needs of their members. However, specific regulations that would enhance safety and soundness include required minimum underwriting and marketability standards. For example, credit unions have no loan-to-value regulation, one that governs the maximum loan amount given the value of the related property.

Other areas where regulations would contribute to safety and soundness include the following:

- Regulations could be added to maximize the potential sale of real estate loans in the secondary market.
- Regulations could specify the tools required to assess a borrower's ability to repay a loan, such as determining the debt ratio and obtaining accurate financial information. (The current NCUA regulation suggests but does not require that credit unions use the standard mortgage loan application form prescribed by the Federal Home Loan Mortgage Corporation or other similar entities).

Tightening the loans-to-one-borrower regulation will also help minimize the risks of real-estate-based lending.

We also believe that NCUA should explore the setting of a limit on the total amount of real-estate-based lending to be held in the portfolios of insured credit unions. In addition, credit unions can and do originate and then sell first mortgages to secondary market institutions, such as the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association, and Credit Union National Association. We believe use of the secondary market to lessen overall real estate lending exposure can help credit unions both serve members and lessen their exposure to high levels of real estate lending, assuming the sales are made without recourse to the credit union.

Low Net Worth Credit Unions Have Higher Amounts of Commercial Lending; Stronger Regulation Is Needed

Reported commercial loans make up a small fraction of credit unions assets—about 21,357 such loans valued at $1.4 billion as of June 30, 1990. However, credit unions with a relatively high volume of such loans represent a disproportionately high share of distressed credit unions, as shown in table 3.2. A recent NCUA study of credit unions in New England also shows that many of those experiencing trouble have high levels of commercial loans.

Table 3.2: Commercial Loans as Percent of Assets as of December 30, 1986 and 1988 and June 30, 1990

Net worth	1986	1988	(June 30) 1990
Less than 0	9.81	10.42	11.18
0 to 2.99%	0.65	0.80	2.83
3 to 6%	0.57	0.83	0.71
Greater than 6%	0.27	0.43	0.45
Industry	0.53	0.66	0.80

Source: Credit union financial reports as submitted to NCUA.

Credit unions have always been allowed to make commercial loans to their members. In reaction to related problems at some credit unions and concerns about the future impact of such lending on credit union safety and soundness, NCUA issued a regulation in 1987 applicable to both federal and state-chartered credit unions (12 C.F.R. 701.21(h)).[7] The regulation defined business lending and lowered the amount of such lending that could be lent to a single member or group of associated borrowers to 20 percent of a credit union's reserves.[8] It did not set a total limit on such lending by a credit union.

We believe this regulation was a sound first step on NCUA's part.[9] The regulation defines commercial lending as any loan, line of credit, or letter of credit, the proceeds of which would be used for a commercial, corporate, business, or agricultural purpose. It also specifies a number of exceptions to the definition. Commercial loans that meet specified criteria do not count toward the 20-percent limitation and are not listed as commercial loans in the credit union semiannual financial reports. The exceptions include

[7]12 C.F.R. 741.3 makes state credit unions subject to 701.21(h), as well as provisions regarding prohibited fees (section 701.21(c)(8)) and nonpreferential loans (701.21(d)(5)). State credit unions can be exempted if their state adopts regulations that the NCUA Board deems equivalent.

[8]Reserves are defined as all reserves, including the allowance for loan losses, undivided earnings, and surplus.

[9]The regulation also requires credit unions to adopt written commercial loan policies and specifies what these policies must require, including: identification of the type of loans to be made; the trade area to be served; the maximum amount of credit union assets, in relation to reserves, to be invested in business loans, the types of loans, and the maximum for individual borrowers; analysis of the ability of the borrower to repay the loan; and identification of senior managers prohibited from receiving such loans. Credit unions are prohibited from making commercial loans to the following nonvolunteers: any Board of Director member compensated as such, the chief or assistant executive officer, and the chief financial officer. (12 C.F.R. 701.21(3)(i)) "Equity kickers" are prohibited. These are arrangements under which a portion of the credit union's compensation for the loan is tied to the profits earned by the borrower.

- loans secured by a one- to four-family dwelling that is the member's primary residence, secondary residence, or one other such dwelling owned by the member;
- loans fully secured by shares in the credit union or deposits in other financial institutions;
- loans made for business purposes, as defined above, to a borrower that total less than $25,000; and
- loans, the repayment of which is fully insured or fully guaranteed by, or where there is an advance commitment to purchase in full by any agency of, the federal, state, or local government. (701.21(h)(1))

Credit unions should, we believe, be sources of credit to meet the small business needs of members. But they should not be providers of large commercial credits. NCUA's 1987 regulation goes far to encourage credit unions to focus their commercial lending toward smaller borrowers. Given the risks in commercial lending, however, we believe it would be prudent for NCUA to take several additional actions. The exclusion from the definition of business loans of loans secured by one- to four-family dwellings, for example, should be tightened to require that the exclusion should apply to loans secured by the member's primary residence only. In addition, NCUA could require that all commercial loans be structured so as to provide for repayment within the life of the related equipment, if any, or within a period less than the general 12-year maturity limit on loans other than for mobile home and residential real estate (12 C.F.R. 701.21(f)). We are also concerned that the regulatory limit of 20 percent of reserves to a single member or group of associated borrowers can be exceeded with approval of the NCUA Board (12 C.F.R. 701.21(h)(2)(ii)), and the Board has delegated this authority to the regional directors (the Offices of Examination and Insurance and General Counsel must concur). NCUA officials in Washington were unable to tell us how many times this exemption was granted.

The lack of a limit on the total amount of commercial lending a credit union may undertake is also disturbing. Although the higher percentage of commercial loans in insolvent credit unions may well reflect lending before the 1987 regulation was in place, we see no reason for credit unions to enter this risky area of business on a large scale. We believe NCUA should set a limit on commercial lending.

Finally, although excluding certain types of commercial lending from the 20-percent limit makes sense for policy reasons, it prevents analysts from assessing credit union exposure to commercial loans. Tightening the exclusions will help mitigate this problem.

State Credit Unions Have Broader Investment Powers

The Federal Credit Union Act specifies the types of investments federal credit unions may make, and an NCUA regulation delineates the permissible and prohibited off-balance-sheet activities. We consider the law and regulation in this regard, with one exception, generally appropriate and adequate. (This exception is discussed in the next section.) They do not, however, apply to state credit unions. NCUA has in place a regulation intended to insure that the more risky investments of state credit unions are properly reserved for, but improvements in its implementation are needed.

The Federal Credit Union Act authorizes federal credit unions to make investments in several general categories:

- obligations of the United States, and specified government-sponsored enterprises, any instrument issued by or fully guaranteed by any agency of the United States, or issued by any wholly owned government corporation;
- shares or deposits of any central (corporate) credit union authorized by the credit union's board;
- investments in organizations providing services associated with the routine operation of credit unions, subject to a limit of 1 percent of total paid-in and unimpaired capital;
- shares of federally insured credit unions;
- banks or institutions the accounts of which are insured by FDIC, or any national bank or specified other entities operating in accordance with the laws of the state in which the credit union does business; and
- obligations of or issued by any state or political subdivision, subject to a limit of no more than 10 percent of total paid-in and unimpaired capital and surplus with any one issuer (exclusive of general obligations).[10]

NCUA has also put into place regulations on federal credit union off-balance-sheet activities. With certain limitations, federal credit unions can enter into cash forward agreements, defined as agreements to purchase or sell a security with delivery and acceptance being mandatory and at a future date. With permission from the NCUA regional director and by meeting other requirements, credit unions can buy options to sell government securities at specified prices within specified time frames to

[10] 12 U.S.C. 1757(7) and (8).

manage their real estate loan interest rate risk.[11] (12 C.F.R. 701.21(i)) The regulation also lists prohibited activities, including buying or selling of standby commitments or futures contracts, and selling securities not owned by the seller. (12 CFR 703.4)

The law and regulation regarding investment vehicles seem adequate to us but do not apply to state credit unions. We asked NCUA what investment regulations apply to state credit unions. The data subsequently developed by the NCUA regional directors showed that 32 states grant state credit unions investment powers in addition to those permissible for federal credit unions. Several examples follow.

- Illinois permits credit unions it charters to invest up to 5 percent of their shares and undivided earnings in the stock or obligations of other financial institutions. Florida permits similar investments but has set no limits.
- Indiana permits credit unions it charters to make unlimited investments in municipal securities.
- North Dakota, Kentucky, New Mexico, and California permit investments in corporate bonds and/or stocks (the first two impose limits, the others do not).
- Rhode Island (only credit unions over $10 million in assets), West Virginia, South Carolina, and California allow credit unions they charter to make any investments that banks or other financial institutions can make. (Note: "other financial institutions" was not defined.)

NCUA regulations do not prohibit these riskier investments but do require that as a condition of federal insurance, state credit unions establish a special reserve for investments permitted by their states that go beyond those authorized by federal law and regulations. (12 C.F.R. 741.7(a)(3)) The insurance agreement stipulates that the amount of the special reserve (known as the "investment valuation reserve") must be at least equal to the net excess of book value over current market value of the investments not authorized by federal law. As of December 31, 1989, there were about 4,600 state credit unions with total investments of $17.5 billion. Analysis of the December 1989 Call Report shows that

[11] Regulations also permit federal credit unions to: (1) enter into repurchase and reverse repurchase transactions, (2) invest in Yankee and Eurodollars at the financial institutions specified in the law, and (3) invest in bankers acceptances. (12 C.F.R. 703.3) In a repurchase agreement, securities are sold subject to a commitment by the seller to repurchase them at a stated price on a specified future date. A reverse repurchase transaction represents the purchase of securities subject to future sale back to the original seller at a fixed date and price.

191 of these credit unions, located in 30 states, had investment valuation reserves totaling about $50 million. We do not know if this amount is the correct amount.

The NCUA investment valuation reserve requirement can function to control the added risk of additional state investment powers if it is enforced. Supervision in this area is discussed in chapter 4.

Limitation on Investments in Corporate Credit Unions

Chapter 6 discusses the important role corporate credit unions now have as investment vehicles for natural person credit unions. It also addresses the need for federal regulation and oversight over them. As discussed and recommended there, this can be accomplished by limiting credit union investments in other credit unions to those that have federal insurance. (See ch. 6.)

Borrowing Authority Needs to Be Reduced

Credit unions can borrow up to 50 percent of their capital (defined as shares and undivided earnings). Because credit unions are member-based cooperatives, we do not believe it is appropriate, generally speaking, to permit them to grow with borrowed funds. Accordingly, we believe that borrowing up to this level should be limited to meet liquidity needs. Provisions could be made for exemptions from this limitation with the advance approval of the NCUA regional director under guidelines to be established by NCUA. This might be appropriate, for example, if a sound and well-managed credit union is loaned up and needs additional resources to meet the borrowing needs of established members.

Prohibition Against Guaranteeing Dividends

The savings credit union member/owners place in their associations (share accounts) are considered equity investments, and the returns on these accounts are considered dividends. The Federal Credit Union Act specifies that the boards of directors of federal credit unions may declare dividends on accounts after providing for required reserves. (12 U.S.C. 1763) NCUA has stated that "the legal prohibition against guaranteeing dividends in advance is inherent in the cooperative structure of credit unions and is embedded" in this section of the act. The current NCUA regulation states that a federal credit union "shall accurately represent the terms and conditions of its share, share draft, and share certificate accounts in all advertising, disclosures, or agreements, whether oral or written." (12 C.F.R. 701.35(b)) It adds that the credit

union may determine the type of disclosure. (12 C.F.R. 701.35(c)) State credit unions are not bound by these requirements.

There is now no regulation requiring that credit unions inform their members that dividends on share or other accounts are based upon available earnings and cannot be guaranteed in advance. This is a key distinction between shares in credit unions and deposits in other depository institutions, for which the yield (interest) can be set and guaranteed in advance. Prior to 1982, NCUA regulation 701.35 had a specific disclosure requirement. The requirement was removed, we were told, as part of the deregulation process.

In May 1990, NCUA issued a proposed revision to regulation 701.35 "to clarify that dividends on member share accounts are based on available earnings and are not guaranteed, and to require notice of this fact when accounts are opened and in any advertisements, solicitations, or similar statements that set forth a dividend rate." In its proposed rule, NCUA emphasized that one of two key aspects of the operation of credit unions is that the return on member savings is based on performance (the other is that each member has one vote). These key aspects, it said, "reinforce the member-service orientation of credit unions and help protect the credit union system against the sorts of outside influences, from majority stockholders, entrepreneurs and others, that have caused or contributed to problems in other segments of the financial services industry." NCUA felt it necessary, "in order to preserve and further this important distinction, and to address occasional cases of improper guarantees" to reinstate a regulatory requirement that federal credit unions disclose that dividends are based on earnings and are not guaranteed. NCUA also noted that while the regulation as drafted would apply only to federal credit unions, safety and soundness considerations might warrant expansion to state credit unions as well.

NCUA asked for comments on its proposed regulation by July 24, 1990. An NCUA summary of the responses noted that 225 commenters responded: 164 from federal credit unions, 40 from state credit unions, 13 from credit union leagues, 2 from state regulatory authorities, 3 from national credit union trade associations, and 3 others. Only 11 were in total agreement. The NCUA summary said reasons given for supporting the proposed regulation included: it sets credit unions apart from other financial institutions, it promotes safety and soundness, and it reinforces the fact that shares represent equity rather than liability.

Two areas of misunderstanding were noted by NCUA officials in the negative comments. First, they said, many commenters believed federal credit unions can guarantee dividends on all accounts or on certificate accounts. NCUA officials said that this was not true. The other area of misunderstanding related to the erroneous assumption that the regulation limited "available earnings" to current earnings, rather than current and undivided earnings. Undivided earnings are those from a prior period that have yet to be distributed. Many commenters felt that the disclosure requirement would confuse members, give the appearance that credit unions were risky investments, impair marketing, and give a competitive edge to banks and savings associations. Federal credit unions responding urged that any disclosure requirement be applicable to state as well as federal credit unions.

We reviewed the comment letters and selected several whose content illustrate the above summary. CUNA commented as follows:

"One of the Board's objectives in issuing the proposal is to help preserve the distinctions between member-owned credit unions and for-profit financial institutions. We think this goal is commendable and fully consistent with efforts to maintain the unique characteristics of credit unions, such as recognizing that share accounts are members' equity, not liabilities. Another objective of the proposal, to ensure that credit union members understand that dividends are paid from available earnings, is endorsed by CUNA's Truth-in-Savings program."

CUNA recommended some specific changes relating to the circumstances under which disclosure should be required and to the flexibility in designing the disclosures. CUNA, as did the National Association of State Credit Union Supervisors, opposed the extension of any disclosure regulation to state credit unions. The other national trade association, NAFCU, commented that the proposed disclosure regulation appeared to be an overreaction to the savings and loan crisis, one that could "erroneously suggest to the public that credit unions are too weak to guarantee their rates."

Comments received from individual federal credit unions include the following:

"Credit unions have been guaranteeing rates for 8 years . . . Prohibiting the guarantees could cause a negative impact on some credit unions . . . If prohibited, we will have to re-educate our members and credit union staff."

"There is no doubt that membership shares . . . do follow the requirement that dividends are based on earnings and are not guaranteed . . . the remainder of our

accounts are deposits [such as] . . . Certificates of deposits, Money Market Checking, IRA Accounts . . ."

"Our experience with new accounts and large depositors has been that, when you pointedly disclose to them in writing that rates are not guaranteed, or, that there is a possibility that the specified rate may not be paid, depositors lose confidence and are unnecessarily upset. This especially occurs when the member "comparison shops" other financial institutes and no mention is made of the possibility of loss of earnings."

"From a competitive standpoint, we would like the public to see credit union products equal to or better than those of other financial institutions in the marketplace. Frequent disclosures that dividend rates are not a sure thing will handicap us."

"When I was a NCUA Chairman, we eliminated the disclosure rule, believing that it was an unnecessary burden for credit unions. Further, the disclosure only confused members who didn't understand what their credit unions were disclosing. Nothing has changed since 1982 when we dropped the disclosure."

Although NCUA requested comments by July 24, 1990, and provided a summary of comments received to NCUA Board members in August 1990, no action had been taken as of March 1, 1991. We were told the NCUA Board had not officially addressed the disposition of the proposed regulation. In its comments on a draft of this report, NCUA indicated that it will not take action but will defer to Congress.

We appreciate the concern expressed in many credit unions' responses that disclosure could put credit unions at a competitive disadvantage. We believe, nonetheless, that if credit unions are unique among depository institutions in that their depositors are member/owners, they should understand the implications of the cooperative structure. Member concern for the safety and soundness of their institution is supposed to be a hallmark of credit unions. We recognize that the provision of federal share insurance has diluted the significance of this factor. However, we believe that all federally insured credit unions should make adequate disclosure that all account dividends are in fact dependent upon earnings.[12]

Branching Regulation Needed

Credit unions are not required to get permission from NCUA before opening a branch office. In contrast, banks and thrifts must get permission from their federal supervisor in advance of establishing a new

[12]Provision could be made for credit unions in states that permit nonmembers to have accounts. In some states the yield on these accounts is considered interest and can be guaranteed in advance.

branch or moving their main office or a branch. Factors considered in granting permission, according to banking agency officials, include assessment of the institution's capital and condition and the additional risk exposure to the insurance fund, compliance with federal and state branching limitations, and the institution's community reinvestment record. For example, a poorly capitalized bank might want to establish a new branch to generate deposits in order to grow quickly. This application would be turned down.

The number of credit unions with branches increases noticeably in relation to asset size according to data collected by the Credit Union National Association. For example, only about 10 percent of those with assets of $2 to $5 million had branches, but 80 percent of those with assets of $50 to $100 million had one or more branches, as of December 1988. This is the latest date for which such data are available, although an NCUA official informed us that he thinks branch operations, for large credit unions, are very common. We recognize that when credit unions were smaller institutions with more limited fields of membership, there was no safety and soundness need to require federal approval for branch openings. However, in the past decade the size of these institutions has increased along with expanded fields of membership. Some states, for example, charter credit unions whose field of membership includes all state residents. (See ch. 9.)

Opening a branch can thus provide an opportunity for growth that may not be adequately supported by capital or management strength. In our review of selected problem credit unions, we noted that NCUA examiners frequently found operating expenses were too high and often suggested the credit unions close some of their branches. NCUA could develop a relatively simple form for all credit unions to use in requesting permission to open a new branch and could utilize the review process to insure that the new branch would not increase NCUSIF's risk exposure.

Additional Audit Requirements Needed

The Federal Credit Union Act requires all federal credit unions to have a yearly supervisory committee audit. A supervisory committee audit is an examination of the internal controls, statements, records, and accounting transactions as well as other financial and legal records, which can be conducted by a credit union's supervisory committee staff itself or by an outside accountant. Since December 1989, NCUA has required annual supervisory committee audits of state credit unions as well. FIRREA amended the Federal Credit Union Act in August 1989 to

require credit unions to receive annual independent audits under specified conditions. (12 U.S.C. 1782(a)(6)(A))

The act and federal regulations require that federal and state credit union boards of directors appoint a supervisory committee to fulfill the audit requirements. The regulations require that the audit determine whether or not the financial condition of the credit union is accurately and fairly presented in the financial statements and whether or not "management practices and procedures are sufficient to safeguard members' assets." The regulations also require effective internal controls, including those to guard against "error, carelessness, fraud, and self-dealing (conflict of interest)." (12 C.F.R. 741.2, 701.12 and 13)

The results of such supervisory committee audits can be used by credit union management as a means of improving operations and by regulators as a complement to safety and soundness examinations. The audit reports, for example, can alert regulators to possible problems when certain conditions exist, such as

- qualified opinions (other than a qualification based on classification of shares as equity rather than as liabilities),
- frequent changes of auditors, or
- failure to have an audit or to submit audit reports to the regulator.

We discuss in chapter 4 the extent to which NCUA has utilized the results of supervisory committee audits in its oversight of credit unions.

An impetus for the December 1989 regulation that state credit unions have supervisory committee audits was the August 1989 amendment to the Federal Credit Union Act to require that NCUA issue regulations requiring an audit of any insured credit union by an outside independent certified public accountant under any of the following three conditions:

- when the annual supervisory committee audit has not been done,
- when the annual supervisory committee audit is not complete or satisfactory, or
- when the credit union has experienced persistent and serious record-keeping deficiencies. (12 U.S.C.A. 1782, West, 1989)

This requirement will contribute to improved credit union oversight if adequately implemented. We asked NCUA how many times such audits have been required. NCUA officials told us that during calendar year 1990, NCUA regional directors had ordered audits at 134 credit unions.

Because all federally insured credit unions are not required to have annual independent audits by certified public accountants, NCUA does not keep statistics on such audit coverage. Accordingly, we are unable to determine how many credit unions are currently receiving such audits.[13]

We have recommended that management reporting on internal controls and compliance with laws and regulations be a condition for federal deposit insurance. We have also recommended that an annual independent audit should be required for federally insured banks, as it is for savings and loans.[14] We see no reason why many credit unions should be excluded from these proposed requirements. A majority of federally insured credit unions are quite small, however. (Of the 13,103 as of June 30, 1990, 9,928 had under $10 million in assets and 5,701 had assets of less than $2 million.) We recognize that it might be appropriate to grant an exemption to such requirements for institutions on the basis of size or some other cost-benefit considerations.

Conclusions

Regulations need to be strengthened in several key areas of credit union operations.

- The present reserving method provides no guarantee that the minimum levels of capital needed to provide a reasonable cushion against losses will be available and does not serve as a check on growth.
- The lending limit applicable to federal credit unions allows them to loan 10 percent of shares and surplus to a single member or group of members. State limits are even higher. These levels far exceed those applicable to banks and thrifts.
- Real estate loan underwriting requirements do not assure either that a borrower's ability to repay a loan is adequately checked or that the loan can be sold in the secondary market. For example, there is no loan-to-value ratio requirement.

[13]In 1988, the Credit Union National Association conducted a survey related to audit coverage. The results of 794 responses, which are not projectable to the credit union industry as a whole, show that: 31 percent of the credit unions surveyed used a certified public accountant (CPA) to do some form of audit services in 1988; 82 percent of these had full-scope independent audits. Larger credit unions were more likely to have such audits than smaller ones—11 percent of credit unions with under $2 million in assets had one in 1988 compared to 88 percent of credit unions with assets of $100 million or more. The only qualification of the full-scope audits was that member shares were classified as equity, not liabilities. CUNA, 1988 Quarter IV Credit Union Panel Survey, May 1989.

[14]Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

- Exclusions from the limit on commercial lending to a member include loans secured by residential properties other than the member's residence, and the regulation does not set maturity limits. There is no credit union limit on commercial lending.
- Credit unions do not have to obtain permission from NCUA to open new branches.
- Credit unions are not required to have annual independent audits or to make annual management reports on internal controls and compliance with laws and regulations.
- Credit unions may borrow up to 50 percent of their shares and undivided earnings for any purpose, an amount that is much too high.

In lieu of applying federal regulations to all state credit unions in areas where state regulations are weaker, NCUA could be given the explicit authority to require that a state credit union whose activities in these areas present a safety and soundness risk follow the regulation applicable to federal credit unions.[15]

Recommendations to Congress

Congress should amend the Federal Credit Union Act, with respect to all credit unions, as follows:

- NCUA should be required to establish minimum capital levels for credit unions no less stringent than those applicable to other insured depository institutions, providing for an appropriate phase-in period.
- The amount that credit unions can loan or invest in a single obligor, other than investments in direct or guaranteed obligations of the U.S. government or in the credit union's corporate, should be limited to not more than 1 percent of the credit union's total assets. Presently permitted limits with respect to credit union service organizations should continue, and exposures of not more than 2 percent of assets should be provided for in repurchase agreement transactions. NCUA should be authorized to set a higher limit for secured consumer loans made by small credit unions and for overnight funds deposited with correspondent institutions.
- NCUA should be required to tighten the commercial lending regulation and include an overall limit.

[15]FIRREA required state-chartered savings associations, regulated by the Office of Thrift Supervision and insured by the Savings Association Insurance Fund, to get permission from the Federal Deposit Insurance Corporation, the fund's manager, to engage in any activity or level of activity not authorized for federal savings associations. Such a requirement could be put in place for credit unions also, but we believe giving NCUA explicit authority to impose such requirements when needed as discussed above should be sufficient. The additional powers available to credit unions are not as broad and risky as those that have been available to savings associations.

- The borrowing authority should be modified to specify that credit unions may not borrow for the purpose of growth, unless prior approval of NCUA is obtained.
- Credit unions should be required to adequately disclose that dividends on shares and other accounts cannot be guaranteed in advance but are dependent on earnings.
- All credit unions should be required to obtain NCUA permission before opening a new branch.
- Credit unions above a minimum size should be required to obtain annual independent certified public accountant audits and to make annual management reports on internal controls and compliance with laws and regulations.
- NCUA should be authorized and required to compel a state credit union to follow the federal regulations in any area in which the powers go beyond those permitted federal credit unions and are considered to constitute a safety and soundness risk.

Recommendations to NCUA

- NCUA should assess its real estate regulation and strengthen it to help insure the sound underwriting of loans and their suitability for sale in the secondary market.
- NCUA should restrict the exclusions from its commercial lending limit set forth in 1987 to help insure that credit unions are not used as vehicles underwriting large commercial ventures.

Agency Comments and Our Response

NCUA agreed with most of the 10 recommendations in this chapter, although it proposed modifications or alternatives to some of them. Our detailed response to its comments on each recommendation is provided in appendix XII. We have recognized NCUA's serious concerns related to our recommended 1 percent of assets limit on credit union loans and investments by adding that NCUA should be authorized to provide exemptions for small credit unions and exemptions for overnight deposits at correspondent institutions for specified purposes.

NCUA indicated it will not take regulatory action to require that credit unions disclose that dividends are not guaranteed in advance. Accordingly, we have re-directed our recommendation from NCUA to Congress.

Highlights

Background

NCUA supervises all federal credit unions through examinations and off-site monitoring of their condition. It examines some state-chartered credit unions but generally relies on state examination reports and its own off-site monitoring reports.

Key Findings

- Off-site monitoring is based on credit unions' Financial and Statistical Reports; NCUA's reviews of the reports are not adequately certified.
- There are no specific requirements for the use or distribution of off-site monitoring reports. Supervisory committee audit reports, which could be useful in off-site monitoring, are not submitted to NCUA when completed.
- NCUA, working with state supervisors, has acted to improve examinations of state credit unions, but it does not have a policy on examination frequency.
- Some state supervisory agencies are not sufficiently independent of the credit union industry, yet NCUA accepts the states' examination reports.
- NCUA was not always effective in compelling sampled credit unions to resolve problems; it did not take formal enforcement actions. Since our study began, NCUA has taken steps to strengthen supervision.

Key Recommendations

- Require documentation at the regional office level of examiners' reviews of Financial and Statistical Reports.
- Issue requirements for use of each off-site monitoring tool. Require credit unions to submit supervisory committee audit reports promptly to NCUA.
- Further strengthen oversight of state credit unions by (1) establishing a policy goal for examination frequency of state credit unions and (2) not accepting state examinations when the state regulatory authority lacks adequate independence.
- Require the NCUA Inspector General to conduct a review of NCUA's use of enforcement powers at problem credit unions since mid-1990.

Chapter 4

Supervision of Credit Unions

As the charterer of federal credit unions and the insurer of all federal and most state credit unions, NCUA has an important supervisory role. NCUA sees its role as one of ensuring that credit union management implements policies to ensure financial soundness and the safety of members' funds and complies with laws and regulations. NCUA emphasizes that each credit union's board of directors and supervisory committee are directly responsible for those actions and that NCUA itself will intervene only when the officials are unwilling to meet their obligations.[1]

NCUA uses a combination of off-site monitoring and on-site examinations and other visits to supervise credit unions. Although the off-site monitoring tools are the same for federal and state credit unions, the frequency of NCUA examinations depends on the institution's charter.

Since 1987, NCUA has made significant changes in supervision. Most important among these are the development of several off-site monitoring tools, new examination and condition rating programs, and a better oversight program for state credit unions. Since 1989, it has taken further steps to improve the implementation of its supervisory powers. Nevertheless, we found that additional improvements are needed. The off-site monitoring tools contain useful data, but NCUA has not issued guidance as to their interrelationships and use. Further, all these off-site monitoring tools are based on credit union call Financial and Statistical Report data, yet examiners' reviews of the data for accuracy are not adequately documented.

Finally, NCUA was not always effective in compelling the problem credit unions we reviewed to address their problems. It did not use stronger enforcement actions available and, at times, acquiesced to state supervisors rather than take timely action against a state credit union. On the basis of our work on depository institutions over the past years, we have concluded that a comprehensive reform package is needed that changes the way banks are regulated, supervised, and—when failing—resolved. The recommendations relating to a formal system of phased regulatory intervention, which we refer to as "tripwires," are equally applicable to credit unions. This "tripwire" system will help ensure that NCUA takes the needed stronger actions. These recommendations are discussed in chapter 8.

[1]NCUA Examiner's Guide, vol. 1, pages 1-2.

Overview of the Oversight Process

Under the Federal Credit Union Act, NCUA has clear authority to examine federally insured credit unions and to take certain enforcement actions when necessary to ensure that they operate in a safe and sound manner. (12 U.S.C. 1784) Although the law does not specify examination frequencies, in 1986, NCUA established a goal of examining every federal credit union annually. In fiscal years 1988 to 1990, NCUA reported that it met that goal (see table 4.1). NCUA and state supervisors jointly oversee state credit unions. NCUA reviews state examinations, may also participate in examinations with state supervisors, and can conduct its own examinations of state credit unions. The state regulators themselves have varying examination frequency requirements. NCUA has no firm policy on examining state credit unions or goal for the number to be examined. It examined about 13 percent of them in fiscal year 1989 and 21 percent in fiscal year 1990.

NCUA policy states that examiners are responsible for monitoring the operations of credit unions assigned to them (an average of 30 each) between examinations, using on-site supervisory contacts if necessary. In four of NCUA's six regions, NCUA examiners are assigned both federal and state credit unions; at two regions, other staff may be responsible for some or all state credit unions.

Table 4.1: Credit Union Examinations (FY 1988-1990)

	Fiscal year		
	1988	**1989**	**1990**
Federal credit unions			
Number of credit unions	9,235	8,939	8,619
Number of NCUA examinations	9,275	9,069	8,672
State credit unions			
Number of credit unions	4,819	4,635	4,415
Number of NCUA examinations	350	584	939

Note: The number of credit unions examined exceeds the total number at year end because some credit unions had been liquidated or merged during the year.

Source: NCUA Office of Examination and Insurance.

NCUA's relationship with state supervisors is summarized in a "document of cooperation," first developed in 1982, with the National Association of State Credit Union Supervisors. The document acknowledged the "overlapping responsibility and jurisdiction" over federally insured state credit unions. Since 1987, it has included criteria that NCUA regional directors and state supervisors are to use in "discussing" which state credit unions NCUA itself will examine. In addition, NCUA regional directors and state supervisors discuss (1) arrangements for submission

to NCUA of state examination reports and credit union data, (2) differences of opinion regarding ratings assigned to state credit unions, and (3) NCUA's provision to state supervisors of monitoring reports and advance notice of actions to be taken against a state credit union.

NCUA describes itself as operating on a "highly decentralized basis" through its six regional offices. NCUA's Office of Examination and Insurance in Washington, D.C., oversees the examination and supervision activities within the regional offices, but each regional director reports directly to the NCUA Board, as does the director of the Office of Examination and Insurance. (See ch. 1 for a discussion of NCUA's structure and app. III for an NCUA organization chart.) The Office of Examination and Insurance provides guidance and training, monitors the performance of the regional offices, provides reports for off-site monitoring, and supports the regions in other supervisory efforts. Although the policy, guidance, and broad national goals are set at NCUA headquarters, each regional director has discretion in implementing policy and in accomplishing goals.

All Credit Unions Receive CAMEL Ratings

In October 1987, NCUA adopted a CAMEL rating system for federal credit unions, and most states use the same or a similar system. The rating is important because it guides the supervisor in the extent of follow-up oversight needed and indicates to the insurer whether reserves for possible losses should be made. NCUA examination reports reveal the CAMEL codes to federal credit union management. State officials may or may not reveal the codes they assign to state credit unions, depending on the state's policy.

CAMEL is an acronym representing five credit union dimensions examiners evaluate: capital adequacy, asset quality, management, earnings, and liquidity management. Examiners assign a code of 1, representing the highest, to 5, the lowest, for each dimension based on their analysis of both quantitative and qualitative information.

The quantitative analysis is based on various ratios for each CAMEL component except "management." For example, examiners calculate at least nine key ratios related to capital adequacy, including capital to assets, net capital to assets, classified assets to capital, and total delinquent loans to capital and to statutory reserves. Using a prescribed matrix, the examiner then determines codes on the basis of the ratios. To evaluate qualitative information related, for example, to capital adequacy, NCUA directs examiners to consider trends, the board of director's policies and

procedures related to equity goals and funds management, whether or not the board has established realistic goals to increase and strengthen its capital position, and whether or not the funds management policies are integrated with capital goals. The examiner can then raise or lower the component code generated by the ratios by one point, on the basis of his or her analysis of qualitative information.

The component code examiners assign for "management" is based completely on their judgment of how well credit union officials are operating the institution within accepted practices and in a safe and sound manner. NCUA's definition of management includes salaried managers, officers, committees, and the board of directors. NCUA guidance highlights six specific areas examiners should consider: condition of records, acceptability of the annual audit and verification of member accounts, policies and procedures, compliance with laws and regulations, budgetary process, and both long and short-term goals for the credit union. Other factors to be considered include personnel policies and any insider dealings.

The examiner also computes a composite CAMEL code for the credit union, which is the arithmetic average of the five component codes. NCUA instructs its examiners to override the composite code however, if either of the following conditions exist:

- if any component is rated 4 or 5, the composite cannot be higher than 3; or
- if three of the five components are rated 3 or lower, the composite rating cannot be higher than 3.

In addition, an examiner can lower a composite code on the basis of his own judgment but is required to explain the reasons in the examination report.

The composite CAMEL code examiners assign a credit union indicates its overall health and the extent of supervision it needs.[2] Thus, they are critical in alerting both credit union management and the examiner's superiors that additional supervisory attention must be devoted to the institution.

To review how well NCUA's CAMEL codes reflected credit union condition, we reviewed NCUA data on the most recent CAMEL codes examiners assigned to each of the 81 credit unions that failed in the first 6 months of fiscal year 1990. We found that examiners had assigned codes of 4 or 5 to 62 of the credit unions. The last full examinations took place an average of 10 months before the credit union failed. This is a clear improvement over fiscal year 1989, during which 50 percent of the credit unions had not been rated 4 or 5 prior to failure.

We were, however, concerned that 19 of the failed credit unions had received CAMEL ratings of 1, 2, or 3 prior to failure and asked NCUA to provide specific data on them to help us determine why serious problems had not been identified. The data showed that 11 of the 19 had failed because of problems of the members' employer, such as bankruptcy. Embezzlement or fraud—conditions examiners do not always detect—were involved at four of the credit unions. NCUA officials acknowledged that two, and perhaps three, of the credit unions had been coded incorrectly. They said the 19th credit union was properly rated a CAMEL 2 but was judged not viable; it had assets of under $30,000. On the basis of this information, we do not believe there are serious problems with the overall CAMEL rating system. NCUA's continuing efforts to update and improve it, which are discussed in the next section, are appropriate. In addition, we found that NCUA had been

[2]According to NCUA's Examiner's Guide, a CAMEL 1 credit union is sound in almost every respect; any critical findings are minor. A CAMEL 2 credit union is also basically sound but may have modest weaknesses that are correctable in the normal course of business. If this occurs, the supervisory response is limited. CAMEL 3 credit unions indicate "a combination of weaknesses ranging from fair to unsatisfactory." NCUA regards these credit unions as "vulnerable," and, thus, they require more supervisory attention than normal, although their overall strength and financial condition make failure "only a remote probability." CAMEL 4 credit unions require close supervision. They have more than a moderate amount of asset weaknesses or a combination of other conditions that are unsatisfactory; unless those conditions are corrected the credit unions' viability may be threatened. NCUA states that "a potential for failure is present but is not pronounced." CAMEL 5 credit unions require immediate corrective action and constant supervision. The volume and character of weaknesses are such that aid from the credit union's shareholders or other sources is required and the probability of failure is high. NCUA redefined its CAMEL code 5 in October 1989 stating that a code 5 credit union would not survive more than 12 months, is insolvent, and that "routine supervision" is not required because supervisory efforts will be directed at finding a merger partner or liquidating the credit union.

alerted to the weakened condition of 12 of these 19 credit unions by one of its off-site monitoring tools.

Further Improvements in Off-Site Monitoring Needed

Off-site monitoring of credit union condition between examinations is needed to identify deterioration or inordinate risk-taking and to schedule supervisory visits, examinations, and appropriate interventions. NCUA now uses four primary tools: (1) the CAEL-CAMEL Comparison Report, which compares the results of financial ratios with the condition ratings assigned the credit union during the previous examination; (2) the Financial Performance Report, which provides condition ratios and other information for a 5-year period; (3) the Risk Evaluation Report, which uses nine ratios to highlight possible risks; and (4) the CURE Report, which uses yet another set of financial ratios to identify credit unions that might fail. These four reports are sent to the NCUA regions. Three of these reports were developed in 1987; the Financial Performance Report was introduced in 1983. All are based primarily or exclusively on the balance sheet, income, and expense data submitted semiannually to NCUA—the financial and statistical reports, or call reports. NCUA also produces other reports on an ad hoc basis.

Call Report Is Basis for Off-Site Tools

It is critical that the data submitted on the call reports be accurate because these data form the basis for off-site monitoring of credit union condition and trends.

We asked NCUA officials how they check the reliability of the data submitted in these reports. Officials told us that NCUA examiners collect and review the call reports for federal credit unions and contact the credit union if any errors or omissions are noted. Following this review, the examiner (or other regional staff) electronically transmits the information to the NCUA headquarters unit that maintains the database for all insured credit unions. According to an NCUA official, state regulators collect and check the state credit unions' call report data, and most states transmit the data directly to the NCUA database unit. NCUA regional staff or examiners, he said, review the data in the course of monitoring state credit unions. If errors are noted, they are to contact the state officials and agree on corrections.

The NCUA Examiner's Guide instructs examiners to review previously submitted call report data during examinations, discuss and resolve any apparent inaccuracies, and submit corrections. Record keeping and other problems are typically present in poorly rated credit unions, so the

review of the call reports is particularly important in those cases. These checks are important and should eliminate technical errors and misrepresentations of asset quality, capital, or earnings. In theory, therefore, the call reports should be relatively accurate. Examiners, however, are not required to certify that they have reviewed the call reports in the examination itself. This function is listed only on an examination checklist, which is left in the field copy of the examination.

Requiring examiners to state in the examination report that they have reviewed the call report data would (1) emphasize the importance of the review process and (2) allow regional office management to ensure that the reviews are being done. Because state credit unions are not examined annually by NCUA, it should develop a system to document review of these submissions as well as those of federal credit unions. In order to better monitor credit union condition off-site, improvements to the call report form itself are also needed. These improvements were discussed in chapter 2.

CAEL-CAMEL Comparison Report

NCUA produces a report semiannually that compares condition codes generated strictly from the call report data with examiner assigned CAMEL codes for both federal and state credit unions. Officials told us they use these reports for several purposes: (1) to monitor the codes examiners assign, (2) to review the adequacy of the ratios used to compute CAMEL, and (3) to help oversee credit union condition.

NCUA computes a code for capital, assets, earnings, and liquidity—all the CAMEL components except management—using the same ratios NCUA examiners must use in developing the CAMEL rating. The average of these codes is the CAEL composite code.

The percentage of credit unions with CAEL codes that differ from CAMEL ratings has declined slightly since 1988, as shown in table 4.2. NCUA officials told us this was probably due to improvements in the ratios. Changes were made to the ratios because officials assume that the examiners' CAMEL ratings are, with few exceptions, the most accurate assessment of a credit union's condition. Although their hope is to further refine the ratios to better reflect examiners' assessments, on-site examinations are expected to discover problems not revealed by financial ratios.

The CAMEL ratings for state credit unions are assigned by the state supervisors. Although states are not required to use NCUA's CAMEL system,

many do, and others, according to NCUA, use ratios that are very similar. We wanted to know whether there was a difference in the CAEL-CAMEL matches for federal and state credit unions. The data do not reveal significant differences, as table 4.2 shows.

Table 4.2: Comparison of CAEL and CAMEL Codes Nationwide

	June 1988		June 1990	
	Federal	State	Federal	State
CAMEL worse than CAEL	23%	28%	24%	29%
CAMEL same as CAEL	56	54	61	58
CAMEL better than CAEL	21	18	14	13

Source: NCUA CAEL-CAMEL Reports.

NCUA's report does not include state-by-state data, however, and NCUA headquarters officials could not tell us whether instances in which CAMEL ratings were better than CAEL codes were concentrated in a few states or if other state patterns were evident. Any such analysis, they said, would be made at NCUA regional offices.

NCUA provides the CAEL-CAMEL report to regional directors but does not provide guidance or instructions for its use. Officials told us that regional directors typically provide it to supervisory examiners, but they did not know if the report was being shared with state supervisors.

The CAEL-CAMEL comparison report appears to be a useful tool for monitoring both federal and state examiners' assignment of CAMEL codes, for refining the ratios used in developing the CAMEL ratings, and for off-site monitoring of credit unions. Without explicit guidance, however, there can be no assurance that such uses are being made of it.

Financial Performance Reports

Since 1983, NCUA has produced a semiannual Financial Performance Report that provides a 5-year trend analysis of each credit union's financial condition and operating results. This report is provided to a federal credit union's board members. The reports for state credit unions are provided to NCUA regional directors and to state supervisors. The report is intended primarily to assist the credit union officials in reviewing past performance, identifying key trends, and setting goals. It includes data on like-size credit unions and the ratios examiners use in computing CAMEL. NCUA provides a "user's guide" to credit union officials to assist them in interpreting the report.

NCUA also instructs its examiners to use the report in identifying possible problem areas that may require further analysis and investigation. In NCUA examinations and other records of problem credit unions we reviewed, we saw indications that examiners often used the reports in this manner and to persuade credit union officials that their institutions' problems were serious.

The Financial Performance Report appears to be a good tool for both credit union officials and examiners because it focuses attention on the institution's performance over a period of time and compares it with institutions of the same size. In addition, both the user's guide and graphics in these brief reports appear helpful to credit union board members, who typically are volunteers rather than financial experts. We see no reason why NCUA should not make the report directly available to state credit unions.

Risk Evaluation Report

NCUA has produced a Risk Evaluation Report semiannually since 1987 to help identify potentially high-risk institutions. It is presently limited to credit unions with assets of $2 million or more. The report is distributed to regional offices and, depending upon their arrangements with state supervisors, the data on state credit unions may be provided to state officials.

The report uses nine financial performance ratios whose values are reported if they exceed specified thresholds.[3] A credit union shows up on the report even if it exceeds the threshold for only one ratio. NCUA makes additions and changes in the thresholds and the ratios on the basis of trends in the industry. For example, a delinquent loan ratio was first included in the December 1989 report. In the June 1990 report, NCUA changed the reporting threshold for real estate loans (less variable rate loans) as a percentage of total loans from 30 percent to 40 percent.

The June 1990 report listed 3,794 (2,820 federal and 974 state) credit unions. (This is about 50 percent of all the insured credit unions that had over $2 million or more in assets.) Because inclusion on the list indicates only that a credit union exceeds the threshold in one or more

[3]Evaluation ratios and thresholds in use for the June 30, 1990, report were (1) net capital below 3 percent, (2) collection problem loans exceed irrevocable reserves, (3) delinquent loans exceed 10 percent, (4) any loss in net income, (5) share growth exceeds capital growth by more than 25 percent, (6) share growth exceeds 30 percent, (7) nonearning assets exceed 6 percent of total assets, (8) long-term assets exceed 40 percent of assets, and (9) fixed-rate real estate loans exceed 40 percent of total loans.

areas, it is not necessarily a cause for concern. This report appears to be a useful off-site monitoring tool and one that, if properly used, could satisfy its objectives.

CURE Report

NCUA's Office of Chief Economist developed the CURE (Credit Union Risk Evaluation) report to help identify credit unions in danger of failing. Since early 1989, NCUA has provided regional directors with three CURE reports. The report now uses 12 financial measures that give weight to factors evident in past failures to predict potential failures 12 to 24 months in advance. As with other monitoring tools, NCUA's Office of Examination and Insurance provides the CURE report to regional directors, who may use and distribute it as they choose. Like the Risk Evaluation Report, the CURE report is an exception report.

One hundred nineteen credit unions failed in fiscal year 1989. We asked NCUA to provide data on their CAMEL and CURE ratings. NCUA reported that both CAMEL and CURE data were available for 111 of the failures. CURE had identified 67 of the 119 failures at least 12 months in advance. And 56 of the failures had been previously CAMEL rated 4 or 5. Combined, the two tools identified 79 of the failures 12 months or more in advance. For those 81 that failed in the first half of fiscal year 1990, 62 had previously been CAMEL rated 4 or 5, a clear improvement. CURE may have identified some of the others, but the CURE report for this period was not yet available.

Improvements in Examination Process Have Been Made but Enforcement Actions Are Still Weak

We studied the supervision of credit unions in the early 1980s and issued a report calling for improvements in

- examination of state credit unions,
- ratings of credit unions, and
- use of enforcement actions.[4]

Our current review has shown that NCUA, in cooperation with state supervisors, has taken actions that have improved examinations of state credit unions and has implemented a new credit union rating system. Nevertheless, NCUA can improve further by making use of supervisory committee audits as well as its new authority under FIRREA to require independent audits and revising the criteria for its own examinations of state credit unions.

[4] Stronger Supervision of Credit Unions Needed (GAO/GGD-83-13, Oct. 6, 1982).

With respect to effectiveness in correcting identified problems, we found that NCUA has continued to rely on informal enforcement actions, even when they did not result in the needed corrections. Its supervisory efforts were not effective—i.e., the preponderance of the credit unions' problems were not resolved over the period of our review—in 15 of the 39 problem credit unions (those with a CAMEL rating of 4 or 5) we reviewed. NCUA officials have assured us they have made organizational and other changes that will result in stronger supervision. Nevertheless, we believe our recommended system of "tripwires" (see ch. 8) is needed to ensure that NCUA takes enforcement action when appropriate.

New Examination and Rating Programs

In October 1987, NCUA adopted a new standardized examination format referred to as the "core" examination. The National Association of State Credit Union Supervisors (NASCUS) helped NCUA develop this examination format, and most states have adopted it. The core examination is intended to focus the examiners' attention on key trends and ratios as well as significant management and operational areas. Key data from a one-page summary of the examinations are entered into an NCUA database.

In 1987, NCUA also began using a new system for rating credit unions—the CAMEL system. (See pp. 91-93.) Ratings are developed during examinations. State regulators assign CAMEL codes to state credit unions; most, but not all are derived in the same manner as NCUA's codes.

Examination of Federal Credit Unions

Examination coverage appears to be adequate. NCUA is not legally required to examine federal credit unions annually but has established and met a goal of examining each one every fiscal year since 1987. In theory, there could be a 23-month time frame between examinations, if a credit union was examined at the beginning of one fiscal year and at the end of the next one. NCUA officials told us, however, that examination frequency is monitored and that such a delay would only happen to a small credit union with good ratings. Each year, examinations for problem and large credit unions are scheduled first. NCUA periodically generates a list of federal credit unions that have not been examined for 18 months or more to monitor regional office scheduling practices. Since May 1989, NCUA policy has required that poorly rated (CAMEL code 4) credit unions be contacted through an on-site visit or telephone call at least quarterly. Prior to that time, there were no specific requirements for contacting problem credit unions or time frames for resolution of their problems.

NCUA also now has in place a standard system for the review of examinations. Those done by NCUA examiners are reviewed by supervisory examiners assigned to the region and located in the field. Until August 1989, each region had its own requirements for regional level review of examination reports. At that time, the Office of Examination and Insurance set out a program to ensure "a quality, uniform examination and supervision program for federally insured credit unions" among the six regions. At a minimum, the national policy requires that the examination reports for the following federal credit unions be reviewed at the regional office level: all those with a CAMEL rating of 4 or 5 and those rated 3 with assets over $20 million, all those with assets over $100 million, and a sample drawn on the basis of criteria determined by the region.

Examination of State Credit Unions

NCUA has taken steps to improve both state examinations of state credit unions and its own involvement in the process. Forty-seven states plus Puerto Rico charter credit unions.[5] All but six states—Tennessee, Georgia, South Carolina, West Virginia, Massachusetts, and New Hampshire—now use the core examination.[6] NCUA officials told us the examination reports of these states capture basically the same information as the core examination and that needed data can be obtained from their reports.

In 1987, NASCUS instituted an accreditation program for state credit union supervisory agencies. In adopting the program, NASCUS noted that the adequacy of state supervisory programs of all financial institutions was being questioned in the wake of bank and thrift problems and, rather than see federal legislation impose an accreditation requirement, NASCUS would develop a program that would "dovetail" with the core examination program. A NASCUS official told us that it takes a state about 2 years to prepare for an accreditation review. By December 1990, five states had sought and received accreditation.[7] The Conference of State Bank Supervisors had adopted a similar accreditation program for state banking supervisory agencies in 1985.

[5]Delaware, Wyoming, South Dakota, and the District of Columbia do not charter credit unions.

[6]California, Illinois, Montana, and Kansas laws permit an audit report to be submitted in lieu of an examination under certain conditions. California performs a "modified core exam" in such instances and assigns a CAMEL code. Illinois followed much the same practice and over the past 4 years has begun phasing in the use of the core examination. Montana requires core work papers from CPAs performing audits, and the supervisor performs examinations every third year. In Kansas, the supervisor does not accept audit reports in lieu of examinations.

[7]The states certified are Michigan, Indiana, Missouri, Idaho, and Connecticut.

NCUA officials told us that when the core examination is not used, NCUA requires state supervisors to submit a "Continued Insurability Status Report" for each insured credit union that also requests key financial and other information that "indicates management's control and effectiveness." Until NCUA revised its Examiner's Guide in October 1989, however, each regional director had the option of waiving state submission of the report.[8]

Under NCUA's present examination review program, the responsible regional offices are to ensure that all state examination reports are reviewed by either the NCUA field examiners or regional office staff, at their discretion. Policy requires that if the NCUA reviewer disagrees with the state assessment of a credit union, he must notify the state. When NCUA reviewers disagree with the state assigned CAMEL ratings, officials told us they typically discuss the ratings with the state and try to reach agreement. If unsuccessful, they will assign an NCUA CAMEL rating to the credit union. Both codes are shown on NCUA's database.

State credit union examination frequency schedules vary. According to a NASCUS survey done in 1990, 27 states require annual examinations, and 6 states require examinations every 12 to 18 months. Forty-four states reported that they actually examine their credit unions every 12 to 18 months.[9] NCUA also can examine state credit unions. Although the percentage of state credit unions that NCUA examines is still limited, it rose from 2 percent in fiscal year 1982 to 13 percent in 1989 and to 21 percent in 1990. The decision as to which state credit unions NCUA will examine is made by the responsible regional director, on the basis of a review of the state examinations, NCUA's off-site monitoring reports, and criteria developed with each state regulator.

[8]This report does not request sufficient information regarding a state credit union's investments that are not permitted under federal law. By regulation, NCUA requires, as a condition for insurance, that an "investment valuation reserve" be set aside for any investments that do not conform to federal standards. (12 CFR 741.7(3)) NCUA policy requires this reserve to be the net of the book over market value for such investments. We informed NCUA officials that neither NCUA's instructions for the insurability report nor the guidance for the core examination direct the examiner to record the specific nonconforming investments. Responsible NCUA officials assured us this would be addressed.

[9]The NASCUS survey also reported that the statutes of three states require exams every 18 to 24 months, and those in two states require them every 24 months or longer. Eight states (Alaska, Connecticut, Indiana, Kentucky, New Jersey, New Mexico, Ohio, Pennsylvania) have no statutory requirement on frequency of exams. Utah mandates exams "as often as necessary." Information was not reported for Puerto Rico. Profile of State Credit Union Supervisory Agencies, June 1990.

Since November 1988, the NCUA-NASCUS Document of Cooperation has specified broad criteria under which an NCUA examination will be justified and charged each NCUA regional director and state regulator to develop more specific mutually satisfactory criteria and procedures for NCUA examination of selected state credit unions. If mutually satisfactory criteria cannot be developed, the following conditions would justify a federal examination:

- adverse financial trends during the prior 6-month call report cycle;
- material exposure to the NCUSIF in relation to all federally insured credit unions, or in relation to all federally insured credit unions in that state, provided the regional director furnishes to the state the rationale therefore;
- state agency rated CAMEL code 4 or 5 at the most recent examination by the state;
- state agency rated CAMEL code 3 and over $20 million in assets at the most recent examination;
- examination cycle in excess of 18 months; and
- corporate credit unions, whether or not federally insured.

We expressed concern to NCUA officials that the Document of Cooperation did not reflect NCUA's unequivocal right to examine any state credit union and that regional directors had to get state concurrence for examining a state credit union, except under the specified circumstances. The Document recognizes that the regulation and examination of state credit unions properly belongs to and is the primary responsibility of the state. NCUA officials emphasized to us that they have the power to examine any federally insured state credit union[10] and will do so over the objections of a state regulator, if necessary. They added that when a state credit union applies for federal insurance, it must sign a document agreeing, among other things, to permit and pay the cost of examinations NCUA deems necessary to protect NCUSIF and to give NCUA access to all records and information concerning the credit union. In our sample of problem credit unions, we did not see instances in which NCUA deferred or did not conduct examinations because of state objections.

However, we did note that two state supervisory agencies have built-in conflicts of interest that effectively limit their independence. The Kansas and Texas supervisory entities have boards on which a majority of the members, by statute, must be credit union officials. In our sample of 16 problem state credit unions, we had 3 chartered by those states

[10]See 12 U.S.C. 1784.

and noted problems with state supervision in 1 of the 3 cases. We also found that NCUA's supervision had been ineffective in this instance because it acquiesced to the state officials. NCUA, we believe, should apply additional scrutiny to state credit unions in states that have these or other arrangements that limit their independence.

Supervisory Committee Audit Reports and New Audit Power Not Used Effectively

Both federal and state credit unions are now required by NCUA to have annual supervisory committee audits.[11] (12 C.F.R. 741.2) During examinations, NCUA examiners are charged with reviewing supervisory committee audits to ensure that they meet the requirements, initiate corrective action when any weaknesses are found, and use the audit as an aid in detecting problems at the credit union. NCUA officials told us that they view any federal credit union's failure to have an annual supervisory committee audit as a safety and soundness concern and have the same concern for state credit unions now that such audits are required for them as well. NCUA also received a mandate in FIRREA to require audits by independent public accounts under specified circumstances. (See ch. 3 for a discussion of the regulatory requirements.)

We view such reporting as an effective supervisory as well as management tool. NCUA does not track audit report submission or adequacy, however, and does not use them as an additional tool for monitoring credit unions between examinations.[12] NCUA officials told us how many independent audits NCUA had ordered. (See ch. 3.) They could not tell us, however, the total number or percentage of audits that were considered unacceptable by examiners or whether audits were done within the required time frames. Such information, they said, is available only in the responsible examiner's field files.

In two of the regions we visited, Chicago and Austin, we looked for indications of examiners' reviews of supervisory committee audits, and we reviewed the audit reports. Our 10 sample credit unions in the Austin region had a total of 23 audit reports applicable to the 31-month period covered in our review; all had at least 1 audit. Our sample of 25 credit

[11] The Examiner's Guide defines a supervisory committee audit as "the critical and systematic examination of the internal controls, statements, records, and accounting transactions prepared by management and the other financial and legal records" that can be conducted by a credit union's supervisory committee or by an outside accountant. See discussion on the specific legal requirements in chapter 3.

[12] NCUA's system for tracking examinations allows examiners to indicate if the audit or verification of accounts are "problem areas," but the nature of the problem is not recorded in the system. During examinations in 1989 and 1988, examiners cited 15 percent of all credit unions for problems with their audits and/or verification of member accounts.

unions in the Chicago region had 47 audit reports during the period; 1 did not have an audit.

Overall, examiners indicated they reviewed most (65 percent) of the audit reports. However, we could seldom discern the extent of their review or if they had used the information provided. For example, one supervisory committee audit report, which was prepared by the state credit union league, was supposed to cover the January 1, 1986, to July 31, 1987, period; the report stated that it had covered September 1, 1986, to July 31, 1987, instead because records for the previous period were not available. The NCUA examination's only reference to the audit was that the credit union had met the minimum standards. The next year's audit, which was prepared by an independent public accountant, noted that the credit union's internal controls for nearly every accounting and operational phase of the credit union were not adequate. We saw no indication in NCUA's subsequent examination report that the examiner had reviewed this audit report.

We made a special review of the 70 audit reports of credit unions in our sample to determine whether or not they would be useful in alerting credit union supervisory audit committee and board members—volunteers who cannot be expected to be financial experts—to serious problems. Since all of these credit unions were CAMEL code 4 or 5, they all had serious problems. We found that 49 of the audit reports in the Austin and Chicago regions were useful in that they reported problems. Reports we judged as not useful, for example, included three that gave a more positive assessment of credit union operations than NCUA examinations and, thus, did not accurately represent credit union condition.

NCUA Supervisory Enforcement Efforts Were Not Always Effective in Our Sample Credit Unions

A final key aspect of supervision is action taken to correct problems identified during examinations. To assess NCUA's effectiveness in this regard, we analyzed in detail a judgmental sample of 39 credit unions—23 federal and 16 state—supervised by the Chicago, Austin, and Concord (California) NCUA regional offices. (See app. VI for our sampling methodology.) These 39 had been designated problem (CAMEL code 4 or 5) institutions as of June 1989 and represented 46 percent of the shares in problem credit unions in these 3 regions. For each of the 39 credit unions, we reviewed NCUA and state examination reports, supervisory contact reports, and other documents for the period October 1, 1987, through April 1990. We interviewed officials at the regional offices, NCUA headquarters, and state supervisors.

We assessed NCUA's effectiveness by determining if its supervision, including any actions taken, compelled credit union officials to address the problems identified and resulted in corrections. We assessed as "significant" problems that remained uncorrected and contributed or could contribute to financial deterioration. To reach such conclusions, we reviewed older examination reports to determine what types of problems examiners had identified and when. We then reviewed subsequent examination reports, other records of supervisory contact, and any records of actions taken to determine if examiners again cited the same problems or if they noted improvements. If the preponderance of the credit union's problems, including all significant problems, were resolved over the period of our review, we considered NCUA's supervision to be effective; if not, we considered supervision ineffective.

Informal and Formal Actions Available to NCUA

NCUA policy prescribes a progressive set of actions to address credit union problems that we refer to as "informal actions." These begin with a written record of action included in examination reports, followed by a letter from the regional director and a letter of understanding and agreement.

Until May 1989, NCUA required letters of understanding and agreement only when it gave assistance to a credit union. NCUA now requires that such letters be issued to all CAMEL code 4 credit unions. The letter outlines a plan for resolving credit union problems and often contains specific prohibitions of certain activities, such as business lending. A standard part of the agreement, both before and after May 1989, stipulates that if the agreed upon actions are not achieved within the time frame set, NCUA may remove any credit union official.

Stronger enforcement actions are provided by the Federal Credit Union Act. These, which we refer to as formal actions, include issuing cease and desist orders, assessing civil money penalties, removing officials, prohibiting other individuals from participating in credit union affairs, and placing a credit union in conservatorship.[13] Although NCUA must notify state regulators before taking actions against state credit unions, NCUA clearly has enforcement authority over them. (12 U.S.C. 1786(o))

NCUA requires its examiners to present the examination results to the credit union's board of directors at a joint conference to inform them of its scope and results and to reach agreement on any needed corrective

[13]NCUA Examiner's Guide, vol. 2, sec. 8, p. 1. See appendix VII for explanations and legal citations for each formal action, including changes made in 1989 under FIRREA.

actions. NCUA policy since 1974 has required the examiners to note corrective actions recommended and agreements reached for all marginal or poorly rated credit unions (those rated CAMEL 3, 4, or 5) in the "record of action" portion of the examination report.

If the examiner believes that a financial problem could or will cause a credit union to become insolvent or to require special assistance within the next 18 months, the record of action must require credit union officials to take specific actions to address the shortfalls.

The law provides for conservatorship actions to take effect immediately, and under special conditions, NCUA can issue temporary cease and desist, suspension, and prohibition orders that are also effective immediately. Otherwise, the law requires that administrative hearings be held before actions are final.[14]

NCUA Relied on Informal Actions

NCUA took a total of 84 actions against the 39 federal and state problem credit unions in our sample (see table 4.3), and state supervisors took actions against 9 of the 16 state credit unions. Some state actions were taken jointly with NCUA. Over half of NCUA's actions were regional director letters issued in the Chicago region.

Table 4.3: Actions NCUA Took in GAO's Sample of 39 Problem Credit Unions and GAO's Assessment of NCUA's Supervision Between October 1, 1987, and April 30, 1990

	Formal action	Regional director letter	Letter of agreement	GAO assessment that supervision not effective
Region IV				
14 federal	0	33	10	4
11 state	0	13	6	3
Region V				
5 federal	0	0	9	2
5 state	0	0	9	2
Region VI				
4 federal	0	0	4	4
Totals	**0**	**46**	**38**	**15**

Source:Compiled by GAO from actions recorded in NCUA documents.

In the 39 problem credit unions we reviewed, no formal actions were used. NCUA has seldom used its formal actions, as table 4.4 shows.

[14]FIRREA altered some of NCUA's enforcement powers. Overall, NCUA's authority was expanded—for example, to permit cease and desist orders, civil money penalties, removals, and prohibitions that include additional people affiliated with the credit unions, and higher money penalties.

Table 4.4: Formal Actions Taken by NCUA in All Regions

	1984	1985	1986	1987	1988	1989	1990[a]
Cease and desist orders	1	0	4	0	0	2	8
Removals, suspensions, and prohibitions	3	0	0	0	1	1	20
Civil money penalties	0	0	0	0	0	0	0
Conservatorships	3	6	7	2	3	7	10
Terminations of insurance	0	1	2	0	1	1	0
Total	**7**	**7**	**13**	**2**	**5**	**11**	**38**

Note: See appendix VII for a definition of each formal action.

[a]As of December 31.

Source: NCUA, Office of General Counsel.

In the following sections we describe instances of ineffective supervision noted at the 39 credit unions in our sample. We judge that supervision of 15 of these credit unions was ineffective.

Records of Action Not Enforced and Sometimes Inappropriately Modified

In April and December 1988 and again in November 1989, examiners cited one federal credit union in the Concord region for inadequately funding its allowance for loan losses. The records of action examiners prepared repeatedly called for management to amend their funding procedures to ensure full and fair disclosure. During this time, credit union management did little to meet the funding obligations. Nevertheless, neither the examiner nor regional officials took any additional action to obtain compliance with the terms of the record of action. The credit union's condition deteriorated, and, finally, a letter of understanding and agreement was issued in December 1989, which, among other provisions, specifically required management to promptly and adequately fund this account. Under supervision by new NCUA regional management, this credit union has begun to show improvement, but its financial condition is still poor.

In a state credit union with a history of serious problems, the NCUA examiner did little to ensure that management implemented the actions outlined in the record of action and, instead, reduced the requirement for compliance in subsequent records of action. At a joint NCUA-state exam completed in September 1988, the NCUA examiner directed management to reduce operating expenses by 5 percent in 1988 and 4 percent the following year. At the next joint examination, which was completed a year later, the same problems with high operating expenses were noted. However, the examiners eliminated the specified percentage reduction from the record of action and stated only that management

should reduce those expenses that did not contribute to operational efficiency. Ultimately, as a condition for continuing assistance, NCUA insisted on a change in management, and the new manager began reducing operating expenses.

Credit Unions Sometimes Did Not Comply With Letters of Understanding and Agreement

A letter of understanding and agreement outlines a plan for resolving the credit union's problems and often prohibits certain activities that NCUA found caused problems, such as business lending. Thirteen of the 15 credit unions where we judged NCUA's supervision ineffective signed such agreements, including 2 of the 5 state credit unions. Despite the more serious supervisory nature of these agreements, credit union officials sometimes still did not comply with their terms. Examiners cited 4 of the 13 credit unions for specific violations of the agreements, yet there was no evidence in the files that regional officials took action to either force management to comply with the agreements or sanction them for violations.

One federal credit union in the Austin region with a 2-year history of severe financial problems repeatedly violated the conditions of its agreements. Agreements were signed in February and December 1988 and April 1989. With NCUA's forbearance from regulatory requirements, the credit union continued paying quarterly dividends. Examiners cited the credit union for poor underwriting policies, a high delinquency rate, refinancing delinquent loans, inadequate collection policies, high operating expenses due to unprofitable services, and weak management. Almost 90 percent of its assets was in loans: 28 percent was in home equity loans, and the balance was in consumer loans. Supervisory committee audits had not been performed, and member accounts had not been verified since 1987. Each successive agreement reiterated the same areas of concern, indicating that management had not implemented corrective measures. The credit union's financial condition continued to deteriorate. It was merged in January 1990, at a loss to NCUSIF of over $700,000.

Austin regional supervisory officials could not fully explain why NCUA did not pursue stronger action against this credit union, despite its repeated violations of the agreements. They said they had chosen to use their resources to seek a merger partner rather than to remove the manager. They also said they had succeeded, in July 1987, in getting the previous manager and other officials to resign. They told us that, nevertheless, such a pattern of failing to halt unsafe practices and to comply with an agreement would no longer be permitted.

Both NCUA headquarters officials and the new regional directors of the three regions we visited assured us that they are now taking more immediate action when credit union management does not meet or is in violation of the terms of a letter of agreement. NCUA is stressing to credit union officials that the agreement is a strong indication of the seriousness of the institution's problems, and every effort should be undertaken to resolve them.

We were provided various examples to demonstrate the effectiveness of the new program requiring letters of agreement as well as NCUA's commitment to sanction credit union officials for violations. For instance, they said the chief executive officers at two credit unions in the Austin region had been recently removed for violating specific terms of agreements. In one case, the agreement prohibited making insider loans and paying bonuses without approval from NCUA regional officials. Without seeking prior approval, the credit union board approved a $65,000 year-end bonus for its chief executive. Also, in direct violation of the agreement, the same executive underwrote a commercial loan, with a preferential rate of interest, to the chairman of the board. NCUA removed another credit union executive for violating an agreement's prohibition against long-term investments and for continued refusal to reduce the cost of funds and high operating expenses.

In the Concord region, NCUA viewed refusal to submit an acceptable plan for correcting its problems as grounds for issuing a preliminary warning letter to a federal credit union in April 1990. The NCUA regional director told credit union officials that if they did not submit and begin implementing a plan, administrative action would follow. By June, an acceptable plan was submitted, and the board made management changes. By January 1991, the credit union's condition was improving. Regional officials anticipate that the next examination may result in removing this large credit union from the problem list.

Management Often Cited as a Problem but Not Often Replaced

NCUA examiners cited managers, and sometimes other officials, for contributing to problems or being unable to resolve them at the 15 credit unions where we assessed NCUA's supervisory efforts as ineffective. NCUA did not take formal action to remove any of these managers, but management at 6 of the 15 did resign at the urging of NCUA (often with support from boards of directors). NCUA policy requires that weak management be replaced as a condition of providing assistance to a credit union. At other times NCUA officials simply persuaded officials that a change was needed.

We asked NCUA officials why they did not take stronger action to remove the managers at seven of the other nine credit unions. In four instances, NCUA regional officials agreed that, in retrospect, they or the officials then in charge should have insisted on replacing management. In one case NCUA regional officials disagreed with our assessment that management should have been removed, despite the fact that NCUA's own examinations had cited management for failure to resolve serious problems. With respect to one credit union that ultimately failed, officials said they preferred to put their energy into finding a merger partner. Regarding another, NCUA officials felt that they had not been closely involved with one problem credit union long enough to insist on a management change. Their records show, however, they had first identified serious management problems there in February 1988; the same manager was still in place in March 1990.

NCUA did not formally remove any officials at these problem credit unions or prohibit them from future involvement in the industry. The officials, therefore, could seek work in other credit unions and at other depository institutions and would not be listed among those banned from such institutions. Although we cannot conclude that adequate grounds existed for NCUA to prevail in removal and prohibition actions, we question their failure to explore whether adequate grounds did exist. Nevertheless, we are encouraged by NCUA's recently increased use of this enforcement power. As table 4.4 shows, NCUA used its legal authority to remove only 1 official in 1989 but removed 20 in 1990. NCUA officials told us the increase in removal actions was partly due to changes made under FIRREA that eased NCUA's burden of proof and partly to other factors, including a new NCUA Board emphasis on taking stronger action. (See app. VII for description of changes.)

NCUA Sometimes Did Not Act Against State Credit Unions When State Supervisors Objected

NCUA officials in two regions believed two state credit unions' problems warranted supervisory action, but when state officials disagreed they acquiesced to the state. Although NCUA subsequently secured letters of agreement with these state credit unions, a year or more had elapsed, and their financial conditions had deteriorated.

NCUA and the state supervisor had performed two joint exams in 12 months at one of these credit unions in the Chicago region. They agreed that it had serious lending problems and was also hampered by high operating expenses due to costly fixed assets and high salaries. But the state supervisor believed the credit union's problems were less severe than NCUA—it assigned a CAMEL code 3, and NCUA assigned a 4. NCUA wanted to seek a written agreement in November 1988, a year after it

assigned its first CAMEL code 4. However, the state objected, and NCUA did not act. A year later, the state and NCUA together obtained a written agreement with the credit union. In the intervening 12 months this medium-size credit union's financial condition deteriorated. We discussed these observations with the NCUA regional director, and he agreed with us that NCUA should have taken more forceful action sooner.

At a large state credit union, NCUA and the state supervisor identified weak lending practices for both consumer and home equity loans, high delinquency rates, questionable workout agreements for delinquent loans, and high operating expenses, including high salaries during three joint examinations in 1988 and 1989. With proper funding of the allowance for loan losses and classification of bad loans, NCUA believed the credit union was insolvent. NCUA attributed these problems to poor management. As a condition of providing assistance to the credit union in late 1988, NCUA wanted the manager replaced. The state supervisors disagreed with NCUA's assessment of loan quality and loan losses. In addition, they believed the current manager was capable of resolving the existing problems. NCUA acquiesced and provided a large amount of assistance to the credit union, without requiring a management change. NCUA increased the assistance in mid-1989. In December 1989, however, NCUA required the credit union to replace the manager before NCUA would provide additional assistance. The credit union's financial condition had deteriorated in the interim.

The region's former director told us that several factors "prevented" him from taking action against this credit union's manager. There were many credit union problems in this state, he said, and he felt it was necessary to rank them in order of importance and work with the state supervisor in resolving them. Two other state credit unions were also having serious problems, and he wanted to get the state's support in dealing with them. Plus, in 1987 NCUA had just convinced the state to allow NCUA examiners to participate in the examination of the state-chartered, uninsured corporate credit union in this state, and he did not want to jeopardize the arrangements. In addition, he told us that dealing with the credit union in question was more difficult because

- a close relative of the state supervisor was a board member of the problem credit union,
- other board members were active in credit unions affairs in the state, and
- the state supervisor was a close friend of the credit union manager.

NCUA subsequently assigned a new director to this region, who told us that relations with this state, where a new supervisor was subsequently appointed, have improved. A new letter of agreement was signed in 1990, and additional assistance was given. An NCUA official told us the credit union is making acceptable progress in improving its condition.

NCUA Internal Studies Identified Supervisory Weaknesses and Called for Changes

During the course of our work, NCUA initiated a study of each region's special actions department, which handles problem credit unions, and also peer reviews of the overall examination and supervisory operations of each region. Various improvements are being implemented as a result, and NCUA plans to conduct peer reviews again in 1991.

NCUA's December 1989 study found inconsistencies in the way regional offices were handling problem credit unions. For example, the approved performance standards for the problem credit unions being handled by the special actions department varied, and financial tracking was not evident in each region. The threat or use of enforcement action was not consistent. In response to the findings, NCUA has established a standard financial tracking system for special actions cases, provided additional training for staff, and clarified when enforcement actions are appropriate.

NCUA initiated peer reviews in January 1990 to improve overall regional and agency operations. Teams made up of headquarters and regional staff review all aspects of the examination and supervision of both federal and state credit unions. Weaknesses they found in some regions paralleled those we had identified:

- Enforcement actions were not used despite the deteriorating condition of some credit unions.
- Examiners were not routinely given monitoring tools, such as the CAEL-CAMEL and CURE reports.
- Review and feedback to examiners on their examination reports was not always adequate or timely.

In addition, they found that the existence and content of local policy and procedures manuals varied greatly. One regional office had none; others lacked manuals for key departments, such as special actions. The teams cited two regions for specific problems related to oversight of state credit unions. One region's reviews of state examination reports and general oversight of state credit unions did not, they said, focus adequately on existing problems and corrective actions. Reports on each

region were submitted to the NCUA Board as the reviews were completed throughout 1990. Regions were making changes in response to the recommendations as we completed our study.

NCUA's Inspector General has announced she would follow up on the implementation of the peer review recommendations. We believe she should include in her follow-up a special assessment of enforcement actions taken against problem credit unions since mid-1990, when our fieldwork related to this aspect of supervision was completed.

Conclusions

The supervision of credit unions needs improvement in several key areas.

NCUA's four primary off-site monitoring tools are appropriate and useful in many respects, but there are no specific requirements for their use, and guidance is quite limited. For example, distribution of some of the reports is at the regional directors' discretion. It is unclear, therefore, if examiners responsible for monitoring credit unions receive all the reports and which, if any, state supervisors receive. Neither the Examiner's Guide nor other policy guidance explains the value of each tool, how they interrelate, and how best to use them.

Call reports are the basis for all the off-site monitoring systems. NCUA requires examiners to review them for errors or misrepresentations and to make corrections. It does not require that examiners certify to their regional offices that these reviews have been made in accordance with NCUA policy. Such a verification would signal the importance of the reviews.

The required supervisory committee audit reports could be an additional off-site tool for monitoring credit unions between examinations. They could alert NCUA to problems and the need to schedule supervisory visits or examinations and also emphasize to credit union management the importance it places on these reports. NCUA does not, however, require that copies be sent to NCUA upon completion.

NCUA has made considerable examination and supervisory improvements since our 1982 study, notably the development of the standardized core examination and the requirement that all credit unions rated CAMEL 4 sign a written agreement addressing resolution of their problems. However, NCUA was ineffective in compelling 15 of the 39 credit unions we reviewed to resolve their problems within the period of

our review. It used only informal actions against these credit unions, despite the fact that the same problems persisted at many, and some violated the agreements. It also acquiesced to the wishes of two state supervisors rather than take stronger action on a timely basis. Formal enforcement action was never taken against the 15 problem credit unions. Although these findings cannot be projected to NCUA's handling of all problem credit unions, our sample represented a significant portion of the assets in problem credit unions as of the June 30, 1989, selection date.

NCUA has, however, taken several actions since we began our review that, if properly implemented, will strengthen their supervisory efforts and address many of our concerns in this area. It set national requirements for review of examinations and for oversight of problem credit unions. It conducted peer reviews of all regional offices and also of their special units that work with the most seriously troubled credit unions. And top-level personnel changes were made in the regions. We also noted that officials were responsive to concerns we expressed as we did our work, and NCUA has begun to use its enforcement powers more frequently. Also, the NCUA Inspector General plans to review steps being taken to implement peer review report recommendations.

Recommendations to NCUA

- NCUA should clarify the purposes, unique values, and requirements for use of each of its off-site monitoring tools. It should determine the appropriate recipients of the tools and distribute them accordingly, within each region.
- NCUA should require documentation at the regional office level of examiners' reviews of all credit union call reports.
- NCUA should invoke its statutory authority to refuse to accept state supervisors' examinations when a state regulatory authority lacks adequate independence from the credit union industry. NCUA should examine all NCUSIF-insured credit unions in such states.
- NCUA should establish a policy goal for examination frequency of state credit unions.
- NCUA should require all credit unions to submit copies of their supervisory committee audit reports to NCUA upon completion.
- The NCUA Inspector General should conduct a review focusing on NCUA's handling of problem credit unions since mid-1990, specifically its use of enforcement powers, and submit a report to the NCUA Board.

Agency Comments and Our Response

NCUA agreed with most of the 7 recommendations related to off-site monitoring and examination in this chapter. (See app. XII.) NCUA disagreed with our recommendation that it should examine all credit unions in those states where the state regulatory authority lacks adequate independence. While NCUA acknowledged that additional scrutiny was indicated in these cases, it believed it should use its discretion whether to examine each credit union. The criteria for deciding whether to examine would depend on the financial data reported by each credit union as well as on NCUA's confidence in the particular state supervisor. We believe the risks to NCUSIF are unacceptable when NCUA relies on examination reports from state supervisors who lack independence and that NCUA should examine all the state-chartered credit unions in such states. As we also note in the report, we identified instances when NCUA acquiesced to the preferences of a state supervisor who lacked independence. (See pp. 110 to 112.) In addition, conducting on-site examinations would ensure that the financial data being provided were reliable.

NCUA disagreed with one other recommendation—that credit unions submit audit reports when completed. It said the cost, labor, and paperwork associated with having each credit union submit them when completed would be excessive compared to the benefits. We believe the benefits would outweigh any inconvenience. The reports would serve as an additional monitoring tool between examinations, and could be especially useful in monitoring state credit unions NCUA does not examine.

Highlights

Background

- Annual credit union failures have increased since 1987—from 105 to 206 in 1990.
- Outstanding assistance to problem credit unions increased from about $49 million in 1987 to $191 million in mid-1990.

Key Findings

- In May 1989, NCUA established policy goals for resolution of credit unions in weak and poor condition and is making progress in meeting the goals.
- Assistance to problem credit unions is concentrated among larger credit unions. NCUA's own criteria for granting assistance to an open credit union had not always been met in the sample of assisted credit unions we reviewed.
- Decisions on resolution methods were not adequately documented in a sample of failed credit unions we reviewed. We could not determine if NCUA had selected the least costly method.
- Legislative guidance as to the role of cost considerations in resolution decisionmaking is lacking.
- We did not find evidence that NCUA regional directors were abusing their authority to grant forbearances from reserving and other regulatory requirements in our sampled credit unions. However, there is no assurance of consistency in forbearance decisions among the regions.

Key Recommendations

- Provide assistance in resolving a failing credit union only when it is less costly than liquidation or essential to provide adequate depository services in the community.
- Follow criteria for providing assistance to open credit unions.
- Maintain appropriate supporting documentation for resolution decisions.
- Establish more stringent approval authority, policy guidance, and internal controls for the use of forbearances.

NCUA's Management of Failures

NCUA, as administrator of the federal share insurance system for credit unions, has responsibility for resolving credit unions that fail. Prompt and cost-effective resolution of failing credit unions is essential in minimizing insurance fund losses. Our past work on the thrift industry has shown that the Federal Home Loan Bank Board's delay in closing insolvent thrifts increased the cost of failures and ultimately bankrupted the Federal Savings and Loan Insurance Corporation Fund.[1]

In May 1989, NCUA established time frames during which poorly rated credit unions were to either improve and be given a better rating or be closed and resolved. We believe these policies were needed and are appropriate, and NCUA has, for the most part, been meeting these time frames. We did find, however, that the credit unions allowed to operate longer in weak condition tended to be the larger ones and that many of these were receiving NCUSIF assistance. It is disturbing that in our case studies we found that NCUA was providing assistance to credit unions when its own preconditions for doing so had not been met. Also, while NCUSIF costs as a percentage of the assets of closed credit unions had fallen in recent years and were less than the loss ratio for failed banks, they nevertheless remained significant—about 12 percent of assets in fiscal year 1990, as of June 30, 1990. Lack of adequate documentation on the failed credit unions in our sample prevented us from determining if the least costly resolution method had been selected.

The recommendations we are making in chapter 8 with respect to a more structured and predictable intervention approach (see ch. 8), together with the recommendations in this chapter regarding legislative guidance on resolution considerations and documentation, should help ensure that weak and insolvent credit unions are not permitted to stay open unless the NCUSIF criteria for open assistance have first been met and that when the credit unions are closed, the least costly method is used.

NCUA usually purchased troubled assets from credit unions at book value, thereby assuming responsibility for managing and liquidating these assets. We assessed these efforts and raised a number of concerns with NCUA about its management of the assets. NCUA restructured its asset disposition activities in the spring of 1990. Although we could not

[1]Thrift Industry: Cost to FSLIC of Delaying Action on Insolvent Savings Institutions (GAO/GGD-86-122BR, Sept. 1986); and Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47, Feb. 1989).

evaluate the effect of the changes, they appeared to address our concerns and, if properly implemented, should improve those operations. We summarize these matters in appendix IX.

Background

The credit union failure rate was high during the early 1980s, dropped sharply in the period from 1983 through 1985, and increased again in 1989 and 1990, as shown in table 5.1.[2]

Table 5.1: Credit Union Failures, FY 1981 Through FY 1990

Year[a]	Receiving 208 assistance[b]	Resolved through merger, liquidation, or purchase & assumption[c]	Total
1981	114	349	**463**
1982	124	327	**451**
1983	113	253	**366**
1984	72	130	**202**
1985	45	94	**139**
1986	30	94	**124**
1987	16	89	**105**
1988	25	91	**116**
1989	44	116	**160**
1990	42	164	**206**

[a]NCUA's fiscal year runs from October 1 to September 30.

[b]Assistance consists of Section 208 cash and/or noncash financial support given to a credit union primarily to solve its financial problems while limiting cost to NCUSIF.

[c]In a merger, a credit union absorbs all of the assets, liabilities, and equity of another credit union. In a purchase and assumption transaction, a healthy credit union purchases all or part of the assets and assumes all or part of the liabilities of the failed credit union. In an involuntary liquidation, a credit union is closed, members' insured shareholdings are paid by NCUSIF, and NCUA pays general creditors, NCUSIF, and uninsured share accounts to the extent permitted by recoveries on the failed credit union's assets. The priority of payouts made to these three parties is discussed in chapter 7.

Source: NCUSIF Annual Reports. Definitions were obtained from NCUA's Examiner's Guide and Chartering and Field of Membership Manual.

[2]The term "failed" credit union, as used in this report, refers to credit unions that were involuntarily liquidated, merged, resolved through a purchase and assumption action, or given financial help under Section 208 of the Federal Credit Union Act in order to continue in business. These four methods are authorized by the act (12 U.S.C. 1751 et seq.) and are described in appendix VII.

Most Problem Credit Unions Are Resolved in a Timely Manner

The need for early identification of problem credit unions and for supervisory actions to correct deficiencies or minimize losses is discussed in chapters 4 and 8. If these efforts are not successful and a credit union is failing, NCUA—as manager of NCUSIF—must act to minimize the impact on the fund. Allowing insolvent institutions with serious problems to remain open creates an incentive for their managers to gamble by investing in higher risk assets, which generate above-average profits if a high return is realized but cause additional losses that subsequently are borne by NCUSIF if the return is not realized. Losses can also build in such institutions when they are left open even if they are placed under good management simply because expenses continue to exceed income. Thus, one way to minimize losses is to resolve them promptly. We found that in the recent past, NCUA has been acting promptly on most of these credit unions.

NCUA's New Time Frame Policies

In May 1989, NCUA issued policies that established time frames within which all credit unions with CAMEL ratings of 4 or 5—defined as problem credit unions—had to be upgraded or resolved.[3] NCUA stated that credit unions rated 4 have conditions that, unless corrected, may threaten their viability; the potential for failure is present but is not pronounced. For those rated 5, the probability of failure is high. The policy states that credit unions rated a CAMEL 4 should be upgraded—improved sufficiently to warrant a better code—or resolved within 12 to 24 months of first receiving the 4 rating. Associations rated a CAMEL 5 are to be resolved within 6 to 12 months of receiving that rating. While these policies apply to all problem credit unions, we found that they are less rigorously applied to the largest associations.

To assess how well NCUA has been meeting its new time frames, we reviewed the status as of June 30, 1990, of those credit unions that had been rated a CAMEL code 4 or 5 as of June 30, 1989. These associations may have received these ratings before June 1989, but since NCUA's policy was not issued until May of that year, we started our analysis as of June 30, 1989.

Of the 83 credit unions that had a CAMEL 5 rating as of June 30, 1989, a year later, 50 had been closed and resolved and 23 had been given a better CAMEL code. Approximately 88 percent of all CAMEL 5 credit unions had thus improved or been resolved within the 12-month time frame.

[3] The policies were established in a May 1, 1989, memorandum from the Director, Office of Examination and Insurance, to Regional Directors. See chapter 4 for a discussion of the CAMEL rating system.

The remaining 10 credit unions still were rated CAMEL code 5. As of December 31, 1990, NCUA reported that 4 of these 10 had failed and been resolved, 4 had been upgraded, and 2 were still rated 5. Of the two, one was seeking a merger partner and the other was under new management.

Table 5.2: June 1990 Status of the 83 Credit Unions Rated CAMEL 5 as of June 1989

Status	Number	Percent
Resolved through merger, purchase and assumption, or liquidation	50	60
Upgraded to better CAMEL rating[a]	23	28
Received same CAMEL rating	10	12

[a]Of these, eight were receiving special assistance from NCUA.
Source: NCUA, Office of Examination and Insurance.

Of the 670 credit unions that had a CAMEL rating 4 as of June 1989, by June 30, 1990—12 months later—196 had been upgraded and 156 had been closed and resolved. Thus, 52 percent of the credit unions had improved or had been resolved within 12 months. Another 294 of the credit unions rated 4 again received a CAMEL rating of 4, and 24 received a worse CAMEL rating—rating 5. Whether these 318 credit unions will improve or be resolved before the 24-month period ends on June 30, 1991, remains to be seen.

Table 5.3: June 1990 Status of the 670 Credit Unions Rated CAMEL 4 as of June 1989

Status	Number	Percent
Resolved through merger, purchase and assumption, or liquidation	156	23
Upgraded to better CAMEL rating[a]	196	29
Received same CAMEL rating	294	44
Received worse CAMEL rating	24	4

[a]Of these, one was receiving special assistance from NCUA.
Source: NCUA, Office of Examination and Insurance.

Duration of Insolvencies

Another measure of NCUA's promptness in resolution actions is how long credit unions that are insolvent are left open.[4] We found that such associations, in general, are resolved reasonably promptly after insolvency has been reported, but that, again, larger insolvent credit unions remain open longer than smaller ones. These larger associations often

[4]See chapter 2 for a description of how we calculated insolvency, on a GAAP basis.

receive NCUSIF assistance. This fact raises concerns as to whether NCUA is improperly keeping larger associations open.

We analyzed the length of time the 120 credit unions closed between October 1989 and June 1990 had been insolvent. Only 28 of the 120 had reported insolvency as of the end of the reporting period before failure. These 28 had first reported insolvency on their semiannual financial and statistical reports 1 to 17 months before closure, with the average being 5 months.

We also analyzed insolvent credit unions as of June and December 1986 through 1989 and June 1990 to determine how many continued to operate even though insolvent. The data shown in table 5.4 do not demonstrate a significant change in recent years. It must be noted that credit unions, because of their cooperative status, have no capital when newly chartered and, under the present reserving method (see ch. 3), have a number of years to build capital. An average of only about 40 new charters were issued annually in fiscal years 1985 through 1990.

Table 5.4: Number of Repeating Insolvent Credit Unions

	June 1986	Dec. 1986	June 1987	Dec. 1987	June 1988	Dec. 1988	June 1989	Dec. 1989	June 1990
One period	41	30	30	22	31	31	36	43	43
Two periods	N/A	22	20	16	12	16	17	22	14
Three or more periods	N/A	12	24	35	35	43	38	34	30
All insolvencies	78	64	74	73	78	90	91	99	87

Note: Table shows the number of periods at which insolvency was reported, whether or not the periods were sequential.

Source: Analysis of credit union semiannual financial and statistical reports provided by NCUA.

Between 1985 and 1989, over half of insolvents consistently had less than $2 million in assets. As shown in table 5.5, about two-thirds of the total assets in all insolvent credit unions were concentrated in large associations—those with over $50 million in assets.

Table 5.5: Assets in Insolvent Credit Unions

Dollars in millions

Asset size/category	Dec. 1985	Dec. 1986	Dec. 1987	Dec. 1988	Dec. 1989
Less than $.5	$2.3	$3.5	$2.6	$2.3	$3.3
$.5 to $1.99	15.1	11.9	8.7	18.3	16.9
$2 to $9.99	72.7	38.1	66.1	118.1	121.3
$10 to $49.99	316.8	282.0	267.4	272.8	355.2
$50 to $99.99	434.5	293.7	226.7	174.3	265.5
$100 and over	345.0	862.0	570.6	647.6	757.1

Source: Analysis of credit union semiannual financial and statistical reports provided by NCUA.

We sought to determine the characteristics of the 30 credit unions indicated in table 5.4 to be both insolvent as of June 1990 and reporting insolvency for three or more periods. Of the 30, 5 had been insolvent for over 2 years and 3 had reported insolvency for at least 3 nonconsecutive periods. We wanted to know if there were more state or federally chartered credit unions in this group of 30 and found that their number was roughly in proportion to their share of the industry. This proportion also held with respect to all 87 that were insolvent. We also reviewed the data to see if size was associated with length of insolvency. Of the 30, 12—40 percent—had over $10 million in assets. In comparison, approximately 24 percent of all credit unions had over $10 million in assets. Six of 12 had assets of $50 million or more.

We asked NCUA to provide summary data on the CAMEL ratings and status of these 30 insolvent credit unions. Of the 30, 18 had been rated 4 in June 1989 and 24 had been rated 4 in June 1990. The 4 rating means that the potential for failure is present but not pronounced. We found that 24 of the 30, including 11 of the 12 with assets of $10 million or more, were receiving NCUSIF Section 208 assistance. This situation concerned us because provision of Section 208 assistance is considered by NCUA to be a form of resolution and can be provided when a failing credit union meets certain criteria, including good management, expected viability, and the ability to repay cash or amortize assistance. This assistance may also be provided to keep an association open while NCUA is searching for a merger partner.

In summary, we found that 24 of the 30 credit unions reporting insolvency for over a year were receiving NCUSIF assistance. The fact that several were quite large raises the question as to whether NCUA was using assistance to keep larger credit unions open when closure might have been more appropriate. We discuss this issue later in this chapter.

Impact of Charter Type on Problem Resolutions

NCUA can close federal credit unions it charters, but states must close those credit unions that states charter. We wanted to see if the type of charter had an impact on resolution timing, and we looked at the issue several ways. First, we found that 91 percent of federal credit unions rated 5 and 85 percent of state credit unions rated 5 were resolved or improved within NCUA's 12-month time frame policy. (See p. 119.) Of the credit unions rated 4 as of June 30, 1989, 24 percent of those with federal charters and 36 percent of those with state charters had improved in the first 12 months of the 24-month time frame, and 24 and 22 percent, respectively, had been resolved. These results do not provide clear evidence of a significant difference in the rate of resolution of state versus federal credit unions.

Another indicator of the impact of type of charter on the timeliness of resolution is the cost to NCUSIF when credit unions fail. We found that the total cost to NCUSIF of resolving federal and state credit unions (excluding assistance transactions) during the October 1986 through June 1990 period were similar when the number of credit unions with each type of charter and the size of the closed credit unions were taken into consideration. The cost of credit union failures, expressed as a percentage of assets, has fluctuated moderately in recent years, and the data suggest the losses are slightly less for federal than for state chartered credit unions. On average, NCUSIF losses on failed federal credit unions equaled about 19 percent of assets, whereas losses on state credit unions averaged about 16 percent of assets. And, if the costs of resolving Franklin Credit Union, a large federal community development credit union that failed as a result of fraud are excluded, the average loss, expressed as a percent of assets, on federal credit unions over the period was 13 percent. During fiscal year 1987, losses on failed federal credit unions equaled about 18 percent of assets and losses on state credit unions equaled about 23 percent of assets. In both fiscal years 1988 and 1989, losses on both federal and state institutions fell within the 10- to 13-percent range. In fiscal year 1990, as of June 30, losses on failed federal credit unions averaged 11 percent of assets, while losses on state credit unions rose to 16 percent of assets.

Data provided by FDIC show that for the October 1988 through September 1989 period, losses on failed banks (excluding assistance transactions) with less than $50 million in assets were 34 percent of assets. NCUA's recent loss record compares very favorably with that of FDIC.

NCUA officials have asked that the Federal Credit Union Act be amended to permit NCUA, as insurer, to close a state credit union when the state

chartering authority will not close it despite requests from NCUA. Officials said that this type of situation is not a widespread problem but has occurred in certain states. FIRREA gave FDIC, as insurer, such power with respect to state savings associations but not state banks. Implementation of the recommendations in this report, particularly with respect to structured and predictable intervention (see ch. 8), should reduce the need for NCUA to have closure authority. We would not object to legislative change to give NCUA this authority.

Assistance to Open Credit Unions Has Expanded

NCUA has the statutory right to give credit unions cash and other forms of assistance and also to give them forbearances from meeting certain legislative and regulatory requirements. An open credit union that is provided cash or noncash assistance is considered to have failed. NCUA said it considers these two options and the forbearances as forms of "special assistance."

Outstanding cash and noncash assistance to credit unions under Section 208 of the act has risen from $49 million for 16 credit unions as of September 1987 to almost $191 million for 41 credit unions as of June 1990. (See table 5.6.) Additional indirect assistance is provided by NCUSIF guarantees of loans and lines of credit granted by NCUA's Central Liquidity Facility. The amount of these guarantees at June 30, 1990, was about $68 million. Credit unions receiving such CLF credits are not discussed further in this section. We describe CLF operations in chapter 8.

Table 5.6: Section 208 Assistance Outstanding as of September 30, 1987 - September 30, 1989, and June 30, 1990

Dollars in thousands

	1987	1988	1989	(June 30) 1990
Number of credit unions receiving 208 assistance	16	25	44	41
Noncash assistance[a]	$39,564	$41,127	$53,959	$75,987
Cash assistance[b]	$9,242	$46,472	$124,389	$114,987
Total assistance[c]	**$48,806**	**$87,599**	**$178,348**	**$190,974**

[a]Noncash assistance includes a "Prior Undivided Earnings Deficit (PUED) - NCUSIF Guaranteed Account" in which the credit union records all losses that exceed its reserves and undivided earnings.

[b]Cash assistance includes capital notes, loans, cash advances, share deposits, and purchases of assets and bond claims.

[c]The dollar amount represents the net amount of cash and noncash assistance outstanding at the end of the period cited. Actual losses on the assistance fluctuate over the period and reflect recovery on cash advances and purchased assets.

Source: NCUA, Office of Examination and Insurance.

NCUA's Examiner's Guide says that assistance is considered for cases in which normal supervisory efforts and the credit union's resources are insufficient to return it to health within a reasonable length of time. It states that special assistance usually involves a workout plan to solve the financial problems of a federally insured credit union, while limiting the liability and the cost to NCUSIF.[5] The guide also indicates that assistance can be given to keep a credit union operating until a merger or purchase and assumption can be arranged. The guide says that, in any event, examiners should consider assistance only for cases in which (1) the causes of the credit union's problems have been corrected, (2) the resulting institution is viable without the continuing need for assistance, and (3) the management has shown it has the ability to direct and control present and future operations.

In the October 1, 1986, through June 30, 1990, period, 115 credit unions received Section 208 special assistance. Seventy-four of those receiving assistance subsequently recovered or were resolved from fiscal year 1987 through June 30, 1990—40 of these credit unions repaid their assistance, 28 were merged or purchased and assumed, and 6 were liquidated. Data on the remaining 41 credit unions still receiving 208 assistance as of June 30, 1990, are given in table 5.6.

We analyzed the 74 credit unions that had received assistance and subsequently recovered or were closed from fiscal year 1987 through June 1990. The average length of time they received assistance was 32 months for those that recovered and 16 months for those that were closed. The average asset size was about $28 million and about $9 million, respectively. The average worth of the 41 credit unions still receiving assistance as of June 30, 1990, was over $37 million. On average, the 41 had been receiving assistance for 13 months.

The increasing use of assistance and its apparent concentration in larger credit unions, while not necessarily inappropriate, raise questions as to whether NCUA is improperly assisting—rather than closing or merging—larger credit unions. We therefore sought to determine if NCUA's criteria for providing assistance were being met.

[5]NCUA Examiner's Guide, Vol. 2, Sec. 9, pp. 1-4.

NCUA Assists Credit Unions That Do Not Meet the Preconditions

Almost 46 percent of the credit unions that received special assistance and were resolved in the October 1986 through June 1990 period did not recover and were subsequently liquidated, merged, or sold. And those that were still receiving assistance as of June 1990 were relatively large. We found that NCUA had not been following its own criteria for providing assistance in four of the five assistance transactions we examined.

NCUA's policy[6] states that a credit union must meet these three conditions before special assistance will be considered:

- The cause of the condition resulting in the need for assistance has been corrected. For example, if a credit union receives assistance because of delinquent loans, the credit union must show that sound lending policies and procedures have been implemented, that a solid collection program is in place, and that the management responsible for the situation has been replaced or has corrected its practices.
- The credit union's management must have the ability to direct and oversee present and future operations. If managers lack this ability, they should be asked to resign.
- The credit union must have reasonable prospects for sound future operations. For example, the credit union must show its ability to repay the assistance given. It must also show a viable base for future operations, such as a strong or growing field of membership. If assistance is being recommended to maintain operations until a merger or purchase and assumption can be arranged, the amount of assistance must be less costly to NCUSIF than an immediate liquidation.

We examined the decisions to provide Section 208 assistance to five credit unions receiving assistance during fiscal year 1989. These five assisted credit unions accounted for 83 percent of NCUA's special assistance outstanding as of September 30, 1989. (See app. VI for a more detailed discussion of our selection methodology.) All three conditions were met in only one case. This credit union, the smallest of the five, had only about $1 million in assets, and examiners stated that most of its problems had stemmed from weak management. Before assistance was granted, its board of directors had replaced the weak management and resolved most of the credit union's problems. Although still insolvent as of June 30, 1990, it had been repaying the assistance NCUA provided and was the only one that had an outstanding balance of less than the original amount of assistance provided.

[6]NCUA Examiner's Guide, October 1986 and October 1989 editions, Vol. 2, Sec. 9, p. 4.

In the other cases, at least one of the three conditions for receiving assistance had not been met. One of these credit unions was subsequently closed and resolved through a purchase and assumption transaction. NCUA's records of this credit union indicated that the assistance had been provided to maintain normal operations until a suitable merger partner could be found. The three remaining credit unions were insolvent and were still receiving assistance as of June 30, 1990. The causes of the difficulties of one of the three credit unions had not been corrected when assistance was first provided. For the second credit union, the causes had not been remedied and the credit union did not have prospects for sound future operations. The third credit union lacked capable management and did not demonstrate the ability for viable future operations when assistance was first given. The assets of these three credit unions were far larger than the industry average of $14.9 million, ranging from $83 million to $548 million. As of June 30, 1990, their outstanding assistance exceeded the original assistance provided.

Another indication that NCUA may be assisting credit unions when its own criteria have not been met is that, of the 24 credit unions insolvent for over a year and being assisted as of June 1990 (see p. 122), 20 had fair (CAMEL 3) or weak (CAMEL 4) management ratings.

Twenty-eight of 115 credit unions that had received assistance in the fiscal year 1987 through June 1990 period were subsequently closed through merger or purchase and assumption. We asked NCUA for summary information on the original purpose for the assistance. Only 9 of the 24 for which data were provided had explicitly been given assistance as a temporary measure until another resolution method could be arranged. This situation also suggests that the conditions for granting assistance had not been met consistently because one of the conditions for assistance is that the credit union will be viable, i.e., will not fail.

NCUA Has No Legislative Criteria for Resolution Decisionmaking

Deciding whether to assist, merge, sell, or liquidate is important to both credit union members and NCUSIF. If a failing credit union is merged or sold, the members can continue to have credit union services, and those with uninsured shares are fully protected. If a credit union is liquidated, however, the members would not have continuing credit union access unless they were eligible to join another credit union, and those with uninsured funds might not be fully paid off. Use of the four resolution methods in the fiscal year 1987 through June 1990 period is shown in table 5.7.

Table 5.7: Credit Union Failure Resolutions Initiated During the Period From October 1, 1986, Through June 30, 1990

Dollars in millions

	Number	Total assets	Average assets	Total costs	Average costs
Assistance to open institutions[a]	81	$2,632	$32	[b]	[b]
Amortized or repaid	40	1,105	28	[b]	[b]
Currently assisted	41	1,527	37	[b]	[b]
Merged	226	516	2	$63	$.277
Purchase and assumption	63	421	7	54	.862
Liquidated	127	227	2	86	.673
Totals	**497**	**$3,796**			

[a]During this period, assistance was initiated with 115 open credit unions. However, 34 of these institutions were subsequently resolved through merger, purchase and assumption, or liquidation. The count and the total assets of these institutions have been moved into the appropriate category to reflect their final resolution.

[b]Total and average costs are not reflected for assisted credit unions because costs fluctuate over the period as the credit union pays back NCUSIF or NCUA increases the assistance.

Source: Numbers were computed by GAO from NCUA data.

Under the Federal Credit Union Act, NCUA may choose among four methods for dealing with a failing credit union, but the act does not specify what criteria NCUA should use in determining which method to use. NCUA officials said the examiner responsible for supervising a failing federal or state credit union is to recommend a resolution method. The first to be considered is assistance. If the criteria for assistance cannot be met, or 208 assistance will not correct the credit union's difficulties, the examiner will consider other resolution alternatives. The examiner will prepare a cost analysis to determine the least costly resolution method. The Examiner's Guide states that funds provided to facilitate a merger or purchase and assumption transaction should not exceed the estimated cost of liquidation. NCUA does not, however, provide any methodology or guidance to use in estimating the alternative resolution costs.

Officials in NCUA headquarters and regional officials emphasized to us that they select the resolution method for a failing credit union on a

case-by-case basis.[7] In addition, they emphasized that continuing to make credit union service available to credit union members can be a factor in deciding whether to assist a failing credit union. If they conclude that assistance will not resolve the credit union's problems, a potential merger or purchase and assumption partner is sought. Liquidation of a credit union is usually viewed as a last resort. NCUA headquarters officials told us that they usually selected the least costly resolution, although they were not required to do so by law or regulation. The need for continuing member access to credit union services can also affect resolution decisions.

Resolution Decisions Are Not Adequately Documented

We reviewed a judgmentally selected sample of 16 credit unions from the universe of those that failed during fiscal year 1989 (160 in total). Our sample included five resolved by liquidation, three by merger, three by purchase and assumption, and five that were receiving assistance as of September 30, 1989. Of the five credit unions that received assistance, one did not survive and was sold in a purchase and assumption transaction, and four were still receiving assistance as of June 30, 1990. In addition to type of resolution, we took charter status and asset size into consideration in selecting the 16 in our sample.[8]

Our analysis of NCUA records showed that in 15 of the 16 cases, officials considered more than 1 resolution method before making a decision. In addition, the estimated cost of at least 1 alternative method was given in 13 of the 16 cases. The documents also recorded that different officials usually rejected resolution methods for similar reasons—(1) assistance was rejected because it was "too expensive" and/or it would take too long for the credit union's condition to improve; (2) merger proposals were sought but rejected because bids received were "too costly;" and (3) liquidations were rejected because they were "too costly."

[7]NCUA has established delegations of authority for approving resolutions as follows:

- For liquidations, the responsible regional director and the General Counsel must concur. Any outlay in excess of $1 million also requires consultation with the Director of Examination and Insurance.
- For mergers and purchase and assumption transactions, prior to June 20, 1990, the regional director had sole authority. Since then, the concurrence of the Director of Examination and Insurance and the General Counsel is also required.
- For special assistance, the regional director may approve assistance of up to $200,000; the Director of Examination and Insurance must concur if the amount is over $200,000 but less than $2 million. The NCUA Board must approve assistance of over $2 million. Regional directors may approve forbearances from certain laws and regulations. (See p. 5-26.)

[8]Our selection methodology is discussed in appendix VI.

While NCUA documents on the 16 cases stated that alternative resolution methods were rejected because they were too costly, the files contained supporting documentation for only 3 of the 16 cases. For these three cases, the estimated cost of the selected resolution method was less than the estimated cost of the alternatives. The comparisons, however, were not made on a present-value basis, a standard analytical technique for comparing costs when the expense and income streams of alternatives differ. For the remaining 13 credit unions, we could not assess NCUA's determination—that it had selected the least costly resolution method—because there was no supporting documentation.

FIRREA set out documentation requirements for the Resolution Trust Corporation (RTC), which is responsible for resolving savings associations formerly insured by the Federal Savings and Loan Insurance Corporation (FSLIC) and placed in receivership or conservatorship between January 1, 1989, and August 8, 1992. For its resolution, RTC is to make available documents that compare the estimated cost of the transaction with the estimated cost of liquidation and that describe any economic or statistical assumptions on which the estimates were based. (12 U.S.C. 1441a (k)(2)) (U.S. Code Service 1990 Supplement.) NCUA should also be required to maintain such documentation in order to provide evidence of its decisionmaking process.

Continuing Access to Credit Union Services

The Federal Deposit Insurance Act, which applies to all FDIC-insured institutions and to those to be resolved by RTC, states that FDIC may not provide assistance to an institution in an amount in excess of the cost to liquidate except in those instances in which "the continued operation of such insured depository institution is essential to provide adequate depository services in its community." (12 U.S.C. 13(c)(4)(A)) This assistance may be provided to the institution itself on an open basis or to another institution qualified to merge with or acquire portions of the failing institution. No such legislative guidance applies to NCUA.

The Federal Credit Union Act authorizes NCUA to merge a failing credit union with any other insured credit union. (12 U.S.C. 1785(h)) If NCUA cannot effect such a merger, it may authorize an FDIC-insured bank or thrift to assume a credit union's liabilities in a transaction that essentially liquidates the credit union and transfers its deposits to the acquiring institution. (12 U.S.C. 1785(i)) Thus, while NCUA officials told us they select the least costly resolution method, they also acknowledged that preserving member access to credit union services factored

into their decision, which could result in a resolution that is more costly to the insurance fund.

For 4 of the 11 credit unions in our sample that were resolved through special assistance, merger, or purchase and assumption, documents show that providing continuing access to credit union services was a factor in avoiding the liquidation alternative. In all cases, however, the chosen resolution method was, according to NCUA, the least costly. Unlike liquidation, all the chosen methods continued member access to credit union services.

We question whether providing continuing member access to credit union services, if it results in a greater resolution cost to NCUSIF, is appropriate for an insurer. We do recognize a legitimate need for depository institution services, however, and believe the Federal Deposit Insurance Act language essentially provides for this and should also be applied to NCUA.

NCUA Has the Power to Grant Various Forbearances

The Federal Credit Union Act gives NCUA the authority to decrease the regular reserve requirement when NCUA believes a decrease is "necessary or desirable."[9] (12 U.S.C. 1762) NCUA regulations implement this authority and also authorize NCUA to approve charges other than loan losses to a credit union's regular reserves. (12 C.F.R. 702.2) The act allows NCUA to require that state credit unions maintain special reserves under specified circumstances. (12 U.S.C. 1781) NCUA guidance states that a waiver of any reserves constitutes special assistance. Section 208 of the Federal Credit Union Act (12 U.S.C. 1788) authorizes NCUA to establish a special account in failed credit unions—the Prior Undivided Earnings Deficit (PUED) - NCUSIF Guaranteed Account. In this account, the credit union records all losses up to a specified amount that exceeds reserves and undivided earnings.

These provisions allow credit unions to pay dividends when they otherwise would not be allowed, because the act states that dividends may be paid after provisions for required reserves have been met. Because credit unions consider member deposits as equity or shares in the institution, the yield on savings is referred to as the dividend. The yield on funds deposited in a bank or savings and loan, in contrast, is an unconditional obligation to pay interest. The rate and amount of interest to be

[9] See chapter 3 for a discussion of the reserving requirements.

paid are insured, within the $100,000 limitation per account, as long as the institution is open.

Most credit unions that receive other types of assistance also receive waivers as a part of a workout plan. Of the five credit unions in our sample that received other types of special assistance, all received waivers of reserve requirements. Waivers and special charges to reserves can also be granted to a credit union as the sole form of special assistance. NCUA does not compile a listing of those credit unions that are receiving waivers or special charges in addition to cash or noncash assistance. As of June 30, 1990, 41 credit unions were receiving cash or noncash assistance; credit union officials told us most of these were also allowed special waivers or charges to reserves.

By decreasing the reserve requirements and guaranteeing the PUED account, NCUSIF permits weak credit unions to pay dividends on shares in full or in higher amounts than would otherwise be permitted. This practice removes an element of potential discipline from credit union operations and increases risks to NCUSIF. These waivers and special charges are generally authorized for credit unions receiving other types of assistance but may be given alone. Chapter 3 discusses a related issue about the need for credit unions to disclose that dividends are dependent on earnings.

As a sole method of assistance, NCUA granted 70 credit unions waivers and special charges amounting to over $12 million between January 1987 and September 1990. NCUA's power to grant waivers and special charges has probably added stability to the industry. When wisely administered, waivers may well have saved insurance costs by preventing failures of certain troubled credit unions. On the other hand, this power could be seriously abused. A waiver could have the effect of delaying and exacerbating insurance losses.

We did not find evidence that NCUA was abusing the waiver powers. Troubled credit unions generally have not been warehoused for long periods of time, and the number of waivers granted credit unions not needing other assistance has not been significant (70 over a 3-1/2 year period). Moreover, of the 70 credit unions granted waivers, 36 have recovered and 14 were still open as of September 30, 1990, and may recover. About $7.7 million of $12 million guaranteed over this period has been repaid.

Nevertheless, to emphasize the importance of the decision to grant waivers and special charges, ensure that such decisions are consistent throughout NCUA, and set in place a structure to oversee their use, the authority to grant waivers and special charges should require the approval of NCUA's Director of the Office of Examination and Insurance and the General Counsel. At the time of this report, the NCUA regional directors could approve waivers and special charges.

NCUA Is Addressing Weaknesses in Asset Disposition Efforts

NCUA acquires and liquidates assets obtained from failing and failed credit unions. Assets of a failed credit union are acquired when the credit union is closed and the insured depositors are paid. From October 1986 through June 1990, NCUA acquired loans valued at $129 million from 115 closed credit unions. When a failed credit union is resolved through a purchase and assumption transaction, only certain assets, typically nonperforming loans and real estate owned, are acquired by NCUSIF. NCUA also obtains assets from credit unions under its Section 208 assistance program; and as of June 30, 1990, it was managing 45 assets purchased for $40 million from 5 open credit unions.

Since the mid-1980s, the composition of assets acquired by NCUA has been changing as real estate-based lending has increased. Disposal of real estate assets is more difficult, and, because real estate values are not measurable with the same degree of precision or frequency as, for example, investment securities, fraudulent or abusive transactions using manipulated appraisals are relatively easier to undertake and more difficult to detect. Difficulties with real estate lending have been highlighted in the aftermath of the thrift crisis. We identified such problems in some of our sample cases. These problems make it increasingly important that NCUA focus on the management of asset disposition efforts.

At the time of our initial work on NCUA asset disposition, NCUA had three separate asset disposition entities, which reported to two different regional directors. We found and informed NCUA officials that the purposes of these entities were not differentiated, that the three entities inconsistently and incompletely implemented NCUA policy, and that improvements were needed in internal controls. NCUA has taken steps that, if properly implemented, should address these concerns. These matters are discussed in appendix IX.

Conclusions

Overall, NCUA appears to be generally acting promptly with respect to failing credit unions. However, the following facts raise some doubts:

(1) assistance has been increasing; (2) the average size of assisted credit unions is larger than the average sizes of other failed and of all credit unions; (3) NCUA's own criteria had not been met before assistance was given to 4 out of the 5 credit unions in our sample; (4) 20 of the repeatedly insolvent credit unions receiving assistance as of June 30, 1991, had fair or weak management ratings; and (5) a number of credit unions assisted in expectation of recovery in the October 1986 through June 1990 period subsequently were closed. Legislative guidance as to resolution decisionmaking and documentation and our recommendations for a more structured and predictable intervention approach should help ensure that appropriate closure decisions are made (see ch. 8).

Recommendations to Congress

We recommend that Congress

- amend the Federal Credit Union Act to authorize NCUA to provide assistance in resolving a failing credit union only when it is less costly than liquidation or essential to provide adequate depository services in the community, and
- require NCUA to maintain documentation supporting its resolution decisions, including the statistical and economic assumptions made.

Recommendations to NCUA

We recommend that NCUA

- require that waivers and special charges be authorized by the Director, Office of Examination and Insurance; the General Counsel; and the regional director;
- develop policy guidance concerning the use of these provisions and monitor their use; and
- adhere to the criteria for assisting credit unions.

Agency Comments and Our Response

NCUA did not disagree with any of our recommendations on failure management and indicated that its present policies address or will address the concerns we raise. (See app. XII.) For example, NCUA said its policy and practices on providing assistance in resolving a failing credit union coincides with our recommendation that such assistance should be less costly than liquidation or essential to provide adequate depository services.

We commend NCUA for the changes it made as we raised concerns during the course of our work. We have not evaluated these changes, but they

Highlights

Background

Forty-four corporate credit unions and, through corporates, U.S. Central Credit Union, serve most credit unions by

- accepting [illegible] for short-term investment. A significant portion (more than [illegible]) of [illegible] deposits, most of these funds [illegible] U.S. Central, which reinvests them outside the [illegible];
- lending to [illegible] purposes; and
- providing [illegible] services such as the processing of share drafts.

Key Findings

- NCUA has [illegible] the supervision of U.S. Central and those corporates that are [illegible] federally insured.
- Regulations specifically tailored to corporates are insufficient, but NCUA has proposed new regulations.
- Corporates generally have low capital but represent a high concentration of industry assets.
- Corporates are perceived as too important to be allowed to fail.
- [illegible] for corporates are not sufficiently detailed, and corporate CAMEL ratings are too often based on judgments rather than quantitative measures.

Key Recommendations

- Restrict any credit union and corporate credit union investments in other credit unions to those institutions that are federally insured.
- Increase the capital of corporates and set maximum limits on corporates' and U.S. Central's single loans or investments, on the basis of their respective total assets.
- Obtain more complete information on corporates for use in assigning ratings for most CAMEL components.

appear to address some of our concerns. Our recommendations for statutory guidance regarding failure resolution decisions and documentation are intended to ensure that such policies are in place and not subject to change without congressional authorization.

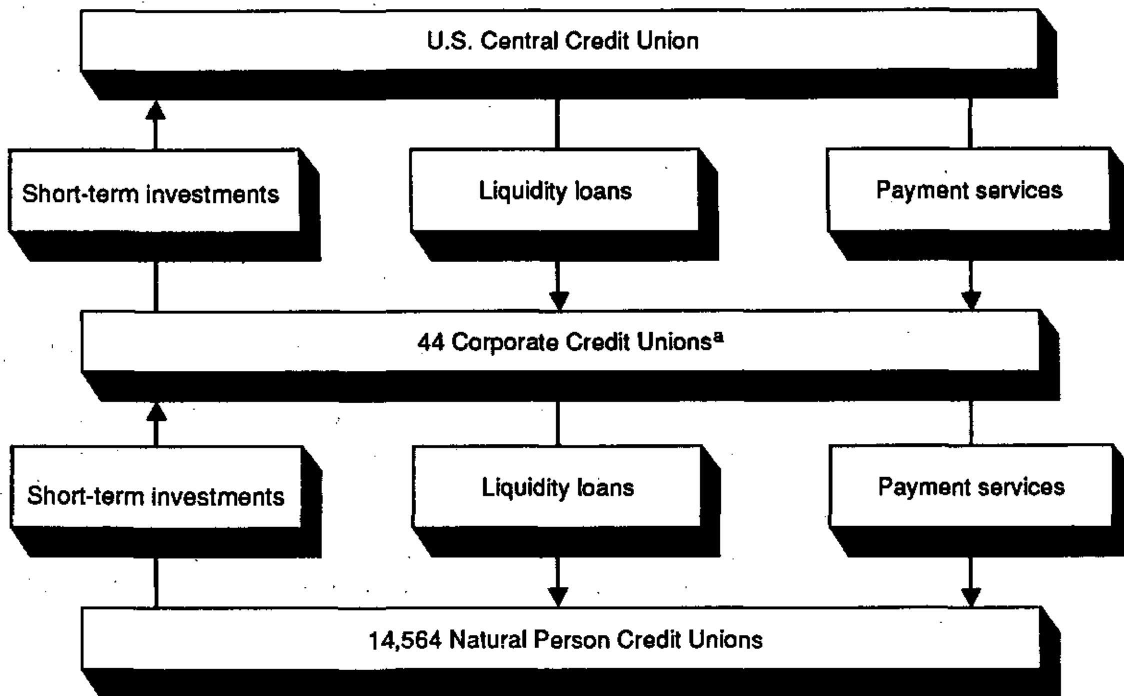
Corporate Credit Unions and U.S. Central

Forty-four corporate[1] credit unions provide important financial services to thousands of natural person credit unions and are cooperatively owned by their member credit unions. As of June 30, 1990, federally insured natural person credit unions had $20.4 billion, which equalled about 10 percent of these credit unions' total assets, invested in their respective corporates. Most corporates' assets are invested in U.S. Central Credit Union, which also provides other financial services to its 42 corporate credit union members/owners.[2] Figure 6.1 illustrates the links among these entities. (See fig. 1.1 in ch. 1 for a diagram of the structure of the credit union industry.)

[1]Use of the word "corporate" in this chapter does not encompass U.S. Central, unless explicitly stated. Forty-three of the 44 corporates report to NCUA. NCUA does not obtain data on one corporate—Central Credit Union Fund, Inc. (Massachusetts)—which is state chartered, not federally insured, and not a member of U.S. Central Credit Union. Because this entity does not provide reports on its condition and income to NCUA, quantitative data on it are not included in any of the tables in this chapter or related narrative.

[2]In addition to Central Credit Union Fund, Inc., one other corporate—League of IBM Credit Unions (LICU)—is not a member of U.S. Central.

Figure 6.1: Services Provided to Natural Person Credit Unions by U.S. Central Credit Union and Corporate Credit Unions



[a]Forty-two corporates are members of U.S. Central Credit Union.

Source: Corporate Credit Union Network, U.S. Central Credit Union, Overland Park, Kansas: January 1989, p. 8.

NCUA has incomplete regulatory and supervisory power over some of these institutions because of their charter and share insurance status. Nevertheless, NCUA encourages credit unions to place unloaned funds in corporates—11,458 of the 13,102 federally insured credit unions reported such investments as of June 30, 1990. It is probable that the great majority of these credit unions rely on NCUA's encouragement in making these investments.

Because of (1) the high concentration of credit union assets in their respective corporates, (2) the low GAAP net worth of the corporate network in relation to its assets, and (3) the fact that more than 90 percent of the aggregate credit union deposits in corporates are not federally insured, the safety and soundness of the entire industry clearly requires that special attention be paid to the safe and sound operation of the corporates and U.S. Central.

There is a general perception that NCUA would guarantee the financial responsibility of corporate credit unions because NCUA officials have indicated that they would not permit a corporate to fail, regardless of its charter or insurance status. This position is understandable in light of the large investments in corporates by federally insured natural person credit unions—about 10 percent of their assets were invested in corporates as of June 30, 1990. However, we believe it is not in the public interest that NCUA should be perceived as guaranteeing corporate credit unions' financial responsibility. These institutions should be maintained in a safe condition on a stand-alone basis, without relying on the capital of their credit union owners or to NCUA.

Changes are needed to augment NCUA's currently incomplete regulatory and supervisory authority over all corporates and provide for more carefully defined asset and liability powers and higher capital requirements. We also found that NCUA has not always used the supervisory authority it does have in the most effective way.

In this chapter we first discuss corporates' current structure, their various roles, and their financial condition. We then analyze NCUA's policies and procedures regulating and supervising corporates and issues related to their insurance.

Structure of Corporate Credit Unions

The main financial operations of the credit union industry are organized in three closely connected levels. (See ch. 1.) The lowest level consists of 14,564 natural person federally and privately insured credit unions, which serve the financial needs of more than 55 million individual members. On the second level are 44 corporate credit unions, which provide major financial services to member credit unions. In general, each corporate has a field of membership limited by geography and, in most cases, primarily limited to those credit unions in a single state. On the top level is U.S. Central Credit Union, which serves 42 of the 44 corporates. Each corporate credit union is cooperatively owned by its member credit unions in proportion to their respective investments in the corporate's total shares. U.S. Central is also cooperatively owned principally by its corporate members. Credit union leagues and organizations may also be in the corporates' fields of membership; the Credit Union National Association (CUNA) is a member of U.S. Central. (See ch. 1 for a full discussion of the industry.)

The industry has a large financial stake in corporates—as of June 30, 1990, $23.3 billion of natural person credit union funds were deposited

for investment purposes in 43 reporting corporates. Federally insured natural person credit unions invested $20.4 billion of this fund which represents 10.4 percent of federally insured credit union assets. As of the same date, 43 of the corporates had $20.3 billion—about 77 percent of their assets—invested in U.S. Central, which represents 58 times their combined $351 million GAAP net worth. Finally, U.S. Central had total assets—primarily in short-term investments—of $23.4 billion supported by its GAAP net worth of $117 million.[3]

Corporate credit unions have a diversity in chartering and share insurance status, as shown in table 6.1. U.S. Central and those 12 corporates that do not have federal share insurance are still subject to a degree of federal oversight because they are members of NCUA's Central Liquidity Facility. (See p. 155.)

Table 6.1: Insurance and Charter Status of Corporate Credit Unions, June 30, 1990

Dollars in millions

	Provider of share insurance/type of charter			
	Federal/ federal	Federal/ state	Cooperative/ state	None/ state
Number of corporates	17	14	4	8
Total assets	**$16,754**	**$4,702**	**$1,108**	**$3,736**

Source: Various NCUA documents and corporate credit union monthly statements provided by NCUA.

Because of the $100,000 limit on share insurance for each member at the 31 federally insured corporates and the lack of any federal insurance for 12 corporates and U.S. Central, most of the deposits in corporates are not federally backed. Only about $1.1 billion of the $23.3 billion in credit union accounts at corporates were federally insured as of June 30, 1990.

There is also a wide range in the size of corporates, as shown in table 6.2. The smaller corporates employ full time staffs of as few as two or three people.

[3]This information came from an unaudited balance sheet, as of June 30, 1990, of U.S. Central Credit Union; Overland Park, Kansas.

Table 6.2: Size Distribution of Corporate Credit Unions as of June 30, 1990

Dollars in millions

Range of total asset size	Number of corporates	Total assets
Less than $100	7	$479
$100 to $500	19	5,257
Over $500	17	20,564
Total	**43**	**$26,300**

Source: Corporate Credit Union Monthly Statements provided by NCUA.

Because a high proportion of corporates' assets—77 percent as of June 30, 1990—are in turn invested in shares and accounts at U.S. Central Credit Union, the safety and soundness of U.S. Central is of paramount importance. U.S. Central is chartered under Kansas law and is not insured.

U.S. Central assets are concentrated in two major categories—federal funds sold (uncollateralized, unsecured loans to other depository institutions) and repurchase agreements (marketable securities purchased under agreements to resell them at a future date). The following policies, published in March 1990, indicated U.S. Central's intention to operate in a safe and sound manner:

- Investments must be confined to government and highly rated private sector debt obligations.
- Sources and uses of investment funds must be matched in amount and maturity.
- Loans to members must be secured. Loans must be approved by a credit committee comprised of U.S. Central members or by duly appointed loan officers and are subject to current financial analysis, required documentation, and the resulting determination of creditworthiness.

Corporates and U.S. Central Have Multiple Roles

The asset and liability structure of corporate credit unions is very different from that of natural person credit unions because of the role corporates play. Corporates provide investment, liquidity, and payment services to member credit unions. These services are comparable to the correspondent services that large commercial banks provide to smaller banks. Corporates accept shares (deposits) from member credit unions for investment. They also lend money to members needing liquidity and provide "wholesale" operating services such as money transfer, share draft (check) processing, and securities safekeeping.

Corporates Today Are Primarily Providing Investment Services

For the past 10 years, natural person credit unions have attracted share deposits from their individual members well in excess of the amounts loaned back out to members. Thus, most credit unions have had substantial amounts of money available for investment and in the recent past, borrowing in the aggregate has been very low. For example, as of June 30, 1990, the 13,102 federally insured natural person credit unions reported about $178 billion in member savings and $124 billion in loans to members. This excess of savings over loans, together with the credit unions' own net worth, financed about $62 billion in credit union investments. About $47 billion had a remaining maturity of less than 1 year. By contrast, these credit unions reported only about $1 billion in borrowings evidenced by notes payable. Of the $62 billion of investments, NCUA reported that about $20.4 billion was deposited for investment purposes in corporates.

This relatively high liquidity of federally insured credit unions was in turn reflected in the condition of corporates, whose members are mainly credit unions. As of June 30, 1990, these corporates reported combined shares of $23.3 billion from their member credit unions and total loans of less than $100 million. Most of the unloaned assets of corporates were passed along in the form of investments in U.S. Central Credit Union.

Changing industry conditions could cause dramatic changes in corporates' activities and financing that would reflect the different functions they were designed to perform. We developed the following hypothetical example, which illustrates how corporates might operate in a different economic environment, as a framework for our discussion of corporates' current condition and our analysis of their regulation and supervision needs.

Corporates Would Change Substantially if the Industry Needed Liquidity

Natural person credit unions could experience a decline in liquidity as a result of increased loans and/or share withdrawals. To meet such needs, they could be expected first to liquidate their investments, including deposits in their respective corporates. The effect on the size of corporates would be intensified because they have been primarily acting as repositories for credit unions' unloaned funds.

For example, if natural person credit union loans grew by about 16 percent, or $20 billion per year, and if shares did not increase, credit unions might finance this activity at first by reducing their $62 billion in investments, including their $20.4 billion of deposits in corporates. After 3 years, both the credit unions' and the corporates' investment assets

would shrink to near zero. (While the corporates would shrink accordingly, the total assets of the member credit unions would not necessarily change—rather, their loan assets would increase as their investment assets decrease.)

Assuming corporates could pay out these withdrawals without experiencing investment losses, they would be greatly reduced in size but remain very sound: their combined GAAP net worth of about $351 million should stay unchanged while assets would decrease by many billions of dollars, resulting in a higher proportion of capital to assets.

If, to continue this hypothetical example, credit union liquidity needs continued to increase, corporates would begin to perform their second major function—providing liquidity to their members. This would require borrowing from outside the industry—from such private sources as banks, brokers, and commercial paper investors, and/or from public sources, such as the Central Liquidity Facility. (See ch. 8.) Just as most of the money sent into corporates goes up to U.S. Central for investment, so it is envisioned that U.S. Central would be the main borrower of outside funds to meet industry liquidity needs. U.S. Central extends lines of credit to corporates for this purpose. These credit lines are subject to semiannual review and reapproval on the basis of U.S. Central's assessment of the corporates' safety and soundness of operations. Similarly, the corporates extend lines of credit to their member credit unions.

In 1989, 10 corporates, including U.S. Central, said they had arrangements in place with the private sector to borrow in the range of $8 billion to $10 billion. U.S. Central was projected to borrow all but about $900 million of this money. These borrowings could support corporate loans to credit unions in like amounts. Whether the corporates could actually borrow this much money, however, would hinge on many factors, including their capital, the perceived quality of their loans to the credit unions, and money market conditions.[4]

The replacement of high quality investment assets with a portfolio of loans to credit unions would increase the riskiness of corporates because the loans could have both lower credit quality and lower liquidity. Thus,

[4]Financial institutions seeking credit from the marketplace are subject to a degree of outside discipline regarding the adequacy of their capitalization. However, this discipline is not fully operative in a normal sense for corporates because all of their members' investments are considered equity. Thus, in the event of bankruptcy or liquidation, general creditors are paid off first.

corporates' balance sheets could change relatively quickly and dramatically if the industry were to go from having excess loanable funds to a shortfall in loanable funds.

Borrowing by Corporates to Fund Member Loans

In chapter 3 we discussed the inappropriate additional risks that can be created if a natural person credit union funds an expansion of its loan portfolio by outside borrowing. In chapter 7 we will describe how increasing the liabilities of a credit union to its general creditors has the effect of increasing the risks to NCUSIF because of the general creditors' preferred position over NCUSIF when a credit union fails and is liquidated.

For natural person credit unions, we have concluded that outside borrowing should not be permitted for the purpose of loan expansion without the prior approval of NCUA. However, for corporate credit unions and for U.S. Central, a similar restriction would defeat one of their principal objectives—to meet the liquidity requirements of member credit unions and, if necessary, fund such requirements by outside borrowing. We therefore believe there should not be restrictions against borrowing by corporate credit unions and U.S. Central for the purpose of expanding loans to their member credit unions. It is possible that a corporate might use borrowed money to make inappropriate risky investments. However, we believe this is an issue best monitored by NCUA.

Financial Condition of Reporting Corporates

During the 1980s, the increase in corporates' assets reflected industry growth and the development of the corporate system.[5] Between December 1978 and December 1987, total assets increased from $1.7 billion to $16.0 billion. However, as shown in table 6.3, their growth between January 1989 and June 1990, accelerated sharply: corporate assets increased by 50 percent, from $17.5 billion to $26.3 billion. This increase was because of industry share growth and the fact that the entire net increase in the total of all credit union investments is reflected in the increase of their investments in corporates.

[5]Assets in federally insured credit unions grew from $51 billion to $165 billion during this period.

Table 6.3: Combined Assets, Liabilities, Shares, and Retained Earnings of 43 Corporate Credit Unions

Dollars in millions

	December 31, 1988	December 31, 1989	June 30, 1990
Assets	$17,481	$21,173	$26,299
Liabilities	2,964	2,763	2,698
Shares	14,245	18,091	23,250
Retained earnings	272	319	351

Source: Corporate credit union monthly statements provided by NCUA.

As shown in table 6.4, corporate assets are still heavily concentrated in investments (93.2 percent), especially in U.S. Central, while loans to member credit unions comprised less than 1 percent of assets.

Table 6.4: Composition of Assets of 43 Reporting Corporate Credit Unions

Dollars in millions

	December 31, 1988		December 31, 1989		June 30, 1990	
	Amount	Percent	Amount	Percent	Amount	Percent
Loans	$577.2	3.3	$190.8	0.9	$96.9	0.4
Investments	14,851.0	85.0	19,246.7	90.9	24,528.5	93.3
Federal agency securities	248.0	1.4	1,215.3	5.7	2,126.6	8.1
Investments at U.S. Central	12,845.3	73.5	16,374.4	77.3	20,317.1	77.3
Other investments[a]	1,757.7	10.1	1,656.9	7.8	2,084.8	7.9
Other assets[b]	2,052.5	11.7	1,735.4	8.2	1,673.8	6.4
Total assets	**$17,480.7**	**100.0**	**$21,172.9**	**100.0**	**$26,298.9**	**100.0**

Note: Numbers may not add due to rounding.

[a]Other investments include U.S. government obligations, deposits at commercial banks, investments with Credit Union Service Organizations, other credit unions' shares, central liquidity facility deposits, capitalization deposits (NCUSIF), other capitalization and insurance funds, and allowances for investment losses.

[b]Other assets include accrued income, land and building, other fixed assets, and other assets (in call report). Other assets is calculated by subtracting loans and assets from total assets.

Source: Corporate Credit Union Monthly Statements provided by NCUA.

Corporate GAAP Capital Is Low and the Special NCUA Regulations for Increasing Corporate Capital Have Been Ineffective

In relation to assets, the GAAP capital of corporate credit unions is lower than that of the natural person credit unions. The $351 million of GAAP capital in the 43 reporting corporates on June 30, 1990, was 1.4 percent of their net assets.[6] This percentage had dropped from 1.7 percent as of December 31, 1989, because assets had grown more rapidly than capital during that period. Natural person credit unions had average GAAP capital to asset ratios of approximately 7.3 percent on June 30, 1990.

There is no minimum capital requirement for corporates; however, NCUA regulations require minimum periodic credits to the corporates' capital accounts. Currently, the rate at which such sums are to be credited depends on the ratio of capital to net assets. The rate is decreased when this ratio reaches 2 percent. Table 6.5 shows that as of June 30, 1990, there were 31 corporates with capital to asset ratios of less than 2 percent, and they held about 86 percent of all corporate assets. The combined capital to asset ratio for all corporates was 1.4 percent. NCUA said this ratio for all federally insured corporates ranged from 1.2 percent to 1.5 percent at the end of years 1985 through 1989. The fact that this ratio has not been reached and has been consistently below the 2-percent level raises a question as to whether the rate of required reserving has been high enough. A review of the history of NCUA's regulation of corporates' reserves shows that this low ratio has been a problem for many years.

Table 6.5: Capital-to-Asset Ratios of Corporate Credit Unions

Institutions' GAAP capital as a percent of assets	Number of corporates and percentage of net corporate assets: December 31, 1989		June 30, 1990	
	Number	Percent	Number	Percent
Less than 1 percent	9	13.9	8	10.2
1 percent to less than 2 percent	16	63.4	23	75.7
2 percent to less than 3 percent	17	22.7	11	14.1
More than 3 percent	1		1	

Note: In accordance with NCUA's regulation, CLF stock subscriptions and reverse repurchase transactions through U.S. Central Credit Union were deleted from total assets before calculating this ratio.

Source: Various NCUA documents.

[6] In considering capital adequacy, NCUA compares GAAP capital to the corporate's net assets. Net assets are total assets minus two special types of assets—stock of the Central Liquidity Facility owned by the corporate and securities purchased from members that have been resold to U.S. Central under reverse repurchase transactions.

Historic Corporate Capital

In 1977, NCUA established a special reserving requirement for corporate credit unions. This special requirement was established, according to NCUA, because the reserving requirements that had been in effect for all insured credit unions had not been successful in building the capital of corporates. Reserving had been based on an NCUA definition of risk assets which, when applied to corporates, resulted in their having virtually no risk assets. Thus, NCUA believed the amounts required to be added to corporate capital were too low to increase the corporates' small capital base. As a result, NCUA set a special reserving requirement for corporates at 2 percent of the corporate's gross earnings that was to be added to the corporate reserve until the reserve equalled 1.5 percent of total assets.

In 1984, NCUA changed this requirement in two ways. It

- required additions to reserves to be based on a percentage of the corporate's average assets rather than on its gross income; and
- required additions to reserves until the reserve and undivided earnings equalled 4 percent of assets, net of certain items.

In commenting on these changes NCUA noted that the reserves to net asset ratio for federally insured corporates had actually declined from 1.1 percent in 1979 to 1.0 percent in 1983. NCUA attributed this lack of progress to the high rate of corporate asset growth during that period. NCUA also observed that "While deregulation offers expanded opportunities it also increases competition and risk to all financial institutions." Because these changes ". . . highlighted the need for all financial institutions to have strong reserves" and because of ". . . the financial record of the corporate credit unions," NCUA said that a level of reserves higher than the previous 1.5 percent was warranted.

It is important to note that the regulation did not and does not actually require corporates to have a 4-percent reserve. However, the regulation does require additions to reserves unless and until the 4-percent level is reached. Therefore, the rate at which additions to the reserve are specified[7] has a significant bearing on how long a corporate takes to reach the 4-percent level. Unfortunately, the current rate, adopted in 1984, has not resulted in significant improvements in corporates' capital ratios.

[7]Since 1984, additions to corporate reserves have been required at two different annualized rates depending upon the level of the corporate's capital. These rates are

- 0.15 percent of average daily assets if the capital ratio is less than 2 percent, and
- 0.1 percent if the capital ratio is from 2 percent to 4 percent.

This is partly because continued corporate asset growth has prevented improvement, just as it had in previous years. As of June 30, 1990, the ratio of the 43 corporates' combined capital (corporate reserve plus undivided earnings) to net assets was 1.4 percent, and the ratio of reserves only to net assets was 1.1 percent.

We acknowledge that the capital ratio of corporates would automatically improve if they shrank significantly. This reduction in size would happen if member credit unions were to liquidate a large amount of their investments in corporates for any reason, such as a need for cash to meet increased loan demand or share withdrawals or simply a decision to invest elsewhere. On the other hand, corporates might continue their growth, which would result in a continuing low capital ratio. Assuming corporates stayed the same size, however, the required rate for additions to reserves is clearly low. For example, if a corporate's capital ratio were 2 percent, at the required 0.1 percent annual addition, it would take about 20 years to reach the 4-percent level.

On March 21, 1991, NCUA issued for comment new regulations for corporates, including new reserving arrangements. A four-tiered system for additions to reserves was proposed. The first three tiers specify the rates of required additions to reserves, based on the relationship of existing reserves to total assets, as follows:

"(a)When the total of the corporate credit union's corporate reserve and undivided earnings is less than 1 percent of net assets, a corporate credit union shall set aside an amount equal to .0020 times the corporate credit union's average daily assets for the transfer period times the number of days in the period divided by 365; then

"(b)The corporate credit union shall set aside an amount equal to .0015 times the corporate credit union's average daily assets for the transfer period times the number of days in the transfer period divided by 365 until the earnings from the reserves and undivided earnings plus fee income are equal to the corporate credit union's operating expenses and required reserve transfers; then

"(c)The corporate credit union shall set aside an amount equal to .0010 times the corporate credit union's average daily assets for the transfer period times the number of days in the period divided by 365 until such time that the corporate credit union's capital shall equal 6 percent of the corporate credit union's net assets."

Regular additions to reserves under these first three tiers of the proposed system will be required until a capital to net asset ratio of 6 percent, rather than the present maximum 4 percent, is reached. However,

the increased annual rate of reserving is not a major improvement. One NCUA official, in fact, told us a 1-percent capital ratio may be adequate. The official said he is not concerned about the low level of capital or the low rate of additions to reserves because corporates are not taking high risks. As an example, he cited their practice of matching the maturities of assets and liabilities. We do not fully agree with this view.

The fourth tier of reserving requirements intends to address corporates' need to break even financially when providing services other than the traditional activities of lending, investment, and cash delivery. Reserving is required, in addition to that provided in the first three tiers, in an amount that equals any operating losses experienced in nontraditional activities. (The requirement does not apply if the service has been offered for less than 2 years.) We believe this is a positive step because it is an attempt to supplement corporates' capital in recognition of the increased risk posed by nontraditional corporate activity. Whether the amount of extra reserving would compensate fully for increased risk is not known. Moreover, we believe it would not relieve NCUA of the responsibility to very carefully monitor any departures by the corporates from their routine services.

In our discussions regarding the capital adequacy of corporates, NCUA's emphasis has been on high asset quality and low interest rate risks, and we have generally agreed with this. However, there is another element of risk that needs to be allowed for—management risk. In GAO's report on the government's risk exposure in government-sponsored enterprises,[8] we defined management (and operations) risk as the potential for losses resulting from the decisions or indecisiveness of a company's managers. Generally, managers can expose their firms to losses through incompetence, inadequate planning, poor internal controls, risky business strategies, fraud and negligence, and other forms of mismanagement. Corporate credit unions, like all enterprises, have such risks, and capital is needed to support them.

There are high concentrations of credit union investments in their corporates, of corporate investments in U.S. Central, and of U.S. Central investments in a small number of private sector debtors. The quality of this investment operation is apparently very high. However, we question whether it is prudent to judge the adequacy of corporate capital using such standards as the risk-based ones now used for traditional

[8]Government-Sponsored Enterprises: The Government's Exposure to Risks (GAO/GGD-90-97, Aug. 15, 1990).

commercial banks. This is especially true when such standards do not allow for management risk and when the safety of the entire industry, not just one or a few entities—however large—is at stake.

In chapter 3 we recommended that a change be made in the maximum amount a credit union can lend to or invest in a single obligor. We said this limit should not apply to loans or investments between corporates and their respective credit union members, or between corporates and U.S. Central. However, we believe the limit—1 percent of total assets—should apply to other loans and investments made by corporates and U.S. Central, and the NCUA Board should not be authorized to make exceptions to this restriction, as it now can under the provisions of 12 USC 1766(a).

It is significant that the proposed regulations authorize a new type of corporate share account. It will be named membership capital share deposit (MCSD) and counted as part of capital. MCSDs are defined as subordinated share accounts that

> "(1) are established, at a minimum as 12-month notice accounts. . .; (2) are limited to members; (3) are not subject to share insurance coverage by the National Credit Union Share Insurance Fund (NCUSIF) or other deposit insurers whose claims are subrogated to the assets of the credit union; and (4) in the event of liquidation, are payable only after satisfaction of all other claims against the liquidation estate, including claims of uninsured shareholders and the NCUSIF."

Because MCSDs are not insured and are subordinated in liquidation to all other claims, they appear to be an acceptable component of the corporate's capital. However, MCSDs should not, in our opinion, be considered as a permanent substitute for a corporate's "core capital" because losses on MCSDs would directly affect the capital of member credit unions that held such investments.

The current rate of required reserving based on average corporate assets is low and the present rate has not resulted in federally insured corporates' meeting the historic 4-percent target capital to net asset ratio. In fact, the ratio, on average, has remained below 2 percent, with no improvements in the past several years. It is not clear whether the proposed rates of reserving will be a sufficient improvement. We do not know what the capital requirement should ultimately be. However, we believe the reserving requirement should cause capital to increase from current levels to the required level in a reasonable period of years. Until such time as a risk-based minimum level is set, a minimum level based

on assets should be established and the rate of reserving should be increased beyond what has been proposed by NCUA. An arrangement such as the proposed membership capital share deposits would be a useful way to augment corporate capital until such time as adequate reserves could be achieved through the traditional process.

NCUA Lacks Complete Authority to Regulate Nonfederally Insured Corporates

A significant portion of credit union assets is invested in corporates, and corporates reinvest most of these funds in U.S. Central. NCUA encourages this practice.[9] We therefore believe it is essential that corporates be regulated and supervised carefully.

NCUA authority to regulate corporate credit unions depends on their charter, insurance status, and membership in the Central Liquidity Facility (CLF). (See p. 153.) Under the Federal Credit Union Act (FCUA), there is no question of NCUA's authority to regulate federally chartered corporates. Under the general rule making authority provided by the act, federally chartered corporates must follow the regulations applicable to all federally chartered credit unions except when NCUA chooses to issue regulations specifically for corporates. Under the share insurance provisions, NCUA is empowered to regulate all federally insured credit unions and therefore corporates. However, the law further says that state reports should be used where possible. NCUA has issued one special regulation applicable to all federally insured corporates—the reserving requirement discussed on page 147.

The act also gives NCUA the authority to prescribe rules and regulations for CLF agent members, which are corporate credit unions. The law provides that agent members must agree "... to comply with rules and regulations the Board shall prescribe ... (and) to submit to the supervision of the Board which shall include, but not be limited to, reporting requirements and periodic unrestricted examinations." However, NCUA has not elected to issue any regulations based on this authority, nor does this authority provide for any enforcement powers.

[9]The Examiner's Guide states:

"It has been, and will continue to be, the policy of the National Credit Union Administration not to take exception to the amount of funds invested by credit unions in corporate credit unions. This is because of:

(1)The downstream diversification of the corporate system,

(2)The existence of Corporate Standards and Guidelines, and

(3)The high degree of supervision given to the corporate system by the NCUA and state regulators."

The 42 U.S. Central corporate members and U.S. Central (the corporate network) have developed a set of standards to regulate corporate activity. Standards & Guidelines is a set of self-regulating procedures related to investments, which has been adopted by all members of the corporate network. There is a Standards and Guidelines Committee, which is an advisory committee to the U.S. Central Board of Directors, made up of five members drawn from corporate credit unions. This committee advises and makes recommendations to the U.S. Central Board concerning the operation and administration of the standards and guidelines.

NCUA has proposed special regulations applicable to all federally insured corporates. These regulations cover a number of areas, including investments, asset-liability management, capital reserving, borrowing, and development of a strategic plan. We encourage NCUA in its effort to develop these special regulations. Our concerns with the present situation are set forth below.

Capital

In principle, we believe it would be desirable for NCUA to establish a minimum capital standard for corporates. Currently, there is no such minimum. Because the nature of a corporate's assets can change so fundamentally from low risk investments to higher risk loans, it would be difficult to justify a fixed minimum standard unless it were risk-based. The difficulty in setting a minimum is increased because the total amount of a corporate's assets can change relatively suddenly—a corporate that has achieved a minimum capital level at a given time could then experience asset growth too rapid for capital growth to match.

Investments and Loans

Because corporate credit unions presently serve their credit union members by accepting and investing a significant portion of their unloaned funds, regulations concerning investments are particularly critical. Federal credit union regulations generally limit investments to deposits in or securities of government entities, federally insured entities, other credit unions, repurchase transactions, and U.S. Central. (See ch. 3.) State laws and regulations governing state-chartered corporates are in some cases

broader.[10] For example, a 1986 study prepared by CUNA said that Connecticut state law permits a corporate to invest in equity securities of banks, their holding companies, certain corporations, and in the stock of public utilities and investment companies within certain limits. In Iowa, a corporate reportedly can invest in venture capital funds or obtain an equity interest in small businesses within the state—limited to 5 percent of its assets.

We have noted that corporates' assets are now primarily invested in U.S. Central. U.S. Central has invested these funds primarily in federal funds[11] in a limited number of leading international banks and in securities purchased from a limited number of dealers under agreements to resell. We are concerned about high and potentially high concentrations of investments that may be made in single obligors other than credit union organizations and the U.S. government. The combination of the relatively low capital of corporates and the large investments they make can result in risk exposures to single obligors that are many times the corporate's GAAP net worth.

We have noted that the balance sheets of U.S. Central and the corporates would change dramatically if they were called upon to perform their liquidity lending function. In chapter 3 we discussed the present limits on loans to one obligor and the need for these limits to be lowered to no more than 1 percent of assets. In the case of corporate credit unions and U.S. Central, such a limit might restrict them from meeting member credit union liquidity needs. Accordingly, it would be appropriate to provide NCUA with the power to authorize a higher lending limit on a loan-by-loan basis.

Relationships With Leagues

There is also risk relating to financial transactions between and among corporates and members that are not credit unions, specifically credit union leagues. The history of corporate credit unions is closely interwoven with the credit union trade associations, known as credit union leagues. (See ch. 1.) Today there are varying degrees of integration of

[10]NCUA does not compile data on the state laws and regulations applicable to state-chartered corporates and neither does the National Association of State Credit Union Supervisors. The most recent comprehensive report of state laws and regulations applicable to all types of credit unions was issued in 1986 by CUNA. The digest said there were no credit union laws at that time in three states and the District of Columbia. Comparative Digest of Credit Union Acts, Credit Union National Association (Madison, Wisconsin: December 1985), p. ii.

[11]Federal funds transactions are uncollateralized, uninsured loans from one depository institution to another.

corporates with their respective leagues. Some corporates include associated leagues in their field of membership, share boards of directors and management, and conduct financial transactions with each other. Other corporates have excluded leagues from their field of membership and therefore have no financial transactions with them. NCUA rules and regulations do not explicitly prohibit overlapping boards, nor do they prohibit financial transactions between these entities.

NCUA has recognized that corporates' relationships with leagues can create difficulties. In 1981, problems developed when corporate credit unions shared the same management with their respective leagues and league service centers. These problems were described in an action memo from NCUA staff to the NCUA Board. We were told by some NCUA regional directors that corporate credit union loans to leagues and their affiliates continued to be an "overriding concern" and that there should be a ban on financial transactions between corporates and leagues and their affiliates. We agree with this position because we believe the resources of a corporate, which are derived from its member credit unions, should not be put at the disposal of a trade association for its own activities.

The NCUA-approved bylaws for corporate federal credit unions, effective March 1983, prohibit any corporate board member from participating in corporate discussions affecting any entity in which he/she has an interest. Since 1985, NCUA guidelines on corporate examinations have required a review of the independence of a corporate's board from a league or other organization. Examiners are to give special attention to agreements and contracts between a corporate and another credit union or league. The revised October 1989 guidelines specify that any adverse effects from such agreements are to be commented on, with notification to the NCUA regional office. Examiners noted problems with the relations between three state-chartered corporates and leagues in the sample of nine corporates we reviewed.

In March 1991, NCUA proposed a new set of regulations for corporate credit unions. One regulation would prohibit corporate board members from participating in discussions affecting any entity in which they have an interest. It would apply to all federally insured corporates. We support the proposed regulation and believe it would be a positive step toward limiting conflicts of interest.

Supervision of Corporate Credit Unions

NCUA is the sole supervisor of corporates with federal charters (17) and has shared supervisory power with state regulators over federally insured state corporates (14). NCUA's only supervisory (but not enforcement) authority over the nonfederally insured corporates and U.S. Central is through their membership in the CLF, which is voluntary. However, according to NCUA officials 43 of the corporates and U.S. Central have agreed to be examined by NCUA, and the corporates have agreed to submit monthly call reports to U.S. Central, which in turn provides them to NCUA.

Over the past few years, NCUA has made efforts to improve the oversight of corporate credit unions. Since 1986, it has trained special examiners for the corporates, updated its guidance to examiners, annually examined 43 of the 44 corporates plus U.S. Central, and developed and implemented a monthly reporting system. The special examiners report to the six regional directors. A small headquarters staff provides some oversight and reviews the examinations.

As discussed below, in the course of our review, we found that NCUA does not have sufficient authority to regulate corporates and that it has not fully utilized the authority it does have. We are also concerned that NCUA delegates responsibility for supervision of the corporates to the regional offices, that it does not assign objectively determined condition ratings to corporates, and that it does not use enforcement actions when needed improvements are not made.

Oversight

As noted, NCUA has been conducting annual on-site examinations of 43 corporates plus U.S. Central. Federally chartered corporates are examined by NCUA corporate examiners; federally insured state-chartered corporates are examined jointly by NCUA and state examiners. Nonfederally insured corporates are subject to CLF reviews, which are also conducted by NCUA corporate and state examiners. For all corporate examinations NCUA uses the same selection of core workpapers[12] and similar processes.[13] (See ch. 4.) NCUA also has asked examiners or experts

[12]Core workpapers are the basic documents used by examiners in their reviews and examinations of corporates. NCUA has designated certain workpapers as mandatory and others as optional and permits examiners to design other workpapers as needed.

[13]The corporate reviews and examinations for federally chartered and state-chartered institutions generally follow the same process. The significant distinctions are that reviews of state-chartered corporates are conducted jointly with the state examiners, the examination report is issued by the state regulatory authority and not NCUA, and any follow-up of administrative actions is done by the state regulator.

from the Office of the Comptroller of the Currency and the Federal Reserve to participate from time to time in the examinations of U.S. Central Credit Union.

Until recently, NCUA has not had reliable and current data that could be used to evaluate corporate condition and performance, despite their key role in the credit union industry. Prior to late 1988, corporates completing condition and income reports used the same form developed for natural person credit unions, which did not capture appropriate data. NCUA officials advised us not to use those submissions because of inaccuracies. A special form—the Corporate Credit Union Monthly Statement (Form 5310)—was developed for corporates and is now completed monthly by 43 of the corporates but not U.S. Central. U.S. Central submits a standard financial statement. Each of the 43 corporates submits a completed form to U.S. Central, which reviews the forms and sends them to NCUA. During the course of our study, NCUA began compiling a monthly report of aggregate statistics on corporates.

These improvements are noteworthy, but we have three continuing concerns with the oversight and supervision of corporates. First, the volatile nature of corporate financial operations, with substantial and frequent inflows and outflows of both investments and member shares, makes possible rapid changes in corporates' risk position that can escape NCUA's immediate attention. For example, a corporate could speculate on money market rates by temporarily investing in large amounts of long-term government bonds. Such transactions might not become apparent to NCUA for an extended period. For this reason, we believe NCUA should arrange for more prompt access to the corporates' financial operations.

Second, we are not satisfied that the financial information reported by corporates is sufficiently detailed to permit an analysis of the safety and soundness of their activities. In the above example, if the corporate invested a 3-year share certificate in 30-year bonds, the substantial interest rate risk would not be identifiable in its monthly financial reports.

Third, we believe responsibility for the oversight and supervision of corporates should not be delegated to regional directors. Corporates are crucially important to the soundness of the industry, their activities require specialized expertise to evaluate, and their number is small enough to permit and favor the central development and application of supervisory policy. However, because the regional directors are familiar

with local conditions, corporates' credit union members, and state leagues, it is assumed that the directors would participate in the supervisory process.

Examination and Enforcement

To test the effectiveness of NCUA supervision, we selected a judgmental sample of nine corporates, including federally chartered, state-chartered and federally insured, and privately and noninsured associations, ranging in asset size from $70 million to about $5 billion as of June 30, 1990. The nine corporates were geographically dispersed throughout the country. We also included U.S. Central in our sample because of its unique position in the industry. We reviewed the two most recent examinations of each corporate available as of November 1989. Nearly all examinations were issued in 1988 and 1989. We reviewed subsequent examinations of each corporate to identify any changes in noted deficiencies.

We found that in some fundamental areas, notably wire transfer arrangements and credit file documentation, corporates did not follow examiner recommendations and did not always correct examiner-identified deficiencies.

Uncorrected Deficiencies Continue

Although our review found numerous uncorrected deficiencies in wire transfer security at corporates, these institutions have not—to date—sustained any known losses in this area. Nonetheless, the deficiencies present the potential for serious problems because fraud in wire transfer can be in very large amounts.

NCUA examiners review the wire transfer policies and practices at corporates as part of the annual corporate examination. The most frequent violations identified by NCUA examiners in the nine corporates we reviewed are described below.

- Inadequate security training or practices was noted at all nine corporates.
- Failure to maintain adequate records of transactions was noted at six corporates.
- Inadequate or nonexistent written procedures governing wire transfer activities were noted at all nine corporates.

While corrective actions were taken at some corporates, we are concerned that at seven of the nine corporates in the sample, examiners identified uncorrected or new deficiencies in these areas.

The NCUA guidance to corporate examiners acknowledges that some corporates have difficulties in meeting the security requirements of the wire transfer security. "Many corporates do not have sufficient personnel to provide for optimal internal controls, but often the controls can be improved dramatically by relatively minor changes in the corporate's procedures."[14] The guide further urges the examiner to (1) ensure that procedures are in place to ensure the corporate performance of daily reconciliations of wire transfer transactions, (2) use the wire transfer questionnaire in the NCUA examination workpapers, and (3) treat areas of material weaknesses with concern.

We have noted that credit unions during the 1980s did not often need to borrow money from their corporates or from other outside sources. Nevertheless, many credit unions established lines of credit at their corporates, and corporates therefore needed to create and maintain credit files. Our review of the examinations of the nine corporates in our sample showed that they were not maintaining complete and timely credit files on the lines of credit (and loans) they extended to their members.

Gathering financial information is a fundamental element of credit administration. Accurate and timely financial data are a prerequisite for prudent lending decisions. NCUA's Examiner's Guide and the relevant examination workpapers require the examiner to ascertain that the corporate is in fact collecting and analyzing financial data for its lines of credit. However, NCUA examiners noted that corporates had not collected complete or current financial data in many cases. Financial statements and audit reports were not obtained or were not fully analyzed. The examinations of some corporates revealed that loans and lines of credit to deteriorating institutions did not appear to be monitored any more closely than problem-free loans. In the worst cases, examiners cited some institutions for not having minimum creditworthiness standards for evaluating potential borrowers or having overly liberal standards.

In every fiscal year 1989 examination we reviewed, the examiner cited a lending practice deficiency; in almost every case the corporate had been cited in the prior exam for the same or a similar deficiency.

[14] "Corporate Examinations," NCUA Examiner's Guide (Washington, D.C., 1989), p. 10.

While the authority to take enforcement actions is limited to corporates that are federally insured, NCUA examiners noted weaknesses but did not take corrective actions even when they had the authority to do so. In fact, from the inception of the corporate examination program in 1986 until 1990, it had not taken any enforcement actions against corporates. NCUA officials told us they have been reluctant to use such tools because of the impact this might have on confidence in corporates. Instead of taking enforcement actions, NCUA officials told us they prefer to intensify the supervisory process. We saw evidence of this at two corporates where examinations were held every 6 months.

The Examiner's Guide reflects NCUA's reluctance to take action against corporates. It says:

"At times, the officials will not agree on recommendations for corrective action to resolve a problem and may refuse to even recognize that a problem exists. The officials should be requested to provide alternative recommendations and/or justification for their position. The examiner must make every effort to ensure that the officials understand that there is a problem. If the officials do not agree with all or part of the recommendations for corrective action, the examiner may consider drafting a letter for the regional director's signature documenting the officials' need to recognize and to resolve the problem area."

The guide does not provide any other advice or guidance to the responsible NCUA examiners.

In 1990, however, NCUA issued two Letters of Understanding and Agreement containing its written expectations for change at those two corporates.

CAMEL Codes Do Not Have Objective Bases

CAMEL ratings assigned to corporates are intended to reflect their financial condition, compliance with regulations, and overall safety and soundness. These ratings—called CAMEL codes—are used to categorize corporates with respect to their capital adequacy, asset quality, management, earnings, liquidity, and overall condition. NCUA officials told us these codes are assigned to a great extent on the basis of the experience, knowledge, and judgment of the examiners. The officials also said management capability is considered in rating the nonmanagement CAMEL components. For natural person credit unions, NCUA assigns ratings, in large part, on the basis of calculations of specific financial ratios. Within strict parameters, an examiner can modify scores on the basis of an analysis of qualitative information. (See ch. 4.) NCUA officials told us the use of financial ratio parameters is not appropriate for corporates

because appropriate ranges for corporates are broader, and corporate assets fluctuate more.

NCUA's practice in rating capital adequacy illustrates the results of this judgment-based approach. Capital was defined as reserves and retained earnings. Assets were defined in accordance with NCUA regulations on reserving. As previously noted, the required rate of adding to corporate capital decreases after a corporate's capital ratio reaches 2 percent. We believe this implies that the 2-percent level is, if not fully adequate, at least a minimal reserve standard and that a ratio lower than 2 percent is therefore less than satisfactory. However, of the 31 corporates with capital ratios of less than 2 percent as of June 1990, 8 were rated 1 (good to excellent) and 11 were rated 2 (adequate to good) in their capital component. These ratings appear to be much more favorable than the regulation implies.

The degree to which judgment has influenced the capital rating is so great that a reasonable relationship between the assigned rating and the actual capital ratio no longer exists. For example, as shown in table 6.6, two corporates with relatively good capital ratios of 2.24 and 2.13 were rated 1 and 3, respectively, and two other corporates with relatively poor ratios of 1.18 and 1.08 were rated 1 and 4, respectively.

Table 6.6: Comparison of NCUA Capital Rating of Corporates[a] To the Range of Capital Ratios in Each Rating Group
(June 30, 1990)

NCUA capital rating	Number of corporates	Range of capital ratios[b]		
		High	Median	Low
1	17	2.24	2.01	1.18
2	12	2.24	1.54	1.04
3	11	2.13	.85	.6
4	2	1.08		.37
Total	**42**			

[a]One corporate is excluded because its activities are not typical of corporate operations.

[b]Capital was defined as reserves and retained earnings. Assets were defined in accordance with NCUA regulations on reserving.

Source: NCUA data.

Assigning CAMEL ratings on a partially judgmental basis, particularly one that seems to inflate the actual condition, has the potential for misleading both the regulator and the corporate itself. This is particularly true if the ratings tend to be biased in a positive direction. We recognize that more judgment may be needed with respect to rating the corporates than is the case with natural person credit unions. We have not studied the situation in sufficient depth to suggest the specific parameters for

assigning the ratings, but we believe the ratings should be consistently applied and reflect the CAMEL component being rated. The absence of quantitative parameters also argues for rating decisions to be made centrally rather than at regional offices where inconsistencies seem more probable.

Insurance Arrangements for Corporates

There is a fundamental difference in the charges paid by credit unions for share insurance and the charges paid by banks and thrifts for deposit insurance. The premium for insurance on a single credit union account is limited to the $100,000 limit of insurance actually provided on that account. By contrast, the premium paid by federally insured banks and thrifts is based on the total balance in each domestic account,[15] regardless of the amount of the balance. For example, this means that given the same insurance coverage and premium rate, the premium paid by a bank or thrift on a single $500,000 account will be five times greater than it is for a credit union, even though only $100,000 of deposit insurance exists for each type of account.

For most natural person credit unions, it would make little difference if premiums were applied to total deposits instead of just to the amount of deposits actually insured. This is because very few credit union members have accounts with balances greater than $100,000, with the result that about 98 percent of the total shares in federally insured credit unions are fully insured. However, for corporate credit unions, we have noted that the preponderance of member investments is in excess of the $100,000 per account limit—all but $1.1 billion of the $18.7 billion deposited in federally insured corporates as of June 30, 1990, was not insured for that reason.

It could be argued that the existing low level of investment or premium revenue to NCUSIF on these corporates does not compensate the Fund for its insurance risks if NCUA believes it is important not to allow a corporate to fail.

We see the following four options for changing the insurance arrangements for corporates; we believe the last one is best:

- Charge premiums on the basis of total shares rather than just insured shares without increasing coverage above the $100,000 limit.

[15]Foreign deposits held by insured U.S. banks are not subject to FDIC insurance assessments.

- Provide insurance on all shares without limit and charge premiums accordingly.
- Withdraw insurance coverage.
- Reduce the risk to NCUSIF by improving its priority compared to that of uninsured shares in the liquidation of a failed institution.

If premiums and the insurance deposit were based on the total shares invested in the corporates, the cash flow to NCUSIF would be increased about 17 times. While this would clearly be better compensation for the risks of the insurance fund, we believe it would also reinforce the message that NCUA cannot permit the corporates to fail and would place a moral obligation on NCUA to this effect.

The alternative of providing insurance coverage in excess of the $100,000 limit would increase NCUA's financial stake in averting the failure of a corporate. We believe this is an undesirable prospect regardless of what premium might be charged because it would represent a severely increased concentration of NCUSIF risk in a small number of institutions.

Termination of insurance coverage for the corporates would reemphasize the need for their safe and sound operation. At the same time, the loss in NCUSIF revenue would have little effect on the Fund's finances. However, there is the question whether this action would destabilize the deposit base of the corporates. This could occur if credit unions had diminished confidence in the safety of these deposits.

The fourth alternative—improving NCUSIF priority in the liquidation of a credit union—would reduce potential taxpayer risk while preserving the benefits of share insurance, particularly to small credit unions having $100,000 or less invested in their corporates. A more complete discussion of the issues involving liquidation priorities is contained in chapter 7.

Conclusions

The statutory borrowing restrictions we have recommended in chapter 3 for natural person credit unions should not apply to corporates and U.S. Central Credit Union.

Corporates hold about 10 percent of the assets of federally insured natural person credit unions and are viewed by NCUA as appropriate investment vehicles for their unloaned funds. Yet, NCUA authority to regulate

and supervise corporates is incomplete, and NCUA does not fully use what authority it does have.

There are a number of ways to address this problem. FCUA could be amended to require that all corporates be federally chartered or at least federally insured. This would give NCUA clear authority to regulate, supervise, and take enforcement action against corporates. However, a requirement for a federal charter could raise states' rights issues. A requirement for federal insurance for corporates would give NCUA sufficient regulatory and supervisory authority. This requirement could be accomplished indirectly by restraining natural person credit unions from investing or depositing funds in corporates that do not have federal insurance. We believe this restraint would be appropriate given NCUA's responsibility for federally insured natural person credit unions.

We believe the capital of corporates should be promptly brought up to a minimum standard established by NCUA. The regulations being developed by NCUA officials regarding additions to corporate capital would not accomplish this objective in a reasonable amount of time, even if corporates were to stop growing. The prospects for solving this problem would be improved if

- a minimum capital level based on assets is established and promptly achieved until a risk-based minimum capital level is implemented;
- the required rate for additions to reserves is increased; and
- NCUA, rather than corporates, oversees the corporates' use of membership capital share deposits, including the prompt issue of these instruments in an amount sufficient for corporates to achieve the minimum capital standard as an interim measure.

We also believe regulations limiting investments of state-chartered corporates to those authorized for federal credit unions and establishing concentration limits are desirable.

Financial reporting by the corporates has been improved, but the volatile nature of their operation justifies faster and more complete access by NCUA in this area.

Our review also shows that NCUA has delegated authority for corporate oversight, examination, and ratings to its regional directors and does not always take effective action to see that noted deficiencies are promptly corrected.

Elements of the CAMEL ratings for corporates appear to be overly affected by judgmental, as opposed to quantitative, criteria. The lack of consistency and the resulting uncertainty as to what the rating actually measures could mislead both the institutions and their regulator(s).

Federal share insurance arrangements for corporates need to be improved because they imply that corporates will not be allowed to fail and because the premiums charged may not compensate for insurance risks. Our recommendations on this issue are contained in chapter 7.

Recommendations to Congress

- FCUA should be amended to confine insured credit union investments in corporates and U.S. Central to those that have obtained deposit insurance from NCUSIF.

  The implementation of this recommendation is critical for accomplishing the needed changes contained in the following recommendations.

- Congress should require NCUA to establish a program to promptly increase the capital of corporates and establish minimum capital standards.

Recommendations to NCUA

- Minimum capital requirements should be established for corporates and U.S. Central, taking all risks into account. In the interim, establish a minimum level based on assets, and set a time frame for achieving this level. This could be achieved by increasing reserving requirements and using subordinated debt arrangements, such as the membership capital share deposits.
- The investment powers of state-chartered corporates should be restricted to the limits imposed on federal corporates.
- Corporate credit union and U.S. Central investments in a single obligor should be limited to 1 percent of the investor's total assets. Exceptions should include obligations of the U.S. government, repurchase agreements that equal up to 2 percent of assets, and all investments by corporates in U.S. Central.
- Corporate credit union and U.S. Central loans to one borrower should be limited to 1 percent of the lender's assets. NCUA should be authorized to make exceptions on a loan-by-loan basis.
- More complete and timely information about corporate financial operations should be obtained.

- A unit should be established at NCUA headquarters that would be responsible for corporate oversight, examination, and enforcement actions.
- The CAMEL rating system for corporate credit unions should be reviewed to reduce the inconsistencies and focus more clearly on the component being rated.

Agency Comments and Our Response

NCUA agreed with a majority of our recommendations related to corporate credit unions. But it had considerable disagreement about the riskiness of corporates and, therefore, what level of improvement is needed. Most significantly, NCUA agreed that actions are needed to ensure that the corporates—and U.S. Central Credit Union—are federally regulated. NCUA also agreed that the corporate's capital should be increased and that minimum capital standards should be established. However, NCUA stated that the risk of corporates is very low and disagreed strongly that there is insufficient diversification in the investment assets of some corporates. Our detailed response to all the NCUA comments is in appendix XII.

Highlights

Key Findings

- The capital that protects taxpayers against losses in the event of credit union failure is less than it may appear to be: Total capital is less than the sum of the industry's GAAP capital and the equity of NCUSIF. This is because the insurance deposit—$1.6 billion as of September 30, 1990—that is counted as part of NCUSIF's equity is not deducted from the capital of the credit unions.
- The standard for adequacy of NCUSIF—1.3 percent of insured shares—does not take into account its liquidity as measured by the amount of NCUSIF assets readily available for future insurance needs.
- NCUA does not have authority to increase insurance premiums.
- NCUA's statutory emergency borrowing authority has not changed, despite industry growth.
- In a liquidation, NCUSIF claims are given equal rank with the claims of uninsured shareholders. If NCUSIF were given a superior ranking, the financial benefits to it would be small in the case of most natural person credit unions; this is because, on average, about 98 percent of the shares of such credit unions are insured. However, NCUSIF would benefit greatly from this improved ranking in the liquidation of a federally insured corporate credit union, because so many of the corporates' shares are in accounts with balances over $100,000. (Only 5 percent of the average corporate's shares are insured.) In the case of the corporates, the current liquidation payment priority creates risks for which NCUSIF is undercompensated.

Key Recommendations

- Require credit unions to expense their 1-percent insurance deposits over a specified number of years.
- Establish an additional required NCUSIF capitalization ratio based on the Fund's liquid assets available for future insurance needs.
- Authorize NCUA to increase insurance premiums.
- Increase NCUA's emergency borrowing authority.
- Change liquidation priorities so that NCUSIF has a claim that is senior to that of uninsured shares.

Share Insurance Issues

This chapter discusses accounting, financing, and liquidation payout issues relating to share insurance and the major improvements we believe should be made. Because these issues are distinct, we are presenting the discussions, conclusions, and recommendations in each section, rather than at the end of the chapter.

The first issue relates to the accounting treatment of credit unions' 1-percent deposit in NCUSIF. Expensing the deposit and funding NCUSIF with premiums would give a clear picture of capital available to the industry, would give NCUA total control of the resources of the Fund, and would constitute a conservative accounting approach.

Improvements in the financing of NCUSIF are discussed next. One involves establishing a financing mechanism to ensure fund liquidity and providing for new emergency financing. (See pp. 174-178.) Finally, a change in payment priorities in the event of an involuntary credit union liquidation is discussed. Presently, NCUSIF and uninsured shareholders are reimbursed on a pro rata basis. This presents too high a risk to NCUSIF, particularly if an insured corporate credit union fails.

Accounting Treatment of Credit Unions' 1-Percent Deposit in NCUSIF

Credit unions recapitalized NCUSIF in January 1985 by depositing 1 percent of their insured shares in the insurance fund. They treat this deposit as an asset on their financial statements, which means that the deposit has not been deducted from the credit unions' capital. NCUSIF treats it as an element of its capital. There are arguments to be made both for and against this accounting arrangement, and we recognize that the Fund is relatively well capitalized at this time.

A clearer picture of capital within the credit union system, however, would result if credit unions removed the deposit from their books over a reasonable time frame and expensed all future deposits made to the Fund. Another important consideration in deciding whether or not the deposit should be expensed is the manner in which the insurance fund should be funded. Expensing the deposit and funding NCUSIF with premiums would give NCUA total control of the resources of the Fund. It might be argued that the deposit should be expensed now, at a time when neither the industry nor NCUSIF is under stress, and when favorable industry capitalization and earnings would make this change relatively easy for most credit unions to afford.

Background

Federal share insurance was first provided to credit unions in 1970, when NCUSIF was established. Insurance premiums were the Fund's primary source of income in its early years, out of which it paid for losses on insured credit unions, for operating expenses, and for building its reserves. The Fund also generated investment income from its reserves. Thus, share insurance was financed the same way as was deposit insurance for banks and thrifts, which had existed since 1934. Similarly, it was intended to be industry financed.

NCUSIF's ratio of equity to insured shares increased from 0 percent in 1970 to .32 percent in 1979, and in 1982 NCUA set a goal of building the equity to 1.00 percent of insured shares. (No target date was set.) Beginning in late 1978, however, credit union losses began to increase. Plant closings and poor investment decisions contributed to these losses. Deregulation of bank and thrift interest rates narrowed credit union advantages in attracting deposits, and inflation and recession impaired credit union performance. In the 1980-1983 period, the Fund experienced significantly lower net income as a result of higher insurance losses. Fund equity during this time increased less rapidly than the volume of insured shares; as a result, the ratio of NCUSIF equity to insured shares declined to .26 percent in 1982. According to the 1984 NCUSIF Annual Report, from which we obtained the historical data in this section, NCUSIF

> ". . . turned to 'noncash' methods to stabilize problems. Contingent liabilities, in the form of asset guarantee contracts and assistance authorized under Section 208 of the Federal Credit Union Act, were used to minimize cash outlays and keep insolvent credit unions operating. These actions, while conserving the Fund's cash reserves, did not solve its problems. Contingent liabilities, however, climbed to a peak of $172 million in 1981, almost equal to the Fund's equity." (See ch. 4.)

NCUA tried to reduce expenses and insurance losses and also exercised its authority to assess a special premium in 1982 and again in 1983. Nevertheless, it was clear the 1-percent goal would not soon be achieved. In 1983 and 1984 NCUA, the industry, and Congress began working on a solution.

NCUSIF Was Changed to a Cash Deposit, Plus an Annual Insurance Premium, System

Congress restructured NCUSIF in the Deficit Reduction Act of 1984, enacted on July 18, 1984. The act provided for (1) a cash deposit in the Fund equal to 1 percent of insured shares, adjusted annually, to remain on deposit with NCUSIF for the period a credit union obtains federal share insurance; and (2) the assessment of premiums, which would be treated

as an operating expense of the credit union, equal to 1/12 of 1 percent of insured shares. The NCUA Board has the option of not assessing the premium if it believes that NCUSIF total capitalization is adequate.

Provision was also made for credit unions to voluntarily withdraw their 1-percent deposit if they elected to withdraw from the federal share insurance system or to voluntarily liquidate. If a credit union is involuntarily liquidated, NCUSIF practice is to remove the deposit from the Fund capitalization account to use, like all other remaining assets of the credit union, in satisfying claims against the credit union. Thus, the cash represented by these deposits is used to satisfy creditors' claims or offset liquidation expenses in the same way as the credit union's other assets.

If the ratio of fund equity to insured shares exceeds the legislatively set normal operating level of 1.3 percent or such lower level as the NCUA board determines to be normal, NCUSIF must distribute to credit unions the excess amount of fund capitalization.

Credit unions maintain an amount equal to 1 percent of their insured shares on deposit with NCUSIF.[1] On their statements of financial condition, credit unions treat this amount as a transfer between cash and an asset account named, for example, "Investment in NCUA Share Insurance Capitalization Fund." On its statement of financial condition, NCUSIF treats the deposit as an element of its fund capitalization in an account named "Accumulated Contributions From Insured Credit Unions." The deposits totalled about $1.6 billion as of September 30, 1990.

NCUSIF does not pay interest on the deposits. It invests them to generate interest income, fund insurance losses, and cover other expenses. The accumulated excess of earnings over losses and expenses, in the account called "Insurance Fund Balance" remains with NCUSIF for investment rather than being paid to credit unions. Since 1984, NCUSIF has waived the payment of annual insurance premiums from credit unions because investment earnings have been sufficient to cover insurance losses and the share of NCUA expenses incurred by the Fund.

As of September 30, 1990, NCUSIF had $1.61 billion in capitalization deposits and $.44 billion in retained earnings. As of June 30, 1990, credit

[1] Each year the amount on deposit with NCUSIF is adjusted to reflect changes in the amount of credit unions' insured shares to ensure that each credit union's 1-percent deposit remains current. If a credit union's insured shares decline, NCUSIF will refund a pro rata portion of the amount on deposit with NCUSIF.

unions' reported GAAP capital was $14.29 billion. Adding the $1.61 billion to the $14.29 billion to determine the total capital available to the industry would be incorrect and misleading because the 1-percent deposit would be counted twice.

Federally insured banks and thrifts have continued to operate exclusively under a premium-based insurance system in which they remit a premium payment of a specified percent of their total domestic deposits annually to the Federal Deposit Insurance Corporation (FDIC) to obtain federal deposit insurance. No cash deposit is made in advance by the insured institutions, though such a change has been considered. Each bank or thrift treats the premium as an operating expense on its statement of operations. Conversely, FDIC treats the premium as income on its statement of operations. If a bank or thrift elects not to continue its federal deposit insurance, its premiums are, unlike the NCUSIF insurance deposit, nonrefundable. If it fails, the premiums paid in are not directly available to pay creditors' claims or to offset liquidation expenses other than those of the insurance fund itself.

Accounting Issues

The accepted industry practice has been that credit unions report the 1-percent deposit in NCUSIF as an asset on their statements of financial condition. This practice has come about because credit unions are required to follow established accounting requirements as set forth in Title II of the Federal Credit Union Act and NCUA accounting rules. NCUA also treats the deposit as if it were a credit union asset when it transfers the cash amount to the account of a credit union in involuntary liquidation to help meet creditor claims and liquidation expenses.

The act, however, does not expressly characterize the deposit as an asset of the credit unions. According to the act, if NCUSIF uses deposit funds to meet its expenses, "the amounts so used shall be expensed and shall be replenished by insured credit unions in accordance with procedures established by the [NCUA] Board." (12 U.S.C. 1782) The statutory language is not clear as to whether the requirement to expense the deposit funds used is directed at NCUSIF or at credit unions. If the expensing requirement is directed at NCUSIF, the accounting treatment by credit unions is therefore unaddressed by the statute, although NCUA may itself require credit unions to expense the 1-percent deposit. However, if the expense requirement is directed at the credit unions, the implication is that it has been carried as an asset on the credit unions' books.

The American Institute of Certified Public Accountants (AICPA) has supported the position that the deposit is an asset of the credit unions, stating that this accounting treatment conforms to GAAP. In a letter to Congresswoman Marcy Kaptur, the chairman of the AICPA Credit Union Committee said that although no specific rule exists in accounting literature that mandates how insurance deposits should be accounted for, the AICPA's position is based on conceptual accounting literature, specifically the Financial Accounting Standards Board's Statement of Financial Accounting Concepts (SFAC) No. 6, Elements of Financial Statements. This statement defines assets as "probable future economic benefits obtained or controlled [by a particular entity] as a result of past transactions or events." In the AICPA's view, the 1-percent insurance deposit meets this conceptual definition because while the credit unions may have little control over the deposits (other than requesting a refund if they voluntarily relinquish federal share insurance), these deposits are considered assets because of the future economic benefits obtained in the form of the foregone expense of an insurance premium. Also, although the amounts deposited with NCUSIF could potentially be lost or impaired, the risk does not invalidate treating deposits as assets since all assets are at similar risk.

American Bankers Association (ABA) officials have voiced an opposing view. They contend that by classifying deposits as assets on credit unions' statements of financial condition, the assets and capital of credit unions are being overstated because credit union insurance deposits are not accounted for in the same manner as insurance premiums that are remitted to other deposit insurance funds, such as FDIC's.

Other Concerns About the Present Treatment

We have two other concerns about the present treatment, in addition to the question as to whether or not accounting treatment allows a credit union to count the deposit as an asset.

First, the current method in effect allows the funds to be counted as capital in two locations—on the credit unions' books and on NCUSIF books. Such accounting blurs a clear understanding of the combined amount of net worth between NCUSIF and the credit unions.

Second, senior NCUA officials told us that when a credit union is involuntarily liquidated, NCUSIF transfers the 1-percent deposit from its capitalization fund to an account representing the estate of the liquidated credit union. From this estate, NCUA as receiver then pays the credit union's general creditors before uninsured shareholders and NCUSIF in the event

of credit union failure. (NCUSIF would be paid as a subrogated account holder for having made whole the insured shareholders.) Thus the 1-percent deposit is used, in effect, to fully reimburse general creditors and then, on a pro rata basis, to partially reimburse the uninsured shareholders and NCUSIF. It is not, therefore, totally available to NCUA to help reimburse NCUSIF for insurance expenses, as would be the case if the Fund were financed by premiums, and is not a clear pledge of assets for the protection of the Fund. We have asked NCUA whether the transfer of the insurance deposit to the estate of the liquidated credit union is consistent with the section of the Federal Credit Union Act that says: "The deposit shall not be returned in the event of liquidation on account of bankruptcy or insolvency." (12 U.S.C. 1782(c)(1)(B)(iii))

NCUA, in supporting the present system, has said:

"The most important reason for treating the one percent deposit as an asset is not accounting, however; the most important reason is that the one percent provides the market discipline needed to produce results. Credit unions have a financial stake in how they perform, how other credit unions perform, and how the NCUSIF performs. It is a clear and compelling method of installing a risk-based system in a financial institution."[2]

While this argument may have merit, it remains subjective. We do not see why an insurance fund, which is intended to be industry financed in either case, would have more effect on management in a premium format than in a deposit one. In either event, we are not sure that peer pressure from other credit unions is a reliable source of discipline on a credit union that is inclined toward risky operations. Nor is there the discipline that would be exerted if insurance premiums increased as riskiness increased. Further, the market discipline that is exerted by those holding deposits in excess of the insurance limit may have little effect on natural person credit unions, since they have very few members with such high deposits. Finally, if NCUSIF losses were to escalate, all credit unions would have to bear the same costs, whether the losses were financed through insurance premiums or insurance deposits.

Prior GAO Positions

We have expressed views on this general issue in two earlier situations. The first occurred in the spring of 1989. An early draft of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) contained a provision that would require credit unions to (1) make

[2]Managing Risk in the Deregulated Age, Director, Office of Examination and Insurance, NCUA, Mar. 1990.

annual insurance payments to a premium-based system and (2) expense their insurance deposits over an 8-year period instead of treating the deposits as an asset. In a letter responding to a request from Congressman Thomas Carper, we agreed that support for treating the 1-percent insurance deposit as an asset can be found in the Financial Accounting Standards Board's Statement of Financial Accounting Concepts, No. 6, "Elements of a Financial Statement." We said, however, that expensing the deposits would provide a more conservative approach for the following reasons:

- The 1-percent deposit is not voluntary and cannot be unilaterally drawn upon as an asset to cover losses.
- In the event of liquidation on account of bankruptcy or insolvency, the deposit is not returned and NCUSIF ultimately determines its use.
- When deposits are treated as assets, they appear to be available as reserves against losses of credit unions when in fact these are permanent deposits with NCUSIF that credit unions have no ability to use.[3]

In a December 7, 1990, letter to the Secretary of the Treasury, we commented on media reports about a plan to require banks to purchase stock from FDIC as a way of bolstering the Bank Insurance Fund. We expressed two concerns. First, banks would have to give up control of the funds used to purchase the stock and therefore would not have those funds available to absorb losses. If the preferred stock were in substance a device to collect insurance assessments to build up the Fund without the banks' recognizing the expense, accounting would not accurately portray the banking industry's condition. We also noted that there would be a serious problem in assigning a value to the stock.[4]

Conclusions

We recognize that, at present, NCUSIF capitalization is high and that there is no expectation that it will diminish significantly in the near term. We also recognize that the industry has been well served by the recapitalization plan. Nevertheless, we believe that conservative accounting policy argues that the deposits in NCUSIF be expensed over a reasonable time frame. This expensing could be provided for in lieu of premiums, assuming NCUSIF equity ratios were met. In the event of a failure, the deposited assets should be available first to the Fund, rather than the failed credit union's estate. Such prioritizing would better reflect the

[3]Letter from Frederick D. Wolf, Assistant Comptroller General, to the Honorable Thomas Carper, dated April 5, 1989.

[4]Letter from the Comptroller General to the Secretary of the Treasury, dated December 7, 1990.

deposits' purpose. The fact that the industry is in reasonably good condition argues for initiating action now, rather than waiting until the Fund and industry are under pressure.

Recommendations to Congress

Congress should require that credit unions expense the 1-percent deposit over a reasonable period of time, to be determined by NCUA. Congress should at the same time emphasize that the assets represented by a failed credit union's insurance deposit should be available first to NCUSIF. This should be coordinated with and consistent with any legislation to recapitalize the Bank Insurance Fund, so as to avoid placing credit unions at a competitive disadvantage.

If Congress does not require that the 1-percent deposit be expensed, NCUA should require credit unions to exclude the amount from both sides of their balance sheet when assessing capital adequacy. This would have the effect of not counting that amount as credit union capital.

Improvements Needed in the Financing of NCUSIF

NCUSIF operations have been satisfactory since the Fund was recapitalized in 1985. Several measures could be adopted, however, to strengthen the financing of the Fund and thereby increase its ability to withstand future stress. These measures involve

- assuring Fund liquidity,
- providing for supplemental financing as needed, and
- reducing the time lag in adjusting the Fund's financing.

Present Situation

NCUSIF annual net income, which declined steadily from $67 million in 1986 to $24 million in 1989, improved in fiscal year 1990 to $35 million. Similarly, annual insurance losses, which increased each year from $38 million in 1986 to $94 million in 1989, declined in fiscal year 1990 to $90 million. NCUSIF has earned substantial income from the investment of the credit unions' 1-percent deposit, and the NCUA Board has waived payment of the insurance premiums each year since the recapitalization. Additions to the Fund's capitalization,[5] resulting from an increase in the insurance deposit and from investment income in excess of insurance losses and other fund expenses, have permitted equity to increase at about the same rate as the growth in insured shares. Equity ranged from

[5]Fund capitalization (fund equity) is the sum of the credit unions' accumulated contributions (their insurance deposit) and the insurance fund balance (retained earnings).

1.23 percent of insured deposits at year-end 1985 to 1.28 percent at year-end 1990. In contrast, fund equity from 1980 to 1984 ranged from 0.26 percent to 0.31 percent of insured deposits, representing a much less safe condition. As of September 30, 1990, fund equity was $2,053 million, 1.25 percent of insured shares. (Our audit of NCUSIF is discussed in ch. 2.)

Recent NCUSIF performance reflects more than just the benefits of the 1985 recapitalization. Compared to banks and thrifts, credit union activities have been more profitable. Credit union lending has focused almost exclusively on consumer loans, primarily car loans, unsecured personal loans, and residential real estate-based loans. Thus, credit unions as a whole have not experienced the heavy losses on commercial or international loans suffered by many banks and thrifts.

Nevertheless, it should be noted that since the recapitalization of NCUSIF, credit unions have operated for the most part in a healthy economy. A severe economic downturn would test the fund, with unpredictable results. Moreover, we believe it is too soon to tell how successful credit unions will be in one rapidly growing activity—real estate-based lending. (Ch. 2 discusses the condition of the industry and risk exposure.)

Present Financing Provisions of NCUSIF

The present financing arrangements are set out in Title II (Share Insurance) of the Federal Credit Union Act. The current provisions of the act and related regulations that would be affected by the improvements we are recommending are described below.

- Each federally insured credit union shall pay to NCUSIF and maintain a deposit equal to 1 percent of its insured deposits. (12 U.S.C. 1782)
- The "normal operating level" for the Fund's equity is defined as 1.3 percent of insured shares or such lower amount as the NCUA Board may determine. The Board is required to distribute back to insured credit unions any amount of fund equity that exceeds the normal operating level. (12 U.S.C. 1782) The Board has defined as normal a range in the ratio between 1.25 percent and 1.3 percent.
- Each insured credit union, at such time as the NCUA Board prescribes, shall pay to NCUSIF a premium charge for insurance equal to 1/12th of 1 percent of insured shares outstanding at the close of the preceding insurance year. (12 U.S.C. 1782)
- The insurance year, which defines the "as of" date for measuring the required NCUSIF equity ratio and any annual premium to be assessed,

ends on June 30. Adjustment of the insurance deposit and the premium payment, if any, is due on the following January 31. (12 C.F.R. 741.9)

Fund Liquidity Should Be Added as a New Criterion for Fund Financing Requirements

The NCUSIF financing procedures set forth in the act take into account only the amount of insured shares and the Fund's equity in relation to insured shares. No account is taken of either the composition of the Fund's assets or its direct and contingent liabilities, both of which nevertheless do represent a possible or probable future call on Fund assets. Failure to recognize such calls could lead to problems if the industry encounters severe stress. A sound insurance fund needs to have an adequate amount of liquid and unencumbered assets available to meet new insurance problems.

In assessing NCUSIF liquidity, we have defined available assets as the sum of cash, cash equivalents, and legally authorized investments (at market value) less direct fund liabilities plus contingent liabilities, including guarantee assistance to credit unions and NCUSIF guarantees, if any, of loans made by the CLF or by other credit unions.[6] A minimum statutory ratio of available assets to total insured deposits should be established, which we call the "available assets ratio." As of September 30, 1990, the available assets ratio of the fund was approximately 1.01 percent, based on available assets at September 30 and insured shares as of June 30, 1990.

If the industry experiences stress, nonliquid assets created through fund assistance to credit unions could increase. Contingent liabilities of the Fund could also increase. (Assistance of all types is discussed in ch. 5.) These changes would not necessarily result in a corresponding decrease in the Fund's equity or equity ratio, although—as the proportion of liquid fund assets declines—they would adversely affect the Fund's ability to meet additional assistance needs.

In order to recognize and take into account such a potential weakening of Fund condition, a minimum available assets ratio could be established. Maintaining such a minimum ratio should override the present requirement that NCUA distribute any funds representing an excess of

[6] The act authorizes the Board to make investments as follows: "The Board may authorize the Secretary of the Treasury to invest and reinvest such portions of the Fund as the Board may determine are not needed for current operations in any interest-bearing securities of the United States or in any securities guaranteed as to both principal and interest by the United States or in bonds or other obligations which are lawful investments for fiduciary, trust, and public funds of the United States, and the income therefrom shall constitute a part of the fund." (12 U.S.C. 1783(c))

the 1.3 percent equity ratio of the Fund. Thus, a shifting or commitment of Fund assets from usable (available) cash and investments into various forms of credit union assistance in a time of industry stress would trigger prompt additional cash payments into NCUSIF by credit unions through premiums. This would increase the probability that NCUSIF would continue to be soundly financed by the industry itself.

A related change in NCUA's powers is also needed. The NCUA Board can now establish a "normal operating level" below the 1.3 percent equity ratio. We do not believe the Board should have this authority. We do believe, however, that the Board should have the power to increase the required level of the equity ratio, as well as the premium rate, in emergency conditions. This flexibility is consistent with new agency powers in managing the other deposit insurance funds.

Additional NCUSIF Emergency Financing

In 1970, when NCUSIF was established, the law provided that NCUA could borrow up to $100 million from the Treasury Department for insurance fund liquidity purposes. In 1979, when CLF was established, CLF was permitted to borrow up to $500 million from the Treasury, if NCUA provided a certification of need, and if Congress appropriated the funds in advance. Because these limits have not been changed since originally specified, their relative importance to the rapidly growing industry has decreased.

Table 7.1 shows a comparison of NCUA's borrowing authority and insured deposits at year-ends 1970, 1980, and 1990. The table indicates that when the borrowing authority is expressed as a percentage of insured deposits, it is relatively much less important now than it was at the time when the two types of borrowing authority were created.

Table 7.1: NCUA Borrowing Authority From U.S Treasury Compared to Shares in Federally Insured Credit Unions in Selected Years

Dollars in billions

Year	Total NCUA borrowing authority[a]	Federally insured shares	Authority as percentage of shares
1970	$0.1[b]	$7.6[d]	1.31%
1980	0.6[c]	51.5[d]	1.17
1990	0.6[c]	180.0[e]	0.33

[a]Borrowings from Treasury by CLF are subject to congressional appropriation in advance. This is not required for borrowings from Treasury by NCUSIF.

[b]Borrowings from U.S. Treasury by NCUSIF only.

[c]Includes NCUSIF borrowing authority for $100 million and CLF borrowing authority for $500 million.

[d]Total shares in federally insured credit unions.

[e]Estimated by NCUA.
Sources: Federal Credit Union Act, Section 203 (d)(1) and Section 306 (b); and NCUA annual reports.

Provisions for adequate emergency resources for NCUSIF need to be put in place. NCUA's authority to borrow $500 million from Treasury on CLF's account is contingent upon appropriations. However, NCUA can borrow up to $100 million for NCUSIF without advance appropriations. In chapter 8, we recommend that CLF be terminated. This would leave NCUA with authority to borrow only $100 million. We believe this may not be a sufficient amount. In replacing CLF's borrowing authority, the requirement for advance congressional appropriation could be applied to all, part, or none of the authorized borrowings. FIRREA authorizes FDIC to borrow $5 billion, subject to the approval of the Secretary of the Treasury on behalf of the bank and savings association insurance funds. As of June 30, 1990, insured deposits in banks and thrifts totalled about $2,741 billion, so the borrowing authority was equal to .18 percent of insured deposits. A proportional authority (.18 percent of the $180 billion in federally insured deposits as of December 31, 1990) would permit NCUSIF to borrow about $324 million.

Time Lag in Fund Financing

Currently, the insurance year ends on June 30, and the latest date for any premium payments and for adjustments to the 1-percent insurance deposit is the following January 31. We believe this 7-month interval is too long. If the future condition of the Fund is such that funds are needed, acceleration of payments to the Fund would be worthwhile. Moreover, in circumstances where credit unions' insured shares are increasing rapidly, an unnecessary lag in adjusting the Fund's finances is clearly undesirable because it delays the recognition of increased risk to the Fund.

NCUA officials told us that the 7-month lag arose because the payment date—January 31—was not changed when the anniversary date of the insurance year was changed in 1986 from December 31 to June 30. They also said that in earlier years many credit unions did not make prompt and accurate premium payments, and the 7-month period was useful in avoiding the need for added payments or refunds because of the large number of adjustments. They told us that tardiness and errors were no longer significant problems and that the payment date could be moved up without creating major administrative difficulties.

In discussing this issue with us, NCUA officials said it would be desirable for administrative efficiency to change the fiscal year of NCUSIF to a calendar-year basis. We agree that this would be a useful change for two reasons:

- Annual results of NCUSIF would compare more conveniently with the annual financial statements of insured credit unions.
- NCUSIF could be compared to the other deposit insurance funds more readily.

Conclusions

Adjustments to financing arrangements for NCUSIF could increase its ability to withstand future stress and lessen the chance that taxpayers would be asked to provide funds to support NCUSIF's insurance commitments. Establishing an available assets ratio for NCUSIF would help assure that it has adequate liquidity. Giving NCUA the power to raise—but not lower—the Fund's equity ratio and to raise premiums would give NCUA more power to make adjustments in Fund equity in advance of anticipated stress. Reducing the period in which credit unions adjust the 1-percent deposit and remit premiums would advance cash flows and more closely relate insurance payments and insured shares. Finally, placing NCUSIF on a calendar fiscal year would improve the quality of its financial statements and facilitate comparison to the other deposit insurance funds.

Recommendations to Congress

Congress should amend the Federal Credit Union Act to

- establish an available assets ratio for NCUSIF;
- authorize NCUA to raise the basic NCUSIF equity ratio, available assets ratio, and premiums and delete its ability to set a normal operating level below the statutory minimum; and

- provide for additional NCUA borrowing from Treasury on behalf of NCUSIF.

Recommendations to NCUA

NCUA should

- reduce the time lag in adjusting the Fund's financing and
- place NCUSIF on a calendar fiscal year.

Liquidation Priorities Continue to Create Problems

Credit unions and corporate credit unions with federal charters are authorized to borrow from any source up to 50 percent of paid-in and unimpaired capital and surplus. (12 U.S.C. 1757(a)) Paid-in and unimpaired capital and surplus is defined as the sum of all shares and share certificates (deposits) and undivided earnings. Therefore, the permissible amount of credit union leveraging by means of debts owed to nonmembers is relatively substantial in terms of the risk it creates for NCUSIF and members. If a credit union fails, outside creditors are currently repaid up to 100 percent before any of the proceeds from liquidation are available to repay NCUSIF for its insurance losses or to redeem any uninsured shares. After general creditors have been repaid in full, NCUSIF and uninsured shareholders share proportionately in the remaining funds.

We believe there are four major problems with this arrangement. First, a credit union will experience little or no market discipline from outside creditors, because the creditors have a very large equity cushion (the members' shares) over and above the credit union's GAAP capital as a protection for their claims. In effect, the total cushion is equal to the total deposits plus the GAAP net worth of the credit union. Second, this highly favorable position for creditors may give credit unions an unfair advantage in competing with other types of consumer finance organizations for outside sources of financing. For example, other organizations may have to pay higher rates when they borrow because their GAAP capital is usually the only protection available to their unsecured creditors. Third, for a credit union whose shares are virtually 100 percent insured, the decrease in risk for creditors is mirrored by a matching risk increase for NCUSIF, which could cause higher NCUSIF costs in liquidation. Fourth, the fact that shareholders are nearly all fully insured removes some of their need to exert any discipline over the operations of their own credit union.

GAO attempted to address this problem in its 1982 report on liquidation priorities by recommending that all three parties—creditors, NCUSIF, and uninsured shareholders—be given equal priority in the event of liquidation.[7] Such a change would have had a favorable effect on the first three of the problems mentioned above.

NCUA responded to our report by issuing an Interpretive Ruling and Policy Statement changing the liquidation priorities as GAO had recommended. However, the ruling was vacated in 1983 by a court order because NCUA had not complied with the Administrative Procedures Act in implementing it.[8] NCUA proposed the new rule a second time, but withdrew the proposal in 1986. NCUA decided that the new regulation was no longer needed, partially because the condition of the insurance fund was so improved by its recapitalization. A major industry argument against the change at that time was that the proposed rule would have simply caused creditors to insist on collateral for any loans to credit unions. A requirement for collateral on all loans would have created added borrowing costs for the credit unions, industry officials said, but it would not have helped NCUSIF because the position of formerly unsecured general creditors would have been changed into that of secured creditors, who would therefore continue to have priority over the insurance fund in a liquidation. While we believe that the industry's argument has merit, the four previously discussed disadvantages of the current priority arrangements would continue unchanged.

Since the original GAO recommendation, there has been a significant growth in corporate credit unions. As previously noted, most of the growth in the federal corporates has been financed by their member credit unions' share investments in excess of the $100,000 insurance limit. We believe this has created a new problem in connection with liquidation priorities: The equal ranking of the claims of NCUSIF with those of uninsured shares puts the insurance fund unnecessarily and unfairly at risk. Uninsured shares create most of the assets and, therefore, most of the risk in corporates. We think it is inappropriate under these circumstances for NCUSIF to have only an equal claim on the assets with uninsured shares if a corporate credit union fails. Instead, NCUSIF should have priority over uninsured shares. We envision that such a change in priority would apply to both corporate and natural person credit unions.

[7] The National Credit Union Administration Should Revise Liquidation Procedures to Reduce the Net Cost of Credit Union Liquidations (GAO/GGD-82-26, Feb. 19, 1982).

[8] CUNA v. NCUA, 573 F. Supp. 586 (D.D.C. 1983).

However, as explained below, the impact of the change would be very different on these two types of credit unions.

Table 7.3 shows a hypothetical comparison of claimant recoveries under three alternative priority arrangements if a typical corporate credit union were to fail. (Table 7.2 outlines the assumptions on which we based the hypothetical scenarios.) The hypothetical corporate is considered typical in that only 5 percent of its shares are insured. The third alternative in the table gives separate priorities as follows: general creditors, NCUSIF, and uninsured shareholders. Such prioritization

- leaves unchanged the preferred, low-risk position of general creditors;
- greatly reduces the risk to NCUSIF, since NCUSIF must be fully reimbursed for all its insurance costs before uninsured shareholders receive any money; and
- increases the risk of member credit unions that hold any uninsured shares and, therefore, have a greater interest in the safe and sound operation of their respective corporates.

Table 7.2: Assumptions Guiding Hypothetical Corporate Credit Union Scenario

Liabilities and shares:		
Unsecured liabilities to general creditors		$15.00
Shares **(5 percent insured)**		
Insured shares	$6.00	
Uninsured shares	114.00	
Total shares		**120.00**
Total liabilities and shares		$135.00
Cash proceeds from liquidation		$100.00

Table 7.3: Failure of a Hypothetical Corporate Credit Union: Distribution of Liquidation Proceeds and Percentage Recoveries Under Three Alternative Liquidation Priority Arrangements

	Recoveries by:		
Alternative liquidation priorities	**General creditors**	**NCUSIF**	**Uninsured shares**
(1) Creditors, (2) NCUSIF and uninsured shares[a]	$15.00 (100% recovery)	$4.25 (71% recovery)	$80.75 (71% recovery)
Creditors and NCUSIF and uninsured shares[b]	$11.11 (74% recovery)	$4.44 (74% recovery)	$84.45 (74% recovery)
(1) Creditors, (2) NCUSIF, (3) uninsured shares[c]	$15.00 (100% recovery)	$6.00 (100% recovery)	$79.00 (69% recovery)

[a]Priorities currently used by NCUSIF.

[b]Priority proposed by NCUA, subsequently withdrawn.

[c]Priority suggested in this report.

The 100-percent recovery experienced by general creditors under the third alternative means that two of the problems we previously cited are not resolved: General creditors continue to have almost no risk, and this lack of potential discipline may give both corporate and natural person credit unions an unfair competitive advantage compared to other institutions that seek deposits from the market. However, we believe NCUA can minimize these problems by limiting the amount of money credit unions can borrow. For example, credit unions cannot currently borrow from the CLF for the purpose of increasing their loans. No similar restraint exists on other borrowings by natural person credit unions. Imposition of such a restraint would help to prevent the leveraging of a credit union beyond its own members' resources for the purpose of expansion. We believe such a policy of restraint would help to ensure credit union soundness. An exception to this restriction would need to be made for borrowings by low-income credit unions from the revolving fund that NCUA administers.

Implementation of the new liquidation priorities would have a different effect on most natural person credit unions. Table 7.5 shows a hypothetical distribution of claimant recoveries if a typical natural person credit union were to fail, subject to the revised liquidation priorities. (Table 7.4 outlines the assumptions on which we based the scenarios in table 7.5.) All of the assumptions in this table are the same as in table 7.2, except that 95 percent of total shares are assumed to be insured, which is more typical of natural person credit unions.

Table 7.4: Assumptions Guiding Hypothetical Natural Person Credit Union Scenario

Liabilities and shares:		
Unsecured liabilities to general creditors		$15.00
Shares **(95 percent insured)**		
Insured shares	$114.00	
Uninsured shares	6.00	
Total shares		**120.00**
Total liabilities and shares		$135.00
Cash proceeds from liquidation		$100.00

Table 7.5: Failure of a Hypothetical Natural Person Credit Union: Distribution of Liquidation Proceeds and Percentage Recoveries Under Three Alternative Liquidation Priority Arrangements

	Recoveries by:		
Alternative liquidation priorities	**General creditors**	**NCUSIF**	**Uninsured shares**
(1) Creditors, (2) NCUSIF and uninsured shares[a]	$15.00 (100% recovery)	$80.75 (71% recovery)	$4.25 (71% recovery)
Creditors and NCUSIF and uninsured shares[b]	$11.11 (74% recovery)	$84.45 (74% recovery)	$4.44 (74% recovery)
(1) Creditors, (2) NCUSIF, (3) uninsured shares[c]	$15.00 (100% recovery)	$85.00 (75% recovery)	$0.00 (zero recovery)

[a]Priorities currently used by NCUSIF.

[b]Priority proposed by NCUA, subsequently withdrawn.

[c]Priority suggested in this report.

In this case, adoption of the third alternative would result in the following differences:

- NCUSIF would have somewhat reduced risk and costs.
- The risks to individual members would be greatly increased on any funds over $100,000 in their accounts, since NCUSIF would have to be fully repaid before members could recover any money.

We are not concerned about the high risk to large deposits, as we consider the mission of natural person credit unions to be one of serving ordinary consumer savers, not large investors.

Conclusions

The liquidation priorities currently used by NCUSIF still create the problems cited in GAO's 1982 report. The problems have been exacerbated by the rapid growth of corporates; this growth has been financed in large part by corporates' issuance of uninsured shares.

Giving NCUSIF second priority in liquidation proceeds would be an improvement because it would diminish NCUSIF losses, at the expense of uninsured depositors. It would not, however, increase either the risks to or the incentives for discipline exercised by general creditors. To minimize the possible lack of creditor discipline, NCUA should place more restrictions on outside borrowing. Our specific recommendations in this regard can be found in chapter 3 with respect to credit unions and chapter 6 with respect to corporate credit unions.

Recommendation to Congress

Congress should amend the Federal Credit Union Act to place NCUSIF in a second position to general creditors but provide that this position rank ahead of uninsured shares.

Agency Comments and Our Response

NCUA agreed in principle with most of the recommendations in this chapter and disagreed with none of them. Although NCUA did not in its letter explicitly support our recommended writedown of credit unions' 1-percent deposit in NCUSIF, after we received the agency's comments, the NCUA Chairman testified that he continued to support this writedown. (See app. XII.) The Department of the Treasury in its comments also supported the writedown. (See app. XIII.)

Highlights

Separation of NCUSIF From NCUA

Key Findings

- It is not necessary to separate NCUSIF from NCUA at this time, provided certain organizational and regulatory changes and other recommendations in this report are implemented.
- NCUA has considerable discretion in its use of enforcement actions and is thus vulnerable to delaying action or taking weaker actions than warranted in the face of unsafe and unsound conditions.

Key Recommendations

- Provide that NCUA's board be expanded to five, with the Chairman of the Federal Reserve Board and the Secretary of the Treasury as ex officio members.
- Separate management responsibility for supervision and insurance within NCUA.
- Specify unsafe practices and conditions and link them formally to specific supervisory actions.

Central Liquidity Facility

Background

The Central Liquidity Facility (CLF) was established in 1979 within NCUA to provide liquidity to the credit union industry. CLF can borrow more than $10 billion to finance its lending activities. Such borrowings may carry the full faith and credit of the government.

Key Findings

- CLF could borrow money and relend it to NCUSIF without collateral and without prior congressional approval.
- Use of CLF has been insignificant because the industry has been in liquid condition.
- Many sources of liquidity for credit unions have become available since 1979.

Key Recommendations

- Terminate CLF, or reduce its borrowing authority and make borrowings subject to prior congressional approval.

Structural Changes in NCUA

In this report, we have identified a number of areas where changes can be made that we believe will improve credit union safety and soundness. In this chapter, we recommend three structural changes in NCUA.

The first issue, one that is explicitly mandated in the FIRREA study requirement, is whether or not supervision of NCUSIF should be separated from the other functions of the NCUA Board. We have considered both the advantages and disadvantages of having chartering, regulation/supervision, and insurance functions placed within a single entity, as is the case now.

On balance, we believe that separation is not immediately necessary if several changes are made to help ensure that NCUSIF is protected. First, the NCUA Board should be expanded and its composition modified. The Board now has a chairman and two other appointed members. Providing that the Chairman, Federal Reserve Board, and the Secretary of the Treasury, ex officio, should be members would provide an independent view and broader perspective to the oversight of NCUA and the credit union industry as well as a direct link to the Administration. Second, separate top-level NCUA staff positions, one for supervision and one for insurance, should be created, and the incumbents should report directly to the NCUA Board. Finally, a series of clearly articulated unsafe and unsound conditions and practices and the specified supervisory responses should be developed and set forth. If, however, Congress enacts sweeping reform that places supervision and examination of depository institutions in a single federal regulator, credit unions should be considered for inclusion once such an entity is operating effectively.

We are recommending two other changes that would affect the mission and structure of NCUA to permit increased focus on the supervisory and regulatory needs identified in earlier chapters. One change involves the NCUA Central Liquidity Facility (CLF). CLF, established in 1979 as a significant source of credit to the industry, serves a purpose that we believe could now be as well or better served by other means. (See p. 209.)

The third change involves the program for specially designated credit unions with limited-income members, for which NCUA has had sole responsibility, including administration of a special federal loan fund, since 1986. We believe NCUA's involvement with limited-income credit unions should be restricted to the chartering, supervision, and insurance of such credit unions. If special federal promotion and financing of these enterprises is desirable, we believe it should be the responsibility of some other federal agency.

Separation of NCUSIF From NCUA

The functions of chartering, regulating, supervising, and insuring credit unions are now contained within one federal entity, NCUA. One of our FIRREA mandates was to consider whether or not the insurance function should be separated from the other functions. We have concluded that the separation of the insurance function is not necessary at this time, provided that the changes we recommend in this report are implemented.

The 1970 legislation establishing NCUSIF and authorizing federal share insurance for credit union accounts assigned responsibility for managing the insurance function to NCUA, the existing federal credit union regulator and supervisor. This was similar to the arrangements then existing for state savings associations and for state-chartered banks that were not members of the Federal Reserve System (state nonmembers). It was identical to the arrangement then in place for federally chartered savings associations. The Federal Home Loan Bank Board (FHLBB) chartered, regulated, and supervised federal savings associations and, through one of its components—FSLIC—insured federal as well as state associations. Accounts at state banks that are Federal Reserve System members (state members) were then and are now insured by FDIC, but these banks are regulated and supervised by the Federal Reserve. However, state nonmembers were and are now regulated and supervised by FDIC. (State-chartered banks, savings associations, and credit unions are also regulated and supervised by state bodies.) National bank accounts were then and are now insured by FDIC, but the banks themselves are chartered, regulated, and supervised by the Office of the Comptroller of the Currency (OCC).

Table 8.1: Regulatory Structure for Insured Institutions

Type of institution	Chartering agency	Regulator/ supervisor	Insurer
BIF-insured[a]			
National bank	OCC	OCC	FDIC
State member bank	State	FRS/State	FDIC
State nonmember bank	State	FDIC/State	FDIC
Federal savings bank	OTS[b]	OTS	FDIC
State savings bank	State	FDIC/State	FDIC
SAIF-insured[a]			
Federal savings association	OTS	OTS	FDIC
State savings association	State	OTS/State	FDIC
NCUSIF-insured			
Federal credit union	NCUA	NCUA	NCUA
State credit union	State	NCUA/State	NCUA

[a]Both BIF and the Savings Association Insurance Fund (SAIF) are administered by FDIC, but they are two separate funds.

[b]Office of Thrift Supervision, an office within the Treasury Department.

Questions have been raised as to which of the functions—chartering, regulation/supervision, and insurance—should be under the jurisdiction of a single entity and which should be organizationally separated to best provide for safe and sound depository institutions as well as to protect the insurance funds and the American taxpayers. There is agreement that the recent experience with the collapse of the thrift industry and its insurer cannot be repeated in any facet of the depository institution industry.

The experience with FHLBB in the 1980s underlined the risk of having the chartering, regulation/supervision, and insurance functions combined when the insured industry is declining and the insurance fund is weak. Weak and insolvent savings associations were allowed to continue in operation, even as losses built up. This was attributable to a preference on the part of the regulator for forbearance in its own right and because its insurance subsidiary (FSLIC) did not have sufficient resources to resolve insolvent institutions. When FHLBB finally acted on a large number of insolvent thrifts in 1988, it resolved them to the extent possible without cash, using instead long-term guarantees. The cost of these transactions to the government is very high.[1] In 1989, FIRREA terminated

[1]Troubled Financial Institutions: Solutions to the Thrift Industry Problem (GAO/GGD-89-47, Feb. 21, 1989); Failed Thrifts: FDIC Oversight of 1988 Deals Needs Improvement (GAO/GGD-90-93, July 19, 1990); and Thrift Resolutions: Estimated Costs of FSLIC's 1988 and 1989 Assistance Agreements Subject to Change (GAO/AFMD-90-81, Sept. 13, 1990).

FHLBB and FSLIC and separated the federal chartering and supervision functions from the insurance function. The former are housed in a new agency (OTS) within the Department of the Treasury, and the insurance function (Savings Association Insurance Fund) is managed by FDIC. FDIC as insurer was also given certain regulatory and supervisory powers, including enforcement powers, over savings associations.

There were, however, certain additional structural and other factors that, to a considerable extent, were unique to FHLBB and the FHLB System (FHLBS). There was a close relationship between the supervisory entities and the savings and loan institutions themselves. FHLBB had delegated supervisory responsibility to the Federal Home Loan District Banks (FHLBanks) in 1985. Unlike FHLBB, FHLBanks were not constrained by either federal salary limits or limits on the number of employees, and it was felt that the hiring and pay flexibility could improve supervision. The FHLBanks, however, were owned by the very savings associations that they were supervising. Some savings and loan officials served as board members of FHLBanks. Our past work showed that while examinations often revealed problems at institutions, corrective actions were often untimely and/or ineffective. We identified some instances in which undue influence by board members at an FHLBank may have contributed to inadequate supervisory actions at troubled thrifts where these board members were officers. In addition, the FHLB System had the explicit statutory mandate of promoting home ownership, which, in effect, gave it the role of industry cheerleader.

The built-in organizational conflicts of interest at FHLBB do not exist at NCUA. Officials charged with examining and supervising credit unions are paid by and report to NCUA itself. In addition, now the share insurance fund is well financed and the industry itself seems to be in reasonably good condition.

We sought quantitative indicators of the impact on insurance of the various supervisory and chartering arrangements. As indicated, FDIC is both regulator/supervisor and insurer of state nonmember banks. We compared FDIC and the other federal bank regulators on the basis of several indicators of performance to determine whether FDIC's dual responsibilities were inhibiting its performance as a regulator.

First, we analyzed the GAAP insolvent FDIC-insured commercial banks open as of June 30, 1990, to see if a smaller or larger percentage were both supervised and insured by FDIC. We found that neither was the

case. The proportion of FDIC-supervised, OCC-supervised, and FRS-supervised banks that were insolvent was about the same (.002, .005, and .001, respectively). Of these three entities, only OCC has chartering power and thus the power to close an institution.

Another indicator of performance is the loss incurred when an institution is closed. On a percentage basis, the losses as a percentage of assets ranged from 20 to 29 percent for banks supervised by FDIC, FRS, and OCC. We analyzed data on banks closed between October 1, 1988, and September 30, 1989, and found that estimated losses as a percentage of assets were

- 20 percent for national banks,
- 29 percent for state member banks, and
- 25 percent for state nonmember banks.

An FDIC study of 1984 and 1985 failures reported that the differences in cost of resolution between national bank failures and state bank failures was not significant.[2]

We analyzed how effective federal bank regulatory agencies were in using available enforcement actions to get bank managers to address capital problems as well as asset, earnings, and management problems that caused capital depletion. Bank regulators have considerable discretion on how and when to use available enforcement actions. We found that FDIC, OCC, and FRS share a philosophy of working with "cooperative" bank managers to get them to address problems identified in the supervisory process. The wide discretion in use of actions and this shared philosophy have resulted in a tendency toward use of informal enforcement actions. Generally, the regulators have had some success in getting banks to restore their capital to required levels but were less successful in getting them to resolve the problems that led to the capital depletion. While some differences existed, FDIC, OCC, and FRS essentially dealt in the same manner with banks that had capital problems. Even though FDIC, as the insurer, has sole authority to terminate deposit insurance, and

[2]FDIC Banking Review, vol. I, no. 1, Fall 1988, p. 11.

OCC—as charterer—can close national banks, there was no discernible difference between the way the regulators supervised banks.[3]

Separation of NCUSIF from NCUA's chartering, regulation, and supervision responsibilities would not, on the basis of these analyses, by itself guarantee either strong supervision or insurance fund health. And such a move could result in additional and duplicative oversight costs. In addition, it can be argued that a regulator/supervisor without insurance responsibility has less incentive to concern itself with the insurance costs, should an institution fail.

Certain changes to NCUA's present organizational structure are needed, however. And the improvements in supervisory intervention that we are recommending for banks[4] should be put in place to help ensure that NCUA has a clear mandate to act when problems are identified and to close failing credit unions promptly.

Changes to NCUA Organization

Composition of NCUA Board

The Federal Credit Union Act as amended in 1978 provided for a three-member NCUA Board.[5] We have not analyzed its operations. We do, however, believe that it would enhance the Board's effectiveness to have, as members, the Chairman of the Federal Reserve Board and the Secretary of the Treasury.

[3]For this review, we randomly selected 72 banks that bank regulators identified as having problems meeting minimum capital standards as of January 1988. We analyzed examination reports and related enforcement actions taken by regulators both before and after that date. Our sampled banks were randomly selected from three locations (Chicago, Dallas, and San Francisco) and were divided equally among the three bank regulators—OCC, FRS, and FDIC. (We could not realistically review a sufficient number of banks to allow us to statistically project our observations across the nation, each location, or each agency. However, we believe our observations do fairly reflect the conditions and circumstances that can influence regulators' enforcement activities. Agency officials agreed that our approach was reasonable and that our results would be indicative of the use of enforcement tools related to bank capital problems. In fact, in analyzing our results, we found a statistically significant association existed between the outcomes of sampled cases where the most forceful available action was taken and improvement in capital condition. This statistically significant association shows a high likelihood that, if we were to make and analyze other random samples from the same universe of capital-deficient banks, we would get essentially the same results.)

[4]Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

[5]According to the act, NCUA "shall be under the management of a National Credit Union Administration Board. . . . the Board shall consist of three members, who are broadly representative of the public interest, appointed by the President, by and with the advice and consent of the Senate. In appointing the members of the Board, the President shall designate the Chairman. Not more than two members of the Board shall be members of the same political party. (12 U.S.C. 1752a(a) and (b))

Credit unions are increasingly involved in activities, such as real estate lending, that banking institutions have long been authorized to perform. They are also now permitted to offer variable rate loans and to engage in off-balance-sheet activities. In addition, corporate credit unions are heavily involved, directly or through U.S. Central Credit Union, in investments in many major international commercial banks.

The presence on the NCUA Board of the Chairman of the Federal Reserve Board would provide an independent view and a broader perspective on the role and oversight of financial institutions. In addition, as the federal supervisor of state member banks and bank holding companies, he/she can utilize experience in this area to benefit NCUA. As credit unions grow larger and their operations more complex, this will be increasingly valuable. Already, for example, NCUA has asked expert FRS staff to join its staff during examinations of corporate credit unions. The presence of such an official, because of the ex officio nature of the appointment, would also give added assurance that objective insurance decisions would be made and that the approach to federal regulation and supervision would be consistent where applicable across industry lines.

The presence on the NCUA Board of the Secretary of the Treasury would provide a direct link to the views of the administration on regulatory and insurance issues concerning depository institutions, should critical policy issues or problems develop.

As a result of the concerns expressed by NCUA and the Federal Reserve Board in their comments on a draft of this report, we have modified our recommendation to permit the two proposed ex officio Board members to delegate their authority to another member of the Federal Reserve Board or another official of the Department of the Treasury who is appointed by the President with the advice and consent of the Senate. (See apps. XII and XIV and pp. 212 to 213.)

Internal Change

NCUA, as noted above, is now headed by the chairman of a three-member Board, which has reporting separately to it through an executive director, five offices, six regional offices, and the Asset Liquidation and Management Center. The five offices are Information Systems, General Counsel, Examination and Insurance, Public and Congressional Affairs, and Chief Economist. (An NCUA organization chart is contained in app. III.) NCUA's Director of Examination and Insurance has told us that in practice the six regions report through him, as does the asset center.

If NCUSIF remains within NCUA, we believe a clearer distinction between the chartering, regulatory, and supervisory functions and the insurance function needs to be made. Separate positions for a Director of Supervision and a Director of Insurance should be established, each reporting separately to the Board. This would elevate any discussions of tradeoffs, for example in favor of weakened supervision over timely insurance action, to the Board level. In recommending this change, we want to emphasize that we are not implying that NCUA's present Director of Examination and Insurance has not been sufficiently strong and effective. It is, rather, the organizational arrangement that needs to be changed to ensure that NCUSIF will, in the future, continue to be protected.

Under this new arrangement, we would envision the regional office directors reporting to the new position of Director of Supervision and the head of the Asset Liquidation and Management Center reporting to the new position of Director of Insurance. The Director of Insurance should have the mandate, authority, and resources to adequately assess the condition of credit unions.

Tripwires Needed to Enhance Supervision and Failure Resolution

On the basis of our work on depository institutions over the past years, we have concluded that a comprehensive three-part reform package is needed that changes the way banks are regulated and supervised, and—when failing—resolved. Our report, Deposit Insurance: A Strategy for Reform, describes these proposed reforms. Many, but not all, are applicable to NCUA and, if implemented together with the NCUA-specific recommendations elsewhere in this report, will help protect NCUSIF. Other elements of our proposed reform approach are discussed elsewhere in this report, such as better financial reporting (see ch. 2) and required management and financial audit reports (see ch. 3).

Our work on bank as well as credit union supervision has shown that examiners often prefer to work informally with managers and directors of the financial institutions they examine to correct deficiencies. Examiners lack a clear mandate and incentives to take more formal action. On the basis of our work we have concluded that the bank regulators, in conjunction with the industry, should develop a formal system of phased regulatory intervention, which we refer to as "tripwires." A regulatory tripwire system would provide federal regulators with a clear mandate to predictably address problems that impair safety and soundness and to protect the insurance fund from losses. The tripwire regulations should be specific enough to provide clear guidance about the

types and timing of actions to be taken. In this way, the mandate for more forceful regulatory action will be clear and the owners and managers of insured institutions will know in advance the consequences of actions that potentially can weaken the financial strength of their institutions.

Such a tripwire system would be appropriate for credit unions as well as banks. A legislative mandate should direct NCUA to (1) specify unsafe practices or conditions that could potentially affect or have already affected the performance of insured credit unions and (2) identify the enforcement actions it will take to correct the unsafe practices or conditions. The mandate should also generally require NCUA to use the identified enforcement actions when the practices or conditions are identified and provide justification for instances in which such actions are not used.

Our proposed strategy consists of four tripwires, each of which is intended to focus supervisory attention on key indicators of unsafe practices or conditions and create a set of expectations among institutions and supervisors concerning the enforcement actions that will follow. The tripwires, as summarized in our deposit insurance report, are shown in table 8.2. Because credit unions as cooperatives can add to capital only through retained earnings, the importance of the first two tripwires is enhanced and the enforcement actions related to the third tripwire will need to be modified. We think that NCUA, in conjunction with Congress and the credit union industry, is in the best position to develop the (1) accepted definitions of inherently unsafe activities and conditions that would trigger mandatory enforcement actions and (2) specific enforcement actions that would be taken.

Table 8.2: Overview of Proposed Tripwire Regulatory Approach for Banks

Conditions triggering regulatory actions	Examples of enforcement actions[a]
Tripwire 1 Unsafe practices in seemingly healthy institutions	Require plan to address problems; growth restrictions; interest rate restrictions; higher capital and/or insurance premiums if improvements not made; civil money penalties.
Tripwire 2 Serious asset or earnings deterioration	Require plan to address problems; growth and interest rate restrictions; higher capital and/or insurance premiums; reduce dividend payments; civil money penalties.
Tripwire 3 Capital deterioration below minimum regulatory standards	Recapitalization plan; force bank to recapitalize; suspend dividend payments; restrict or eliminate asset growth; interest rate restrictions; increase insurance premiums; prohibit subordinated debt interest payments; perform break-up analysis.
Tripwire 4 Capital depletion	Place bank in conservatorship; terminate insurance; liquidate or merge bank.

[a]The tripwire approach would in no way preclude federal regulators from using available informal or formal enforcement actions not listed in this table. These include such actions as removing bank officers and directors, cease and desist orders, or prohibition orders. Furthermore, application of bank enforcement actions should become progressively more severe and would include a more comprehensive set of actions as violations become more serious.

Source: This table was presented and discussed in our report, Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, Mar. 4, 1991).

Conclusions

We have concluded that it is not necessary at this time to separate NCUSIF from NCUA to enhance industry safety and soundness and protect the insurance fund if certain safeguards are put in place. These are intended to help ensure that neither insurance nor supervisory decisions are compromised by the existence of a single board. The appropriate combination of functions also reduces the likelihood that a regulator/supervisor will act without adequate regard for the insurance implications. The safeguards include those recommended elsewhere in this report, such as strengthened regulation in lending areas, more frequent and detailed financial reporting, authorization for credit unions to invest only in corporate credit unions that are federally insured, and required annual financial audits and management reports for all but the smallest credit unions.

In addition, provision for an expanded NCUA Board, with two members ex officio, the Chairman of the Federal Reserve Board and the Secretary of the Treasury, will bring to the Board a broader perspective on financial market regulatory and insurance issues, will enhance the importance of the insurance function within NCUA, and will provide a link to the Administration's thinking on public policy issues affecting insured depository institutions. Other structural changes should further focus responsibility for these two key functions.

A clear congressional mandate that enforcement actions should be taken when unsafe and unsound practices or conditions are identified is also needed. Such action will give a clear signal to both credit unions and NCUA that actions are to be taken when problems in institutions are identified. NCUA, together with Congress and the credit union industry, is in the best position to identify the specific conditions, practices, and actions that should be considered in devising such a tripwire system.

With these changes, if implemented fully, an immediate separation of the supervision and insurance functions is not needed. However, the Congress may consider comprehensive reform of depository institution supervision. If there is broad reform enacted that places examination and supervision under a single federal entity, credit unions should be considered for inclusion once such an entity is operating effectively. The insurance function could then be placed under FDIC or a separate entity.

Recommendation to NCUA

- Immediately establish separate supervision and insurance offices that report directly to the Board.

Recommendations to Congress

Amend the Federal Credit Union Act to

- require that NCUA, in consultation with Congress and the credit union industry, identify specific unsafe and unsound practices and conditions that merit enforcement action as well as the appropriate action, and promulgate these requirements by regulation;
- require NCUA to take appropriate enforcement action when unsafe and unsound conditions or practices, as specified in law or NCUA regulations, are identified; and
- provide for a five-member NCUA Board, with two members ex officio, the Chairman of the Federal Reserve Board and the Secretary of the Treasury. Authorize the two ex officio members to delegate their authority to another member of the Federal Reserve Board or to another official of the Department of the Treasury who is appointed by the President with the advice and consent of the Senate.

If there is a broad reform of the depository institution regulatory structure and Congress legislates an approach that places all examination and supervision functions under a single federal regulator, credit unions

should be considered for inclusion once such an entity is operating effectively. The insurance function could then be placed under FDIC or under a separate entity.

The Central Liquidity Facility Poses Risks and Is Not Needed

The National Credit Union CLF was established as a mixed ownership government corporation to "improve general financial stability by meeting the liquidity needs of credit unions and thereby encourage savings, support consumer and mortgage lending, and provide basic financial resources to all segments of the economy."[6] Liquidity needs were defined to include short-term, seasonal, or long-term loans to natural person credit unions. In addition, CLF can make secured loans to cooperative share insurers and, since 1982, to NCUSIF under terms and conditions as established by the NCUA Board. CLF is capitalized by the cash investments of its member credit unions and is governed by the NCUA Board.

The independent certified public accountant's audits of the CLF balance sheet and income statements for the periods ending September 30, 1989, and September 30, 1988, are included in appendix V.

The key to CLF's ability to meet the liquidity needs of the industry and NCUSIF lies in the statutory power of the NCUA Board to borrow money on behalf of CLF from outside the industry's own resources. As of September 30, 1990, CLF had the statutory power to borrow about $10.9 billion for this purpose from any source. Compared with the approximately $2.1 billion in NCUSIF itself and the estimated $180 billion of insured credit union shares at year-end 1990, this power is a very substantial one. It is also significant that a May 24, 1982, Attorney General opinion concluded that the obligations of CLF are supported by the full faith and credit of the United States.

Actual use of CLF has been low, compared with its potential resources and the size of the industry.[7] The maximum CLF loans outstanding at any one time was approximately $291 million in fiscal year 1985. One reason for this low level of use is that the credit union industry has clearly not experienced a need for major liquidity support. In fact, as we said in chapter 2, industry liquidity began to improve significantly in 1980, just

[6]Federal Credit Union Act (12 U.S.C. 1795).

[7]CLF has a small staff of only four people. This small staff size has worked because CLF can draw upon the supervisory and insurance staff and other resources of NCUA. CLF officials told us they also rely on U.S. Central and the corporate credit union network to provide some services. For example, they said the corporates maintain credit files on many of their members that are currently not borrowing from CLF. (Ch. 6 discusses corporate credit unions.)

as CLF was getting started. In the years 1980 through 1982, credit union shares grew while loans outstanding remained virtually unchanged. This more liquid condition has largely continued ever since. Table 8.3 shows this liquidity improvement as measured by the decrease in the ratio of loans to shares for both federal and state credit unions. We believe this ratio is a reasonable gauge of liquidity because unloaned credit union funds are generally invested in assets maturing in less than 1 year.

Table 8.3: Loan-to-Share Ratios of Federally Insured Credit Unions

Year-end	Federal credit unions	State credit unions
1976	86.7%	92.8%
1977	88.7	95.3
1978	92.9	98.1
1979	91.6	95.8
CLF organized		
1980	77.4	79.0
1981	77.3	76.7
1982	68.2	70.6
1983	66.5	70.9
1984	72.7	75.8
1985	67.4	69.0
1986	62.9	64.1
1987	66.5	68.0
1988	70.6	72.4
1989	73.2	73.6
June 30, 1990	68.9	69.2

Source: NCUA Annual Reports, 1985 and 1989; NCUA 1990 Midyear Statistics for Federally Insured Credit Unions.

As we will describe, other sources of liquidity are now available to credit unions. This situation is another reason why we believe CLF, which can issue obligations the Attorney General says bear the full faith and credit of the federal government, is neither essential nor desirable. However, if CLF does continue to exist, we believe changes in its authorization are needed to reduce its potential risk, particularly in its ability to make unsecured loans and to borrow large sums from the public without further congressional review and approval.

CLF Membership, Financial Structure, and Operations

Membership in CLF is voluntary and is available to both federal and state-chartered credit unions. A credit union can join CLF directly or through a corporate credit union acting as its agent.

As of September 30, 1990, approximately 13,000 credit unions were members of CLF. However, all but 196 of these joined through their respective corporate agents. CLF reported that about 1,500 credit unions with aggregate total assets of $9.5 billion were not CLF members. Membership levels have been stable in recent years, and NCUA officials expect little change.

In order to become a member of CLF, a credit union must subscribe to CLF capital stock in an amount not less than one-half of 1 percent of its paid-in and unimpaired capital and surplus. Half of the stock subscription must be deposited with CLF; the other half is not remitted but is invested in assets designated by the NCUA Board and is subject to call at the discretion of the NCUA Board. Corporate credit unions pay subscriptions on the same basis, acting as agents for all their members that do not directly belong to CLF. Table 8.4 shows CLF's abbreviated statement of condition as of September 30, 1990.

Table 8.4: Assets, Liabilities, and Equity of CLF as of September 30, 1990

Dollars in millions	
Assets	
Cash	[a]
Investments	$457
Loans to members	67
Accrued interest receivable	9
Total assets	**$533**
Liabilities	
Notes payable	$57
Member deposits	15
Other liabilities	1
Total liabilities	**$72**
Equity	
Capital stock required	$452
Retained earnings	9
	$461
Total liabilities and equity	**$533**

Note: Numbers may not add due to rounding.

[a]Cash was less than $500,000.
Source: CLF Financial Statement.

The equity accounts do not reflect the one-half of CLF's total capital stock that members have subscribed to but not paid for.

The $57 million in notes payable represented CLF borrowings from the Federal Financing Bank, a component of the Department of the Treasury. As a matter of policy, all CLF borrowings have been from this source. CLF may borrow money from any outside source, however, subject to a limit. All subscribed capital stock (required plus on-call) is counted as a part of the base for determining how much money CLF can borrow. By law, CLF can borrow up to 12 times the sum of its subscribed capital and surplus. (12 U.S.C. 1795) As noted, as of September 30, 1990, in accordance with this formula, about $10.9 billion could have been borrowed from any source.

Of the $67 million in loans to members, $52 million was outstanding in secured loans to 10 credit unions. As a matter of policy, CLF requires these loans to be secured by collateral having a market value of at least 107 percent of the loan balance. Another two credit unions had $15 million in loans that were guaranteed by NCUSIF as part of assistance packages granted under Section 208 of the Federal Credit Union Act. (See ch. 5 for a discussion of Section 208 assistance.) The largest concentration of CLF assets—$422 million of its $457 million in total investments—is in the obligations of U.S. Central Credit Union. Of this amount, $22 million was invested in ordinary share deposits in U.S. Central. The larger part of the investment, about $400 million, is called a "redeposit" in U.S. Central and results from a special membership arrangement agreed to by the NCUA Board and implemented in 1984.

The redeposit arrangement was intended to induce more credit unions to join CLF—only about 30 percent of all active credit unions had joined in the first 4 years of CLF operation. NCUA reported that many credit unions believed that U.S. Central would earn a greater investment return on their funds than would CLF because CLF investment powers were more limited than the investment powers of credit unions. For example, credit unions can invest in state obligations, while CLF cannot. These credit unions therefore perceived that there was an undesirable opportunity cost in CLF membership.

Under the special agreement, 29 corporate credit unions joined CLF as agent members. Because of the large number of credit unions belonging to these 29 corporates, the agreement had the immediate effect of more than tripling CLF's membership base from 5,300 natural person credit unions to more than 18,000. The NCUA Board initially agreed to reinvest

all but $50 million of CLF's paid-in capital shares in share accounts with U.S. Central and the corporate credit unions "... as long as liquidity demands remain low ..."[8] This arrangement continues to be in effect. As the industry grew, the required member shares increased, and the redeposit, which was $190 million as of September 30, 1985, more than doubled in size by September 30, 1990.

Long-Range Concerns About CLF Safety and Soundness in a Period of Industry Stress

CLF has been relatively inactive largely because credit union liquidity needs have been low since its establishment. At this time, we have no reason to believe that the industry is about to encounter a period of difficulty. Were this to occur, however, CLF operations and condition could change dramatically in two ways as a result of discretionary NCUA actions. The changes would require NCUA policy revisions, not congressional approval.

CLF Borrowing and Lending Authority

The first change relates to CLF's borrowing activity. Industry stress could create substantial liquidity needs in the organizations to which CLF is authorized to lend—credit unions, private share insurers, and NCUSIF. For 1990, there was a $600 million legislative limit on gross obligations for all new direct CLF loans to member credit unions.[9] That limit had been set by Congress each year for about the past 10 years. (As we previously noted, the maximum amount of total outstanding CLF loans at any one time was about $291 million, during fiscal year 1985.)

NCUA's policy is to regard the congressional loan limit as a limit on all CLF borrowing. However, given CLF's capitalization as of September 30, 1990, NCUA could change this policy and borrow a total of more than $10 billion. The proceeds of such borrowing could be used to provide liquidity to private share insurers and to NCUSIF without congressional approval.[10] CLF borrowings needed to finance such loans may carry the full faith and credit of the government, thus exposing taxpayers to losses on CLF loans.

[8]Central Liquidity Facility 1984 Annual Report, p. 5.

[9]P.L. 101-144; Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1990.

[10]The Federal Credit Union Act was amended in 1982 to empower CLF to lend money to NCUSIF. (P.L. 97-320.) Available legislative history does not clarify the reasons for this change, but NCUA, in the 1985 NCUSIF annual report, referred to the fund as having been "on the brink of bankruptcy" at the time the law was amended. (NCUSIF 1985 Annual Report, p. 3.)

Potential Unsecured Loans

We are concerned about another change that could occur in CLF operations that would adversely affect the quality of its loans. While CLF loans are currently either collateralized or are guaranteed by NCUSIF, it is done as a matter of policy, not law. The Federal Credit Union Act does not require any collateral security for CLF loans to NCUSIF or to credit unions, or even that these borrowers be solvent.

CLF has been described by CLF officials as the lender of last resort for the credit union movement. However, from a safety and soundness standpoint, we found that CLF's powers and potential practices in lending to credit unions are broader in three respects than those of the traditional lender of last resort to depository institutions, the Federal Reserve System. These three differences follow:

- Federal Reserve loans must always be secured (that is, collateralized).[11]
- CLF officials told us they are able to develop ". . . innovative solutions to specialized credit union problems that simply cannot be offered by the Federal Reserve." CLF officials point out that these differences include longer maturities and less stringent collateral requirements.
- The statutory limit on borrowing by federally insured credit unions—50 percent of their paid-in and unimpaired capital and surplus—applies to their borrowings from the Federal Reserve but not to borrowings from CLF, which have a statutory exemption from this limitation.

The more liberal terms and conditions of the loans that CLF could make, compared to Federal Reserve loans to the same credit union borrowers, mean that the risk of loan losses would be greater for CLF than for the Federal Reserve.

Implications of Dissolving CLF

There have been major changes in the public and private arrangements to provide needed financial support to credit unions since CLF was established in 1979. Given these changes and our concerns about the potential credit risk involved in CLF lending should the industry experience problems, we examined the potential impact of dissolving CLF by assessing alternative sources of liquidity for the entities to which it may lend—credit unions, NCUSIF, and cooperative insurers.

[11] Acceptable collateral is confined to direct or guaranteed obligations of the United States or, subject to specific prior approval of the Federal Reserve Board, other collateral.

Alternative Sources of Credit Union Liquidity

Credit unions may borrow money from any source but are subject to the previously noted maximum borrowing limit. The federal entities authorized to lend to credit unions are the Federal Reserve System, NCUSIF, the Federal Home Loan Bank System, and the Farm Credit Banks. These entities have varying criteria as to the purpose, duration, and collateral requirements of the loans.

The credit union industry in the mid-1970s envisioned a network of corporate credit unions, capped by U.S. Central Credit Union, that would eventually become a major provider of liquidity to natural person credit unions. U.S. Central and the corporates would obtain funds for this purpose by borrowing from private sector sources. U.S. Central officials told us that a liquidity shortage created the need to establish additional external lines of credit beyond those obtained from the private sector. Thus, CLF was established. At the time of this report, however, the corporate network was more fully developed. NCUA officials told us that by 1989, 10 corporate credit unions, including U.S. Central, had reported to them that various types of credit lines totaling at least $8 billion were available from such private sources as banks and brokers. Corporate credit unions, acting as intermediaries, also facilitate borrowing and lending between natural person credit unions in different geographic regions and in response to varying needs, such as low versus high local loan demand. Comprehensive data, however, are not available to indicate the volumes and trends in these transactions. This intra-industry financing should reduce the need for outside borrowing.

The Monetary Control Act of 1980 for the first time authorized natural person credit unions that offer transaction (that is, share draft) accounts to borrow from Federal Reserve Banks. (12 U.S.C. 461(b)(7)) Short-term liquidity needs of such credit unions with qualifying collateral can thus be met at the Federal Reserve discount window. However, according to Federal Reserve officials, only a few credit unions have done so.

NCUSIF, recapitalized in 1985, now has substantial funds for closing insolvent credit unions, for temporarily assisting them in order to prevent closing, and for other purposes (see ch. 2). As of September 30, 1990, NCUSIF held cash and investments, net of direct and contingent liabilities, of $1.8 billion, and Treasury was authorized by the Federal Credit Union Act to lend the fund another $100 million. We believe the provision of liquidity assistance to distressed or failing credit unions is an insurance function that properly should be carried out by NCUSIF and reflected on its balance sheet. However, this activity is somewhat

obscured in cases in which NCUSIF guarantees some CLF loans to credit unions. While the outstanding balance of such guarantees of CLF loans is now disclosed in a footnote to the NCUSIF financial statements, it does not appear on the balance sheet because it is a contingent liability on which no estimate of losses has been made.

The fourth potential source of liquidity for credit unions is the FHLBS. FIRREA authorized credit unions to join that system if they held at least 10 percent of their total assets in residential mortgage loans and met certain other criteria. (12 U.S.C. 1422(b)) Among the benefits of membership is the right to borrow funds (referred to as "advances") to meet overnight or longer term needs if appropriate collateral is provided. The first credit union to join the system, one of the nation's 50 largest, did so in October 1990. Only one other application to join the FHLBS was on file as of October 15, 1990.

A fifth potential source of liquidity for federal credit unions is the Farm Credit Banks. The administration of the Federal Credit Union Act was originally vested in the Farm Credit Administration and its Governor. Since the act was passed in 1934, federal credit unions have been authorized to borrow up to 100 percent of their paid-in and unimpaired capital and surplus from federal intermediate credit banks, which are now known as Farm Credit Banks. The limit for these borrowings is twice the amount that a federal credit union can legally borrow from any other source except CLF. As of October 15, 1990, none have done so, according to Farm Credit Administration officials. These officials also told us that the Farm Credit System has little information on credit unions. We believe this borrowing authority is an anachronism, put into effect because credit unions were once administered by the Farm Credit Administration. We see no reason why it should be continued.

Corporate Credit Unions and the Private Share Insurers Should Not Need CLF

Corporates may also join CLF as agent members and have done so through U.S. Central Credit Union. Corporate credit unions are not routinely eligible to use the Federal Reserve discount window because they are classified as "banker's banks."[12] They can, however, borrow from within the industry. We have been told by both NCUA and credit union

[12]The corporates are classified as what are popularly known as "banker's banks" as defined by the Federal Reserve's Regulation D. A banker's bank is a financial institution primarily owned by and doing business only with other financial institutions and not the general public. This status is economically desirable for corporate credit unions because banker's banks are, unlike other depository institutions, exempt from the requirement of maintaining noninterest-bearing reserve accounts at the Federal Reserve. However, Federal Reserve's Regulation A provides that financial institutions that are not required to maintain reserves under Regulation D are not routinely permitted to borrow from the Fed's discount window.

officials that corporates have a long tradition of mutual self-help when problems develop. Such help comes from their own respective credit union members and also from other corporates, including U.S. Central.[13] An advantage for the corporates of having CLF financial support in a distress situation lies in CLF's low borrowing cost. We believe that a financially sound corporate with acceptable collateral should meet its liquidity needs in private markets and that a distressed corporate, if insured by NCUSIF, should request Section 208 assistance from NCUA.

Cooperative share insurance funds can also borrow from CLF. Title III of the Federal Credit Union Act empowers the NCUA Board, on behalf of CLF, to

"advance funds on a fully secured basis to a State credit union share or deposit insurance corporation, guaranty credit union, or guaranty association. Such advance shall not exceed twelve months in maturity, shall be relent at an interest rate not exceeding that imposed by the Facility, and shall not be renewable. (12 U.S.C. 1795f(a)(16).)"

We have no reason to believe that CLF is an indispensable source of credit to the cooperative insurance funds.[14] It would seem that these funds should normally be able to borrow from private sector sources, though possibly at higher interest rates. Alternatively, it would seem likely that if the available collateral security is composed of marketable assets, these assets could be sold by the insurers, thus avoiding their need to borrow.

In any case, CLF common stock, owned in part by federally insured credit unions, is at risk in CLF; the U.S. government has a contingent liability for CLF debt; and the potentially lower interest rates on CLF loans are possible because of their government backing. The conditions imply a degree of federal support for private cooperative insurance enterprises—a questionable public policy.

[13]For example, officials of one corporate credit union that had experienced investment losses told us that it was supported, beginning in 1980, for a 7-year period by a combination of loans and special deposits at below-market rates from various industry sources, including its own member credit unions, other corporates, and U.S. Central. Cash and noncash support was also provided by NCUA and NCUSIF.

[14]In the 11-year history of CLF, it has made only one loan—for $3 million in fiscal year 1983—to a cooperative share insurer.

Other Concerns Related to CLF Operations

Policy for Adding to CLF Reserves Is Not Progressing Toward Achievement of Long-Range Goal

As of September 30, 1990, CLF had reserves (retained earnings) of $9 million, or about 1.7 percent of total assets. The NCUA Board has stated that CLF activities are not completely risk free. According to the 1988 CLF Annual Report, the NCUA Board has set a long-range goal for these reserves at 4 percent of assets. However, actual additions to reserves have not been large enough to improve the relationship of reserves to assets, as shown in table 8.5.

Table 8.5: CLF Reserves as a Percentage of Assets

Dollars in millions

September 30	Reserves	Assets	Reserves/assets
1986	$6.2	$409.0	1.5%
1987	6.8	481.5	1.4
1988	7.6	540.7	1.4
1989	8.3	565.6	1.5
1990	9.0	533.0	1.7

Source: CLF Annual Report for 1986, 1987, 1988, and 1989 and CLF audited financial statement for 1990.

At fiscal year-end 1990, CLF would have needed $21 million in retained earnings to reach the 4-percent level—an increase of $12 million. CLF has reported income after dividends to members in each fiscal year of its operations, ranging from a low of $15,000 in fiscal year 1982 to a high of $2,400,000 in fiscal year 1984. A decrease of about 34 percent in CLF's $35 million dividend to members would have accomplished the 4 percent target level. However, the actual addition to retained earnings for 1990 was only about $686,000.

The dividend rate on CLF's redeposit with U.S. Central in recent years appears to have been a major if not the controlling factor in determining CLF's annual net income. This situation occurred because the rate on the dividend paid to CLF is "administered," that is, the rate is arrived at by agreement between CLF and U.S. Central—so that the dividend amount, when "combined with all of CLF's other earnings is sufficient to pay CLF's entire operating and reserving costs."[15]

It could be argued that a 4-percent reserve is higher than necessary at this time because CLF has high-quality assets and a loss-free history. In

[15]CLF Annual Report, 1989, p. 7.

an industry crisis, however, CLF could grow through authorized outside borrowing to about 20 times its present size. It would also see its asset quality deteriorate as assets shifted from investments to loans to credit unions, especially if the policy to collateralize loans were relaxed or discontinued. At such a point, the relationship of reserves to assets could be decreasing even though the need for a larger cushion against losses might be indicated. The book value of CLF stock, which is owned by its members, would be impaired as soon as the retained earnings account was exhausted.

In these circumstances, financially healthy credit unions with no foreseeable need to borrow from CLF might prudently decide to withdraw from membership, and the CLF might be destabilized. A CLF member whose stock represents less than 5 percent of CLF stock outstanding may withdraw on 6 months notice; if the member's stock represents 5 percent or more, 24 months' notice is required. (12 U.S.C. 1795(c)) If CLF loan losses were large, the impact on other credit union members that had not withdrawn might be significant.

CLF's Investment Powers Are Too Broad

The law currently permits CLF to invest in obligations of the United States or its agencies, to make deposits in federally insured financial institutions, and to invest in shares or deposits in credit unions. Such investment powers, in our opinion, were acceptable on the assumption that CLF debt did not carry the full faith and credit of the United States. This is because a loss on CLF investments that were financed with borrowed money would not have explicitly contributed to the government's risk in standing behind CLF's debts. However, in 1982, more than 3 years after the legislation established CLF, the Attorney General determined that CLF debt had government backing. Because of this opinion, we believe it would have been prudent and in the government's best interest for CLF to have changed its policy by limiting its investments to federal obligations only. This change would eliminate credit risk from the investment portfolio.

Some critics have singled out CLF's redeposit in U.S. Central as being of questionable safety and soundness. We believe that the degree of safety of this investment hinges in part on whether or not CLF's claim would have priority over all U.S. Central member claims in the event of liquidation. In 1987, U.S. Central reported to CLF an opinion of counsel that CLF's claims would have priority over its members' claims in the event of liquidation. U.S. Central officials told CLF that it would share this opinion with its charterer and supervisor, the Kansas Credit Union Administrator, for review and evaluation. However, as of February

1991, CLF officials told us that CLF had not received the Kansas Administrator's evaluation.

Conclusions

We see no clear reasons why the actual and potential beneficiaries of CLF—corporate and natural person credit unions, private share insurers, and NCUSIF—should not be able to operate successfully if CLF were to be dissolved. We believe the legitimate needs of all parts of the CLF constituency can be met by other, more appropriate providers. A transition period for the very few existing borrowers to make other credit arrangements might be required.

Dissolution of CLF would relieve the long- and short-term concerns we have discussed concerning its operations. Foremost among these, unlikely though it may be, is that the current CLF legal structure would permit major support of NCUSIF without current congressional debate and approval. The other safety and soundness concerns we have raised are heightened by the fact that CLF borrowing in support of its loan and investment programs is backed, according to the Attorney General, by the full faith and credit of the U.S. government. Except for assistance to insolvent credit unions, which should be given by NCUSIF if it is given at all, we see no justification for the government to back other CLF transactions.

Recommendations to Congress

CLF, as established by Title III of the Federal Credit Union Act, should be dissolved.

If CLF is to continue to operate, we recommend statutory changes to limit the risk in its operations. These should include

- sharply reducing CLF borrowing authority from the current level of 12 times subscribed capital and surplus;
- requiring the terms and conditions of CLF loans to be no more liberal than those made by the Federal Reserve; and
- prohibiting CLF loans or guarantees of any kind to NCUSIF, and, in the event the NCUA Board certifies that CLF does not have sufficient funds to meet liquidity needs of credit unions, authorize the Department of the Treasury to lend to NCUSIF, rather than to CLF, in order to meet such needs.

The power of federal credit unions to borrow from the Farm Credit Banks, as provided for in the Federal Credit Union Act, should be removed.

NCUA's Role as Regulator and Insurer Conflicts With Role of Administrator of Revolving Loan Fund

Credit unions designated as limited-income credit unions are permitted to accept deposits from nonmembers and are eligible for loans from a special federal fund. Limited-income credit unions are those that have been designated as serving "predominantly low-income members." (See ch. 1.) As of the June 30, 1990, 181 credit unions were considered limited-income credit unions; 161 (89 percent) of these had under $2 million in assets. Limited-income credit unions received two benefits that were not shared by other credit unions. All insured credit unions may accept deposits from members, public units, and nonmember credit unions. Federally chartered limited-income credit unions, unlike other federal credit unions, may also accept deposits from other nonmember entities.[16]

Limited-income credit unions may also participate in the Community Development Revolving Loan Program for Credit Unions. The Community Development Revolving Loan Fund was established by "A Joint Resolution Making Further Continuing Appropriation for the Fiscal Year 1980 and for Other Purposes" of 1979 (P.L. 96-123) with $6 million, to support the efforts of credit unions active in (a) providing basic financial and related services to residents in their communities; and (b) stimulating economic activities in the communities they service. (12 C.F.R. 705.2) In order to participate in the program, a credit union must have a current limited-income designation. In addition, a limited-income credit union must increase its member and nonmember share deposits by an amount at least equal to the loan amount.

Loan activity has been very limited in scope, but loan experience has been satisfactory. Before 1990, there were two sets of loans made by the fund as shown in table 8.6.

[16]An NCUA regulation issued in July 1989 now limits all public unit and nonmember accounts to 20 percent of the total shares of a federal credit union. (12 C.F.R. 701.32(b)) A credit union may, however, seek an exemption from this limit. This regulation was put into place shortly after a federal limited-income credit union with a large number of nonmember accounts failed because of fraudulent activity. According to NCUA, this limit balances the interests of a credit union in accepting deposits from public units, nonmember credit unions, and other nonmember entities (in the case of low-income credit unions) with the risk posed to the credit union and NCUSIF resulting from the potential misuse of the funds.

Table 8.6: Lending by the Community Development Revolving Loan Fund

Issue date	Number of credit unions	Aggregate amount of loans	Average loan per credit union	Total losses
10-01-80	28	$4.5 million	$161,000	0[a]
12-30-83	16	2.2 million	$137,500	**$57,670**
Total	**39[b]**	**$6.7 million**	**$172,000**	**$57,670**

[a]One 1980 loan for $100,000 was refinanced for $200,000 in 1983 and subsequently experienced a $35,190 loss.

[b]Five credit unions participated in both sets of loans.

Source: NCUA, Community Development Revolving Loan Fund records.

All loans carried an original maturity of 5 years and, with the exception of the three loans on which losses were experienced, had been repaid in full by December 31, 1988. Lending activity resumed in 1990 and as of December 31, 1990, 14 loans amounting to over $2 million had been approved. Loan applications show that the limited-income credit unions plan to use the loan money primarily to increase liquidity and to expand their loan portfolios to include greater mortgage, home renovation, consumer, automobile, and small business lending.

The Community Development Credit Union Revolving Loan Fund Transfer Act (P.L. 99-609) designated NCUA as administrator of the fund. NCUA delegated management of the fund to the president of the Central Liquidity Facility. He in turn delegated the authority to grant loans from the fund to the NCUA regional directors. The NCUA directors have not been given any guidance on monitoring those credit unions that received loans from the fund.

In the fiscal year 1990 budget, OMB suggested that the balance of the fund be transferred to the Neighborhood Reinvestment Corporation, an independent agency that provides technical services and assistance to improve and preserve housing in low-income communities. OMB said it was concerned that NCUA's management of the Revolving Loan Fund would conflict with NCUA's primary mission as a regulator, which is to ensure the safety and soundness of the credit union industry.

Conclusion

We, like OMB, believe that the fund should be administered by an organization that does not have supervisory responsibility for the credit unions to which the loans are made. The fund's objectives—providing basic financial services and promoting community development—could conflict with NCUA's basic supervisory responsibility.

Recommendation to Congress

We recommend that Congress amend the Community Development Credit Union Revolving Fund Transfer Act to designate an entity other than NCUA as administrator of the fund.

Agency Comments and Our Response

NCUA substantially agreed with many of the recommendations in this chapter and described actions it has taken related to them or proposals for modifying them.

NCUA objected to separating the insurance and supervision functions within NCUA at this time. And, if a single depository institution regulator were to be established and operating effectively, NCUA would strongly oppose being made part of that agency. NCUA's detailed comments on our recommendations and our response are presented in appendix XII.

NCUA objected to the expansion of the NCUA Board to five members and the inclusion of the Secretary of the Treasury and Federal Reserve Chairman on the grounds that it is unworkable because they might not be able to attend all Board meetings.

The purpose of this recommendation is threefold. It is to (1) ensure that NCUA's Board includes members who can bring a broader perspective on financial market regulatory and insurance issues; (2) enhance the importance of the insurance function; and (3) provide a link to the administration's thinking on public policy issues affecting insured depository institutions. NCUA appeared to object to the recommendation because it believes the Secretary of the Treasury and the Chairman of the Federal Reserve Board would not be able to attend many meetings and that Board decisions would therefore require a unanimous vote of the other three members. NCUA also indicated that over the past several years there have been periods with at least one vacancy on the three-member board.

The Department of the Treasury, in its comments, did not disagree with our recommendation but pointed out that its current legislative proposal calls for the director of the proposed Office of Depository Institutions Supervision to be, ex officio, on the NCUA Board. The Chairman of the Federal Reserve Board did not comment on the desirability of expanding the NCUA Board and providing for ex officio members. He did say, however, that making the Federal Reserve Chairman an ex officio member could distract from the Federal Reserve's ability to focus on its principal responsibilities.

We continue to believe it is critical for the future soundness of NCUSIF that the objectives of our recommendation be achieved and that the Federal Reserve Chairman and the Secretary of the Treasury are in the best position to accomplish these objectives. To provide some flexibility, however, we have modified our recommendation so that they could delegate authority to another presidentially appointed and Senate-confirmed official within their respective organizations.

In regard to our CLF recommendation, NCUA said that NCUSIF and credit unions must be assured of backup liquidity prior to terminating CLF. While we believe ample alternative liquidity sources exist, and that CLF is not needed, our recommendation provides that, at the least, Congress needs to sharply curtail the risks that CLF could incur without further congressional review. We believe this should be done without delay, although we continue to prefer the termination of this facility.

Highlights

Background

- The law specifies three types of common bond: occupational, associational, and community. Most credit unions (over 10,000) have common bonds primarily made up of occupational groups.
- Credit unions can now offer the same range of consumer lending products as banks and thrifts. In addition to powers held directly, they can offer services, such as insurance, through third-party affiliates.

Key Findings

- Credit unions are successfully competing with other depository institutions, due in part to loosened membership restrictions, and expanded asset and account powers.
- NCUA has loosened the definition of "common bond" considerably in the past decade. Since 1982, groups with different common bonds can belong to one credit union.
- Expansions of common bond helped in merging troubled credit unions but made it more difficult for members to know each other's creditworthiness.
- Credit unions are generally exempt from federal and state taxation. Congress did not specify in legislation the reason for the federal exemption.

Matter for Congressional Consideration

- If common bond is important to ensuring the safety and soundness of credit unions and distinguishing them from other insured depository institutions, legislative guidance should be provided on the purpose and limits of the common bond and multiple group charters.

Evolution of Credit Unions' Role in the Financial Marketplace

Credit unions have existed side-by-side with commercial banks and savings associations for most of this century. Clear differences between them and these other depository institutions still exist but are diminishing as a result of congressional and regulatory actions. The most significant of the changes affecting credit unions occurred in the 1970 to 1989 period and include the authorization of federal insurance in 1970, the steady expansion of the criteria that define the membership requirement, the authorization to make long-term and variable-rate loans, and the authorization to offer a variety of accounts. The principal impact of these changes can be seen in the continued growth of the industry.

As credit unions have become larger and increasingly compete with banks and savings associations, questions have been raised about the purpose of the present common bond membership requirement and credit union tax treatment. The membership requirement has been relaxed by NCUA to facilitate mergers, make credit union services more widely available, and provide a diversity of membership to help credit unions weather economic downturns. This relaxation has also helped enable them to grow larger. As of mid-1990, 3,174 credit unions had assets of $10 million or more; 375 credit unions had assets of $100 million or more. Untaxed credit unions are increasingly seen as competitors of taxed banks and savings associations in providing personal loans and depository services.

Congress has not explicitly addressed the reasons for or outer limits of the common bond membership requirement. Given the changes in the industry in the past two decades (broader asset and account powers, provision of share insurance, and relaxation of the common bond requirement), this is an appropriate time to provide the legislative guidance that will help define credit unions' future role as depository institutions by clarifying the purpose and limits of the common bond requirement.

Expansion of Field of Membership

A traditional distinguishing characteristic of credit unions has been the understanding that their members share a common bond and that this common bond facilitates their judgment as to the creditworthiness of fellow members and thus contributes to the credit union's safety and soundness. Federal credit unions and credit unions in most states are required to establish and demonstrate a common bond in order to obtain a charter. Over the years, however, the common bond requirements have been loosened considerably. Today, groups with very different common bonds are permitted to belong to a single credit union. Some

credit unions have dozens—even hundreds—of common bonds. The term "field of membership" is often used to encompass multiple common bonds.

The Federal Credit Union Act in 1934 set forth, without defining further, three types of common bond: occupation; association; or geographic location in a well-defined neighborhood, community, or rural district. Table 9.1 shows the most recent data available on the distribution of credit unions by type of common bond. The evolution in the meaning of these three types of common bond is discussed in this section.

Table 9.1: Credit Unions by Type of Common Bond (June 30, 1990)

	Occupational	Associational	Community
Number	10,239	1,966	891
Assets	$169.8 billion	$10.4 billion	$15.2 billion
Members:			
Actual	46.8 million	3.9 million	4.6 million
Potential	125.8 million	41.6 million	42.4 million

Note: NCUA officials advise that the type common bond of credit unions with multiple group charters is considered to be that of the majority of their common bonds. Seven credit unions with assets totalling $140 million are in an "other" category and are not included in this table.

Source: 1990 Midyear Statistics for Federally Insured Credit Unions, NCUA.

Early History

The first credit unions in North America were formed around certain groups of otherwise associated people. For example, the members of the first credit union in the United States were associated with St. Mary's church in New Hampshire, where a special law was passed in April 1909 permitting its incorporation. A few weeks later, Massachusetts enacted the first general credit union law in the country. Those forming credit unions in Massachusetts in the early 20th century saw credit unions as associations composed of members who knew each other. In the first third of the century, many states enacted laws for chartering and regulating credit unions, laws that generally included common bond requirements.

The Federal Credit Union Act in 1934, which first authorized federal charters for credit unions, limited membership in a federal credit union to groups having "a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district." (12 U.S.C. 1759)

Congress did not, however, elaborate on this definition at the time or express the reason for the requirement. Although courts have inferred that the purpose of the 1934 common bond requirement was to facilitate safe and sound operations, the legislative history does not make this explicit. Congress has not addressed the issue in subsequent amendments to the Federal Credit Union Act or other legislation.

Those associated with the early credit union movement developed what is now referred to as a model credit union act. This document was intended to be used by states in drafting their own credit union legislation, thereby assuring some national conformity. With respect to common bond, the model act as worded in 1924 stated:

> "Credit union organizations shall be limited to groups (of both large and small membership) having a common bond of occupation, or association or to groups within a well-defined neighborhood, community or rural district."

Federal Credit Unions

NCUA began expanding the criteria for the federal credit union common bond in the 1960s and did so steadily through 1989. These changes were documented in internal manuals and policy statements. Two significant changes occurred before 1972. In 1967, NCUA replaced its prior requirement that members be "extensively acquainted" with the requirement that members "know" each other. And, in 1968, NCUA adopted lifetime membership privileges ("once a member always a member").

In 1972 NCUA issued a chartering manual. This manual described common bond as:

> "a characteristic prerequisite to the fulfillment of group objectives and when present among persons of related interests and purposes, these persons could be expected to effectively operate a credit union."

The 1972 manual set forth definitions of the three types of common bond.

- Occupational bond: Members are employed by the same employer or in that employer's related activities. NCUA said it preferred a field of membership confined to people "who work in" one locality and required an explanation for a field that included employees "who are paid from or supervised by" several locations.
- Associational bond: Members belong to an organization in which participation fosters common loyalties and mutual interests. NCUA stated that

the association should be firmly established before it sought a credit union; it should not be established for the purpose of forming a credit union. The charter should restrict membership to people who were qualified under the association's rules at the time NCUA approved the charter.

- Residential bond: Members are residents within a well-defined geographical area who have a community of interests, activities, and objectives. NCUA stated that this common bond may include people who work in an area as well as residents. Because residential groups are less likely than occupational groups to share a community of interest, NCUA recommended forming a credit union along occupational rather than residential lines in urban areas, defined as areas with population of 2,500 or more.

A revised chartering manual was issued in 1980. It further loosened the definition of common bond.

"Common bond is defined as the sharing of some unifying factor or characteristic among persons which simultaneously links them together and distinguishes them from the general public."

The three types of common bond were defined as follows:

- Occupational bond: Members are (1) employed by the same employer or (2) work in related activities within a general locality or (3) work in a limited specified area.
- Associational bond: Members belong to an association in which participation fosters common loyalties, mutual benefits, and mutual interests. NCUA stated that the organization should hold regular meetings or sponsor other activities that provide contact among members.
- Community bond: There is regular contact among people who live or work in a well-defined neighborhood, community, or rural district. Renters as well as owners may be members of the group. NCUA stated that the burden of proving the existence of a well-defined community is on the charter applicant.

NCUA also added new standard language for all types of common bond that further loosened the federal definition of common bond.

"Field of membership includes spouses of people who died while eligible for membership, employees of credit unions, members of their immediate family, and organizations of such persons."

Major changes were again made in 1982. For the first time, credit unions could have members with different common bonds. Occupational and associational credit unions could merge or be merged by NCUA. Likewise, associational groups could add as members individuals within a defined community. A multiple group field of membership could thus include groups with different common bonds.[1] NCUA's immediate need for authorizing such multiple group charters was to enable it to merge credit unions that would otherwise close or fail. The Federal Credit Union Act was amended in October 1982 to allow NCUA to merge or to transfer some of the assets and liabilities of a credit union that was insolvent or in danger of insolvency to another federally insured credit union. NCUA also saw the change as a way of making credit union services available to those who previously had not had access. The 1982 changes have been described by NCUA as the start of its "deregulation" of field of membership criteria.[2]

In 1983, NCUA expanded the authority of its regional directors to approve multiple group fields of membership to include not only groups within a well-defined area of the main credit union office, but groups situated around existing branch offices.[3] (However, NCUA advised a credit union should not establish a new branch office for the purpose of expanding its field of membership.)

In November 1984, NCUA issued a consolidated statement of existing policies. It also added special rules for credit unions chartered by senior citizen associations, noting that its policy was to sponsor and assist the formation of senior citizen associations for the purpose of providing credit union services to their members.

NCUA also made certain other changes in 1984:

- Occupational and associational groups: NCUA announced a new requirement for adding new groups to an existing credit union. If a new group was eligible for membership in another credit union, the group must

[1]In multiple groups composed of associational and/or occupational groups, each group was required to have its own common bond and all groups were to be within a well-defined area. In multiple groups in which at least one of the groups had a community field of membership, the combined field was limited to a narrower geographical area, such as a well-defined neighborhood, community, or rural district.

[2]NCUA Interpretative Ruling and Policy Statement 84-1, "Membership in Federal Credit Unions," November 1984.

[3]NCUA defines a branch office as any office where an employee accepts deposits and disburses loans.

explain the reason for rejecting that service. NCUA also changed the branching policy set out in 1983 to allow credit unions to add groups as a partial justification for a new branch. NCUA explained that the limitation set out in 1983 denied service to existing fields of membership and was difficult to enforce.

- Community-based groups: NCUA specified that in instances when a credit union proposed expanding its boundaries, a regional director could approve the addition if the resulting field of membership was under 35,000. If the field was over 35,000, NCUA headquarters had to approve the charter amendment. (This policy, it said, does not apply when a community-based credit union wanted to add occupational or associational groups outside its boundaries. In such instances the regional director could make the decision, regardless of the size of the resulting field of membership.)

In 1987, NCUA chartered an "associational" credit union to serve the members of the American Association of Retired Persons. The fact that NCUA could and did charter a credit union with such a large potential national membership—the AARP credit union claimed a potential membership of 19 million—raised considerable concern.[4] It also did not seem entirely consistent with NCUA's policy, dating back to 1980, that in an association having many members or covering a large area, "separate credit unions should be organized, where possible, on the basis of local chapters or other units that will provide compact fields of membership and convenient credit union service."[5]

In December 1989, NCUA published a manual that "sets forth for the first time in one place NCUA's policies and procedures for granting and permitting change to a Federal credit union charter."[6] In it, NCUA reemphasized its prior policy concerning large credit unions: NCUA policy is to organize associational charters at the lowest organizational level which is economically feasible. The policy required that associational charters needed to have geographical or operational area limitations and to hold annual meetings. NCUA also changed its procedures to require approval by NCUA's Director of Examination and Insurance and the directors of all affected regions before issuing a federal charter to any associational credit union with proposed fields of membership of 500 or more persons that cross NCUA regional boundaries. The 1984 policy on expanding the

[4] In 1990, AARP announced it was disbanding its credit union, due to a lack of participation.

[5] Chartering and Organizing Manual for Federal Credit Unions, March 1980, p. 4-1.

[6] Chartering and Field of Membership Manual, p. i.

field of membership of community-based credit unions was also modified in 1989. They can no longer add groups outside their boundaries. The only way they can increase their field of membership is by expanding their boundaries consistent with community-based membership criteria.

State Credit Unions

It is difficult to obtain current information on the common bond or field of membership laws and regulations with respect to state credit unions. NCUA officials in Washington do not have current data. One reference book has been the Credit Union National Association's Comparative Digest of Credit Union Acts. It was last updated in 1986, and CUNA officials told us CUNA has no present plans to update this volume. The 1986 digest, however, noted that "Following the federal credit union lead, the field of membership of credit unions was broadened in a number of states in 1984-85" (p. iv). It listed 16 states with acts similar to the federal act[7] and 7 with acts similar to the present model credit union act.[8] (The model act is broader than the federal act because field of membership, it says, "may include but is not necessarily limited to groups having common bond.") Laws vary in the other states. For example, in Rhode Island, Oregon, and Puerto Rico, the digest reported that the state legislation refers to credit unions' bylaws for a definition of field of membership.

We asked the National Association of State Credit Union Supervisors if that organization had more recent data. Officials told us that they had conducted a survey in 1987 of state chartering and merging policies.[9] Thirty-nine of the 40 state bodies that responded said their states allow mergers. All but three said that credit unions with unlike common bonds can be merged. Thirty-four state statutes allow community charters; 24 of these do not impose a population limit. Officials were not aware of any significant changes in common bond requirements since 1988.

In Utah, credit unions can have statewide fields of membership. The director of Utah's State Department of Financial Institutions wrote us defining and supporting his state's law and practices. The law, he said,

[7]The states are Alabama, Alaska, Colorado, Connecticut, Iowa, Kansas, Louisiana, Michigan, Minnesota, Mississippi, Missouri, New Mexico, North Dakota, Tennessee, Texas and Washington. Comparative Digest of Credit Union Acts, CUNA, 1986.

[8]The states are Georgia, Hawaii, Montana, Nevada, New Jersey, New York, and North Carolina.

[9]State Chartering and Merger Policy Survey, National Association of State Credit Union Supervisors, 1988.

does not specifically address statewide fields of memberships. However, it does authorize fields of membership that include contiguous Utah counties. He said there are numerous reasons for this practice, which was first authorized several years ago. First, he said it would be hard not to allow it as it does not conflict with any laws. Second, he said, Utah has found it best to give credit unions the maximum flexibility to define their fields of membership. He emphasized that permitting individuals who were once members to always be members (as NCUA has allowed for federal credit unions) had already resulted in situations where "the original common bond is rapidly diluted to the point where it becomes virtually non-existent. The field of membership then becomes nothing more than an arbitrary designation of certain people in the general population."

Finally, he said, Utah has seen several instances in which restrictions on fields of membership would have adversely affected the safety and soundness of the credit unions. He cited a case in which a company had closed but its credit union was still healthy because it opened membership first to the community and then to the whole state. He added that he saw competition between credit unions for members.

We asked NCUA officials if, in approving a state credit union for NCUSIF insurance, NCUA considers its common bond. Common bond is considered only as part of NCUA's assessment of economic viability, they said. If the credit union has under 500 potential members, it is unlikely to succeed and must provide convincing support to the contrary.

Challenges in Court

Expanded powers and relaxed common bond restrictions have brought credit unions into more direct competition with other depository institutions, such as banks. Banking institutions, in response to the increased composition, have gone to court to stop credit union charters that define particularly large fields of membership on the grounds that potential members do not share the requisite common bond. The lawsuits have to date met mixed results.

The North Carolina Supreme Court, in a case brought by the state banking and savings and loan associations, ruled that a proposed field of membership did not satisfy the common bond requirement established by state statute.[10] A credit union serving North Carolina state government employees attempted to add to its field of membership a group

[10]In re Appeal of North Carolina Savings and Loan League, 276 S.E. 2d 404 (N.C. 1981).

consisting of local government employees who participated in the state administered retirement system and federal employees who worked with the local employees. The court inferred from the state statute that the state legislature had imposed the common bond requirement to achieve a "substantial unity of character and interest" among credit union members to promote the institution's "financial stability." Therefore, not all shared interests would qualify as a common bond. The shared interest had, it said, to be of such nature as to provide assurance of financial stability. The court further held that participation in the same retirement system did not constitute a sufficient commonality of interest to satisfy the requirement that credit union members share a common bond of a similar occupation, association, or interest.

In a later case, a federal circuit court dismissed a banking industry challenge to a proposed federal charter for the same group of local and federal employees in North Carolina on the grounds that banks did not have standing to sue to enforce compliance with the Federal Credit Union Act.[11] The federal court held that banks were not within the zone of interest that Congress intended the act to protect. Congress had established the federal credit union system "as an alternative to an unacceptable credit structure that included banks." This, it said, suggested that Congress "had purposefully sacrificed the competitive interests of banks" in favor of making credit more readily available to people of small means. Specifically, the court held that Congress did not intend the common bond requirement to limit the reach of credit unions for the protection of banks. Rather, a common bond ensures the cohesive operation of credit unions by encouraging the election of directors who share a common interest or occupation with the credit union's membership.

Notably, in both cases the courts found that a common bond contributes to the sound management of a credit union and, thus, to the safety and soundness of the industry as a whole. Yet, neither court found much legislative guidance on what the limitations of a common bond are. Furthermore, the contrary results in the two cases involving the same group of potential members demonstrate how various jurisdictions define and apply the common bond requirement in widely different ways.

A final type of litigation involving common bond has involved the Internal Revenue Service. These cases are discussed in appendix X.

[11] Branch Bank and Trust Co. v. National Credit Union Administration Board, 786 F.2d 621 (4th Cir. 1986).

Membership Characteristics

The purpose of the Federal Credit Union Act as set forth in 1934 was to

"establish a Federal Credit Union System, to establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping stabilize the credit structure of the United States." (Emphasis added.) (12 U.S.C. 1751)

None of the common bond criteria, however, address the economic status of members or potential members. While there is no statistically reliable data on the income levels of credit union members earlier in the century, it was accepted that members were generally not affluent. Expansions of the common bond requirements may have contributed to changes in membership characteristics. What little data are available on membership characteristics now suggests members are not all of "small means."

Data reported by the Credit Union National Association and the Secura Group, a financial services consulting firm, provide an indication of the present demographics of credit union members. The Secura Group concluded in its study for the American Bankers Association that "based on the data in various surveys in the late 1980s, the typical credit union member would be in his early forties, a homeowner, employed, with well above average income, better educated than a nonmember, and with access to financial services from a variety of sources."[12]

We asked NCUA officials if they had or were aware of data that would conflict with the Secura Group's study. They said they expected the description of credit union members is right because most credit unions are organized around occupations.

Similarly, a major planning study of the credit union movement made by the Credit Union National Association in 1987 reported that credit unions have "changed drastically over the years . . ." Among these were changes to credit unions' demographics.[13] In 1989 the Association contacted 1,000 credit union members and 757 nonmembers, selected randomly. The study reported that credit union market penetration had dropped substantially among young adults and low-income households

[12]The Credit Union Industry: Trends, Structure, and Competitiveness, A Study Prepared for the American Bankers Association Under the Direction of the Secura Group, Washington, D.C., p. 52.

[13]The Credit Union System, Report of the CUNA System Planning Committee, October 1987, p. 9.

and had expanded among retired people. People in low-income households, it found, were less likely to belong to credit unions than people in middle and upper income households. Overall, it reported that credit unions served 32 percent of American adults and another 24 percent were eligible to join a credit union. The typical member, the survey found, is older, more likely to be employed, and has a higher income than a nonmember.[14]

While we did not undertake any independent audit work in this area, the available data clearly indicate that credit unions do not exclusively serve people of "small means" today.

Share Insurance Dilutes Importance of Member Discipline

Discipline to control risk-taking by depository institutions can be provided by creditors, depositors, owners, and managers. (See ch. 7.) In the case of credit unions, creditors other than depositors are generally fully protected. This is because their position in the liquidation of a failed credit union is senior to that of the depositors, whose shares represent equity, not debt. Credit union members are essentially the institution's depositors and owners and, in the case of a small credit union, even its managers. (Credit union member deposits, whether they are in regular savings (share) accounts, certificates of deposit, or even Individual Retirement Accounts (IRAs), are viewed as share accounts.)

An important aspect of the traditional common bond between members of a credit union was the willingness of some members to put their personal savings at risk by letting the credit union lend these funds to other members. Federal share insurance for credit union accounts was not authorized until 1970. Credit union officials have told us that this relationship between savers and borrowers engendered a higher sense of obligation than borrowers might otherwise feel toward their ordinary creditors.

The relationship has, no doubt, diminished with the expansion of the common bond. The average membership of most credit unions is almost 2,000, as table 9.2 shows. Credit unions with over $100 million in assets averaged almost 52,000 members as of June 30, 1990.

[14]In Their Own Words: People Talk About Credit Unions, CUNA, 1989.

Table 9.2: Credit Union Members by Asset Size (June 30, 1990)

Dollars in millions

Asset size	Number of credit unions	Average membership	Total members	Potential members
$.5 and under	2,375	256	609,690	3,389,799
$.5 to $2	3,326	680	2,264,235	7,097,346
$2.01 to $10	4,227	1,973	8,340,932	26,559,195
$10.01 to $50	2,394	6,959	16,660,933	65,311,060
$50.01 to $100	405	19,754	8,000,751	50,906,063
Over $100	376	51,745	19,456,468	56,716,545
Total	**13,103**		**55,333,009**	**209,979,908**

Source: 1990 Midyear Statistics for Federally Insured Credit Unions, NCUA, p. 67. The number of credit unions differs from that presented elsewhere in its report because NCUA inadvertently included in its Midyear Statistics one association that was not federally insured at that time.

The advent of share insurance in 1970 further diminished this linkage: savers knew their money was safe (up to the insurance limit, now $100,000) whether or not the credit union was well-managed and successfully collected its loans. Also important, the borrowers knew that their fellow members' share accounts were safe even if they—the borrowers—defaulted on their loans and the credit union failed. Although the credit union industry continues to emphasize that credit union members are the owners of their institutions, to the extent that their share accounts fall under $100,000 they are, in essence, insured equity holders.

There is another theoretical difference between the dividends paid on credit union shares and interest on bank deposits. Interest must be paid as promised on a bank deposit. By contrast the return (dividend) on credit union shares is, in theory, contingent upon earnings. In 1982 NCUA withdrew a regulation requiring that such a disclosure be made by federal credit unions. In April 1990 it issued a draft regulation that would reinstate such a requirement. Many negative comments were received and as of March 1, 1991, no regulation had been issued. (See ch. 3.) In addition, through NCUSIF assistance, NCUA has permitted certain weak credit unions to pay dividends. (See ch. 5.)

Credit Union Asset and Account Powers Broadened

Credit unions' powers have expanded greatly since the late 1970s, giving them the ability now to offer the same range of consumer lending products as banks and thrifts can.

At the start of the 1970s, the industry consisted of 23,000 credit unions, slightly over half of which had less than $500,000 in assets and almost a third had fewer than 200 members. Their lending was primarily short-term, low interest consumer installment loans. There had been increases in asset powers, but federal credit unions were still generally restricted to small, short-term loans. For example, the original unsecured loan limit of $50 and maturity limit of 2 years had been raised several times, but in 1967 they were still only 5 years and $750, respectively.

According to a history of the credit union movement, many in the industry realized that developments in the financial services industry mandated that the industry had to change to survive.

"By the late 1960s it became clear to many credit union leaders that the financial universe within which they operated was changing rapidly. Credit unions faced increasing competition from other institutions. Commercial banks competed aggressively to attract new customers for installment loans, especially on automobile purchases; all-purpose credit cards were becoming commonplace; and retail stores' revolving credit plans were providing an increasing share of consumer credit. Competition for savers' dollars to meet rising credit demands became just as intense. Banks and savings and loan associations were developing a variety of savings instruments, such as certificates of deposit and savings, paying variable rates of interest; mutual funds attracted savings; life insurance companies launched aggressive campaigns to market variable annuities plans; and even the federal government pushed its offerings of money market securities that paid record high rates. This competition became more intense during the seventies, as spiraling inflation and rising interest rates caused consumers to seek the best returns on savings and the lowest interest rates on money they borrowed. Disintermediation and cross-intermediation became a problem for all financial institutions, as customers pursued higher interest rates for their savings.

"As with most segments of American society, credit union leaders saw their own operations and their competitive position as being linked with the new electronic marvel, the computer. Beginning with the recognition that electronic data processing would simplify and reduce the costs of ordinary bookkeeping requirements, the computer began to be seen as a revolutionary device that could promote the "cashless, checkless society" predicted years earlier. Electronic funds transfer (EFT) was already facilitating check clearings and credit card billings, and close on the horizon were direct deposits of payrolls and recurrent government payments, such as social security benefits. A traditional credit union advantage of payroll deductions for members' savings and loan payments appeared threatened, especially since consumers could enjoy the convenience of having their whole paycheck deposited for them and apportioned to their checking, savings, and loan accounts.

Even more challenging was the potential for using computers in automated teller machines that banks could install in supermarkets and other remote locations. The ATMs would allow bank customers twenty-four-hour-a-day deposit and withdrawal privileges, as well as transfer of funds from one type of account to another, and all these transactions could be handled in a location convenient to the customer without visiting the bank's main office.

"These challenges to the movement appeared so great to some that the very survival of credit unions seemed to be at stake. Many spokespeople, especially the professionals, insisted that credit unions had to change. . ."[15]

The history further relates that many associated with credit unions, primarily with large credit unions, felt that credit unions had to expand and modernize, but that state and federal laws and regulations highly restricted their ability to meet member needs and thus survive the growing competition from other institutions. It noted that the Credit Union National Association

"placed itself firmly behind those who desired to see credit unions become full-service institutions. By the end of the decade [the 1970s] that goal had been realized with the passage of the most sweeping amendments in the history of the Federal Credit Union Act."[16]

Table 9.3 summarizes the more significant changes to federal credit union asset and account powers and the date of the enabling legislation or regulation. Appendix I lists the important events in credit unions' expansion of powers in more detail.

[15]Moody, J. Carroll and Fite, Gilbert C., op cit, pp. 265 and 266.

[16]Ibid, p. 268.

Table 9.3: Selected Key Expansions of Federal Credit Union Asset and Account Powers

Year	New power
1959	Maximum maturity of loans raised to 5 years and unsecured loan limit raised to $750
1968	Secured loan maturity limit raised to 10 years and unsecured loan limit raised to $2,500
1977	30-year maturities on residential mortgage loans Loan maturities on nonresidential loans raised to 12 years
	15-year maturities on mobile homes and home improvements loans
	Self-replenishing lines of credit
	Investments in government-insured or guaranteed loans, real estate and student loans for the purpose of forming pools, and in credit union service organizations
	Different types of share accounts, including share certificates
1980	Share draft (checking) accounts
1981	Variable interest rate consumer and mortgage loans
1982	A variety of products and services to members from third-party sellers
	Investment in securities or other obligations issued or guaranteed by a U.S. agency
1989	Purchase of put options on securities of certain government sponsored enterprises

Source: The Federal Credit Union Act as amended in 1959, 1968, 1977, 1980, 1982, and NCUA regulation.

These expansions in both account and asset powers have enabled credit unions to offer virtually the same mix of consumer financial services as banks and savings and loans may and enabled them to maintain or increase market share.

In addition to powers held directly, credit unions can offer members additional services made available by third parties, such as those offered by affiliates of Credit Union National Association. The latter offer, for example, various kinds of insurance.

Credit unions can also offer services provided by certain profit-making entities with which they are associated. These organizations, referred to as credit union service organizations (CUSOs), are established by credit unions or groups of credit unions to provide a variety of financial and operational services. A federal credit union may invest in shares, stock, or obligations of CUSOs an amount not exceeding 1 percent of its total paid in and unimpaired capital and surplus (shares and undivided earnings). It may also make loans to CUSOs not exceeding 1 percent of this amount. (This authority and the limits were legislated in 1977.) Most state credit unions also have limits, although they may exceed the federal limit.

Although CUSOs can extend credit union services, there are little current data in this area. A 1986 survey by the National Association of Credit Union Service Organizations, based on 74 respondents, showed that 72 percent offered insurance products; 16 percent offered mortgages; and from 4 to 15 percent offered a variety of other products, including discount brokerage, automobile buying services, travel services, tax preparation, and real estate brokerage. NCUA, in 1986, set forth in regulation those activities permissible for a federal credit union's CUSO. These are similar to, but in some instances broader than, those permitted within bank holding companies. (12 C.F.R. 701.27)

Credit Unions Are Tax Exempt

Credit unions, unlike other federally insured depository institutions, are exempt from federal income taxation. The legislative history does not give a clear rationale for the exemption. State credit unions were originally recognized because of their similarity to other mutual financial institutions that were at the time tax exempt. When the other mutual financial institutions lost their exemption in 1951, state credit unions explicitly retained exempt status. Federal credit unions were granted exempt status in 1937.

While credit union activities have evolved through legislative and regulatory action, credit unions have maintained their general federal and state tax-exempt status. The taxation of credit unions was proposed by the executive branch in 1978 and 1985. Both proposals argued that tax-exempt status gives credit unions an unwarranted competitive advantage over banks and thrift institutions. In testimony defending the current tax-exempt status of credit unions, credit union industry officials and others argued that the unique service mix offered by credit unions, the mutual nature of the institutions, and the potential harm that taxation would have on undercapitalized credit unions justify continuing exempt status.

A detailed discussion of the tax treatment of credit unions, other depository institutions, and other cooperative institutions is provided in appendix X.

Conclusions

Credit unions have evolved into competitive depository institutions that can provide federal insurance for their members' deposits (shares) and offer a wide range of consumer banking services. The definitions of field of membership and common bond that limit their memberships have

been relaxed, and credit unions reported in mid-1990 that they had 55 million members and potential membership of 210 million.

The authorization of share insurance in 1970 sharply diminished any assumption that a common bond among members was necessary to help ensure that their own savings would be safely lent and, consequently, that the institution would be safely and soundly operated. Subsequently, the common bond membership requirements were relaxed and membership grew. And, there is no evidence that today's credit union members are for the most part "of small means."

Matter for Congressional Consideration

If credit unions are to remain distinct from other depository institutions because, in part, of their common bond membership requirement, and if this requirement is intended to further the safe and sound operation of credit unions:

- Congress should consider stating this general intent in legislation and setting forth guidelines on the limits of occupational, associational, and community common bonds, as well as the purpose and limits of multiple group charters. These guidelines should be for all federally insured credit unions.

Agency Comments and GAO Response

NCUA did not object to this recommendation, but stressed that without its change of policy on the common bond requirement, credit unions and NCUSIF might not have survived the 1980s. We do not disagree that some relaxation of the requirement was appropriate. As the requirement has been relaxed, however, the distinction between credit unions and banks and thrifts has diminished. NCUA also said the common bond, combined with the cooperative structure of credit unions, ensures that they remain true to their consumer orientation and avoid the sort of costly risks undertaken by other depository institutions. The consumer orientation of credit unions derives fundamentally from legal restrictions on their powers, not from the fact that they are cooperatives with defined fields of membership. And, as we point out, the availability of federal share insurance itself challenges the basis of the cooperative structure as a risk control mechanism, as does the increasing size and membership diversity of credit unions. This is especially true if credit unions are not required to disclose that dividends are dependent upon available earnings, as we recommend. If the existence of a common bond is seen to be such a key characteristic of credit unions, then a statutory definition is clearly appropriate.

Finally, NCUA cautions that the dual chartering system needs to be taken into consideration should state as well as federal credit unions be required to meet federal common bond guidelines. Despite the dual chartering system, NCUA and Congress have required state as well as federal credit unions to meet federal standards in areas they believed important, such as reserving and commercial lending. We believe federal guidance regarding common bond is also appropriate.

Summary Chronology of the Credit Union Industry

1909	The first credit union in the United States is incorporated.
1917	The Massachusetts Credit Union Association is chartered. Its stated purpose was to "disseminate information in respect to the benefits of credit unions...; to organize and assist in the organization of credit unions; to make loans to credit unions at a rate not exceeding six percent per annum and generally to promote and assist credit unions."
1934	The Federal Credit Union Act (FCUA) is enacted. The Farm Credit Administration is designated to administered federal credit unions. CUNA is organized.
1937	FCUA is amended to exempt federal credit unions from federal taxation and limit state taxation.
1942	Oversight of federal credit unions is transferred from the Farm Credit Administration to FDIC.
1948	Oversight of federal credit unions is transferred from FDIC to the Bureau of Federal Credit Unions within the Federal Security Agency.
1966	Federal credit union investments in shares or other investments guaranteed by the Federal National Mortgage Association are permitted.
1967	NAFCU is established.
1968	Federal credit union investments in shares in central or corporate credit unions and Government National Mortgage Association obligations are permitted.
1970	The National Credit Union Administration Act amends FCUA to establish NCUA as an independent agency within the federal government and establishes NCUSIF to provide share insurance. Credit unions serving predominantly low-income members are authorized to accept funds from nonmembers.
1972	FCUA is amended to allow federal credit unions to invest in obligations of the Student Loan Marketing Association.
1974	FCUA is amended to permit federal credit unions to invest in securities and obligations of the Federal
	Home Loan Mortgage Corporation.
1974	The U.S. Central Credit Union is established.
1977	FCUA is amended to expand saving, lending, and investment powers by (1) increasing loan maturities on nonresidential loans to 12 years; (2) allowing 30-year residential mortgage loans and 15-year mobile home and home improvement loans; (3) permitting self-replenishing lines of credit; (4) permitting investments in government insured or guaranteed loans; (5) lowering the reserve formula for larger credit unions; and (6) allowing different types of share accounts, including share certificates.
1978	FCUA is amended to (1) restructure NCUA into a three-member board whose members are appointed by the President for staggered 6-year terms and (2) establish CLF under NCUA to provide liquidity for credit unions.
1978	NCUA issues regulations to permit the sale of mortgages to FNMA, FHLMC, and GNMA.
1979	Credit unions are given a 90-day authorization by Congress to offer share drafts.
1980	The Depository Institutions Deregulation and Monetary Control Act amends FCUA to (1) classify credit unions as depository institutions, (2) provide permanent authority for share drafts, (3) establish a timetable for phasing out deposit interest rate ceilings, (4) raise the federal deposit insurance coverage limit to $100,000, (5) raise the loan rate ceiling for federal credit unions to 15 percent and authorize NCUA to increase this ceiling if necessary.
1981	By regulation, NCUA allows federal credit unions to make variable interest rate consumer and mortgage loans.
1982	The Garn-St. Germain Depository Institutions Act amends FCUA to (1) eliminate limits on size and maturity of mortgage loans, allow refinancing of first mortgages, and extend the maturity limit on second mortgages; and (2) permit NCUSIF to borrow from CLF and make CLF an agent of the Federal Reserve System.
1982	The Nation Credit Union Administration Should Revise Liquidation Procedures to Reduce the Net Cost of Credit Union Liquidation (GAO/GGD-82-26, Feb. 19, 1982) issued. This GAO report says that although NCUA has made recent efforts to reduce the cost of liquidation, GAO believes more needs to be done. NCUA could reduce the net costs of liquidation by maximizing the value of the loan portfolio and reducing expenses. In addition, GAO believes more active NCUA supervision is needed to ensure compliance with policies intended to reduce the net cost of liquidations.

(continued)

1982	Stronger Supervision of Credit Unions Needed (GAO/GGD-83-12, Oct. 6, 1982) issued. In this report, GAO examines the role of NCUA in supervising federal credit unions and federally insured state-chartered credit unions. GAO recommends steps to improve and strengthen NCUA supervisory actions taken against federal credit unions. GAO also recommends that NCUA first determine the acceptability of various state examination programs and then continue to monitor their capabilities.
1982	By regulation, NCUA permits federal credit unions to offer a wide variety of products and services to their members from third-party sellers.
1982	The credit union service organization regulation is changed to allow federal credit unions greater flexibility in cooperating with other credit unions and other investment partners in order to provide a wide range of services to credit unions and their members.
1982	NCUA permits credit unions with different common bonds to merge.
1984	The Deficit Reduction Act amends FCUA to require credit unions to recapitalize NCUSIF with a deposit equal to 1 percent of their insured shares and sets the Fund's equity base at no more than 1.3 percent of insured shares.
1989	NCUA allows federal credit unions to purchase put options on GNMA, FNMA, and FHLMC securities. NCUA extends the maturity limit for other than first mortgage loans from 15 to 20 years. Credit unions can now offer 20-year loans for mobile homes, secondary mortgages, and home improvements.

Number of Credit Unions by State and Charter (June 30, 1990)

Dollars in millions

State	Insured credit unions		State credit unions	Federal credit unions
	Number	Total assets		
Alabama	230	$3,583	97	133
Alaska	18	1,341	2	16
Arizona	80	2,674	32	48
Arkansas	109	544	29	80
California	903	29,805	240	663
Colorado	210	3,580	88	122
Connecticut	294	3,040	96	198
Delaware	55	499	[a]	55
District of Columbia	107	2,129	[a]	107
Florida	238	7,899	25	213
Georgia	233	3,028	28	205
Guam	3	73	[a]	3
Hawaii	134	2,636	4	130
Idaho	72	637	25	47
Illinois[b]	852	5,832	603	249
Indiana	328	5,138	44	284
Iowa	253	1,853	247	6
Kansas	118	1,392	77	41
Kentucky	184	1,572	73	111
Louisiana	364	2,256	81	283
Maine	114	1,540	14	100
Maryland	166	4,179	7	159
Massachusetts	280	6,073	41	239
Michigan	616	11,042	399	217
Minnesota	248	3,445	185	63
Mississippi	170	911	50	120
Missouri	196	1,859	174	22
Montana	99	724	18	81
Nebraska	113	972	45	68
Nevada	32	990	2	30
New Hampshire	46	1,323	28	18
New Jersey	439	3,704	33	406
New Mexico	70	1,298	32	38
New York	880	11,445	61	819
North Carolina	256	5,257	160	96
North Dakota	84	500	59	25
Ohio	688	5,869	230	458

(continued)

State	Insured credit unions		State credit unions	Federal credit unions
	Number	Total assets		
Oklahoma	120	2,674	38	82
Oregon	156	2,812	28	128
Pennsylvania	1,122	7,891	141	981
Puerto Rico	33	288	1	32
Rhode Island	36	1,032	23	13
South Carolina	131	2,254	33	98
South Dakota	71	387	[a]	71
Tennessee	162	2,593	32	130
Texas	675	12,108	80	595
Utah	172	2,435	120	52
Vermont	61	403	54	7
Virginia	311	10,055	96	215
Virgin Islands	5	14	[a]	5
Washington	132	4,485	21	111
West Virginia	145	808	2	143
Wisconsin	450	4,264	447	3
Wyoming	39	289	[a]	39
Totals	**13,103**	**$195,436**	**4,445**	**8,658**

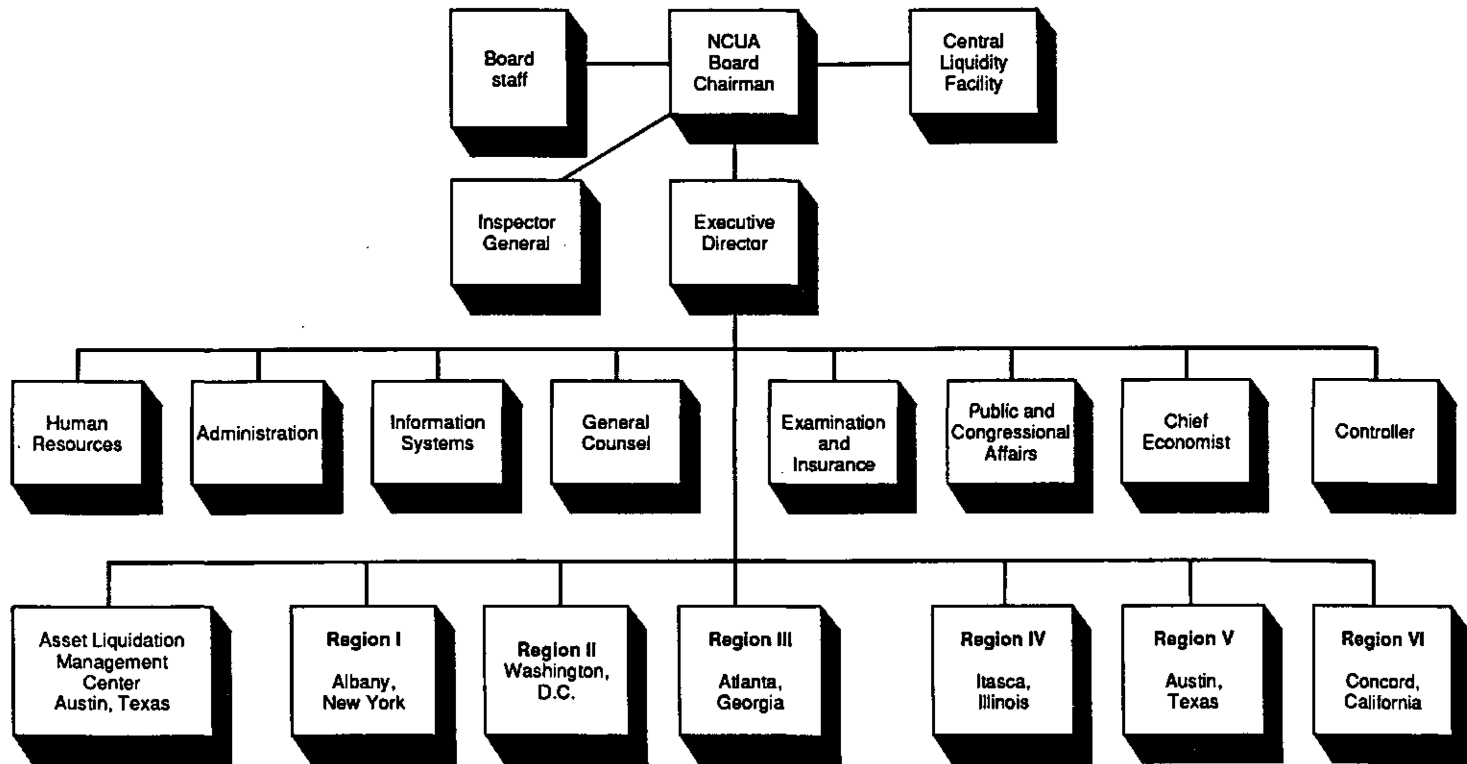
Note: The total amount of assets does not add due to rounding.

[a]These states and other entities do not charter credit unions.

[b]According to NCUA officials, one state credit union in Illinois, was inadvertently included in the data in this publication. Its assets were $173 million. Also, another state credit union located in Illinois and with assets of $8 million should be recategorized as a federal credit union.

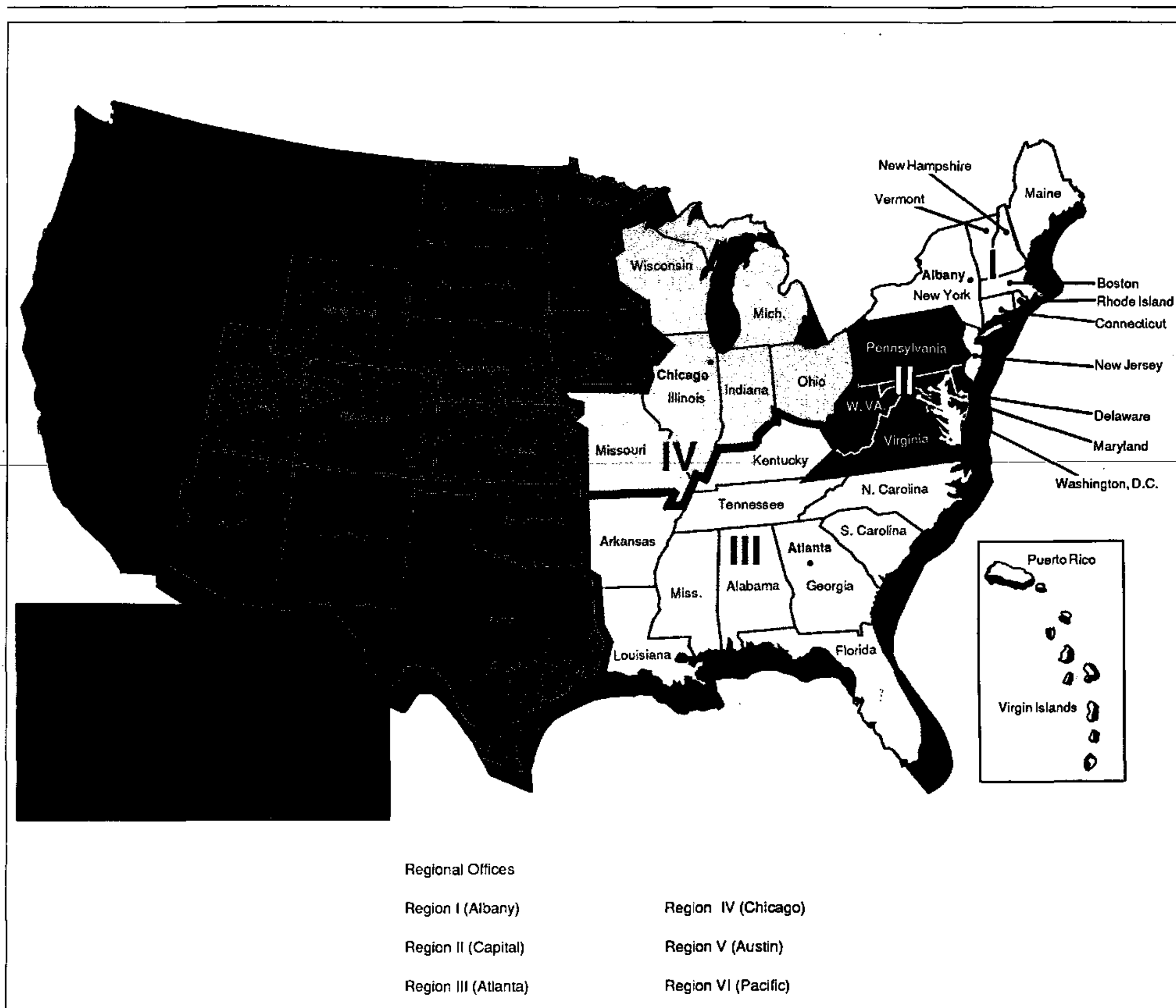
Source: 1990 Midyear Statistics for Federally Insured Credit Unions, NCUA, pp. 1, 30, and 59.

NCUA Organization Chart (May 1991)



Source: NCUA, Office of Examination and Insurance.

Map of NCUA Regions



Source: NCUA, 1990 NCUSIF Annual Report.

Review of the Financial Statements of the National Credit Union Administration for the Fiscal Years Ended September 30, 1990 and 1989

This appendix presents the results of our review of the independent certified public accountant's audits of the financial statements of the National Credit Union Administration's Operating and Share Insurance Funds and its Central Liquidity Facility for the fiscal years ending September 30, 1990 and 1989.

In the auditor's opinion, the statements for the fiscal years ending September 30, 1990 and 1989, for the National Credit Union Administration's Operating and Share Insurance Funds and the Central Liquidity Facility are fairly presented. The independent auditor's reports on the Administration's internal control structure and on its compliance with laws and regulations are also provided.

The Federal Credit Union Act of 1934, as amended (12 U.S.C. 1751 et seq.), established the National Credit Union Administration as an independent agency of the executive branch. The Administration regulates and insures federally chartered credit unions and insures state-chartered credit unions that apply and qualify for insurance. To accomplish this, it administers the three funds which provide support services to all federally insured credit unions: the Operating and Share Insurance Funds and the Central Liquidity Facility. The Operating Fund is a revolving fund that provides administrative services to the credit union system. The Share Insurance Fund is a revolving fund created to insure member accounts in all federal credit unions and qualifying state-chartered credit unions. The Central Liquidity Facility is a mixed-ownership government corporation established to meet the cash flow needs of member credit unions. Additional information on the organization and purpose of the Operating and Share Insurance Funds and the Central Liquidity Facility is provided in the notes to the financial statements, which are included in the report.

The Administration contracted with an independent certified public accounting firm, Price Waterhouse, to perform, in accordance with generally accepted government auditing standards, financial and compliance audits of the fiscal year 1990 and 1989 financial statements of the National Credit Union Administration's Operating and Share Insurance Funds and its Central Liquidity Facility. Our reviews of the audits were made under provisions of the Federal Credit Union Act of 1934 (12 U.S.C. 1752a(f),1789(b) (2), and 1795h), which authorizes us to audit the Administration's financial transactions consistent with the principles and procedures applicable to commercial corporate transactions. To fulfill our audit responsibilities, avoid duplication and unnecessary

expense, and make the most efficient use of our resources, we reviewed the independent auditor's work and reports.

We conducted our review of the auditor's work in accordance with generally accepted government auditing standards. To determine the reasonableness of the auditor's work and the extent to which we could rely on it, we

- reviewed the auditor's approach and planning of the audit;
- evaluated the qualifications and independence of the audit staff;
- reviewed the financial statements and auditor's reports to evaluate compliance with generally accepted accounting principles and generally accepted government auditing standards; and
- reviewed the auditor's working papers to determine (1) the nature, timing, and extent of audit work performed, (2) the extent of the audit quality control methods the auditor used, (3) whether a study and evaluation was conducted of the entity's internal control structure, (4) whether the auditor tested transactions for compliance with applicable laws and regulations, and (5) whether the evidence in the working papers supported the auditor's opinion on the financial statements and internal control structure and compliance reports.

In addition, in light of deteriorating conditions in other federal deposit insurance funds, we placed additional emphasis on (1) gaining an understanding of the National Credit Union Administration's methodology for establishing a reserve for insurance losses based on information gathered through the Administration's regulatory process and (2) reviewing the auditor's testing of the reserve for insurance losses. However, we did not independently verify all regulatory information provided to us.

In the opinion of Price Waterhouse, the financial statements of the National Credit Union Administration's Operating and Share Insurance Funds and its Central Liquidity Facility present fairly their financial positions as of September 30, 1990 and 1989, and the results of their operations and of cash flows for the years then ended, in conformity with generally accepted accounting principles. Also, Price Waterhouse's reports to the Administration on internal control structure and on compliance with laws and regulations did not disclose any material internal control weaknesses or noncompliance with laws and regulations.

During our review, we found nothing to indicate that Price Waterhouse's opinions on the fiscal year 1990 and 1989 financial statements of the National Credit Union Administration's Operating and Share Insurance

Funds and the Central Liquidity Facility are inappropriate or cannot be relied on, nor did we find anything to indicate that the auditor's reports on internal control structure and on compliance with laws and regulations are inappropriate or cannot be relied on.

We believe that the financial statements, together with Price Waterhouse's opinions and our review of that work, as well as the information contained in our comprehensive report, provide Congress with a dependable basis for overseeing the financial position of the National Credit Union Administration's Operating and Share Insurance Funds and its Central Liquidity Facility. This appendix presents the financial statements and the auditor's opinions thereon.

In conjunction with our review of the independent certified public accountant's audits, we examined the financial condition of the credit union industry as discussed in chapter 2. In chapter 2, we discuss issues related to the structure, regulation, and supervision of the credit union industry that may have an impact on the Share Insurance Fund.

National Credit Union Share Insurance Fund

1801 K Street, N.W
Washington, DC 20006

Telephone 202 833 7932

Price Waterhouse

REPORT OF INDEPENDENT ACCOUNTANTS

November 15, 1990

To the Board of the National Credit Union Administration

In our opinion, the accompanying balance sheets and the related statements of operations, of insured credit union accumulated contributions and insurance fund balance, and of cash flows present fairly, in all material respects, the financial position of the National Credit Union Share Insurance Fund at September 30, 1990 and 1989 and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the National Credit Union Share Insurance Fund's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in Government Auditing Standards, issued by the Comptroller General of the United States which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

Price Waterhouse

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Price Waterhouse

REPORT OF INDEPENDENT ACCOUNTANTS

November 15, 1990

To the Board of the National Credit Union Administration

We have audited the financial statements of the National Credit Union Share Insurance Fund (the Fund) as of and for the year ended September 30, 1990, and have issued our report thereon dated November 15, 1990.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of the Fund for the year ended September 30, 1990, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of the Fund is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

November 15, 1990
To the Board of the National Credit Union Administration
Page 2

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- Investment purchases and maturities
- Operating fee collections
- Cash disbursements
- Payroll

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we have reported to management of the Fund in a separate letter dated November 15, 1990.

This report is intended for the information of the Board of the National Credit Union Administration Fund's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Price Waterhouse

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Price Waterhouse

REPORT OF INDEPENDENT ACCOUNTANTS

November 15, 1990

To the Board of the National Credit Union Administration

We have audited the financial statements of the National Credit Union Share Insurance Fund (the Fund) as of and for the year ended September 30, 1990, and have issued our report thereon dated November 15, 1990.

We conducted our audit in accordance with generally accepted auditing standards and the provisions of Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the National Credit Union Share Insurance Fund is the responsibility of the Fund's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Fund's compliance with material terms and conditions of Title II of the Federal Credit Union Act, as amended in August 1987. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, the Fund complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the Fund had not complied, in all material respects, with those provisions.

This report is intended for the information of the Board of the National Credit Union Administration and the Fund's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Price Waterhouse

NATIONAL CREDIT UNION SHARE INSURANCE FUND
BALANCE SHEETS

	September 30, 1990	September 30, 1989
ASSETS		
Cash, including cash equivalents of $83,249,644 and $514,044,000 (Notes B and E)	$ 84,260,898	$ 524,979,628
Investments (Notes B and E)	1,814,885,712	1,323,909,955
Capital notes advanced to insured credit unions	67,890,846	39,359,717
Note receivable - National Credit Union Administration Operating Fund (Note H)	1,980,766	2,052,766
Other notes receivable (Note F)	13,013,688	8,732,014
Other receivables	2,170,067	8,310,797
Assets acquired in assistance to insured credit unions:		
Liquidating and acquired credit union assets	127,803,380	105,545,042
Allowance for losses on acquired assets	(21,200,000)	(23,501,000)
	106,603,380	82,044,042
Accrued interest receivable	53,674,828	40,101,853
Total assets	$2,144,480,185	$2,029,490,772
LIABILITIES AND FUND CAPITALIZATION		
Due to National Credit Union Administration Operating Fund (Note H)	$ 626,060	$ 191,721
Accounts payable	302,442	
Amounts due to insured shareholders of liquidated credit unions	15,204,879	9,331,655
Estimated losses from supervised credit unions (Note C)	72,688,000	40,912,000
Estimated losses from asset and merger guarantees (Note C)	3,024,000	6,553,000
Total liabilities	91,845,381	56,988,376
Fund capitalization:		
Insured credit union's accumulated contributions (Note D)	1,613,976,947	1,568,974,263
Insurance fund balance	438,657,857	403,528,133
Total fund capitalization	2,052,634,804	1,972,502,396
Commitments (Notes C and H)		
Total liabilities and fund capitalization	$2,144,480,185	$2,029,490,772

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION SHARE INSURANCE FUND
STATEMENTS OF OPERATIONS

	Year ended September 30,	
	1990	1989
Revenue:		
Interest income	$159,095,503	$147,900,128
Other income	1,168,938	899,678
Total revenue	160,264,441	148,799,806
Expenses:		
Administrative expenses (Note H)		
Employee wages and benefits	22,263,674	18,973,326
Travel expense	3,648,449	3,977,074
Rent, communications, and utilities	2,308,433	2,197,839
Contracted services	1,232,397	1,552,305
Other administrative	5,699,764	4,116,505
Total administrative expenses	35,152,717	30,817,049
Provision for insurance losses	89,982,000	93,608,000
Total expenses	125,134,717	124,425,049
Excess of revenue	$ 35,129,724	$ 24,374,757

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION SHARE INSURANCE FUND
STATEMENTS OF INSURED CREDIT UNION ACCUMULATED CONTRIBUTIONS
AND INSURANCE FUND BALANCE

	Insured Credit Union Accumulated Contributions	Insurance Fund Balance
Balance at September 30, 1988	$1,476,757,851	$379,153,376
Contributions from insured credit unions, net	92,216,412	
Excess of revenue		24,374,757
Balance at September 30, 1989	1,568,974,263	403,528,133
Contributions from insured credit unions, net	45,002,684	
Excess of revenue		35,129,724
Balance at September 30, 1990	$1,613,976,947	$438,657,857

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION SHARE INSURANCE FUND
STATEMENTS OF CASH FLOWS

	Year ended September 30, 1990	1989
Cash flows from operating activities:		
Excess of revenue	$ 35,129,724	$ 24,374,757
Adjustments to reconcile excess of revenue to net cash provided (used) by operating activities:		
Provision for insurance losses	89,982,000	93,608,000
Payments relating to losses from supervised credit unions and asset and merger guarantees, net	(61,735,000)	(97,278,000)
Changes in operating assets and liabilities:		
(Increase) in advances to credit unions	(28,531,129)	(34,243,206)
(Increase) in other notes receivable	(4,281,674)	(8,732,014)
Decrease (increase) in other receivables	6,140,730	(8,310,797)
(Increase) in assets acquired from credit unions, net	(24,559,338)	(12,169,206)
(Increase) in accrued interest receivable	(13,572,975)	(9,389,310)
(Increase) decrease in amounts due to National Credit Union Administration Operating Fund	434,339	(520,101)
Increase (decrease) in amounts due to insured shareholders of liquidated credit unions	5,873,224	(2,959,212)
Increase in accounts payable	302,442	
Net cash provided (used) by operating activities	5,182,343	(55,619,089)
Cash flows from investing activities:		
(Increase) decrease in investments, net	(490,975,757)	240,937,999
Collections on note receivable - National Credit Union Administration Operating Fund	72,000	72,000
Net cash (used) provided by investing activities	(490,903,757)	241,009,999
Cash flows from financing activities:		
Contributions from insured credit unions, net	45,002,684	92,216,412
Net (decrease) increase in cash and cash equivalents	(440,718,730)	277,607,322
Cash and cash equivalents at beginning of year	524,979,628	247,372,306
Cash and cash equivalents at end of year	$ 84,260,898	$524,979,628
Composed of:		
Cash	$ 1,011,254	$ 10,935,628
Cash equivalents - U.S. Government securities with maturities less than 3 months	83,249,644	514,044,000
Total	$ 84,260,898	$524,979,628

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION SHARE INSURANCE FUND
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1990

NOTE A - ORGANIZATION AND PURPOSE

The National Credit Union Share Insurance Fund (the Fund) 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 as discussed in Note D. The Fund was established as a revolving fund in the United States Treasury under the management of the National Credit Union Administration (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 maximum amount of insurance is $100,000 per shareholder.

NCUA exercises direct supervisory authority over federal credit unions and coordinates any required supervisory involvement with the state chartering authority for state-chartered credit unions insured by the Fund. Insured credit unions are required to report certain financial and statistical information to NCUA on a semi-annual basis and are subject to periodic examination by NCUA. Information derived through the supervisory and examination process provides the Fund with the ability to identify credit unions experiencing financial difficulties that may require assistance from the Fund.

Credit unions experiencing financial difficulties may be assisted by the Fund in continuing their operations if the difficulties are considered by the Fund to be temporary or correctible. This special assistance may be in the form of a waiver of statutory reserve requirements, a guarantee account, and/or cash assistance. If continuation of the credit union's operations with Fund assistance is determined to be infeasible, a merger partner may be sought. If the assistance or merger alternatives are not considered practical, the credit union is liquidated.

The first form of special assistance are waivers of statutory reserve requirements, whereby the credit union is permitted to cease making additions to its regular reserve and, in more severe cases, to commence charging operating losses against its regular reserve. When all reserves have been depleted by the credit union, the Fund may provide a reserve guarantee account in the amount of the reserve deficit. In addition, the Fund may provide cash assistance in the form of share deposits and capital notes or may purchase assets from the credit union.

Mergers of financially troubled credit unions with stronger credit unions may also require Fund assistance. Merger assistance may be in the form of cash assistance, purchase of certain assets by the Fund, and/or guarantees of the values of certain assets (primarily loans).

When a credit union is no longer able to continue operating and the merger and assistance alternatives are not considered practical, the Fund will liquidate the credit union, dispose of its assets, and pay members' shares up to the maximum insured amount. The values of certain assets sold (primarily loans) are at times guaranteed to third-party purchasers by the Fund.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

Cash Equivalents and Investments

Title II of the Federal Credit Union Act limits the Fund's investments to United States Government securities or securities guaranteed as to both principal and interest by the United States Government. Investments are stated at cost adjusted for amortization of premium and accretion of discount. Cash equivalents are highly liquid investments with original maturities of three months or less.

Advances to Insured Credit Unions

The Fund provides cash assistance in the form of interest and non-interest bearing capital notes (carried at face value), share deposits, and loans to certain credit unions to assist them in continuing operations.

Assets Acquired from Credit Unions

The Fund acquires the assets of liquidating credit unions pending their ultimate disposition. To assist in the merger of credit unions, the Fund may purchase certain credit union assets. In addition, the Fund may provide cash assistance by acquiring non-performing assets of a credit union experiencing financial difficulty. Such assets acquired are recorded at their estimated net realizable value.

Insurance Premium Revenue

The Fund could assess each insured credit union a regular annual premium of 1/12 of 1% of member share deposits (insured member share deposits in the case of corporate credit unions) outstanding as of June 30 of the preceding fiscal year. The NCUA Board waived the 1990 and 1989 share insurance premium.

Income Taxes

The Fund is exempt from Federal income taxes under §501(c)(1) of the Internal Revenue Code.

NOTE C - PROVISION FOR INSURANCE LOSSES

Management identifies credit unions experiencing financial difficulty through the supervisory and examination process. The estimated losses from these supervised credit unions are determined by management based on a case-by-case evaluation.

In exercising its supervisory function, the Fund at times will extend guarantees of assets (primarily loans) to third party purchasers or to credit unions to facilitate mergers; such guarantees totaled approximately $6,600,000 and $12,891,000 at September 30, 1990 and 1989, respectively. The estimated losses from asset and merger guarantees are determined by management based on a case-by-case evaluation.

The activity in the reserves for estimated losses from supervised credit unions and asset and merger guarantees for the years ended September 30, 1990 and 1989 was as follows:

	Year ended September 30,	
	1990	1989
Beginning balance	$ 47,465,000	$ 51,135,000
Provision for insurance losses	89,982,000	93,608,000
Insurance losses and transfers to the allowance for losses on acquired assets	(74,165,957)	(114,750,000)
Recoveries	12,430,957	17,472,000
Ending balance	$ 75,712,000	$ 47,465,000

In addition, the Fund guarantees loans made by the Central Liquidity Facility (CLF) and Corporate Credit unions to credit unions. Total outstanding line-of-credit guarantees at September 30, 1990 and 1989 are approximately $35,943,000 and $60,977,000, respectively.

NOTE D - FUND CAPITALIZATION

Title VIII of Public Law 98-369, effective July 14, 1984, provided for the capitalization of the Fund through the contribution by each insured credit union of an amount equal to 1% of the credit union's insured shares to be paid initially by January 21, 1985, and to be adjusted annually thereafter. The annual adjustment of the contribution is based on member share deposits outstanding as of June 30 of the preceding fiscal year and is billed on a calendar year basis. The 1% contribution will be returned to the insured credit union in the event that its insurance coverage is terminated, insurance coverage is obtained from another source, or the operations of the Fund are transferred from the NCUA Board.

The aggregate contributions of $1,613,976,947 at September 30, 1990, consists of $1,530,103,924 of insured credit union accumulated contributions and $83,873,023 of the previously accumulated fund balance which was designated by the NCUA Board as a component of credit union accumulated contributions in 1984. Total insured shares at June 30, 1990 were $176,624,550,000 for which additional net contributions of approximately $152,268,553 will be payable to the Fund in January 1991.

The law requires that, upon receipt of the 1% contribution, the total fund balance must be maintained at a normal operating level to be determined by the NCUA Board. The NCUA Board has determined this level to be a range of 1.25% to 1.3% of insured shares.

The NCUA Board did not declare any dividends during 1990 or 1989.

NOTE E - CASH EQUIVALENTS AND INVESTMENTS

All cash received by the Fund which is not used for outlays related to assistance to insured credit unions and liquidation activities is invested in U.S. Treasury securities.

Cash equivalents and investments consist of the following:

	September 30, 1990			
	Yield to Maturity at Market	Book Value	Market Value	Face Value
Cash Equivalents				
U.S. Treasury Securities - overnight funds	8.92%	$ 83,249,644	$ 83,249,644	$ 83,249,644
U.S. Treasury Securities				
Maturities up to one year	8.26	$ 699,797,037	$ 702,696,000	$ 700,196,000
Maturities over one year	8.99	1,115,088,675	1,118,322,920	1,100,197,920
		$1,814,885,712	$1,821,018,920	$1,800,393,920

	September 30, 1989			
	Yield to Maturity at Market	Book Value	Market Value	Face Value
Cash Equivalents				
U.S. Treasury Securities - overnight funds	9.43%	$ 514,044,000	$ 514,044,000	$ 514,044,000
U.S. Treasury Securities				
Maturities up to one year	7.86	$ 524,292,182	$ 523,191,188	$ 525,199,000
Maturities over one year	8.35	799,617,773	797,350,000	800,600,000
		$1,323,909,955	$1,320,541,188	$1,325,799,000

Total investment purchases and sales during fiscal year 1990 are approximately $1,015,429,000 and $524,093,000, respectively. Total investment purchases and sales during fiscal year 1989 are approximately $88,808,314,000 and $88,782,570,000, respectively. It was not practical to separate the purchases and sales during 1989 by maturity date; therefore, these amounts include investment transactions with maturities greater than three months and cash equivalents.

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NOTE F - OTHER NOTES RECEIVABLE

The Fund entered into both secured and unsecured term notes related to the sale of assets held by the Asset Liquidation Management Center and recoveries on failed credit unions. The notes are being repaid in monthly principal installments with terms ranging from one to thirty years and interest rates ranging from 9.5% to 12%. The other notes receivable balance at September 30, 1990 and 1989 was $13,013,688 and $8,732,014, respectively.

NOTE G - AVAILABLE BORROWINGS

The Fund is authorized under the Federal Credit Union Act to borrow from the Treasury of the United States upon authorization by the NCUA Board to a maximum of $100,000,000 outstanding at any one time. The Central Liquidity Facility of NCUA is authorized to make advances to the Fund under such terms and conditions as may be established by the NCUA Board. No amounts were borrowed from these sources during 1990 or 1989.

NOTE H - TRANSACTIONS WITH NCUA OPERATING FUND

Substantial administrative services are provided to the Fund by the NCUA Operating Fund. NCUA charges the Fund for these services based on an annual allocation factor approved by the NCUA's Board of Directors derived from a study conducted by these Funds of actual usage. The allocation factor was 50% to the Fund and 50% to the NCUA Operating Fund in the years ended September 30, 1990 and 1989. The cost of services provided by the NCUA Operating Fund was approximately $31,796,000 and $28,769,000 for 1990 and 1989, respectively, and includes pension contributions of approximately $1,802,350 and $1,572,500 for 1990 and 1989, respectively, to the Civil Service Retirement System and Federal Employees Retirement System defined benefit retirement plans.

In fiscal year 1988, the Fund entered into a $2,160,766 thirty year unsecured term note with the NCUA Operating Fund. The note is being repaid in monthly principal installments of $6,000 with interest at a variable rate. The average interest rate during fiscal years 1990 and 1989 was approximately 8.22% and 8.1%, respectively. The note receivable balance at September 30, 1990 was $1,980,766.

The NCUA Operating Fund leases certain office space under lease agreements which expire through 1998. The future minimum aggregate lease payments through expiration of the leases are approximately $9,531,000 at September 30, 1990. Based on the allocation factor approved by the NCUA Board of Directors for fiscal year 1990, the Fund will reimburse the NCUA Operating Fund for approximately 50% of the future lease payments. The cost of services provided by the NCUA Operating Fund includes rental charges of approximately $1,320,000 and $1,140,000 for 1990 and 1989, respectively. The amounts were derived using the current annual allocation factor.

National Credit Union Administration Operating Fund

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REPORT OF INDEPENDENT ACCOUNTANTS

November 15, 1990

To the Board of the National Credit Union Administration

In our opinion, the accompanying balance sheets and the related statements of revenue, expenses and changes in fund balance and of cash flows present fairly, in all material respects, the financial position of the National Credit Union Administration - Operating Fund at September 30, 1990 and 1989 and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the National Credit Union Administration's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards and the standards for financial and compliance audits contained in Government Auditing Standards issued by the Comptroller General of the United States which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

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REPORT OF INDEPENDENT ACCOUNTANTS

November 15, 1990

To the Board of the National Credit Union Administration

We have audited the financial statements of the National Credit Union Administration Operating Fund (the Fund) as of and for the year ended September 30, 1990, and have issued our report thereon dated November 15, 1990.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of the Fund for the year ended September 30, 1990, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of the Fund is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

November 15, 1990
To the Board of the National Credit Union Administration
Page 2

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- Investment purchases and maturities
- Capital contribution collections
- Disbursements to shareholders for liquidated credit unions
- Loss reserve, additions, payments and recoveries
- Cash disbursements
- Payroll

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

However, we noted certain matters involving the internal control structure and its operation that we reported to management of the Fund in a separate letter dated November 15, 1990.

This report is intended for the information of the Board of the National Credit Union Administration and the Fund's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

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REPORT OF INDEPENDENT ACCOUNTANTS

November 15, 1990

To the Board of the National Credit Union Administration

We have audited the financial statements of the National Credit Union Administration Operating Fund (the Fund) as of and for the year ended September 30, 1990, and have issued our report thereon dated November 15, 1990.

We conducted our audit in accordance with generally accepted auditing standards and the provisions of Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the National Credit Union Administration Operating Fund is the responsibility of the Fund's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the Fund's compliance with material terms and conditions of Title I of the Federal Credit Union Act, as amended in August 1987. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, the Fund complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the Fund had not complied, in all material respects, with those provisions.

This report is intended for the information of the Board of the National Credit Union Administration and the Fund's management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Price Waterhouse

NATIONAL CREDIT UNION ADMINISTRATION - OPERATING FUND
BALANCE SHEETS

	September 30, 1990	September 30, 1989
ASSETS		
Cash, including cash equivalents of $10,916,298 and $7,053,043 (Note B)	$10,916,298	$ 7,053,043
Due from National Credit Union Share Insurance Fund (Note C)	626,060	191,721
Employee advances	323,807	392,387
Other accounts receivable	649,181	254,024
Prepaid expenses	255,991	247,045
Office building and land, net of accumulated depreciation of $105,469 and $63,281	2,152,483	2,194,671
Furniture and equipment, net of accumulated depreciation of $4,781,457 and $3,190,760	3,317,099	4,504,087
Leasehold improvements, net of accumulated amortization of $215,327 and $97,730	328,687	374,564
Total assets	$18,569,606	$15,211,542
LIABILITIES AND FUND BALANCE		
Accounts payable	$ 2,047,851	$ 1,495,530
Accrued wages and benefits	2,599,835	2,218,144
Accrued annual leave	3,026,219	2,909,260
Accrued employee travel	763,325	860,924
Note payable to National Credit Union Share Insurance Fund (Note C)	1,980,766	2,052,766
Total liabilities	10,417,996	9,536,624
Fund balance:		
Available for operations	4,334,107	654,362
Invested in fixed assets, net	3,817,503	5,020,556
Total fund balance	8,151,610	5,674,918
Commitments (Note D)		
Total liabilities and fund balance	$18,569,606	$15,211,542

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION ADMINISTRATION - OPERATING FUND
STATEMENTS OF REVENUE, EXPENSES AND CHANGES IN FUND BALANCE

	Year ended September 30,	
	1990	1989
Revenue		
Operating fee revenue	$32,294,318	$28,925,893
Investment income	1,638,702	1,291,900
Miscellaneous income	339,513	366,076
Total revenue	34,272,533	30,583,869
Expenses (Note C)		
Employee wages and benefits	22,263,676	18,973,325
Travel expense	3,648,450	3,977,074
Rent, communications, and utilities	2,308,434	2,197,839
Contracted services	1,232,397	1,552,305
Other administrative	2,342,884	2,068,044
Total administrative expenses	31,795,841	28,768,587
Excess of revenue	2,476,692	1,815,282
Fund balance at beginning of year	5,674,918	3,859,636
Fund balance at end of year	$ 8,151,610	$ 5,674,918

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION ADMINISTRATION - OPERATING FUND
STATEMENTS OF CASH FLOWS

	Year ended September 30,	
	1990	1989
Cash flows from operating activities:		
Excess of revenue	$ 2,476,692	$1,815,282
Adjustments to reconcile excess of (expenses) revenue to net cash provided by operating activities:		
Depreciation and amortization	1,716,332	1,498,041
Gain on disposition of fixed assets	(312)	(4,361)
Changes in operating assets and liabilities:		
(Increase) decrease in amounts due from National Credit Union Share Insurance Fund	(434,339)	520,101
Decrease in employee advances	68,580	228,272
Increase in other accounts receivable	(395,157)	(85,686)
Increase in prepaid expenses	(8,946)	(28,174)
Increase (decrease) in accounts payable	552,321	(1,108,887)
Increase in accrued wages and benefits	381,691	249,507
Increase in accrued annual leave	116,959	324,391
(Decrease) increase in accrued employee travel	(97,599)	185,909
Net cash provided by operating activities	4,376,222	3,594,395
Cash flows from investing activities:		
Purchases of fixed assets	(452,913)	(949,778)
Proceeds from sale of fixed assets	11,946	5,840
Net cash used by investing activities	(440,967)	(943,938)
Cash flows from financing activities:		
Repayments of note payable	(72,000)	(72,000)
Net cash (used) by financing activities	(72,000)	(72,000)
Net increase in cash and cash equivalents	3,863,255	2,578,457
Cash and cash equivalents at beginning of year	7,053,043	4,474,586
Cash and cash equivalents at end of year	$10,916,298	$7,053,043
Composed of:		
Cash equivalents - U.S. Government securities with maturities less than 3 months	$10,916,298	$7,053,043
Cash		
Total	$10,916,298	$7,053,043

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION ADMINISTRATION - OPERATING FUND
NOTES TO FINANCIAL STATEMENTS
SEPTEMBER 30, 1990

NOTE A - ORGANIZATION AND PURPOSE

The National Credit Union Administration - Operating Fund (the Fund) was created by the Federal Credit Union Act of 1934. The Fund was established as a revolving fund in the United States Treasury under the management of the National Credit Union Administration Board for the purpose of providing administration and service to the Federal Credit Union System.

NOTE B - SIGNIFICANT ACCOUNTING POLICIES

Cash Equivalents

The Federal Credit Union Act permits the Fund to make investments in United States Government securities or securities guaranteed as to both principal and interest by the United States Government. All investments in fiscal years 1990 and 1989 were cash equivalents and are stated at cost which approximates market. Cash equivalents are highly liquid investments with original maturities of three months or less.

Depreciation and Amortization

Building, furniture and equipment and leasehold improvements are recorded at cost. Depreciation and amortization are computed by the straight-line method over the estimated useful lives of the building, furniture and equipment and the shorter of the estimated useful life or lease term for leasehold improvements. Estimated useful lives are forty years for the building and three to ten years for the furniture and equipment and leasehold improvements.

Operating Fee Revenue

The Fund assesses each federally chartered credit union an annual fee based on the credit union's asset base as of the preceding June 30. The fee is designed to cover the costs of providing administration and service to the Federal Credit Union System. The Fund recognizes operating fee revenue on a fiscal year basis.

Income Taxes

The Fund is exempt from Federal income taxes under §501(c)(1) of the Internal Revenue Code.

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NOTE C - TRANSACTIONS WITH THE NATIONAL CREDIT UNION SHARE INSURANCE FUND (NCUSIF)

Certain administrative services are provided by the Fund to NCUSIF. The Fund charges NCUSIF for these services based upon an annual allocation factor approved by the NCUA Board derived from an estimate of actual usage. The allocation factor was 50% to NCUSIF and the Fund in the years ended September 30, 1990 and 1989. The cost of the services allocated to NCUSIF, which totaled approximately $31,796,000 and $28,769,000 for the years ended September 30, 1990 and 1989, respectively, are reflected as a reduction of the corresponding expenses in the accompanying financial statements.

In fiscal year 1988, the Fund entered into a $2,160,766 thirty year term note with NCUSIF, for the purchase of a building. The note is being repaid in monthly principal installments of $6,000 with interest at a variable rate. The average interest rate during fiscal years 1990 and 1989 was approximately 8.22% and 8.1%, respectively. The outstanding principal balance at September 30, 1990 was $1,980,766. The total interest paid in fiscal years 1990 and 1989 was $166,444 and $184,275.

NOTE D - COMMITMENTS

The Fund leases office space under lease agreements which expire through 1998. Office rental charges for the years ended September 30, 1990 and 1989 amounted to approximately $2,640,000 and $2,279,000 of which approximately $1,320,000 and $1,140,000 was reimbursed by NCUSIF. In addition, the Fund leases office equipment under operating leases with lease terms less than one year.

The future minimum lease payments as of September 30, 1990, are as follows:

1991	$2,276,379
1992	2,304,681
1993	2,182,135
1994	1,772,758
1995	229,737
Thereafter	765,792
	$9,531,482

Based on the allocation factor approved by the NCUA Board for fiscal year 1990, NCUSIF will reimburse the Fund for approximately 50% of the future lease payments.

NOTE E - RETIREMENT PLAN

The employees of the Fund are participants in the Civil Service Retirement and Disability Fund (CSRDF) which includes the Federal Employees' Retirement System (FERS). Both plans are defined benefit retirement plans covering all of the employees of the Fund. FERS is comprised of a Social Security Benefits Plan, a Basic Benefits Plan and a Savings Plan. Contributions to the plans are based on a percentage of employees' gross pay. Under the Savings Plans employees can

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also elect additional contributions between 1% and 10% of their gross pay and the Fund will match up to 5% of the employees' gross pay. The Fund's contributions to the plans for the years ended September 30, 1990 and 1989 were approximately $3,604,700 and $3,145,000, of which $1,802,350 and $1,572,500 was reimbursed by NCUSIF, respectively.

The Fund does not account for the assets of the above plans and does not have actuarial data with respect to accumulated plan benefits or the unfunded liability relative to eligible employees. These amounts are reported by the U.S. Office of Personnel Management for the Civil Service Retirement and Disability Fund and are not allocated to individual employers.

National Credit Union Administration Central Liquidity Facility

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REPORT OF INDEPENDENT ACCOUNTANTS

November 5, 1990

To the Board of the
National Credit Union Administration and
the National Credit Union Administration
Central Liquidity Facility

In our opinion, the accompanying balance sheets and the related statements of operations and retained earnings and of cash flows present fairly, in all material respects, the financial position of the National Credit Union Administration Central Liquidity Facility at September 30, 1990 and 1989 and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles. These financial statements are the responsibility of the National Credit Union Administration Central Liquidity Facility management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

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REPORT OF INDEPENDENT ACCOUNTANTS

November 5, 1990

To the Board of the National Credit
Union Administration and the National
Credit Union Administration Central Liquidity Facility

We have audited the financial statements of the National Credit Union Administration Central Liquidity Facility (CLF) as of and for the year ended September 30, 1990, and have issued our report thereon dated November 5, 1990.

We conducted our audit in accordance with generally accepted auditing standards and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of the CLF for the year ended September 30, 1990, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of the CLF is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless

November 5, 1990
To the Board of the National Credit
Union Administration and the National
Credit Union Administration Central Liquidity Facility
Page 2

occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories:

- Investment placement and maturities
- Loan grants and collections
- Notes payable, borrowings and repayments
- Capital and liquidity reserve additions and withdrawals

For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a reportable condition in which the design or operation of one or more of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

This report is intended for the information of the Board of the National Credit Union Administration and the National Credit Union Administration Central Liquidity Facility and management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

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REPORT OF INDEPENDENT ACCOUNTANTS

November 5, 1990

To the Board of the National Credit
Union Administration and the National
Credit Union Administration Central Liquidity Facility

We have audited the financial statements of the National Credit Union Administration Central Liquidity Facility (CLF) as of and for the year ended September 30, 1990, and have issued our report thereon dated November 5, 1990.

We conducted our audit in accordance with generally accepted auditing standards and the provisions of Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to the CLF is the responsibility of the CLF's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of the CLF's compliance with material terms and conditions of Title III of the Federal Credit Union Act, as amended to August 1987, and Part 725 of the Rules and Regulations of the Board of the National Credit Union Administration, as amended to July 1985, which we believe have financial significance to the CLF. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests indicate that, with respect to the items tested, the CLF complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that the CLF had not complied, in all material respects, with those provisions.

This report is intended for the information of the Board of the National Credit Union Administration and the National Credit Union Administration Central Liquidity Facility and management. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Price Waterhouse

NATIONAL CREDIT UNION ADMINISTRATION

CENTRAL LIQUIDITY FACILITY

BALANCE SHEETS

(Expressed in thousands of dollars)

	September 30, 1990	September 30, 1989
ASSETS		
Cash	$ 7	$ 6
Investments	457,335	443,715
Loans to members	66,590	112,172
Accrued interest receivable	9,073	9,744
Total assets	$533,005	$565,637
LIABILITIES AND EQUITY		
Liabilities		
Notes payable	$ 56,581	$111,410
Member deposits	14,880	14,297
Accrued interest payable	663	853
Accounts payable and other liabilities	166	169
Total liabilities	72,290	126,729
Equity		
Capital stock - required	451,719	430,598
Retained earnings	8,996	8,310
Total equity	460,715	438,908
Commitments		
Total liabilities and equity	$533,005	$565,637

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION ADMINISTRATION

CENTRAL LIQUIDITY FACILITY

STATEMENTS OF OPERATIONS AND RETAINED EARNINGS

(Expressed in thousands of dollars)

	Year ended September 30,	
	1990	1989
Income		
Income from investments	$36,549	$36,331
Interest on loans	6,703	9,945
Other	34	34
Total income	43,286	46,310
Expenses		
Agent commitment fee	377	377
Personnel services	238	235
Other services	55	82
Rent, communications and utilities	39	47
Supplies and materials	27	18
Personnel benefits	26	29
Printing and reproduction	13	8
Employee travel	11	16
Shipping and delivery	9	
Total operating expenses	795	812
Interest		
Federal Financing Bank	6,530	9,607
Member deposits	564	561
Total expenses	7,889	10,980
Net income	35,397	35,330
Dividends to members	34,711	34,651
Addition to retained earnings	686	679
Retained earnings at beginning of period	8,310	7,631
Retained earnings at end of period	$ 8,996	$ 8,310

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION ADMINISTRATION
CENTRAL LIQUIDITY FACILITY
STATEMENTS OF CASH FLOWS
(Expressed in thousands of dollars)

	Year ended September 30, 1990	1989
Cash flows from operating activities:		
Income from investments	$ 37,020	$ 34,798
Interest received on loans	6,903	10,208
Other income received	34	34
Cash paid for operating expenses	(798)	(783)
Interest paid on borrowings	(6,720)	(9,871)
Net cash provided by operating activities	36,439	34,386
Cash flows from investing activities:		
Investment maturities	240,592	402,964
Loan principal repayments	74,159	194,012
Purchase of investments	(254,212)	(434,928)
Loan disbursements	(28,577)	(185,744)
Net cash provided by (used in) investing activities	31,962	(23,696)
Cash flows from financing activities:		
Proceeds from borrowings	23,171	62,410
Addition to member deposits	192	457
Issuance of required capital stock	22,106	33,311
Borrowing repayments	(78,000)	(69,148)
Withdrawal of member deposits	(34,884)	(34,195)
Redemption of required capital stock	(985)	(3,525)
Net cash used in financing activities	(68,400)	(10,690)
Net increase in cash	1	
Cash at beginning of year	6	6
Cash at end of year	$ 7	$ 6
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 35,397	$ 35,330
Adjustments to reconcile net income to net cash provided by operating activities:		
Decrease (increase) in accrued investment income receivable	471	(1,533)
Decrease in accrued loan interest receivable	200	263
(Decrease) increase in accounts payable and other liabilities	(3)	29
Decrease in accrued interest payable	(190)	(264)
Interest deposited in member deposits	564	561
Total adjustments	1,042	(944)
Net cash provided by operating activities	$ 36,439	$ 34,386
SUPPLEMENTARY DISCLOSURE OF NON-CASH TRANSACTIONS:		
Rollovers:		
Loans	$ 576,374	$ 438,092
Borrowings	448,875	458,537
Dividends added to member deposits	34,711	34,651

The accompanying notes are an integral part of these financial statements.

NATIONAL CREDIT UNION ADMINISTRATION

CENTRAL LIQUIDITY FACILITY

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 1990 AND 1989

NOTE 1 - ORGANIZATION AND PURPOSE

The National Credit Union Administration Central Liquidity Facility (CLF) was created by the National Credit Union Central Liquidity Facility Act (Act). The CLF is designated as a mixed-ownership government corporation under the Government Corporation Control Act. The CLF exists within the National Credit Union Administration (NCUA) and is managed by the National Credit Union Administration Board. The CLF became operational on October 1, 1979.

The purpose of the CLF is to improve general financial stability by meeting the liquidity needs of credit unions. The CLF is a tax-exempt organization under Section 501(c) of the Internal Revenue Code.

NOTE 2 - SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

The CLF maintains its accounting records on the accrual basis of accounting.

Allowance for Loan Losses

Loans to members are made on both a short-term and long-term basis. For all loans the CLF either obtains a security interest in the assets of the borrower or in some cases receives the guarantee of the NCUA Share Insurance Fund.

The CLF evaluates the collectibility of its loans to members through examination of the financial condition of the individual borrowing credit unions and the credit union industry in general.

No allowance for loan losses was considered necessary at September 30, 1990 and 1989.

Investments

The CLF invests in members' share accounts (see Notes 5 and 8). All of the CLF's other investments are short-term with no maturities in excess of one year. These investments are recorded at cost, which approximates market value.

NOTE 3 - GOVERNMENT REGULATIONS

The CLF was created by the Act and is subject to various Federal laws and regulations. The CLF's operating budget requires Congressional approval and the CLF may not make loans to members for the purpose of expanding credit union loan portfolios. The CLF's investments are restricted to obligations of the United States Government and its agencies, deposits in federally insured financial institutions and shares and deposits in credit unions. Borrowing is Congressionally limited to twelve times equity and capital subscriptions on-call. However, the CLF has internally imposed a $600 million limitation on its borrowings. At September 30, 1990 and 1989, the CLF was in compliance with these limitations.

NOTE 4 - LOANS TO MEMBERS

During 1990 loans were made only to member credit unions. These loans carried interest rates which ranged from 7.79% to 8.17% at September 30, 1990 (8.25% to 9.87% at September 30, 1989). The loans outstanding at September 30, 1990 are scheduled to mature during fiscal year 1991 (the loans outstanding at September 30, 1989 matured during fiscal year 1990). Included in loans to members at September 30, 1990 and 1989 are loans to U.S. Central Credit Union in its capacity as agent of the CLF (see Note 8) in the amount of $66,590,000 and $65,772,000, respectively.

The CLF also provides members with extended loan commitments and lines of credit. There were $49,000,000 in outstanding commitments or lines of credit at September 30, 1990.

The CLF provides lines of credit for state insurance corporations. Advances against these lines are non-revolving and fully secured by a senior perfected security interest in negotiable, marketable securities acceptable to the CLF. As of September 30, 1990, no advances had been made against the lines and all existing lines expired on that date. Subsequent to September 30, 1990, lines of credit totaling $13.5 million have been authorized. Each line of credit calls for a commitment fee of 1/4 of 1 percent per annum.

NOTE 5 - INVESTMENTS

Funds not currently required for operations are invested as follows (dollars in thousands):

	September 30,	
	1990	1989
U.S. Central (see Note 8)		
Redeposits	$400,231	$377,600
Share accounts	22,104	26,115
Time deposits	35,000	40,000
	$457,335	$443,715

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NOTE 6 - NOTES PAYABLE

All of the CLF's borrowings have been from the Federal Financing Bank. The interest rates on these obligations are fixed and range from 7.59% to 8.044% at September 30, 1990 (8.121% to 8.405% at September 30, 1989). Interest is generally payable upon maturity. The notes outstanding at September 30, 1990 are scheduled to mature during fiscal year 1991 (the notes outstanding at September 30, 1989 matured during fiscal year 1990).

The Secretary of the Treasury is authorized by the Act to lend up to $500 million to the CLF in the event that the Board certifies to the Secretary that the CLF does not have sufficient funds to meet the liquidity needs of credit unions. This authority to lend is limited to such extent and in such amounts as are provided in advance by Congressional Appropriation Acts. On December 23, 1981, President Reagan signed PL 97-101 which provided $100 million of permanent indefinite borrowing authority which may be provided by the Secretary of the Treasury to the CLF to meet emergency liquidity needs of credit unions.

NOTE 7 - CAPITAL STOCK AND MEMBER DEPOSITS

The required capital stock account represents subscriptions remitted to the CLF by member credit unions. Regular members' required subscription amounts equal one-half of one percent of their paid-in and unimpaired capital and surplus, one-half of which amount is required to be remitted to the CLF. Agent members' required subscription amounts equal one-half of one percent of the paid-in and unimpaired capital and surplus of all of the credit unions served by the agent member, one-half of which amount is required to be remitted to the CLF. In both cases the remaining one-half of the subscription is required to be held in liquid assets by the member credit unions subject to call by the National Credit Union Administration Board. These unremitted subscriptions are not reflected in the CLF's financial statements. Subscriptions are adjusted annually to reflect changes in the member credit unions' paid-in and unimpaired capital and surplus. Dividends are declared and paid on required capital stock.

Member deposits represent amounts remitted by members over and above the amount required for membership. Interest is paid on member deposits at a rate equivalent to the dividend rate paid on required capital stock.

NOTE 8 - MEMBERSHIP INCREASE

During the year ended September 30, 1984, the CLF accepted a membership request from U.S. Central Credit Union (USC) on behalf of 29 of its corporate credit union members. At September 30, 1990 and 1989, $423,980,407 and $402,956,000, respectively, of the required portion of subscribed capital stock was on deposit with the CLF by USC on behalf of its member credit unions.

In addition, by accepting this membership request, the CLF is initially committed to reinvest all but $50,000,000 of its total share capital in USC at market rates of interest. At September 30, 1990 and 1989, $422,335,000 and $403,715,000, respectively, were invested in USC share accounts at approximately 7.75 % and 8.11% respective yields.

NOTE 9 - SERVICES PROVIDED BY THE NATIONAL CREDIT UNION ADMINISTRATION

The National Credit Union Administration provides the CLF with miscellaneous services, data processing services, and supplies. In addition, the National Credit Union Administration pays CLF employee salaries as well as CLF's portion of monthly lease payments. The CLF reimburses the National Credit Union Administration on a monthly basis for these items.

Total reimbursements for the years ended September 30, 1990 and 1989 amounted to approximately $318,000 and $277,000, respectively.

NOTE 10 - PENSION PLAN

The employees of the CLF are participants in the Civil Service Retirement and Disability Fund (CSRDF) which includes the Federal Employees' Retirement System (FERS). Both plans are defined benefit plans covering all of the employees of CLF. FERS is comprised of a Social Security Benefits Plan, a Basic Plan and a Savings Plan and is mandatory for all employees hired on or after January 1, 1984. Contributions to the plans are based on a percentage of employees' gross pay. Under the Savings Plan employees can also elect additional contributions between one and ten percent of their gross pay and the CLF will match up to five percent of the employee elected contributions. CLF's contributions to the plans for the years ended September 30, 1990 and 1989 were approximately $14,000 and $16,000, respectively.

CLF does not account for the assets of the above plans nor does it have actuarial data with respect to accumulated plan benefits or the unfunded liability relative to eligible employees. These amounts are reported by the U.S. Office of Personnel Management for the Civil Service Retirement and Disability Fund and are not allocated to individual employers such as CLF.

NOTE 11 - LEASE

The CLF leases office space jointly with the National Credit Union Administration under a non-cancellable operating lease expiring in 1998. The agreement provides for annual rent adjustments based on increases in the consumer price index. Under the terms of this lease, the CLF and the National Credit Union Administration are jointly and severally liable for future minimum lease payments as of September 30, 1990, as follows (dollars in thousands):

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Year ended September 30,	
1991	$1,141
1992	1,141
1993	1,141
1994	1,141
	$4,564

The CLF's portion of these lease payments (rent expense) for each of the years ended September 30, 1990 and 1989 was approximately $39,000 and $34,000, respectively.

Sampling Methodologies

We selected three different samples of credit unions as part of our review: one of problem credit unions (CAMEL rated 4 and 5), one of failed credit unions (as defined in chapter 5), and one of corporate credit unions.

The sample of 39 problem credit unions was drawn from the 3 NCUA regions with the largest amount of credit union shares in problem institutions as of June 30, 1989: 25 from Region IV (Chicago, Illinois); 10 from Region V (Austin, Texas); and 4 from Region VI (Concord, California). The judgmentally selected sample held almost half (46 percent) of the shares in problem credit unions in those three regions. They ranged in share size from under $1 million to over $700 million. The sample included 16 state credit unions—41 percent of the sample which is virtually the same proportion of state credit unions among all those insured by NCUSIF.

Our sample of 16 failed credit unions was made up of institutions that were liquidated, merged, resolved through purchase and assumption transactions, or assisted. In making our judgmental selection we sought to obtain maximum coverage of the amount of losses NCUSIF sustained and to achieve the best balance possible among state and federal credit unions because of their proportion of the industry and of failures. We judgmentally selected five liquidated credit unions and three that were resolved through purchase and assumption transactions. Together, these eight credit unions accounted for 87 percent of NCUSIF's losses on such resolutions during fiscal year 1989, as of June 30. Our sample of five assisted credit unions represented 90 percent of the amount of assistance being provided as of June 30, 1989, the overwhelming majority of which was in Region V. The three merged credit unions we chose represented 48 percent of NCUSIF's losses on mergers for the same time period. Four of the 16 in our sample were state credit unions; 24 percent of all failures through June 1989 were state institutions.

From the 44 corporate credit unions, we judgmentally selected 9 on the basis of their charter, insurance status, regional location, CAMEL rating, and asset size. We chose two each with the following charter and insurance characteristics: state charter, federal insurance; state charter, private insurance; and state charter, no insurance. We chose three corporate credit unions with federal charters and federal insurance. The nine corporate credit unions we chose ranged in asset size from $70 million to above $5 billion as of June 30, 1990. All six NCUA regions and CAMEL codes 1 through 4 were represented in the sample. There were no code 5 corporates. We also reviewed aspects of the oversight of U.S.

Central Credit Union, such as NCUA's examinations and monitoring of activities.

Summary of Enforcement Powers

NCUA has extensive powers under the law to ensure that credit unions operate safely and soundly. If they do not, NCUA has the power to remove federal insurance and/or close the credit unions. Specifically, NCUA can

- issue cease and desist orders (including temporary orders),
- assess money penalties,
- remove officials,
- prohibit others from participating in credit union affairs,
- place a credit union in conservatorship,
- arrange a merger or purchase and assumption,
- liquidate insolvent federal credit unions and revoke charters of solvent federal credit unions, and
- terminate insurance.

NCUA must notify state regulators before taking actions against federally insured, state-chartered credit unions. Although NCUA is not empowered to close a state credit union, NCUA can terminate the credit union's insurance (12 U.S.C. 1786(b)), place it into conservatorship (12 U.S.C. 1786(h)), and act as the liquidating agent if appointed by the state regulator or a court. (12 U.S.C. 1787(b))

FIRREA altered some of NCUA's enforcement powers; overall, its authority was expanded. For example, NCUA authority now permits cease and desist orders, civil money penalties, removals, and prohibitions that include additional people affiliated with the credit unions, and higher money penalties.

Cease and Desist Orders

NCUA guidance to examiners says that the cease and desist order is the most appropriate action for dealing with persistent and serious problems. Prior to FIRREA, the law provided for a cease and desist order against a credit union if it was engaging, had engaged in, or was about to engage in an unsafe or unsound practice, violation of law, rule, regulation, "or any condition imposed in writing by the Board in connection with the granting of any...request...or any written agreement entered into with the Board...." (12 U.S.C. 1786(e)(1))

In addition, NCUA could issue a temporary cease and desist order, which would become effective immediately, if it believed the continuation of the credit union's actions precipitating the order was likely to cause insolvency, "substantially" dissipate assets or earnings, or "seriously" weaken the condition of the credit union. Under FIRREA, "substantially"

was replaced with "significant" and "seriously" was deleted. (12 U.S.C. 1786(f))

Civil Money Penalties

FIRREA expanded NCUA's authority related to civil money penalties. Previously, the law allowed NCUA to assess a maximum of only $1,000 a day for violations of a cease and desist order. Penalties could be assessed against any person involved in a credit union's affairs or against the credit union itself. FIRREA provided three tiers of penalties ranging from up to $5,000 a day in the least severe tier to $1 million a day in the most severe tier. In the case of a penalty against a credit union, the penalty would be 1 percent of its assets or the most severe tier, whichever is less. (12 U.S.C. 1786(k))

Removal of Officials and Prohibition of Others

NCUA can remove credit union directors, officers, or committee members when their individual actions are deemed detrimental or create a potential loss to the credit union. These actions can include unsafe and unsound practices as well as violations of law, regulations, or rules. A prohibition action is designed to stop an individual from further participation in credit union affairs. It is generally taken against a person who is not a director, officer, or committee member but is involved with the credit union in another capacity, such as a lawyer or employee. A prohibition action can also be taken against a business entity. NCUA must show that the person's conduct resulted in "substantial" financial loss or other damage to the credit union. FIRREA combined NCUA's removal and prohibition authority and deleted the word "substantial." (12 U.S.C. 1786(g))

Conservatorship

NCUA can take possession and control of a credit union's business and assets in the following cases:

- The Board concludes the action is needed to conserve the assets of an insured credit union or protect the NCUSIF or the interests of the members of the insured credit union.
- The credit unions' board of directors consents to the action.
- There is a deliberate violation of a final cease and desist order.
- The credit union has concealed or refused to submit documents for examiners or any lawful agent of the Board to review. (12 U.S.C. 1786(h)(1))

When federal credit unions are involved, NCUA can take immediate possession. However, when state credit unions are involved, NCUA must have prior written approval from the state regulator unless the full NCUA Board votes to act without the state's approval after 30 days notice has been given to the regulator. FIRREA did not change NCUA's powers with respect to conservatorships.

Other Changes Under FIRREA

FIRREA expanded NCUA's authority in all the above areas by specifying that cease and desist orders, removals, prohibitions, and civil money penalties could be brought against a broader variety of persons. Those covered now include independent contractors who participate in any violation of the law or regulations, any breach of fiduciary duty, or any unsafe or unsound practice, "which caused or is likely to cause more than a minimal financial loss to or a significant adverse effect on, the insured credit union." (12 U.S.C. 1786(r))

Another FIRREA provision empowers NCUA to assess civil penalties against any credit union that submits false or misleading information or reports, or fails to submit any report. The penalty for inadvertent errors is $2,000 per day for each day the information remains uncorrected. The burden to establish inadvertence rests on the credit union. If the misleading information was not filed inadvertently, the penalty is $20,000 per day. NCUA can assess a penalty as high as $1 million a day, or 1 percent of assets per day, whichever is less, if the credit union acted with reckless disregard for accuracy. (12 U.S.C. 1782 (a)(3))

NCUA Powers to Resolve Credit Unions

NCUA has four options for resolving a failed credit union: liquidation, merger, purchase and assumption, and provision of special assistance. Resolution of failing credit unions is discussed in chapter 5.

Liquidation

FCUA empowers NCUA to revoke the charter or liquidate any federal credit union upon finding that the credit union is insolvent or has violated any provisions of the act, the regulations, its charter, or the bylaws. (12 U.S.C. 1766(b)(1)) Since May 26, 1982, NCUA regulations have also provided for the immediate suspension of a solvent federal credit union's charter when the Board determines that grounds for liquidation exist and immediate action is necessary to

- prevent dissipation of the credit union's assets or earnings,
- prevent further weakening of the credit union's condition, or

- otherwise protect the interest of credit union members or the NCUSIF.

The NCUA Board may take possession of all credit union books, records, assets, and property. (12 C.F.R. 747.702)

Although NCUA is not empowered to liquidate a state credit union, the act does authorize NCUA to act as the liquidating agent if appointed by the state regulator or a court. (12 U.S.C. 1787(j))

Mergers

FCUA authorizes NCUA to merge an insured credit union that is insolvent or in danger of becoming insolvent with any other insured credit union if (1) an emergency requires expeditious action, (2) other alternatives are not reasonably available, and (3) the public interest would be served. The act does not authorize NCUA to merge a credit union with a bank or a savings and loan. (12 U.S.C. 1785(h) and (i))

Purchase and Assumption

NCUA says that this resolution method combines the qualities of both a merger and a liquidation. NCUA finds a buyer for some or all of the credit union's assets and liabilities, and the failing credit union is closed by its charterer. The act allows NCUA to authorize a federally insured credit union to purchase any of the assets and assume any of the liabilities of a credit union that is insolvent or in danger of insolvency if the NCUA Board finds that the three conditions noted above exist. It also permits federally insured banks and thrifts to purchase assets or assume liabilities if NCUA's attempt to effect a merger or consolidation with an insured credit union is unsuccessful. (12 U.S.C. 1785(h) and (i))

Termination of Insurance

NCUA's strongest authority over state credit unions is its authority to terminate insurance. Such action leaves the credit union to find insurance elsewhere, operate without insurance, or close. Shareholders are protected as provided for in the act. The act requires notice to shareholders and provides for continuation of insurance coverage for 1 year from the time insurance is terminated. (12 U.S.C. 1786(c) and (d))

The act authorizes NCUA to terminate the insurance of any federally insured credit union when NCUA determines that the credit union is

- engaging in or has engaged in unsafe or unsound practices;
- continuing to operate in an unsafe or unsound condition; or

- violating or has violated any law, rule, regulation, order, written condition imposed by the Board, or written agreement entered into with the Board. (12 U.S.C. 1786)

The law also stipulates that NCUA will notify the credit union and its state regulator of the specific violations. If the credit union does not take corrective action within 20 to 120 days (the time allowed depends on the severity of the violations), the NCUA Board can terminate the credit union's insurance in not less than 30 days. (12 U.S.C. 1786 (b)(1))

Causes of Depository Institution Failure and Distress

This appendix provides a brief summary of material on the causes of credit union failure and distress and on bank and thrift failures.

Our review of NCUA records on a sample of 16 failed credit unions and 39 problem credit unions revealed that examiners had identified the same internal control weaknesses, which consistently related to lending practices, in almost all the institutions.[1] These results were not projectable to all failures or all problem credit unions, but these results did represent a significant percentage in terms of shares in problem credit unions (46 percent) and in failure costs (75 percent), as of June 1989.

Examiners generally found the following practices at failed and problem credit unions:

- Loans were made to members with high debt ratios.
- Debt ratios of borrowers were not computed.
- Employment and other indications of borrowers' ability to repay loans were not verified.
- Delinquent loans were refinanced.
- Liens on loan collateral were not perfected.
- There were high concentrations of loans to individual borrowers.

While examiners did not typically limit these underwriting weaknesses to any one type of loan, they did note instances where appraisals for real estate loans were not current. Significant losses caused by interest rate risks taken in investments were not noted in our sample organizations.

In almost all cases, examiners noted weak management or limited involvement of the board of directors. Fraud was the major cause of failure in one instance, which was the costliest credit union failure to date. This low-income credit union, which failed in 1988, misled NCUA by keeping two separate sets of books. The official books showed that it was a relatively small institution with $2 million in assets. In reality, this credit union attracted over $40 million, primarily in nonmember deposits, but had only $3 million in assets at the time of failure.

Accurate and complete records are critically important to credit union management, members, and supervisors in making business decisions and monitoring credit union activities and health. Failed credit unions in our sample had extensive problems with record keeping. Among the

[1] The sample selection methodologies are discussed in appendix VI.

problem credit unions we reviewed, examiners cited record keeping problems at 80 percent. NCUA told us that examiners noted record keeping problems in 20 percent of all credit unions examined in 1988 and 1989.

The results of our study of 16 failed credit unions generally parallel those found by NCUA in its 1987 study of 1981-1985 failures.[2] NCUA noted that credit unions failed for "mundane reasons, such as faulty lending operations or inept internal procedures," rather than problems such as fraud or failure of the credit union's sponsor. Major problems cited also included inadequate lending procedures and policies, weak collection practices, and weak internal operations often characterized by high expenses or poor record keeping. Examiners, the NCUA study reported, found that poor record keeping had a "major impact" on 41 percent of the failed credit unions. Apathy on the part of boards of directors also contributed to the weak management of the failed credit unions.

Our work on the bank and thrift failures has shown that federal supervisors identified similar lending-related problems, with fraud contributing significantly to the losses at thrifts. In our study of bank failures, we found that federal regulators identified serious internal control weaknesses that contributed significantly to virtually all the 184 bank failures in 1987.[3] We also found examples of insider abuse, fraud, and environmental factors (such as adverse economic conditions) in our study, but we found that weak internal controls greatly increased a bank's vulnerability to these factors.[4] Regulators only rarely cited fraud or insider abuse as a significant contributing factor in the bank failures. In our study of 26 thrifts that failed in the 1985-1987 period, however, we found numerous and sometimes blatant violations of laws and regulations and indications of fraud or insider abuse at all the institutions.[5]

[2] Causes of Credit Union Failures, 1981-1985, NCUA Office of the Chief Economist (Washington, D.C., Sept. 1987).

[3] Bank Failures: Independent Audits Needed to Strengthen Internal Controls and Bank Management (GAO/AFMD-89-25, May 31, 1989).

[4] Those internal control weaknesses that contributed most significantly to the 184 bank failures were inadequate or imprudent loan policies and procedures (79 percent), inadequate supervision by the bank's board of directors (49 percent), weak loan administration (42 percent), and poor loan documentation and inadequate credit analysis (41 percent).

[5] Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Reorganization of Asset Liquidation and Management Functions

In 1985, NCUA consolidated its handling of failed credit unions from six regional offices into two Asset Liquidation Centers located in Washington, D.C., and in Austin, Texas. These centers were responsible for disposing of the assets from closed credit unions. A third entity, the Asset Liquidation Management Center also in Austin, Texas, was established in 1988 and managed real estate assets acquired from open, NCUA-assisted credit unions.

We assessed these operations early in our review. We found that the Asset Liquidation Management Center's mission statement did not address the distinction between assets it was to handle and those to be handled by the other two centers. We also found that the centers inconsistently and incompletely implemented NCUA policy. For example, the Asset Liquidation Center in Austin, Texas, sold almost all of the loans it acquired; while the center in Washington, D.C., sold only 6 percent of the loans it acquired and arranged with a collection firm to collect on (not sell) the remainder. Officials at the latter center told us they automatically sent portfolios to the collection agency rather than seeking buyers for them because of resource constraints. Neither center had documentation to support the decisions to sell or collect on loans.

We shared our concerns with NCUA management in the spring of 1990. In May 1990, it was announced that these three entities were to be combined into the Asset Liquidation Management Center, located in Austin, Texas, which reports directly to the NCUA Board. NCUA's Director of the Office of Examination and Insurance has overall responsibility for monitoring the center's work, providing guidance, determining compliance, and concurring with certain actions the center takes. NCUA officials also told us they would take a number of corrective actions, such as developing a "loan profile" to use in both deciding whether to sell or collect on a loan and requiring documentation of the decision. NCUA's planned actions in this area, if properly implemented, address our concerns.

One Collection Agency Used for Over 3 Years and NCUA Did Not Review Its Performance

When we did our initial work, NCUA had used only one collection firm since October 1986, assigning to the firm over $31 million of loans and paying it $2 million in fees. We noted that although NCUA monitored collection activity for individual loans on a monthly basis, it had no system for monitoring or assessing the collection agency's overall effectiveness. NCUA officials told us they would retain other collection agencies on a more regional basis and began to do so in May 1990. In addition, NCUA plans to make unannounced visits to the collections agencies to examine their work and to periodically require an outside audit.

Problems in Establishing Market Value of Assets and Other Internal Control Weaknesses

We reviewed in detail the Asset Liquidation Management Center's management of 14 of the 56 real estate assets under its management as of December 31, 1989, and its sale of 20 assets. We found that for 14 of the 20 assets sold in the July 1988 through December 1989 period, business plans had not been prepared despite written policy to that effect. We also noted that the center's policy did not clearly specify the delegation of authority for approving asset disposal decisions. In addition, we raised questions with NCUA about a variety of internal controls. NCUA officials told us they chose not to delay marketing properties in the absence of a business plan, but they assured us that the sales were approved by the Office of Examination and Insurance Director, although there was no record of this approval.

Under NCUA asset management and disposition policies, as revised in October 1990, a business plan is required for all commercial assets and may be required for significant noncommercial assets.

The revised policies also specify policies and delegations of authority with respect to decisions related to the disposal of assets, such as financing the sale of assets and approving business plans. We noted that NCUA provided the financing for 3 out of the 20 assets sold in the 18-month period studied and that there was no guidance or policy on such financing, such as the conditions under which it could be provided. NCUA policies in effect prior to June 1990 did not specify when an appraisal had to be obtained. NCUA officials agreed they needed to have better methods for estimating the net realizable value of an asset. As required by FIRREA, NCUA issued a regulation on appraisals in August 1990. The regulation generally requires appraisals for all real estate related transactions valued at over $50,000.

Credit Unions Are Exempt From Federal Income Taxation

Credit unions, unlike other federally insured depository institutions, are exempt from federal income taxation. The tax-exempt status of state credit unions was originally recognized because of their similarity to other mutual financial institutions that at the time were tax exempt. When the other mutual financial institutions lost their exemption in 1951, state credit unions explicitly retained exempt status. Federal credit unions were granted exempt status in 1937.

While both federal and state credit unions are exempt from federal income tax, there are differences in the way tax law treats the two types of credit unions. State credit unions are required to pay federal tax on unrelated business income and can be taxed by their home state. Since federal credit unions are recognized as tax-exempt instrumentalities of the federal government, they are specifically exempt from federal tax on unrelated business income and are exempt from many state taxes.

IRS oversight of both federal and state chartered credit unions has been rather limited. State credit unions may apply for tax-exempt status and file annual returns either individually or as a group through state regulatory agencies. After unsuccessfully challenging the tax-exempt status of a credit union in court, IRS concluded that the provision of banking services by a state credit union could not serve as a basis for challenge of tax-exempt status. Federal credit unions do not file annual returns with IRS.

As tax-exempt financial institutions that are organized as cooperative or mutual associations, credit unions can be compared to other financial institutions, other tax-exempt organizations, and other cooperatives. In contrast to credit unions, commercial banks and thrift institutions are subject to the corporate tax. This gives credit unions an advantage in that to the extent that they compete with these institutions, they can finance the expansion of similar services at a lower cost through untaxed rather than taxed retained earnings. Credit unions share several characteristics with other tax-exempt organizations, but tax code requirements and IRS regulations restrict these organizations and impose tax on certain types of income. Credit unions are not subject to many of these requirements. While some types of cooperatives are specifically exempt from tax, cooperatives generally are taxed in order to ensure that all income is taxed at either the individual member or cooperative level.

The taxation of credit unions was proposed by the executive branch in 1978 and 1985. Both proposals argued that tax-exempt status gives

credit unions an unwarranted competitive advantage over banks and thrift institutions. In testimony defending the current tax-exempt status, credit union officials and others argued that the unique service mix offered by credit unions, the benefits of mutual, nonprofit organization, and the potential harm that taxation would have on undercapitalized credit unions justifies continuing exempt status.

If credit unions were made subject to taxation, they could reduce their taxable income by reducing loan rates and/or by increasing deposit rates. This would reduce taxes paid by credit unions, but could increase taxes paid by the members. If credit unions wished to maintain retained earnings at the same level as before the imposition of the tax, they would have to increase loan rates or decrease deposit rates.

The Historical Basis for Credit Union Tax Exemption

Internal Revenue Code section 501(c) describes 25 categories of organizations that are exempt from federal income tax. State credit unions are exempt in a category by themselves under section 501(c)(14)(A). Federal credit unions are exempt under section 501(c)(1). Section 501(c)(1) exempts certain corporations that have been organized under an act of Congress, designated as instrumentalities of the United States, and that are exempt from tax by the Internal Revenue Code or by certain congressional acts.

State Chartered Credit Unions

Mutual financial institutions predate the corporate and personal income tax system. Domestic building and loan associations (now called savings and loans) and mutual savings banks not having a capital stock represented by shares were exempted from tax by the Revenue Act of 1913 (P.L. 63-16). Cooperative banks without capital stock organized and operated for mutual purposes and without profit were exempted by the Revenue Act of 1916 (P.L. 64-271). Credit unions were not exempted in either of these acts. Their tax-exempt status was addressed directly for the first time in 1917, when the Attorney General stated that credit unions organized under the laws of Massachusetts were entitled to exempt status because they were very similar to cooperative banks.

The Revenue Act of 1951 (P.L. 80-183) amended section 101(4) of the 1939 Internal Revenue Code to repeal the tax-exempt status for cooperative banks, savings and loan societies, and mutual savings banks, but it specifically provided for the tax exemption of state chartered credit unions. While the act's legislative history contains extensive discussion of the reasons why the tax-exempt status of the other mutual institutions was revoked, it does not discuss why credit unions retained their

exemption. The provisions in the bill removing exempt status were included in Senate amendments to the House bill. In conference, the House of Representatives agreed to these provisions with some amendments.

The Senate report (S.R. 781, 82d Congress, 1st Session) stated that the exemption of mutual savings banks was repealed in order to establish parity between competing financial institutions. According to the Senate report, tax-exempt status gave mutual savings banks the advantage of being able to finance growth out of untaxed retained earnings, while competing corporations (commercial banks) paid tax on income retained by the corporation. The report stated that the exempt status of savings and loans was repealed on the same grounds. Moreover, it stated that savings and loan associations were no longer self-contained mutual organizations, for which membership implied significant investments over time, risk of loss, heavy penalties for cancellation of membership or early withdrawal of shares, and in which members invested in anticipation of becoming borrowers at some time. Instead, investing members were simply becoming depositors who received relatively fixed rates of return on deposits that were protected by large surplus accounts, and borrowing members found dealing with a savings and loan similar to dealing with other mortgage lending institutions.

The Senate report also specifically rejected two arguments that savings and loan associations did not have income that could be taxed. The Senate report described the first argument as being based on "the theory that both the borrowers and the investors are members of the association and that the interest paid by the borrowers on their loans is really only paid to themselves as members of the association." In rejecting this argument, the report states:

> "The mutuality argument assumes that in the long run, the investments of each member are equal to the debts he has owed the organization. It also assumes that the membership in each organization is fixed and that eventually each member will receive a proportionate share of the accumulated earnings of the organization. These assumptions might have been valid for the original savings and loan associations which terminated after they had fulfilled their purposes for the original membership groups. They are not generally valid, however, for the present-day associations, where investing members may never contemplate becoming borrowers and where the organizations are permanent and a member has no right to a share in the undistributed earnings upon withdrawal."

Second, the report states:

"Another basis on which it is argued that the savings and loan associations do not have income is that all their receipts are either paid out as expenses or as dividends to members or accumulated for the mutual benefit of the members. However, an individual member or depositor has no claim to a share of the accumulated earnings unless he remains in the organization until its dissolution.

"The income which is added to reserves and undivided profits by the savings and loan associations cannot be treated as income to a member or depositor for income tax purposes under the doctrine of constructive receipt because the member cannot obtain it unless he remains a member of the association until it is dissolved. It is the income of the associations. The fact that it is retained for the benefit of the members makes it analogous to the income retained by an ordinary taxable corporation for the benefit of its stockholders."

The Revenue Act of 1951 provided for taxation of these financial institutions as regular corporations, with two exceptions: dividends on withdrawable accounts paid to depositors would be deductible, and the act added generous rules regarding deductions for additions to a bad debt reserve. The method for determining the bad debt deduction allowed deduction of up to 100 percent of income if the total bad debt reserve balance, taxable surplus, and profits did not exceed 12 percent of total deposits or withdrawable accounts. This provision effectively allowed these institutions to avoid any payment of tax. However, over time, Congress reduced the amount they can deduct for additions to a bad debt reserve, increasing their effective tax burden.

Under current law, state credit unions are exempt from tax under Internal Revenue Code section 501(c)(14)(A). This section states that credit unions that are (1) operating on a nonprofit basis, (2) organized without capital stock, and (3) operating for mutual purposes can qualify for exemption. While state credit union laws generally require that credit union members share a common bond, it is not specifically required in the Internal Revenue Code.

In 1966, IRS revoked the tax-exempt status of St. Mary's Bank, a state chartered financial institution. St. Mary's had been incorporated in 1909 by an act of the New Hampshire Legislature and so predated the state credit union law. St. Mary's appealed the revocation in district court. The government argued that St. Mary's tax-exempt status should be revoked because it was not formed under the state's credit union law, because the nature of its services indicated that it was operating as a commercial savings and loan association, and because its charter did not specify a common bond.

In 1976, the U.S. District Court in New Hampshire upheld St. Mary's tax-exempt status. The court found that the state's recognition of an institution as a credit union must be accepted as long as the recognition was not a "gross misuse" of the term credit union. The court found that the state of New Hampshire's recognition of St. Mary's as a credit union was not a "gross misuse" of the name since St. Mary's was a cooperative institution controlled by its members and the membership shared a "de facto" common bond. The court also found that since St. Mary's operated for mutual purposes and operated without profit, it met the qualifications expressly required of a credit union under Internal Revenue Code section 501(c)(14). Further, while noting that tax exemption may give St. Mary's a competitive advantage, the court chose not to overturn the tax laws to define new tests for determining whether an institution is a credit union when neither Congress, through legislation, nor IRS, through regulation, had done so.

On appeal in 1977, the government argued that St. Mary's was operating like a commercial bank or mutual saving bank and should be taxed as such. The First Circuit Court of Appeals reaffirmed that the state had not grossly misused the term credit union and stated that:

> "A credit union is a democratically controlled, cooperative, nonprofit society, organized for the purpose of encouraging thrift and self-reliance among its members by creating a source of credit at a fair and reasonable rate of interest in order to improve the economic and social conditions of its members. A credit union is fundamentally distinguishable from other financial institutions in that the customers may exercise effective control."

The court further stated that offering demand deposit accounts and real estate loans did not prevent St. Mary's from meeting Internal Revenue Code requirements for operation of a credit union and that a de facto common bond was sufficient for the purposes of tax law.

After the St. Mary's case, IRS concluded that the provision of banking services by a state credit union could not serve as a basis for challenging tax-exempt status. Additionally, while IRS has acknowledged that while a de facto common bond was sufficient, it believes that under the test applied by the court in the St. Mary's case, it would be a "gross misuse of the name" for a state to charter a credit union without a common bond.[1] However, IRS has not subsequently challenged the tax-exempt status of a state chartered credit union.

[1] General Counsel Memorandum 37467, 38345.

In 1950, Congress made certain tax-exempt organizations subject to income tax on unrelated business income, which is income derived from business that is substantially unrelated to the organization's purpose for exemption. The intent of taxing unrelated business income is to prevent tax-exempt organizations from unfairly competing with taxable organizations in areas of business unrelated to the purpose of the exempt organization. In the Tax Reform Act of 1969, Congress extended the tax on unrelated business income to most tax-exempt organizations, including state credit unions.

Examinations of state credit unions have disclosed that IRS has imposed the unrelated business income tax on income earned from insurance sales. Preliminary IRS estimates indicate that 79 unrelated business income returns were filed by section 501(c)(14) entities in 1987, and the total tax paid was $76,000.

Federal Credit Unions

The Federal Credit Union Act of 1934 authorized the chartering of federal credit unions. The stated purpose of the act was to "establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States." Federal credit unions were originally subject to the federal income tax and could be taxed by states in the same manner as they taxed state chartered banks.

In 1937, the act was amended to, among other things, exempt federal credit unions from federal tax and limit state taxation to taxes on real and tangible personal property. The committee reports (H.R. 1579, and S.R. 1009, 75th Congress, 1st session) on the amendment indicate that taxing federal credit unions like commercial banks placed a disproportionate and excessive burden on federal credit unions, particularly because states taxed credit unions on the basis of share capital. The House report states that:

> "In view of the fact that Federal credit unions may not accept deposits, their share capital represents a much greater proportion of their total resources than is the case in other financial institutions. As Federal credit unions are mutual or cooperative organizations operated entirely by and for their members, it appears appropriate that local taxation should be levied on the members rather than on the organization itself."

As a consequence of the 1937 amendment, federal credit unions are exempt from tax under Internal Revenue Code section 501(c)(1). Certain

corporations that are organized under an act of Congress, designated as instrumentalities of the United States, and that have been specifically exempted from tax under either the Internal Revenue Code or certain congressional acts, qualify for tax-exempt status under section 501(c)(1). Federally chartered credit unions meet these three requirements and thus are exempt from federal tax under this section. As federal instrumentalities, federal credit unions are also exempt from state income tax and, unlike state credit unions, are exempt from tax on unrelated business income. Other 501(c)(1) entities include the Federal Deposit Insurance Corporation, the Government National Mortgage Association and Farm Credit Banks. In contrast, federally chartered banks are also instrumentalities of the United States but have not been exempted from federal corporate income tax.

While some states have challenged the instrumentality status of federally chartered credit unions, courts have found that federal credit unions are federal instrumentalities and immune from state taxation. In a 1988 Court of Appeals case, United States v. State of Michigan, 851 F.2d 803 (6th Cir. 1988), the Sixth Circuit upheld the instrumentality status of federal credit unions, finding they were immune from state taxation. The state of Michigan had imposed a sales tax on credit unions; the United States challenged the tax on behalf of federally chartered credit unions located in Michigan. The court, quoting from a Supreme Court case, stated "there is no simple test for ascertaining whether an institution is so closely related to governmental activity as to become a tax-immune instrumentality." The court noted that "the leading cases suggest that we examine the purpose for which federal credit unions were created, that we determine whether they continue to perform that function, and that we assess the federal government's control over and involvement with these organizations."

In examining the function of credit unions, the court found that:

> "through federal credit unions, therefore, the federal government makes credit available on liberal terms and at low rates of interest to middle-class Americans who, because they frequently lack adequate security, might otherwise have to turn to small loan financiers who can extort excessive interest rates in times of unexpected need."

The court rejected Michigan's contention that federal credit unions do not deserve tax-immune instrumentality status because they now offer essentially the same financial services as those offered by private banks. The court found that "merely because federal credit unions have

added other financial services to attract members and remain competitive with other types of financial institutions does not undermine the central fact: federal credit unions were designed and continue to perform important governmental functions." The court also found the following factors persuasive: that federal credit unions are authorized to act as fiscal agents of the United States, that they are subject to federal regulation, and that they are statutorily tax exempt.

Other courts that have examined the tax status of federal credit unions have also found them to be exempt as federal instrumentalities. See United States v. State of Maine, 524 F. Supp. 1056 (D.C. ME. 1981), and Tabco Federal Credit Unions v. Goldstein, No. 2836 1 Md. Tax Cases (CCH) Para. 200-411.

IRS Oversight of the Credit Union Industry Is Limited

IRS is responsible for overseeing more than one million tax-exempt organizations. In most cases, IRS reviews applications submitted by organizations seeking recognition of tax-exempt status to ensure that the organizations are organized and operated for the purposes allowed under the 501(c) section for which exemption is sought. After approving tax-exempt status, IRS can review the reported operations of organizations to ensure that they continue to qualify for tax-exempt status and comply with any applicable laws or regulations, such as reporting and paying tax on unrelated business income.

IRS neither receives applications for exemption from federal credit unions nor examines their activities. NCUA is exempt from tax under section 501(c)(1) and has received a group exemption letter from IRS that exempts the federal credit unions that it regulates. This procedure is designed to relieve subordinate organizations from having to apply separately for recognition of tax-exempt status. NCUA approves the chartering, merging, and termination of federal credit unions. Periodically, NCUA reports to IRS on federal credit unions that have been chartered, merged, or terminated. However, IRS does not maintain a complete and current listing of federal credit unions; it obtains only the annual changes from NCUA.

The extent to which IRS approves applications for state chartered credit unions depends upon the state in which the credit union is chartered. If a state has a regulatory authority that oversees credit unions, this authority can use the group ruling process for those credit unions it charters if it becomes recognized as tax-exempt itself and establishes that subordinate organizations are subject to its supervision and control.

As in the case of federal credit unions, state chartered credit unions are considered to be subordinate to their regulating authority. If there is no overall authority, each credit union applies to IRS for approval of its exempt status. In 12 states, credit unions apply individually to IRS for recognition by submitting a statement showing the date and state of incorporation and that the state credit union law with respect to loans, investments, and dividends, if any, is being complied with. In 35 states, credit unions obtain their tax-exempt status through the group ruling process. For these states, IRS receives only the names and addresses of individual credit unions. As of calendar year 1991, three states and the District of Columbia did not charter credit unions.

Most Credit Unions Do Not File Annual Returns With IRS

Most tax-exempt organizations other than private foundations with gross receipts of $25,000 or more are required to file an annual return with IRS that provides information on the organizations' income, expenditures, and activities. IRS uses these annually filed forms (Form 990) to select organizations for examination. In 1988 and 1989, credit unions filed 1,351 and 1,447 Form 990s, respectively. Most credit unions, however, do not file these returns because of exclusions and group filing requirements. Revenue Ruling 60-364 permits the state chartering agency to file a consolidated return for all the credit unions under its jurisdiction. At the time of this report, the state chartering agencies in 31 states were doing so. Individual credit unions are responsible for filing a Form 990 in 16 states.

IRS conducts examinations of tax-exempt organizations to ensure their continued compliance with the basis for their exemption and with tax and reporting requirements. As shown in table X.1, IRSconducted 266 examinations of state credit unions during the 4-year period from fiscal year 1986 through fiscal year 1989. As a result of these examinations, IRS recommended additional tax and penalties of $6,738. IRS' examination rate for state credit unions, in terms of number of returns examined per number of active entities, has been lower than the overall average for section 501(c) organizations.

Table X.1: Results of IRS State Credit Union Examinations

Year	Active credit unions	Form 990s filed	Examinations	No change (percent)[a]
1986	6,068	1,402	134	13
1987	6,417	1,599	62	06
1988	6,518	1,351	34	29
1989	6,184	1,447	36	28

[a]No change represents examination cases that resulted in no additional tax due or in which no administrative deficiencies were found. A change case could be a case for which a tax deficiency was found or an administrative deficiency without tax consequence was present, such as an incomplete return or computational error.

Source: IRS Annual Reports, IRS exempt organization master file data.

Effect of Tax-Exempt Status

While credit unions as organizations are exempt from tax, income that members receive from credit unions is taxed. Members who receive dividends on share accounts are taxed on that income, just as depositors at commercial banks are taxed on interest income from savings or checking accounts. However, unlike income retained by other financial institutions, income retained by credit unions is not taxed until it is distributed to members.

Tax exemption gives credit unions a competitive advantage over banks and taxable mutual financial institutions in that they can finance expansion of services through untaxed retained earnings. On the other hand, if credit unions distribute all income to shareholders and do not retain earnings at the entity level, all income will be taxed at the individual level. In this case, credit unions have little tax advantage relative to taxable mutual financial institutions, whose income is taxed once at either the individual or entity level.

NCUA data show that on average during 1989, federally insured credit unions paid out 87 percent of income before cost of funds as dividends on shares, interest on borrowed money, and interest on deposits. Thirteen percent of income was retained at the credit union level.

We also used 1989 NCUA data to calculate statistics on retained earnings and reserves for those solvent credit unions that did not have to add to regular reserves for regulatory purposes; 5,981 credit unions met this criterion. Half of these credit unions retained more than 15 percent of income, and half retained less than 15 percent. One quarter retained more than 22 percent of income, and one quarter retained less than 9 percent. Of the 5,948 credit unions that met the previously mentioned criterion and had some regular reserves, half had total reserves that are

more than 2.5 times their regular reserves, and half had less. One quarter had reserves greater than 3.5 times their regular reserves, and one quarter had total reserves less than 2 times their regular reserves. Of these credit unions, 5 percent had total reserves greater than 6.5 times regular reserves.

Taxation of Credit Unions Relative to That of Other Organizations

As institutions that link savers and borrowers, credit unions have operational characteristics that make them comparable to other financial institutions. However, they have traditionally operated as mutual, cooperative organizations. In this respect, credit unions can be compared to other membership-type tax-exempt organizations or to other cooperative businesses.

Taxation of Other Financial Institutions

Financial institutions link savers with borrowers and, by doing so, serve to make saving and investing economically efficient. Several types of institutions perform this function: commercial banks; mutual savings banks; savings and loan associations; credit unions; and investment institutions, which include mutual funds, real estate investment trusts, and investment clubs.

Any competitive advantage credit unions may have as a result of their tax-exempt status depends upon the tax burden faced by other financial institutions. Financial institutions differ in how they are treated for tax purposes. The tax burden depends on the tax rate and the rules determining the taxable income of these institutions.

Commercial Banks

Commercial banks generally are corporations owned by shareholders and are thus subject to the corporate tax. As such, commercial banks are treated as taxable entities apart from their owners, and net income is taxed at the corporate level according to the corporate tax rate schedule. Net income is defined as the excess of revenue from loans, securities, and fees over the interest paid to depositors and other expenses. Corporate income is taxed whether distributed to shareholders as dividends or retained in the corporation. After-tax income distributed as dividends is also taxed at the shareholder level. The economics literature has not reached a consensus on the extent to which the corporate tax results in higher prices to consumers for the goods and services produced by corporations, in lower wages to workers in the corporate sector, or in lower rates of return to corporate shareholders. In the case of banks, the price of the services provided is the spread

between interest rates paid to depositors and rates charged to borrowers. To the extent that the corporate tax increases this price, rates on deposits would be lower and rates on loans would be higher relative to what they would be if banks were not subject to the corporate tax.

Commercial bank taxation came under congressional scrutiny in the 1980s after studies found that commercial banks appeared to have low average effective tax rates. The Tax Reform Act of 1986 included several provisions that changed how banks in particular are taxed. First, the ability of banks to deduct interest on borrowing used to buy or hold tax-exempt securities, which other taxpayers are not allowed to do, was seen as a method by which banks could avoid tax. After the Tax Reform Act, a bank's interest expense that is allocated to tax-exempt securities, as measured by the ratio of tax-exempt assets to total assets, cannot be deducted. Second, like other taxpayers, banks were allowed deductions for bad debts; however, one of the methods banks could use to calculate this deduction—the reserve method—was considered overly generous and contributed to banks' low effective tax rates. The Tax Reform Act prohibited large commercial banks from using the reserve method for calculating allowable deductions for bad debts. In addition, existing balances in bad debt reserves were generally recaptured (included in income) over a 4-year period, beginning in the first taxable year after December 31, 1986. Third, special rules for net operating losses of financial institutions were repealed so that, after a transition period ending in 1994, financial institutions would have the same rules as other corporations.

It was predicted that these changes, along with changes in the corporate alternative minimum tax and the computation of foreign tax credits and the elimination of the investment tax credit, would more than offset the Tax Reform Act's reduction in the maximum corporate tax rate, and increase the explicit tax payments of banks and raise effective tax rates.[2] The fact that these changes were made so recently makes it difficult to evaluate their effects and makes it misleading to compare the historical effective tax rates of commercial banks with the tax-exempt status of credit unions. However, the general trend in the taxation of commercial banks has been to eliminate special rules and to tax these institutions more like other corporations.

[2]See O'Brien, James M., and Matthew D. Gelfand, Effects of The Tax Reform Act of 1986 on Commercial Banks, Tax Notes, February 9, 1987, pages 597-604; and Neubig, Thomas S., and Martin A. Sullivan, The Effect of the Tax Reform Act of 1986 on Commercial Banks, in Compendium of Tax Research 1987, Office of Tax Analysis, Department of the Treasury, pages 279-305.

Thrift Institutions

As discussed earlier, savings and loan associations, mutual savings banks, and cooperative banks (thrifts) were originally tax exempt but lost this status in the Revenue Act of 1951. Originally, thrifts generally were mutual organizations in the sense that they were owned by their depositors and did not raise funds through the sale of stock. While many thrifts are still mutual organizations, as of June 30, 1990, 43 percent of privately held thrifts were stock organizations. Special rules apply to financial institutions that qualify as domestic building and loan associations, but these rules, as discussed next, do not depend on mutual organization.

Internal Revenue Code section 591 allows thrifts to deduct dividends or interest on deposits if the amounts paid are subject to withdrawal. This provision recognizes the similarity of interest paid by a commercial bank and dividends paid by thrifts if the amounts paid are subject to withdrawal and the tax code allows both to be deducted. For mutual thrifts that distribute earnings through deductible dividends, the corporate income tax is levied on retained earnings, and income is taxed at either the depositor level or the entity level.

Under current tax law, a thrift can qualify for special rules regarding deductions for bad debts if it meets three tests. First, the supervisory test requires that the institution be either FDIC insured or subject to state or federal supervision and examination. Second, the business operations test requires that the institution's principal business must be acquiring the savings of the public and investing in loans. Third, the assets test requires that at least 60 percent of the institution's total assets consist of qualifying assets, which include cash, obligations of the United States, and loans secured by real property. If a financial institution does not meet these tests, it is treated like a commercial bank for tax purposes. If the tests are met, the institution qualifies for some special tax rules that are more generous than those afforded to banks.

The Tax Reform Act of 1986 also revised the rules regarding how thrifts can calculate deductions for bad debts. Before the act, thrifts that qualified to calculate the deduction using the reserve method could deduct up to 40 percent of their income as an addition to the reserve for bad debts. The act reduced the percentage of income that could be deducted using this method from 40 percent to 8 percent. While this change should increase the effective tax burden on thrifts, thrifts still have more generous bad debt deduction rules than large commercial banks.

Mutual Funds, Real Estate Investment Trusts, and Investment Clubs

Regulated investment companies (mutual funds), real estate investment trusts, and investment clubs are entities that enable individuals to pool their funds to invest in various types of financial assets. They receive similar tax treatment in that all income earned by individuals through these investments is taxed once—at either the entity level or the individual level.

In order to qualify for the tax treatment afforded a mutual fund, a company must, among other things, earn at least 90 percent of its income from dividends, interest, security loan payments, and capital gains from the sale of stock or securities. The company must also annually distribute 90 percent of its income as dividends to shareholders and can deduct these dividends when calculating taxable income. Mutual fund dividends received by shareholders are taxable income for the shareholder, unless the mutual fund is passing through income from investments in tax-exempt securities. This treatment, combined with a 4-percent excise tax on undistributed earnings on the difference between 98 percent of income and the amount actually distributed, seeks to ensure that income is taxed at either the company or the shareholder level.

A real estate investment trust is an entity that receives most of its income from passive real estate related investments. Like mutual funds, a real estate investment trust is treated as a conduit for its shareholders; it can deduct income distributed to shareholders and is subject to the corporate tax only on the income it retains.

Individuals can also pool their savings to invest in financial assets through investment clubs. Depending on organizational and operational characteristics, investment clubs are taxed either as corporations or as partnerships. Partnerships are not taxable entities themselves but must allocate all net income earned to the individual partners. This income is then taxed at the individual level.

Taxation of Cooperatives

While certain types of cooperative organizations have had long-standing tax-exempt status, cooperatives in general have always been subject to the corporate income tax unless specifically exempted. Certain farmers' cooperatives were exempt from tax until the Revenue Act of 1951. The Senate Report to the Revenue Act (S.R. 781) cited advantages exempt cooperatives had relative to other taxable cooperatives and it also said that as a result of the bill, all earnings of a cooperative will be taxable to

either the cooperative, its patrons, or its stockholders, with the exception of amounts paid to patrons on the basis of purchases of personal items. In 1962, after certain court decisions found that noncash allocations by cooperatives could be both deducted by cooperatives and not included in taxable income of members, new tax rules concerning cooperatives were enacted as Subchapter T of the Internal Revenue Code. The purpose of these rules was to impose tax on income either at the cooperative level or at the individual member level.

To be taxed as a cooperative under subchapter T, a corporation must operate on a cooperative basis (i.e., the corporation must provide services to members at cost and make distributions to members (patrons) in proportion to the amount of business transacted with them). In general, cooperatives are taxed much like other corporations, except that they can deduct dividends paid to members if the dividends meet certain requirements. To be deductible, patronage dividends must be paid to a patron (1) on the basis of the quantity or value of business done with or for the patron, (2) pursuant to a preexisting obligation of the cooperative, (3) determined by reference to the net earnings of the cooperative from business done with or for its patrons, (4) in money or as a written notice of allocation that can be redeemed for money and that informs the patron to include the noncash allocation as income, and (5) within 8-1/2 months of the close of the cooperative's fiscal year. Dividends that do not meet these requirements are not deductible.

Dividends are generally required to be included in taxable income by the member, except if they are attributable to purchases of personal, living, or family items, or to capital items. This exception treats these dividends as refunds, or downward price adjustments on these items, rather than additional taxable income to the member. If all earnings from business with members are distributed as patronage dividends, the cooperative can act as a conduit for its members and not incur any corporate tax liability. However, earnings not allocated to members and retained at the cooperative level are taxed at corporate tax rates.

Credit Unions and Other Tax-Exempt Organizations

A wide variety of organizations can qualify for tax-exempt status. In general, to be recognized as tax-exempt by IRS, an organization must be organized and operated for one of the tax-exempt purposes in the Internal Revenue Code. Of the 1,038,070 organizations on the IRS tax-exempt organization master file at the end of fiscal year 1989, 45 percent qualified under section 501(c)(3), which exempts religious, educational, charitable, and scientific organizations. Some of the other types

of organizations that qualify for tax-exempt status are general membership or fraternal organizations, employee benefit organizations, and specific types of mutual or cooperative companies. All or some types of credit unions share some characteristics with these organizations. However, specific code requirements and IRS regulations restrict these organizations and impose tax on certain types of income. Credit unions are not subject to many of these requirements.

General Membership and Fraternal Organizations

A variety of voluntary associations that perform various services for members are exempt from tax. This group includes labor, agricultural, and horticultural organizations that seek to improve working conditions, product quality, and productive efficiency; business leagues; clubs organized for pleasure and recreation; fraternal beneficiary societies, orders, and associations that operate under the lodge system and provide for the payment of life, sickness, accident, or other benefits to members; domestic fraternal societies, orders, and associations that operate under the lodge system and whose net earnings are devoted to religious, charitable, or educational purposes; and homeowners' associations.[3]

The Tax Reform Act of 1969 provided for the taxation of investment income for social clubs, unless the investment income was used for religious, charitable, educational, or related purposes. The Senate Report (No. 91-552) stated that

> "Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation (or other benefits) without the intervening separate organization. However, where the organization receives income from sources outside the membership, such as income from investments (or in the case of employee benefit associations, from the employer) upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure and recreation (or other benefits) to its membership."

[3]The tax treatment of certain homeowners' associations (Internal Revenue Code Section 528) is similar to that of social clubs. Membership dues, fees, and assessments are exempt from tax, but other income is taxed.

Consistent with this rationale, social clubs do not pay tax on dues, fees, and other charges from members used to pay expenses and provide recreational facilities, but like individuals acting alone, these clubs cannot earn untaxed investment income.

The rationale of allowing individuals to act together through an organization without tax consequences, if their individual actions would not generate taxes, does not justify the tax-exempt status of credit unions. If an individual loans funds to another individual, all interest income received by the lender is subject to tax. Similarly, if an individual invested in financial assets directly rather than through a credit union, all interest or dividends received by the individual would be taxed.

Like credit unions, these organizations generally are nonprofit membership organizations. However, not all nonprofit membership organizations qualify for tax-exempt status. Nonprofit organizational form is required for some types of exempt organizations, but nonprofit organization alone does not lead to tax-exempt status. For example, nonprofit automobile associations have been denied tax-exempt status as social clubs because of a lack of commingling of members and because rendering commercial services to members at a lower cost than they otherwise would have to pay is not an exempt purpose.

Employee Benefit Organizations

In addition to employment-based credit unions, many types of voluntary employee associations organized for specific purposes are exempt.

Voluntary employee beneficiary associations that provide for payments of life, sickness, accident or other benefits to members can be exempt from tax. The benefits that these organizations are permitted to provide are primarily of an insurance nature, designed to improve employee health and protect earning power from unexpected interruption. Other tax-exempt employment-based organizations include local associations of employees, the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes; teachers' retirement funds of a purely local character; trusts established to pay supplemental unemployment benefits; and certain pension trusts funded through employee contributions.

The membership characteristics of these organizations are similar to credit unions whose membership is limited to employees of specific firms. The members are allowed to pool resources to provide specific

types of benefits for each other, much as credit union members pool savings to loan to each other. However, the benefits that voluntary employment beneficiary associations can provide do not include loans to members (except in distress) or the provision of saving facilities for members. Like social clubs, investment income earned by voluntary employees' beneficiary associations is subject to tax as unrelated business income, unless it is set aside for the exempt insurance function of the organization.

Specific Types of Mutual or Cooperative Companies

Several types of mutual and cooperative organizations are specifically exempt from tax. Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations are exempt if 85 percent or more of income consists of amounts collected from members for the purpose of meeting losses and expenses. "Like" organizations include cooperative electric and water companies. Before the Tax Reform Act of 1986, mutual insurance companies (other than life) were exempt if they provided insurance substantially at cost and if certain income, including annual net written premiums, did not exceed $150,000. The Tax Reform Act of 1986 broadened this exemption to include stock insurance companies as well as mutual insurance companies and raised the limit on premiums to $350,000.

While these cooperatives are tax exempt, the Internal Revenue Code restricts the size of some of them. The size of electric and telephone cooperatives is not restricted by tax law. Unlike the tax rules for credit unions, the tax rules regarding benevolent life insurance associations and mutual insurance companies include a size restriction. For benevolent life insurance companies, the "purely local" restriction is an indirect limit on size and is more stringent than the restrictions placed on credit unions with community-based common bonds. Under Treasury regulations, an organization whose operations are limited only by the boundaries of a state is not considered to be purely local in character. (Reg. section 1.501(c)(12)-1(b)) The direct size restriction for mutual and stock property and casualty insurance companies is not imposed on credit unions.

Arguments for and Against the Taxation of Credit Unions

Proposals have been made at various times by the executive branch to tax credit unions. Taxation was advocated by the President's 1978 Tax Program; Treasury's 1984 Tax Reform for Fairness, Simplicity, and Economic Growth; and by the President's 1985 Tax Proposals to Congress for Fairness, Growth, and Simplicity. These proposals generally

endorsed the creation of a "level playing field" among financial institutions, in which organizations engaged in similar activities are taxed similarly. In response, opponents of the taxation of credit unions have argued that since credit unions are organizationally and operationally different from other financial institutions, their membership receives services that would not be provided to them by other institutions. Opponents also have argued that taxation would hinder credit unions' ability to raise capital, jeopardizing their safety and soundness.

Arguments for Taxation

In 1978, the Carter Administration proposed that the tax-exempt status of credit unions be repealed in order to establish parity between credit unions and thrift institutions. The administration argued that the relaxation of rules regarding common bond, the expansion of credit union powers, and the rising median income of credit union members indicated that credit unions were no longer true mutual institutions serving low-income workers who had been excluded from banking services elsewhere. The administration proposed that the taxation of credit unions be phased in over a 5-year period, after which credit unions would be taxed on the same basis as thrift institutions.

In 1984, the Department of the Treasury report to the President included a proposal to repeal the tax exemption of credit unions and to tax credit unions on the same basis as other thrift institutions. The report argued that tax exemption gave credit unions a competitive advantage over other financial institutions and that the taxation of credit unions would "eliminate the incentive for credit unions to retain, rather than distribute, current earnings." In 1985, the Reagan administration proposed the taxation of credit unions with over $5 million in gross assets.[4] Under this proposal, credit unions with less than $5 million of gross assets would remain tax exempt because it was felt that taxing small credit unions would significantly increase administrative burden for a relatively small revenue increase.

Arguments Against Taxation

In 1985 hearings before the House Committee on Ways and Means on the administration's proposal to tax credit unions, representatives of the Credit Union National Association, the National Association of Federal Credit Unions, the Consumer Federation, and private individuals presented arguments supporting the tax-exempt status of credit unions. In summary, they testified that tax-exempt status is justified because credit unions provide unique services, such as small loans, financial

[4]See the President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1985, pp. 247-248.

counseling, and low-cost checking accounts, that for-profit financial institutions are unable or unwilling to provide. They stated that taxing credit unions would lead credit unions away from their mutual, non-profit orientation and structure, leading to reductions in these types of services. They testified that taxation would hinder credit unions in building reserves, and since credit unions do not have the ability to raise capital through the sale of stock, their safety and soundness would be jeopardized. It was also argued that credit unions are similar to other tax-exempt organizations that are nonprofit, membership-based organizations related to employment or other group characteristics.

Effects of Taxing Credit Unions Like Other Mutual Financial Institutions

If credit unions were taxed like other mutual financial institutions, their net income would be taxed according to the corporate income tax rate schedule. Under current law, the first $50,000 of income is taxed at 15 percent, income over $50,000 but less than $75,000 is taxed at 25 percent, and income over $75,000 is taxed at 34 percent. If taxable income is greater than $100,000, an additional 5-percent tax is imposed in order to phase out the benefits of the lower rates applied to the first $75,000 of income. Corporations with taxable income of $335,000 or more in effect pay tax at a flat rate of 34 percent.

Since dividends on accounts subject to withdrawal would be a deductible expense for credit unions, they would be taxed only on income retained and not distributed to members. Credit unions retain earnings to finance expansion of services and to fund increases in desired and required reserves. If a credit union decided to grow through the use of retained earnings, it could only do so with after-tax earnings. To retain the same amount of earnings as it did before becoming taxable, a credit union would have to increase loan rates and/or decrease rates on share deposits. If a credit union had no need to expand services or reserves, it could minimize its corporate tax liability by distributing more earnings to members through higher rates on share deposits for savers, by reducing earnings through lower loan rates to members who borrow, or both. Increased rates on deposits would reduce the tax liability of the credit union but increase the tax liability of the depositor. Alternatively, reduced borrowing rates on loans for which interest is deductible (mortgage and home equity loans) would increase tax liability for those borrowers. If a credit union reduced borrowing rates on loans for which interest is not deductible, such as personal loans and car loans, the tax liability of the credit union would decrease with no corresponding increase in members' tax liability. Therefore, the gain in revenue for the federal government from taxing credit unions would be realized through

explicit payments of tax by credit unions and through increased income tax payments by members.

The Congressional Budget Office (CBO) estimated in February 1990 that taxing credit unions like other thrift institutions would yield $3.7 billion in additional revenue for the period 1991 through 1995. CBO estimated that retaining the exemption for credit unions with less than $10 million in assets would not appreciably lower this amount.[5]

[5]Reducing the Deficit: Spending and Revenue Options, Congressional Budget Office (Washington, D.C., Feb. 1990), pp. 405-406.

List of All Recommendations

Chapter 2

Recommendation to Congress

- Hold annual oversight hearings at which the NCUA Board testifies on the condition of credit unions and NCUSIF and assesses risk areas and reports on NCUA's responses.

Recommendations to NCUA

- Require credit unions with assets greater than $50 million to file financial and statistical reports quarterly.
- Expand the information required from credit unions with assets greater than $50 million on the financial and statistical reports in the areas of asset quality, interest rate sensitivity, management, and common bond.

As their experience develops, smaller credit unions should also be required to file more detailed, quarterly reports.

Chapter 3

Recommendations to Congress

Congress should amend the FCUA according to the following:

- NCUA should be required to establish minimum capital levels for credit unions no less stringent than those applicable to other insured depository institutions, providing for an appropriate phase-in period.
- The amount that can be loaned or invested in a single obligor, other than investments in direct or guaranteed obligations of the U.S. government or in the credit union's corporate, should be limited to not more than 1 percent of the credit union's total assets. Presently permitted limits with respect to credit union service organizations should continue, and exposures of not more than 2 percent of assets should be provided for in repurchase agreement transactions. NCUA should be authorized to set a higher limit for secured consumer loans made by small credit unions and for overnight funds deposited with correspondent institutions.
- NCUA should be required to tighten the commercial lending regulation and include an overall limit.
- The borrowing authority should be modified to specify that credit unions may not borrow for the purpose of growth, unless prior approval of NCUA is obtained.

- Credit unions should be required to adequately disclose that dividends on shares and other accounts cannot be guaranteed in advance but are dependent on earnings.
- All insured credit unions should be required to obtain NCUA permission before opening a new branch.
- Credit unions above a minimum size should be required to obtain annual independent certified public accountant audits and to make annual management reports on internal controls and compliance with laws and regulations.
- NCUA should be authorized and required to compel a state credit union to follow the federal regulations in any area in which the powers go beyond those permitted federal credit unions and are considered to constitute a safety and soundness risk.

Recommendations to NCUA

- NCUA should assess its real estate regulation and strengthen it to help ensure the sound underwriting of loans and their suitability for sale in the secondary market.
- NCUA should restrict the exclusions from its commercial lending limit set forth in 1987 to help ensure that credit unions are not used as vehicles underwriting large commercial ventures.

Chapter 4

Recommendations to NCUA

- NCUA should clarify the purposes, unique values, and requirements for use of each of its off-site monitoring tools. It should determine the appropriate recipients of the tools and distribute them accordingly, within each region.
- NCUA should require documentation at the regional office level of examiners' reviews of all credit union call reports.
- NCUA should invoke its statutory authority to refuse to accept state supervisors' examinations when a state regulatory authority lacks adequate independence from the credit union industry. NCUA should examine all NCUSIF-insured credit unions in such states.
- NCUA should establish a policy goal for examination frequency of state credit unions.
- NCUA should require all credit unions to submit copies of their supervisory committee audit reports to NCUA upon completion.

- The NCUA Inspector General should conduct a review focusing on NCUA's handling of problem credit unions since mid-1990, specifically its use of enforcement powers, and submit a report to the NCUA Board.

Chapter 5

Recommendations to Congress

- Amend FCUA to authorize NCUA to provide assistance in resolving a failing credit union only when it is less costly than liquidation or essential to provide adequate depository services in the community, and
- Require NCUA to maintain documentation supporting its resolution decisions, including the statistical and economic assumptions made.

Recommendations to NCUA

NCUA should

- require that waivers and special charges be authorized by the Director, Office of Examination and Insurance; the General Counsel; and the regional director;
- develop policy guidance concerning the use of these provisions and monitor their use; and
- adhere to the criteria for assisting credit unions.

Chapter 6

Recommendations to Congress

- FCUA should be amended to confine insured credit union investments in corporates and U.S. Central to those that have obtained deposit insurance from NCUSIF.

The implementation of this recommendation is critical for accomplishing the needed changes contained in the following recommendations.

- Congress should require NCUA to establish a program to promptly increase the capital of corporates and establish minimum capital standards.

Recommendations to NCUA

- Minimum capital requirements should be established for corporates and U.S. Central, taking all risks into account. In the interim, establish a minimum level based on assets, and set a time frame for achieving this level. This could be achieved by increasing reserving requirements and using subordinated debt arrangements, such as the membership capital share deposits.
- The investment powers of state-chartered corporates should be restricted to the limits imposed on federal corporates.
- Corporate credit union and U.S. Central investments in a single obligor should be limited to 1 percent of the investor's total assets. Exceptions should include obligations of the U.S. Government, repurchase agreements that equal up to 2 percent of assets, and all investments by corporates in U.S. Central.
- Corporate credit union and U.S. Central loans to one borrower should be limited to 1 percent of the lender's assets. NCUA should be authorized to make exceptions on a loan-by-loan basis.
- More complete and timely information about corporate financial operations should be obtained.
- A unit should be established at NCUA headquarters that would be responsible for corporate oversight, examination, and enforcement actions.
- The CAMEL rating system for corporate credit unions should be reviewed to reduce the inconsistencies and focus more clearly on the component being rated.

Chapter 7

Recommendations to Congress

Congress should require credit unions to expense the 1-percent deposit over a reasonable period of time—to be determined by NCUA. At the same time, Congress should emphasize that the assets represented by a failed credit union's insurance deposit should be available first to NCUSIF. This action should be coordinated with and consistent with any legislation to recapitalize the Bank Insurance Fund in order to avoid placing credit unions at a competitive disadvantage.

If Congress does not require that the 1-percent deposit be expensed, NCUA should require credit unions to exclude the amount from both sides of their balance sheet when assessing capital adequacy. Then, that amount would not be counted as credit union capital.

In addition, Congress should amend FCUA to

- establish an available assets ratio for NCUSIF;
- authorize NCUA to raise the basic NCUSIF equity ratio, available assets ratio, and premiums, and delete NCUSIF ability to set a normal operating level below the statutory minimum;
- provide for additional NCUA borrowing from Treasury on behalf of NCUSIF; and
- Place NCUSIF in a position second to general creditors but rank this position ahead of uninsured shares.

Recommendations to NCUA

- Reduce the time lag in adjusting the Fund's financing and
- Place NCUSIF on a calendar fiscal year.

Chapter 8

Recommendations to Congress

Congress should amend FCUA to

- require NCUA, in consultation with Congress and the credit union industry, to identify specific unsafe and unsound practices and conditions that merit enforcement action, identify the appropriate corrective action, and promulgate these requirements by regulation;
- require NCUA to take appropriate enforcement action when unsafe and unsound conditions or practices, as specified in law or NCUA regulations, are identified; and
- provide for a five-member NCUA Board, with two members ex officio, the Chairman of the Federal Reserve Board and the Secretary of the Treasury. Authorize the two ex officio members to delegate their authority to another member of the Federal Reserve Board or to another official of the Department of the Treasury who is appointed by the President with the advice and consent of the Senate.

If there is a broad reform of the depository institution regulatory structure, and Congress legislates an approach that places all examination and supervision functions under a single federal regulator, credit unions should be considered for inclusion once such an entity is operating effectively. The insurance function could then be placed under FDIC or under a separate entity.

CLF, as established by Title III of the FCUA should be dissolved.

If CLF continues to operate, we recommend statutory changes limiting the risk in its operations. These should include

- sharply reducing CLF borrowing authority from the current level of 12 times subscribed capital and surplus;
- requiring the terms and conditions of CLF loans to be no more liberal than those made by the Federal Reserve; and
- prohibiting CLF loans or guarantees of any kind to NCUSIF, and, in the event the NCUA Board certifies that CLF does not have sufficient funds to meet liquidity needs of credit unions, authorize the Department of the Treasury to lend to NCUSIF, rather than to CLF, in order to meet such needs.

The power of federal credit unions to borrow from the Farm Credit Banks, as provided for in FCUA should be removed.

Congress should amend the Community Development Credit Union Revolving Fund Transfer Act to designate an entity other than NCUA as administrator of the revolving Fund.

Recommendation to NCUA

- Immediately establish separate supervision and insurance offices that report directly to the Board.

Chapter 9

Matter for Congressional Consideration

If credit unions are to remain distinct from other depository institutions because, in part, of their common bond membership requirement, and if this requirement is intended to further the safe and sound operation of credit unions:

- Congress should consider stating this general intent in legislation and establish guidelines on the limits of occupational, associational, and community common bonds as well as the purpose and limits of multiple group charters. These guidelines should apply to all federally insured credit unions.

Comments From the National Credit Union Administration

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

May 24, 1991

OFFICE OF THE CHAIRMAN

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to comment on your report on credit unions and the National Credit Union Administration. I appreciate your staff's professionalism and the many months of hard work that have gone into this report. I would also like to compliment GAO's work on two other recent reports, "Deposit Insurance, A Strategy for Reform," and "Bank Supervision, Prompt and Forceful Actions Needed." While not pertaining directly to credit unions, we at NCUA found both reports to be insightful and helpful to overall financial reform.

See comment 1.

Regarding the report on credit unions, we either agree with or do not object to most of your recommendations. When we disagree we offer a constructive alternative. Our response to each recommendation is attached. We note that bringing all of these recommendations to bear without proper time, thought, and flexibility will overwhelm both credit unions and NCUA.

See comment 2.

Two comments appear in the executive summary that we disagree with and that bear special mention here. Neither comment appears to be supported by the facts in the report, nor are the comments essential to the points GAO is trying to make. The first is the sentence "GAO notes, however, that neither the industry nor the fund have been under pressure in recent years," offered as qualification after saying that NCUA does not resemble the now-defunct Federal Home Loan Bank Board.

In fact, in recent years the credit union system and NCUA have had a record of success <u>despite</u> troubling times. Over the last five years, the credit union system has lost through merger or liquidation almost 2,800 or 20 percent of all federally insured credit unions. During this same period, share deposits doubled, the sophistication and complexity of the investment markets increased greatly, one large private insurance fund for credit unions failed, and the NCUSIF suffered the three largest losses in its history. In addition, credit unions and the NCUSIF have incurred substantial losses in the Southwest and New England, largely as a result of commercial lending by a small number of credit unions.

Mr. Richard L. Fogel
May 24, 1991
Page Two

Notwithstanding these stresses, credit union capital stands at 7.6 percent, loan delinquency is at an all-time low, and the NCUSIF has been profitable every year since its recapitalization. In short, the credit union system has remained sound because of the conservative nature of credit unions themselves, and because NCUA, through its structure and policies, is in a position to respond appropriately.

See comment 3.

Our second concern with the executive summary is the suggestion that if legislation is passed creating a super agency, Congress may want to include NCUA in the reorganization and move NCUSIF to FDIC. This idea does not appear to be supported or addressed anywhere in the report. In fact, in your March 1991 report on deposit insurance, you specifically noted that GAO had no recommendations for regulatory consolidation or reconfiguration. We feel strongly that credit unions and NCUA should not be singled out by such a statement now. Indeed, we are puzzled by the origin and intent of such a statement. The success of the NCUSIF's capitalization in 1984 has not been disputed by anyone, nor has anyone ever concluded after legitimate study that NCUA is an ineffective regulator. Alone among the federal deposit funds, the NCUSIF is working well, posing no danger to the taxpayers. Alone among the financial regulators, NCUA has been able to move forward with a level of recruiting, training, and technology that the others wish they had. To suggest the forced disappearance of a strong insurance fund and a competent regulator into a super bureaucracy does not serve the public well, and we respectfully request that the paragraph at issue be dropped from the executive summary.

Again, notwithstanding the above concerns and a limited number of other disagreements reflected in the attachment, I want to reiterate my appreciation for this report. Your staff's review and evaluation of NCUA over the past 20 months has been a very constructive process, and I commend your staff's thoroughness and professionalism. Most of GAO's recommendations, several of which we are acting on already, will strengthen the credit union system and enhance NCUA's effectiveness as a federal financial regulator.

With kindest personal regards, I am

Sincerely,

Roger W. Jepsen
Chairman

Comments of the Chairman, National Credit Union Administration Board

on the

General Accounting Office's Report to Congress

on the

Reforms for Assuring Future Soundness in Credit Unions

Chapter 2, NCUA Recommendation - Require that credit unions with assets greater than $50 million file financial and statistical reports quarterly.

Response: Quarterly reporting for federally insured credit unions with assets in excess of $100 million is scheduled to begin with the March 31, 1992, period. Current plans call for expansion after 1 year to credit unions with assets in excess of $50 million. Long-range plans call for quarterly reporting for all federally insured credit unions.

Chapter 2, NCUA Recommendation - Expand the information required from credit unions with assets greater than $50 million on the financial and statistical reports in the areas of asset quality, interest rate sensitivity, management, and common bond.

Response: Expanded reporting was initiated with the December 1990 Call Report, by gathering more data on real estate loans; specifically, 1st Mortgage Loans Sold, Real Estate Loan Liquidity, Delinquent Real Estate Loans.

Further expansion is under study and GAO's comments will be helpful in our review process.

Chapter 2, Congressional Recommendation - Hold annual oversight hearings at which the NCUA Board testifies.

Response: Congress and the Banking Committees frequently hold hearings on matters of interest to NCUA and the credit union system, and NCUA welcomes the opportunity to testify on the condition of credit unions and the NCUSIF. We have no objection to any external reviews, such as annual oversight hearings.

See comment 4.

Chapter 3, NCUA Recommendation - NCUA should assess its real estate regulation and strengthen it to help insure the sound underwriting of loans and their suitability for sale in the secondary market.

Response: NCUA has conducted a number of studies to determine the potential effects of increased real estate lending by insured credit unions. Research Studies No. 10, 12 and 14, by the NCUA Office of the Chief Economist, address various issues related to real estate lending. In October 1989, NCUA Letter No. 112 was issued to all insured credit unions. A follow-up letter is expected to be released by June 1, 1991. This letter will outline the minimum requirements for safe and sound real estate lending. Examiners will use the letter as a guide to determine the condition of credit union loan portfolios. In addition, the Examiner's Guide is being revised in the same areas. A draft of the revisions is expected to be released within the next 45 days with a final change to be adopted on or about November 1, 1991.

We will continue to evaluate the need for additional regulatory limitations. Preliminary reviews show that the 1989 letter resulted in a number of changes, including the dramatic slowing in real estate lending growth. Historically low delinquency, 1.2 percent, and low loss experience underscore the conservative underwriting standards of credit unions. We believe that the guideline approach, followed with educational efforts by NCUA,

has been successful in promoting change. We will not hesitate, however, to adopt additional regulatory limitations if credit unions take risks that are inconsistent with the guidelines.

See comment 5.

Chapter 3, NCUA Recommendation - NCUA should restrict the exclusions from its commercial lending limit set forth in 1987 to help insure that credit unions are not used as vehicles for underwriting large commercial ventures.

Response: The NCUA Board proposed a number of significant changes to the member business loan regulation, Section 701.21(h), in January 1991. A revised proposal was issued for comment on April 4, 1991. This proposal includes numerous provisions to control the risk of business loans. Specifically, the proposal eliminates the exclusion, from the definition of member business loan, of loans secured by a member's interest in a 1 to 4 family dwelling other than the primary residence. The loans-to-one-borrower limit would be lowered from 20 percent of reserves to 10 percent. The definition of reserves would exclude allowance accounts. Proposed restrictions on speculative, development and construction lending would severely curb any such lending by credit unions.

See comment 6.

Chapter 3, NCUA Recommendation - NCUA should issue a regulation applicable to all insured credit unions requiring them to adequately disclose that dividends on shares and other accounts cannot be guaranteed in advance but are dependent on earnings.

Response: Existing NCUA regulations require that "A federal credit union shall accurately represent the terms and conditions of its share, share draft, and share certificate accounts in all advertising, disclosures, or agreements, whether written or oral." Advertising that specifies or implies a guarantee is not permissible under the existing regulation and should be dealt with during examination contacts or otherwise. Any additional requirements should be initially addressed by Congress, in the context of Truth-In-Savings legislation.

See comment 7.

Chapter 3, Congressional Recommendation - Require NCUA to establish minimum capital levels for credit unions no less stringent than those applicable to other insured depository institutions.

Response: NCUA's CAMEL rating system establishes minimum capital standards for credit unions. In general, a credit union with less than 3 percent net (after losses) capital is rated a code 4.

By policy, a code 4 must improve or resolve problems within 24 months or be merged or liquidated. NCUA's insistence on strong capital and its incorporation into the rating system is one reason credit unions have the highest percentage of reserves to assets among all financial institutions.

In recent years, there has been a significant decline in the number of low net worth credit unions and of their market share as indicated in the GAO report. We agree that undercapitalized credit unions should have approved capital plans and be put under operating limits and special oversight, both to control the risk to the NCUSIF and to prevent excessive growth in weaker credit unions. We would also support a minimum capital benchmark, where NCUA could liquidate a credit union under Title II of the Federal Credit Union Act before actually becoming insolvent. This would be useful when NCUA determines that a credit union is not viable, continues to deteriorate, or has not been responsive to meeting minimum capital objectives.

We agree with GAO's observations that while existing reserving requirements and absence of minimum capital levels have not resulted in an undercapitalized industry, minimum capital standards would help bring up the bottom of the industry. Considering that credit unions can build capital only by setting aside net earnings, NCUA would need flexibility to allow reasonable timeframes for both new and troubled credit unions to meet the standards.

See comment 8.

Chapter 3, Congressional Recommendation - Limit the amount that can be loaned or invested in a single obliger, other than investments in direct or guaranteed obligations of the U.S. Government or in the credit union's corporate, to not more than 1 percent of the credit union's total assets. Presently permitted limits with respect to credit union service organizations should continue and exposure of not more than 2 percent of assets should be provided for in repurchase agreement transactions.

Response: We agree that the current limit in the Federal Credit Union Act, which allows loans to members up to 10 percent of the credit union's unimpaired shares and surplus is too high. As a practical matter, concentrations approaching that limit are very uncommon in credit unions. Examiners would take exception to concentrations approaching anywhere near this size. GAO's draft report states that for credit unions which are engaged exclusively in making traditional consumer loans, the effect of a loan-to-one-borrower limit on 1 percent of assets would probably be minimal. For the 43 percent of credit unions that have less than $2 million in assets, however, such a limit could have a significant effect on their ability to make secured consumer loans, such as auto loans. Therefore, while we support a greater asset diversification, some additional consideration needs to be given to small credit unions, where the risk to the NCUSIF is minimal. We would recommend that secured consumer credit be exempt or a higher limit imposed for secured consumer credit.

Also, for many credit unions, a 1-percent investment limit may not allow for adequate overnight funds to be on deposit at a correspondent bank to meet cash needs, clearing account needs, share draft reserve requirements, etc. A 1-percent investment limit may also result in a degree of diversification, for larger credit unions, that results in unacceptable levels of credit risk.

To avoid more exposure to credit risk and management risk in larger credit unions, and to lessen the burden in smaller credit unions, we suggest that an investment limit of 5 percent of assets would be more reasonable, with the NCUA Board reserving the authority to establish lower limits for types or classes of investments. The Federal Credit Union Act, the NCUA Rules and Regulations, and the pending proposed changes to the NCUA investment regulation are much more restrictive than the investment authority provided to banks and thrifts, which makes different concentration limits for credit unions appropriate. Finally, we assume from the report that this recommendation would apply to all federally insured credit unions. We agree that it should, and recommend clarification in the final report.

See comment 9.

Chapter 3, Congressional Recommendation - Congress should amend the Federal Credit Union Act to tighten the regulation concerning commercial lending and include an overall limit.

Response: Commercial lending at credit unions constitutes less than 1 percent of total assets. The NCUA Board has, however, recognized the higher risk in this area and issued regulatory limitations beginning in 1987. At that time, the NCUA Board stated that the regulation would be reevaluated after 3 years. Revisions were proposed in January 1991. Final action is expected to be taken within the next 90 days, addressing the issues raised in the GAO report. Thus, congressional action does not appear to be needed. Nonetheless, we have no objection to congressional review and guidance, but would caution against overly restrictive legislation. Flexibility must be provided, for example, for agricultural-based credit unions, and for small business-purpose loans to credit union members.

See comment 10.

Chapter 3, Congressional Recommendation - Modify the borrowing authority to specify that credit unions may not borrow for the purpose of growth, unless prior approval of NCUA is obtained.

Response: Credit unions rarely borrow funds, particularly to fund growth. As of December 31, 1990, total borrowing in federally insured credit unions totaled $1.2 billion (.5 percent of total assets). Of this total, $.9 billion were reverse repurchase agreements. We feel that effective supervision will continue to ensure that credit unions do not abuse their borrowing authority. We would have no objection, however, to legislation strengthening NCUA's ability to regulate borrowing, including a requirement that borrowing for purposes of growth be subject to NCUA's advance approval. Also, the authority of FCUs to borrow "from any source" (12 U.S.C. 1757(a)) has, in the past, prevented NCUA from regulating the issuance of uninsured investment notes to nonmembers. We recommend that the "from any source" language be removed from the statute.

See comment 11.

Chapter 3, Congressional Recommendation - Congress should amend the Federal Credit Union Act to require all insured credit unions obtain NCUA permission before opening a new branch.

Response: Restrictions on credit union membership and NCUA's 5 percent regulatory limit on fixed assets have generally served as effective checks on excessive or unsound branching. Properly defined, however, we would have no objection to a simple approval process for brick and mortar "branches". Such a process could serve as an additional check against excessive growth and expenses by problem credit unions.

As an alternative, Congress may wish to require that credit unions notify NCUA before opening new branches.

Chapter 3, Congressional Recommendation - Require insured credit unions above a minimum size to obtain annual independent certified public accountant audits and to make annual management reports on internal controls and compliance with laws and regulations.

Response: We agree with this recommendation and encourage CPA audits. In the recent past, we have made it a requirement that corporate credit unions have opinion audits. Additionally, as a result of legislation supported by NCUA, an opinion audit is now required for any federally insured credit union that has experienced serious and persistent recordkeeping deficiencies.

Chapter 3, Congressional Recommendation - Congress should amend the Federal Credit Union Act to provide NCUA with the authority and require that it compel a state credit union to follow the federal regulations in any area in which the powers go beyond those permitted federal credit unions and are considered a safety and soundness risk.

Response: We concur with this recommendation. While we believe that we currently have general rulemaking authority over all federally insured credit unions pursuant to Title II of the Federal Credit Union Act, we would welcome any congressional clarification.

Chapter 4, NCUA Recommendation - Clarify the purposes, unique values, and requirements for use of each of its off-site monitoring tools. It should determine the appropriate recipients of the tools and distribute them accordingly, within each region.

Response: We agree with this recommendation. We currently have a project underway that will identify, state the purpose, and recipient(s) for all NCUA reports.

See comment 12.

Chapter 4, NCUA Recommendation - Require documentation at the regional office level of examiners' reviews of all credit union call reports.

Response: Examiners are required to document that the Call Report has been reviewed on the Examination Scope (NCUA 2055) workpaper which is reviewed by the examiner's supervisor. Having the separate block on this workpaper shows the importance of reviewing call reports. However, we will review the benefits of some extra form of certification.

See comment 13.

Chapter 4, NCUA Recommendation - NCUA should invoke its statutory authority to refuse to accept state supervisors' examinations when a state regulatory authority lacks adequate independence from the credit union industry.

Response: We agree and believe that we already exercise this authority. The issue is whether a lack of independence clouds the state regulator's view with the result that problems are deferred or not identified. Each state examination report is reviewed by NCUA staff and its CAEL rating is determined independent of any rating assigned by the state regulator. When the NCUA review detects areas of concern that are not identified by the state regulator, NCUA makes efforts to reconcile this difference. In cases where these concerns are not satisfactorily resolved, NCUA reserves the absolute right to make an independent on-site examination. This system has worked well. To the extent that this issue needs to be clarified to staff or state regulators, it will be done.

See comment 14.

Chapter 4, NCUA Recommendation - NCUA should examine all NCUSIF-insured credit unions in such states [when a state regulatory authority lacks adequate independence from the credit union industry].

Response: The GAO report notes that two states have supervisory boards on which a majority of the members are credit union officials. We agree that there is a built-in conflict of interest, and that NCUA should apply additional scrutiny in these arrangements (particularly for the credit unions of supervisory board members) and others that may limit supervisory independence. It may not be feasible or necessary, however, for NCUA to examine every federally insured state-chartered credit union in these states. Depending on the effectiveness of the individual state supervisor, we prefer to continue to rely primarily on financial data, including such factors as size and trends, to determine which credit unions to examine. We do reserve the right to examine any insured credit union as determined by the NCUA, and this may include all credit unions in a particular state, if evidence indicates that the objectivity of the state regulator has been compromised and state examination reports lack credibility.

See comment 15.

Chapter 4, NCUA Recommendation - NCUA should establish a policy goal for examination frequency of state credit unions.

Response: At present, agency policy on the frequency of examinations of state credit unions is implied through a number of different sources. In order to clarify NCUA's goals and ensure a clear understanding by staff and state regulators, we will develop a policy statement establishing examination frequency goals for state credit unions. At the same time, it should be noted that state examination programs are an important resource and offer additional supervisory views which supplement, but do not replace, analysis by NCUA.

See comment 16.

Chapter 4, NCUA Recommendation - Require all credit unions to submit copies of their supervisory committee audit reports to NCUA upon completion.

Response: We believe our present system of reviewing the audit at each annual examination is a more efficient and effective method. The cost, labor, and paperwork of requiring all credit unions to forward their audit reports to NCUA is excessive when compared to the benefits. Larger credit unions and credit unions with problems are required to forward copies of their audits to the examiner upon completion.

Chapter 4, NCUA Recommendation - Ask the Inspector General to conduct a review focusing on NCUA's handling of problem credit unions since mid-1990, specifically its use of enforcement powers, and submit a report to the NCUA Board.

Response: We have no objection to the recommendation.

See comment 17.

Chapter 5, Congressional Recommendation - Amend the Federal Credit Union Act to authorize NCUA to provide assistance in resolving a failing credit union only when it is less costly than liquidation or essential to provide adequate depository services in the community.

Response: The recommendation coincides with our current policy and practice. Our 1986 policy statement on special assistance and the special assistance section of the Examiner's Guide establish these criteria. NCUA made significant quality control improvements in 1989 which further strengthened the tripwires for special assistance.

See comment 18.

Chapter 5, Congressional Recommendation - Require NCUA to maintain documentation supporting its resolution decisions, including the statistical and economic assumptions made.

Response: We agree with this recommendation and believe we have policies and requirements in place to achieve this end. We have made several improvements, including processing checklists, quality control features, data-base tracking, and a more aggressive central office review which have addressed the deficiencies noted by GAO.

See comment 19.

Chapter 5, NCUA Recommendation - Require that waivers and special charges be authorized by the Director, E&I, and the GC, as well as the RD, and that policy guidance concerning the use of these provisions be developed, and that their use be monitored.

Response: All waivers and charges are currently formalized in Letters of Understanding and Agreements (LUAs) with the respective credit unions. The LUAs always require approval by the regional directors, and frequently require concurrence by the Director, Office of Examination and Insurance, General Counsel and the NCUA Board. Most waivers and charges allowed are in conjunction with 208 assistance, so many of these actions have

the approval and concurrence of the Washington Office. These actions are closely tracked and monitored. Those few waivers or charges that occur outside of special assistance are small and nonrepetitive. The regions are required to report monthly on the status of these credit unions. The Department of Risk Management compiles a database summary which monitors the condition of these credit unions and produces periodic summary reports. Instruction 7300.1, last revised in August of 1989, outlines requirements for reserve charges and waivers.

See comment 20.

Chapter 5, NCUA Recommendation - Adhere to criteria for assisting credit unions.

Response: Checklists are being used at both the Regional and Washington levels to assure all criteria are addressed. Staffing and Washington presence has been increased on 208 cases to improve documentation, quality, and consistency. Quality control reviews are being conducted and Washington files have all been reviewed and documentation requested where deficiencies have been noted. The Regional and Washington Offices have processing manuals which they follow as they process assistance cases.

See comment 21.

Chapter 6, Congressional Recommendation - Amend the Federal Credit Union Act to confine insured credit union investments in corporates and U.S. Central, to those that have obtained deposit insurance from the NCUSIF.

Response: We concur with this recommendation. NCUA has recently proposed a change to the NCUA Rules and Regulations which would effectively limit investment in corporate credit unions to those that follow NCUA's regulatory standards. Federal insurance of all corporates is still needed, however, to provide NCUA with regulatory and enforcement jurisdiction. NCUA has submitted proposed legislation to the House and Senate Banking Committees to accomplish this objective.

See comment 22.

Chapter 6, Congressional Recommendation - Require NCUA to establish a program to promptly increase the capital of corporates and to establish minimum capital standards.

Response: We agree, in principle, to both of these concepts. We caution, however, that minimum capital standards for corporates will be difficult to establish and maintain due to natural fluctuations in the asset sizes of corporates resulting from their role as an investment and liquidity medium for their member credit unions.

Because they are closely supervised and invest only in highly rated instruments, the risk presented by corporate credit unions is, in our view, very low. Comparison of capital at corporates to capital at commercial banks is inappropriate and could mislead uninformed readers to the conclusion that corporates are severely undercapitalized. This is not the case. NCUA requires high standards for corporates in the area of asset quality, matching of rates and maturities, and diversification. We believe that these issues are of equal importance to strong capital. In summary, the issue of adequate capital is a complex matter which cannot be simply resolved by establishing a minimum capital level, but which must also address risk, which is the next recommendation.

Chapter 6, NCUA Recommendation - Establish minimum capital requirements for corporates and U.S. Central, taking all risks into account. In the interim, establish a minimum level based on assets, and a timeframe for achieving this level. This could be done through increased reserving requirements and use of subordinated debt arrangements such as the membership capital share deposits.

Response: We are currently working toward that goal and expect to accomplish such a system by the end of 1991.

Chapter 6, NCUA Recommendation - Restrict the investment powers of state-chartered corporates to the limits imposed on federal corporates.

Response: We concur with this recommendation. Our proposed new corporate regulation should accomplish this goal. In some cases, state regulators may elect to adopt more stringent provisions.

See comment 23.

Chapter 6, NCUA Recommendation - Limit corporate credit union and U.S. Central investments in a single obliger to one percent of the investor's total assets. Exceptions should include obligations of the U.S. Government, repurchase agreements up to two percent of assets, and all investments by corporates in U.S. Central.

Response: We agree with the concept of diversification of risk and have insisted on such policies during examinations of corporates. We do not believe that diversification down to 1 percent of assets is advisable for corporate credit unions. The proposed regulation establishes a 5 percent diversification limit which we consider more appropriate. In evaluating risk, it is important to place all risks in perspective. Concentrating on eliminating one risk has implications for other risks. For

example, diversification to 1 percent would have the effect of expanding the number of investment vehicles used. Expanding the universe of available investment vehicles will entail acceptance of additional credit risk. Existing policies, and the proposed regulations, require diversification, as well as limitations on the credit risk and liquidity risk. Accordingly, we believe 5 percent to be a more acceptable level of diversification.

See comment 24.

Chapter 6, NCUA Recommendation - Limit corporate credit union and U.S. Central loans to one borrower to one percent of the lender's assets. NCUA should be authorized to make exceptions, on a loan-by-loan basis.

Response: We do not concur with this recommendation. Corporates exist in order to provide for liquidity to their credit union members. Limiting the lending authority to 1 percent of assets will severely cripple this ability with only a marginal decrease in risk exposure. U.S. Central would be limited to lending an aggregate of 43 percent (1 percent for each corporate) of assets in view of their limited membership. NCUA insists on high credit standards and regular monitoring of lines of credit. We believe that this adequately addresses lending risks to the corporate system.

In addition, the proposed regulation provides a mechanism to limit lending based on reserves. This is considered necessary in order to enable corporates to function during times of low liquidity. In such circumstances, shares would flow out of the corporates, assets would shrink significantly and the resulting lending ability would be severely impacted. By relating the lending authority to reserves, this problem is averted.

See comment 25.

Chapter 6, NCUA Recommendation - Obtain more complete and timely information about corporate financial operations.

Response: Significant improvements have been made in both the timeliness and level of reporting by corporates during the period under review. In addition, the primary line of defense rests with the individual corporate examiners. These examiners will continue to receive monthly financial reports from each of the corporates under their supervision. We will continue to work with corporate credit unions to improve both the quality and timeliness of corporate reports.

See comment 26.

Chapter 6, NCUA Recommendation - Establish a unit at NCUA headquarters with responsibility for corporate oversight, examination, and enforcement actions.

Response: We agree that a level of oversight and centralized responsibility for the corporate program is necessary at the central office level. At the present time, one full-time staff position is responsible for providing oversight and monitoring of the corporate examination program. Existing oversight includes a review of all corporate examinations, scheduling of examinations, corporate examiner training, establishment of policy and analysis of monthly 5310 reports. We recognize the importance of the corporate examiner's role. We also recognize the importance of increased Washington Office participation in scheduling and coordinating exams and follow-up, especially with respect to U.S. Central. We continue to believe, however, that regional responsibility over corporates and corporate examiners is necessary.

See comment 27.

Chapter 6, NCUA Recommendation - Review the CAMEL Rating System for corporate credit unions to reduce the inconsistencies and focus more clearly on the component being rated.

Response: We agree that the CAMEL Rating Ssystem for corporate credit unions should be reviewed to reduce inconsistencies and to focus more clearly on the component being rated. Annual review of the CAMEL system and corporate examination procedures has been an integral part of the corporate examination program since 1986. We plan to continue this effort in order to maintain the highest standards for corporates. In general, NCUA believes that corporates need to be held to a higher standard than natural person credit unions. This means that all exceptions are treated seriously and pursued to expedite resolution in the case of corporates.

See comment 28.

Chapter 7, Congressional Recommendation - Congress should require that credit unions expense the 1% deposit over a reasonable period of time, to be determined by NCUA. Congress should at the same time specify that the assets represented by a failed credit union's insurance deposit should be first available to the NCUSIF. This should be coordinated with and consistent with any legislation to recapitalize the Bank Insurance Fund, so as to avoid placing credit unions at a competitive disadvantage.

Response: Based upon the recent action of the House Financial Institutions Subcommittee, it appears unlikely that Congress will require credit unions to expense the 1% insurance deposit.

Therefore, it may be advisable to focus on GAO's alternative recommendation that the 1% deposit be excluded from both sides of the balance sheet when calculating capital adequacy. It is probably a good idea to segregate and specifically earmark those reserves. This would appear to remove the major concern that the existing structure results in an overstatement of the financial position of credit unions and the NCUSIF. Even excluding the 1% deposit, the capital ratio in credit unions is the highest among financial institutions.

We have no objection to the recommendation to make the 1% deposit of a failed credit union available to the NCUSIF first.
We agree that any action taken by Congress concerning the 1% deposit be consistent with any legislation enacted to recapitalize the Bank Insurance Fund (BIF) or Savings Association Insurance Fund (SAIF).

See comment 29.

Chapter 7, Congressional Recommendation - Congress should establish an available assets ratio for the NCUSIF.

Response: We agree with this recommendation. We would recommend that the NCUSIF have a minimum statutory available assets to insured shares ratio of approximately .75 percent - .80 percent. This ratio would override the normal equity ratio, now at 1.3 percent, when determining the amount of excess funds above the statutory operating level which should be returned to credit unions. It would also trigger the collection of funds to the NCUSIF for operating purposes. If Congress does establish an available assets ratio for the NCUSIF, a ratio of equal value should also be included in any legislation to recapitalize the Bank Insurance Fund and Savings Association Insurance Fund.

See comment 30.

Chapter 7, Congressional Recommendation - Congress should authorize NCUA to raise the basic NCUSIF equity ratio, available assets ratio, and premiums and delete its ability to set a normal operating level below the statutory minimum.

Response: We agree with this recommendation. NCUA should have the ability to establish higher NCUSIF operating levels to ensure the health and stability of the Fund, and maintain the confidence of its insured credit unions. Also, we recommend that NCUA be given the authority to assess risk-based premiums based upon the level of capital for each credit union.

Chapter 7, Congressional Recommendation - Congress should provide for additional NCUA borrowing from Treasury on behalf of the NCUSIF.

Response: We agree with this recommendation. The present borrowing authority of the NCUSIF from the U.S. Treasury is $100 million. An additional $500 million can be obtained through the CLF after appropriations. The NCUSIF has never borrowed from the CLF, the U.S. Treasury, or required taxpayer funds to operate. However, should the CLF be abolished, a greater borrowing limit from the U.S. Treasury should be available to meet liquidity needs in an emergency situation.

Chapter 7, Congressional Recommendation - Congress should amend the Federal Credit Union Act to place the NCUSIF in a second position to general creditors, but provide that this position would rank ahead of uninsured shares.

Response: We agree with this recommendation. Although NCUSIF losses from uninsured shares have been minimal, this change in payout priority would be particularly helpful in clarifying that the U.S. Government does not stand behind credit unions' deposits in excess of $100,000 in their corporates.

Chapter 7, NCUA Recommendation - NCUA should reduce the lag time in adjusting the Fund's financing.

Response: We do not object to this recommendation. The lag time can be easily shortened from 7 to 3 months, using the present computerized invoicing program.

Chapter 7, NCUA Recommendation - NCUA should place the NCUSIF on a calendar year basis.

Response: We generally agree with this recommendation. This would facilitate the NCUSIF comparison with the BIF and SAIF, and better match the results of the Fund to year-end credit union performance. Also, it would be beneficial for NCUA to change the insurance year from June 30 to December 31. Funds due to the NCUSIF would be based upon year-end data as opposed to June 30 credit union data.

See comment 31.

Chapter 8, NCUA Recommendation - Immediately establish separate supervision and insurance offices that report directly to the NCUA Board.

Response: We disagree. As you have stated in your report:

> "Separation of NCUSIF from NCUA's chartering, regulation, and supervision responsibilities would not, based on these analyses, by itself guarantee either strong supervision or insurance fund health. And such a move could result in additional and duplicative oversight costs. In

addition, it can be argued that a regulator/supervisor without insurance responsibility has less incentive to concern itself with insurance costs, should an institution fail."

We believe that today's deregulated financial marketplace requires that the regulatory and insurance functions be closely coordinated. It is our view that quick, decisive action is the key to successful oversight and that the artificial separation of insurance and supervision that was possible under heavy regulation is undesirable for the future.

At NCUA, the examination and insurance functions coexist in a single office that is divided into four departments. The Department of Insurance is responsible for all financial accounting, follows GAAP accounting, and continues to receive unqualified opinions from both our outside CPA firm and GAO. The Department of Supervision oversees the examination and supervision of credit unions and the training of examiners. The Department of Risk Management assesses risk in all insured institutions, evaluates workout cases, analyzes requests for assistance, and ensures that the expenses of case resolutions are appropriate. The Department of Operations enforces accounting rules, EDP requirements, consumer laws, and investment limits in credit unions.

The six regions examine, supervise, and make the initial assessment of the degree and severity of problems and the scope, if any, of assistance. Each region provides monthly reports to the Washington Office which detail all material problem cases and the potential loss.

The Office of Examination and Insurance provides a monthly report of all insurance activities to the NCUA Board. Material items involving assistance, workout cases, or deviations from the examination and supervision program must be approved by the NCUA Board.

NCUA's organizational structure recognizes the inseparability of supervision and insurance functions -- both of which have as their ultimate goal, maintaining a safe and sound credit union system. At the same time, our structure avoids the pitfalls of the FHLBB/FSLIC/FHLMC systems, wherein the regulator was responsible for promoting growth in mortgage credit and the Home Loan Banks were directed by savings and loan officials. As GAO's draft report indicates, such a built-in organizational conflict does not exist at NCUA. Quick action, use of formal and informal "tripwires," and the strict adherence to GAAP accounting by credit unions and the NCUSIF have served the credit union system well and would go a long way towards strengthening the entire financial system. Reform should focus on these measures rather than on artificial separation of supervisory and insurance functions.

See comment 32.

Chapter 8, Congressional Recommendation - Require NCUA, in consultation with Congress and the CU industry, to identify specific unsafe and unsound practices and conditions that merit enforcement action, as well as the appropriate action, and promulgate these requirements by regulation.

Response: The recommended concept of "tripwires" that would automatically actuate enforcement or other action by the Agency is similar to our existing system which we will continue to refine. However, in practice, tripwires have some shortcomings. Safety and soundness is frequently not black or white and requires great care and judgment to assure fairness to those concerned. We will make further effort to define all of our specific actions more clearly . However, trying to specify all unsound practices and specific required enforcement actions could create inflexibility and invite attempts to circumvent our efforts.

See comment 33.

Chapter 8, Congressional Recommendation - Require NCUA to take enforcement action when unsafe and unsound conditions or practices, as specified in the recommended regulation, are identified.

Response: NCUA uses a system of thresholds and timeframes similar to the recommended tripwires to trigger enforcement actions. NCUA Instructions establish the maximum time period credit unions will be allowed to remain in business if they are coded a CAMEL 4 or 5, or if other serious deficiencies are identified. The Department of Risk Management, and other offices, continually prepare reports to identify those credit unions requiring action and ensure steps are taken to resolve the problems. As stated above, inflexible tripwire may work against accomplishing these goals.

See comment 34.

Chapter 8, Congressional Recommendation - Provide for a five member NCUA Board, with two members, ex officio, the Chairman of the Federal Reserve Board and the Secretary of the Treasury.

Response: We recognize the desirability of a broad perspective on the NCUA Board concerning the role and oversight of financial

institutions. We also recognize the Treasury's interest, as the ultimate guarantor of NCUSIF insured savings, in ensuring that NCUA perform its mission effectively. We believe there are mechanisms in place to achieve these ends. Most importantly, the three NCUA Board members are Presidential appointees, confirmed with the advice and consent of the Senate. Further, the Federal Financial Institutions Examination Council (FFIEC) and its various working groups ensure constant communication among the regulatory agencies on issues of examination and supervision.

We have been and continue to be willing to consider proposals to enhance these oversight goals without unduly compromising NCUA's independence. We strongly believe, however, that GAO's specific proposal is unworkable. Given the frequency with which it is necessary to hold NCUA Board meetings (for example, 30 Board meetings were held in 1990), and considering the responsibilities and schedules of the Secretary of the Treasury and the Chairman of the Federal Reserve Board, it is unrealistic to expect that they would be able to attend many of the NCUA Board meetings. In their absence, a majority approval by the existing Board would require a unanimous vote of the remaining three Board members. Further, NCUA's experience over the last several years with three appointed Board seats would suggest further periods of at least one vacancy, greatly compounding these problems. Accordingly, we strongly recommend against the GAO proposal. If Congress deems existing oversight mechanism to be insufficient, we would recommend that other alternatives be carefully considered.

See comment 35.

Chapter 8, Congressional Recommendation - The CLF, as established by Title III of the Federal Credit Union Act, should be dissolved.

Response: The NCUSIF and credit unions must be assured of backup sources of liquidity prior to any dismantling. This area is crucial and must receive careful analysis and review prior to any final legislation.

Chapter 8, Congressional Recommendation - Congress should remove the power of federal credit unions to borrow from Farm Credit Banks as provided for in the Federal Credit Act.

Response: We do not object to this recommendation. Credit unions have traditionally had sufficient liquidity with little need to borrow money. For those that do, industry sources of liquidity are available through the corporate network and the CLF. The NCUSIF, Federal Reserve System, and Federal Home Loan Bank System are also authorized credit union lenders.

Chapter 8, Congressional Recommendation - Recommend that Congress amend the Community Development Credit Union Revolving Fund Transfer Act to designate an entity other than NCUA as administrator of the fund.

Response: We have no objection to the recommendation. We do recommend that whoever administers the fund take strong efforts to fairly distribute in a manner that does not jeopardize the safety and soundness of the credit union.

See comment 36.

Chapter 9, Congressional Recommendation - If credit unions are to remain distinct from other depository institutions because, in part, of their common bond membership . . . Congress should consider stating this general intent in legislation and setting forth guidelines on the limits of occupational, associational, and community common bonds, as well as the purpose and limits of multiple group charters.

Response: We have no objection to this recommendation. The NCUA Chartering and Field of Membership Manual, updated in December 1989, sets forth our existing guidelines for chartering and field of membership expansion of federally chartered credit unions. These guidelines do not apply to state-chartered federally

insured credit unions. As GAO's draft report indicates, this Manual sets forth in one place NCUA's chartering and membership policies and procedures, thus adding much more consistency to chartering issues among the regions.
It must be noted, however, that the states follow a wide range of policies regarding chartering, fields of membership, and common bond for state-chartered credit unions. In fact, some states permit very liberal, open field of membership for credit unions. Any recommendation, or congressional action, in this area, should consider the dual chartering system and the states' crucial role on the issue.

NCUA modified the definition of "common bond" for federal credit unions in the past decade for several reasons including: to provide credit availability to millions who historically did not have credit available; to allow for some diversification as a means of reducing risk to the NCUSIF; and to afford more opportunities to merge troubled credit unions as opposed to liquidating them at considerably more cost to the NCUSIF.

In view of the large number of plant closings and the substantial increase in mergers and acquisitions of American companies over the past decade, without this change in policy, credit unions and the NCUSIF might not have survived the 1980s. Select group additions are permitted as a means to diversify some of the risk associated with one group. Each group must have its own common bond and must be within the operational area of the home or a

branch office. In the case of mergers, two credit unions with unlike field of memberships may combine only when they are located in the same operational area.

In summary, economic realities necessitated some changes in the common bond guidelines to protect the credit union system from failure; however, a common bond, even when it is a multiple common bond, has very distinct characteristics compared to serving the general public over a wide geographic area as in the case of banks and thrifts. The common bond, combined with the cooperative structure of credit unions, ensures that they remain true to their consumer orientation and avoid the sorts of risk that are resulting in taxpayer liability for the many billions of dollars in losses in other depository institutions.

The following are GAO's comments on the National Credit Union Administration's (NCUA) May 24, 1991, letter.

GAO Comments

1. The extensive improvements recommended in this report could not be made simultaneously and immediately so as to "overwhelm" NCUA and the industry. Many require legislative and regulatory changes that must be debated by Congress and are subject to public comment. And, since we have been discussing our concerns and thoughts on ways to address them with NCUA officials for many months, NCUA has already begun to make some improvements. The annual congressional oversight hearings we recommend would be an appropriate forum for monitoring the status of the reforms we believe warranted.

2. We do not intend to imply that the industry and NCUSIF have been without challenges in recent years. Chapter 2 discusses the growth of the industry within the past decade, the risks facing it, the difficulties in the early 1980s that necessitated the 1985 recapitalization of NCUSIF, and the relative present soundness of the industry and the Fund. Chapter 5 discusses recent failures: table 5.1 shows that 711 credit unions failed in the 1985-1990 period. Our point is simply that in recent years the industry and NCUSIF have not faced the magnitude of failing institutions and declining insurance fund balances that thrifts and the Federal Home Loan Bank Board did.

3. Our March 1991 report on deposit insurance did not develop specific recommendations as to whether federal banking regulatory agencies should be restructured or consolidated (see Deposit Insurance: A Strategy for Reform, (GAO/GGD-91-26, Mar. 4, 1991, pp. 77-78). We believe, however, that if Congress does establish a single regulator for depository institutions, credit unions should not be automatically excluded. As they grow both in size and powers, credit unions increasingly resemble other insured depository institutions and their risk exposure increases. Nevertheless, because the present problems in the thrift and banking industries would be sufficient challenges in establishing such an entity, we have recommended that Congress not include credit unions until that regulator is operating effectively. These issues are discussed in chapter 8. (See pp. 187 to 197.)

4. NCUA's concern about real estate-based lending is appropriate because a substantial portion of credit union assets have been loaned in that area. The relatively low level, to date, of delinquencies and losses on these loans is a positive factor. However, credit unions' significant

involvement in such lending has been relatively recent and their portfolios have not been fully tested by a period of high inflation or a protracted economic downturn. Thus, it is too soon to tell whether lending practices have been sound. NCUA comments that it is issuing further guidance to both credit unions and its own examiners. While such guidance is appropriate, we believe that regulations should be strengthened now, as well.

5. NCUA's current proposed regulatory change would permit only those loans secured by the borrower's principal residence to be excluded from its definition of member business loans. This tightening of the exemptions, if promulgated, will satisfy our recommendation.

6. The regulation that NCUA cites in its comments applies only to federal credit unions and does not require them to inform their members that dividends on share or other accounts are based on available earnings and cannot be guaranteed in advance. NCUA issued a proposed regulation in May 1990 that would have required such disclosure. Many negative comments were received—some of which indicated the respondents thought certain dividends could be guaranteed. As of March 1991, the NCUA Board had not announced its acceptance, modification, or withdrawal of the proposed regulation. In its comments, NCUA indicates it will not take action itself but will defer to Congress. Accordingly, we have redirected our recommendation to Congress.

7. NCUA agreed that minimum capital requirements would help bring up the bottom of the industry but said that flexibility would be needed for new and troubled credit unions. We recognize that credit unions cannot build capital as stock institutions can and our recommendation provides for an appropriate phase-in period. (See p. 86.) However, we believe that troubled credit unions, credit unions that achieve the established capital level and then fall below it, should be handled according to the "tripwire" regulations we are recommending (see p. 68 and pp. 194-196 and p.197).

8. While NCUA agrees that a lower limit is desirable, it brings up two considerations that we believe have merit:

- The 1-percent limit may be too low for small credit unions. We have modified our recommendation to note that NCUA should be authorized to set by regulation a higher limit for secured credit issued by small credit unions.

- The 1-percent limit may be too low to allow for adequate overnight funds on deposit with correspondent institutions to meet cash needs, clearing account needs, share draft requirements, etc. We have modified our recommendation to note that NCUA should be authorized to set exceptions for such purposes by regulation.
- NCUA also noted that the loan and investment limits we recommend should be more clearly stated to apply to state as well as federal credit unions. We have changed the text to prevent any misunderstanding.

We do not agree with NCUA that a limit of 5 percent of assets per obligor would provide a sound level of diversification. These issues are discussed in comments 22 and 23 regarding corporate credit unions.

9. We believe a limit on commercial lending is consistent with the dominant mission of credit unions today as federally insured providers of consumer credit and should therefore be statutorily set to preclude any future relaxation by regulation.

NCUA's most recent proposed regulation would place a cap of 100 percent of reserves on a federal credit union's total member business loans. The cap would include a limit of 15 percent of reserves on total loans to finance real estate construction, development, and speculation. We agree these would be sound restrictions. The proposed regulation also provides for an exemption from the cap for credit unions that meet specified conditions and obtain approval from their NCUA regional office. We are aware that certain credit unions continue to have narrow fields of membership that tend to have inherent demands for a much higher proportion of business loans. If Congress believes NCUA should have the authority to provide exceptions from the general cap, however, we believe another higher cap should be put in place for the exempted credit unions.

10. NCUA asks that the Federal Credit Union Act be amended to remove the authority of federal credit unions to borrow "from any source." Our work did not reveal significant problems in this area, but we would raise no objections to this change.

11. While NCUA does not object to this recommendation, it suggests that Congress may wish to require, instead, that credit unions simply inform NCUA in advance of opening a branch. We see no reason why credit union oversight in this area should be less stringent than that given banks and thrifts.

12. NCUA examiners note the review of call reports on their examination checklist, which remains in the field copy of the examination (see pp. 94 and 95). We believe that raising the amount of documentation and the organizational level to which it is provided is important because of NCUA's dependence on data from call reports for off-site monitoring. NCUA should also develop a system to document its review of state credit union call reports because these associations are not examined annually by NCUA.

13. We address NCUA's comments in chapter 4. (See p. 115.)

14. This is not a separate recommendation but is part of the prior one. See comment 13.

15. We agree with NCUA that state examinations are an important resource in the oversight of state credit unions. We found that the cooperative efforts of NCUA and state supervisors have resulted in an improved examination process. (See pp. 98 and 99.)

16. We believe that the annual supervisory committee audit reports would be useful for off-site monitoring, especially when submitted to NCUA upon completion. There should be little additional cost involved in copying and forwarding the report to NCUA.

We asked NCUA to clarify its comment that larger and problem credit unions were required to submit their audit reports to examiners because we were unaware of such a requirement. Officials told us there is no such written requirement but many examiners ask that audits be sent to them in such circumstances.

17. We discuss NCUA's current policy on assistance to open credit unions and guidance to examiners on selecting resolution methods in chapter 5. As noted there, however, NCUA's lack of documentation prevented us from determining if actual practice conformed to the policy. Our recommendation is intended to establish a statutory failure resolution policy for credit unions, one that is consistent with the guidance in Section 13(c) of the Federal Deposit Insurance Act.

18. While NCUA comments that it is instituting changes in this area, we believe a statutory requirement would better assure documentation.

19. We recognize that in most cases waivers and charges are provided together with other forms of special assistance that require Washington-

level approval. Our recommendation for approval from that level for all waivers and charges is intended to ensure consistency among the regions and serve to highlight the importance of forbearance from regulations. With respect to NCUA's comments related to monthly reporting and monitoring, we found that data were not readily available in Washington.

20. We have discussed our concerns with NCUA officials in this area for some time and commend them for taking the actions cited. We have not reviewed these new efforts but, if implemented as described, they should result in compliance with our recommendation.

21. The draft legislation proposed by NCUA applies only to federal credit unions. An NCUA official explained NCUA's position that its general rule making authority could be used to extend this restriction to apply to state-chartered federally insured credit unions as well. However, congressional clarification of NCUA's authority over these state-chartered institutions would be provided by implementation of our recommendation that NCUA be given authority and required to compel a state credit union to follow the federal regulations in any area in which the powers go beyond those permitted federal credit unions and are considered to constitute a safety and soundness risk.

22. NCUA agrees in principle that corporate credit unions should be required to promptly increase their capital and that minimum capital standards should be established. It also notes that it is working to implement by the end of 1991 a risk-based minimum capital system. However, we believe NCUA's discussion about the current condition of corporate credit unions tends to minimize the present level of risk, and we are therefore concerned that NCUA's requirements for corporates' capital will not be high enough to ensure financial soundness. For many years, the relative level of corporate capital, which was acknowledged by NCUA as too low to begin with, has not been improving as corporates grew. This has prevented corporates from achieving the capital strength that NCUA regulation has long implied was necessary. We also believe it essential that any risk-based capital system developed include a core capital requirement related to total assets, regardless of risk.

While we agree that the investment assets of corporates are generally of high quality, it does not necessarily follow that the corporates themselves are not risky. We believe they are unnecessarily risky because their investment assets are not diversified and do not agree that NCUA now has sufficiently high standards of diversification. (See pp. 149 and

150 and p. 153.) We are recommending changes in this area also. The most recent NCUA proposal regarding diversification, discussed in comment 23, is not adequate.

23. We disagree. It could even be argued that our recommended 1 percent of assets limit on investments in a single obligor is not strong enough because it would not achieve as much investment diversification as is desirable. A 1-percent limit would still permit a corporate to risk an amount that is substantially more than its own net worth in one uncollateralized investment in one debtor. In contrast, NCUA's counter proposal—a 5-percent limit—would not materially change the excessive investment concentrations that in some cases already exist. Moreover, we do not agree that a lower investment limit would necessarily create additional investment risk. Instead, funds that became available because of a reduced investment limit could be put into less risky types of investments.

24. The proposed regulation NCUA is referring to would establish a maximum credit exposure of a corporate credit union to each member credit union borrower, excluding CLF loan and repurchase transactions. The maximum would be the higher of 100 percent of the corporate's capital or 10 percent of its paid-in and unimpaired shares and deposits plus capital. Our recommendation calls for NCUA to be authorized to make exceptions from the 1-percent limit on a loan-by-loan basis. We recognize NCUA's concern that the 1-percent limit would overly restrict U.S. Central Credit Union's operations but believe, given the importance of the institution to the industry, that requiring NCUA's prior approval to exceed the limit is prudent. We would not, however, object to NCUA's proposal of an alternative limit based on the corporate's capital, provided it is defined as GAAP capital. We also believe the percentages proposed by NCUA are too high.

25. Our report recognizes that there have been improvements in corporate reporting but also demonstrates that additional changes are needed, as NCUA agrees.

26. The full-time staff position at NCUA headquarters does not include supervisory authority over corporates: that authority is delegated to regional directors. The number of corporates is very small and their basic functions, while complex, are similar, while the geographic territory covered by individual corporates is large and not coterminous with the NCUA regional offices. Under these conditions, we do not believe NCUA has justified its position, which is clearly stated in its Examiner's

Guide, that the primary responsibility for corporates should be at the regional level. (See p. 159.) Our report makes clear, however, that we believe regional office participation in the oversight process is desirable. (See 156 to 157.)

27. We asked NCUA officials to clarify whether they had recently reviewed the CAMEL rating system and, if so, what changes were made. The officials said they were reviewing the system and would set specific quantitative parameters that reflect the component being rated. Management capability will no longer be considered in rating nonmanagement components. Examiners will, however, have some limited flexibility in revising the rating, just as they do with CAMEL ratings for natural person credit unions. If fully implemented as described, these changes will address our concerns.

28. After we issued our draft report to NCUA for comment, the Chairman of the NCUA Board testified on May 7, 1991, before the Senate Banking Committee that he supported requiring a write-down of the 1-percent deposit. Not withstanding the subcommittee's action, we continue to believe that a write-down of the 1-percent deposit is the best course of action to eliminate the double counting that currently exists. The alternative that NCUA suggests is not unacceptable to us, however, it is only a second best solution to the double counting problem.

29. This report does not address needed changes in the financing of the bank and thrift insurance funds, though in principle we see no reason why a similar provision should not apply. We believe Congress should establish such a ratio for NCUSIF now to help ensure its continuing soundness.

30. This report does not recommend the establishment of risk-based premiums for credit unions because we do not believe it is essential at this time for NCUSIF's future soundness, provided our other recommendations are implemented. However, should the banking and thrift industries and their insurers develop and implement such premiums, it would be appropriate to adapt them to credit unions.

31. This recommendation is not calling for the separation of insurance and supervision activities in different organizations, as the NCUA comments appear to suggest. We are recommending that within NCUA, responsibility for each function be clearly placed in different offices, offices whose directors report individually to the NCUA Board. The

Board, which is accountable to Congress, is the level at which any conflicts between these two functions should be resolved. As presently organized, the potential exists that such conflicts could be resolved at a lower level of NCUA in a manner that could be unacceptable to the Board.

32. NCUA's reference to the similarity of its current system to our recommended tripwires apparently refers to its policy regarding closure or improvement of CAMEL 4- and 5-rated credit unions (see NCUA's next comment and p. 119). This policy, while a start, is not as fully responsive to the recommendation as NCUA indicates in that it applies only to credit unions already in seriously weakened condition. Our proposed approach involves interventions to deal with unsafe practices that precede and indeed frequently result in an unsafe or weakened condition.

We are not recommending that NCUA attempt to develop an exhaustive list of all unsafe and unsound practices. Rather, fundamental indicators of unsafe and unsound operations or conditions should be focused on. We also note that a tripwire system would not preclude regulators from using available informal and formal actions. (See pp. 194 to 196.) The tripwire system would supplement, not replace, the existing body of law and regulation and the other reforms we are recommending elsewhere in this report.

33. As noted in comment 31, we recognize the value of NCUA's policy regarding credit unions rated CAMEL 4 and 5. The tripwire system we are recommending, however, is intended to take effect long before credit unions reach such weakened condition. Unlike stockholder-owned institutions, credit unions can only raise capital through earnings. The earlier tripwires, based on thresholds of unsafe practice that have not yet been reflected in serious asset or earnings deterioration, are, therefore, even more important.

In our review we found that NCUA was ineffective in compelling 15 of the 39 credit unions we studied to resolve their problems within the period of our review. It used only informal actions against these credit unions and also acquiesced to some state supervisors rather than take stronger action on a timely basis. (See pp. 104 to 112.) Tripwires are intended to reduce but not remove NCUA's "flexibility" and give NCUA a clear mandate to predictably address serious practices and conditions, a mandate that the owners and managers of credit unions would also know in advance.

34. We address NCUA's comments on this recommendation in chapter 8. (See pp. 212 and 213.)

35. We address NCUA's comments on this recommendation in chapter 8. (See p. 213.)

36. We address NCUA's comment on this recommendation in chapter 9. (See pp. 231 and 232.)

Comments From the Department of the Treasury

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

May 29, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

I am writing in response to your request for Treasury comments on the May 1991 draft of a GAO report entitled, "Credit Unions: Reforms for Assuring Future Soundness." Your report provides useful insights into the structure, activities and financial condition of the credit union industry and helps to identify many important issues for consideration by Congress and the Administration.

See p. 185.

I would like to take this opportunity to comment on two recommendations in your report which are similar to recommendations in the Treasury Department's recent report entitled, "Modernizing the Financial System: Recommendations for Safer, More Competitive Banks." The first recommendation calls on Congress to require credit unions to expense their one percent deposit with the National Credit Union Share Insurance Fund (NCUSIF) "over a reasonable period of time."

As your report points out, because credit unions treat this deposit as an asset rather than an expense, it is double-counted as capital by the credit unions and the NCUSIF. This double counting overstates the amount of protection between potential losses and the taxpayer. It is for exactly this reason that the Administration's legislative proposal, "the Financial Institutions Safety and Consumer Choice Act of 1991," would require credit unions to expense their one percent deposit over a twelve-year transition period.

See pp. 212 and 213.

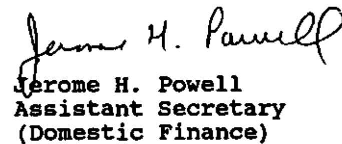
Your report also recommends changing the composition of the board of the National Credit Union Administration (NCUA) to include the Chairman of the Federal Reserve Board and the Secretary of the Treasury as *ex officio* members. While we agree that the regulation and supervision of all federally insured financial institutions should be more consistent, our own recommendation for accomplishing this objective is somewhat different. Our legislative proposal would require that one of the two NCUA board positions not occupied by the Chairman be filled with the Treasury Department's top banking regulator. Under our proposal, this regulator would be the director of the new Office of Depository Institutions Supervision. We believe this reorganization would provide an important nexus between the

Administration and the regulation of all federally insured institutions, thus helping to ensure more consistent regulatory policies.

Your report contains a number of other recommendations for consideration by Congress to ensure the continued safety and soundness of the credit union industry. We look forward to working with you on these issues.

We appreciate the opportunity to review and comment on this report.

Sincerely,



Jerome H. Powell
Assistant Secretary
(Domestic Finance)

Comments From the Federal Reserve Board

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

May 22, 1991

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

See pp. 212 and 213.

This is in response to your letter of May 2, 1991, requesting my comments on the General Accounting Office ("GAO") draft report entitled Credit Unions: Reforms for Assuring Future Soundness. In particular, you requested comment on the GAO's recommendation that the Chairman of the Federal Reserve Board be made, ex officio, a member of an expanded board of the National Credit Union Administration ("NCUA").

The draft report notes that credit unions are increasingly involved in activities that banking institutions have performed historically and that credit unions are heavily involved, directly or indirectly, in investment in major international commercial banks. The report also states that the GAO believes that it would enhance the NCUA Board's effectiveness to have, as members, the Chairman of the Federal Reserve Board and the Secretary of the Treasury.

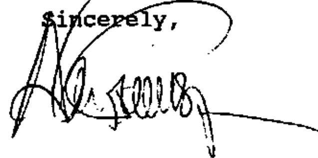
With respect to the Chairman of the Federal Reserve Board, the report states that "The presence on the NCUA Board of the Chairman of the Federal Reserve Board would provide an independent view and a broader perspective on the role and oversight of financial institutions." The report further indicates that this presence would give added assurance that objective insurance decisions would be made and that the approach to federal regulation and supervision would be consistent, where applicable, across industry guidelines.

As you know, the Federal Reserve's principal responsibilities are the maintenance of macro economic, price and financial system stability through the conduct of monetary policy and the discharge of important supervisory duties involving the commercial banking system. The management of monetary policy has become an increasingly complex task in today's more global financial markets. At the same time, as you are aware, the challenges facing bank regulators--in particular, the need to

modernize and strengthen the competitiveness of our banking system and to continue to resolve problem and failing banking situations--have increased significantly. In recent years, the Chairman of the Federal Reserve Board has also been given other new and major responsibilities, such as serving as a member of the Resolution Trust Corporation Oversight Board. Placing the Chairman of the Federal Reserve Board on the Board of the NCUA would require a significant commitment in terms of time and attention and could distract from the Federal Reserve's ability to focus on its principal monetary policy and bank supervisory responsibilities.

In view of these considerations, I believe that it would be inappropriate to add the Chairman of the Federal Reserve Board to the Board of the NCUA.

Sincerely,



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