CREDIT UNIONS
Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management
Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management

What GAO Did This Study
Recent legislative and regulatory changes have blurred some distinctions between credit unions and other depository institutions such as banks. The 1998 Credit Union Membership Access Act (CUMAA) allowed for an expansion of membership and mandated safety and soundness controls similar to those of other depository institutions. In light of these changes and the evolution of the credit union industry, GAO evaluated (1) the financial condition of the industry and the deposit (share) insurance fund, (2) the impact of CUMAA on the industry, and (3) how the National Credit Union Administration (NCUA) had changed its safety and soundness processes.

What GAO Found
The financial condition of the credit union industry has improved since GAO’s last report in 1991, and the federal share insurance fund appears financially stable. However, a growing concentration of industry assets in large credit unions creates the need for greater risk management on the part of NCUA. The question of who benefits from credit unions’ services has also been widely debated. While it has been generally accepted that credit unions have a historical emphasis on serving people of modest means, our analysis of limited available data suggested that credit unions served a slightly lower proportion of low- and moderate-income households than banks.

CUMAA and subsequent NCUA regulations enabled federally chartered credit unions to expand their membership, serve larger geographic areas, and add underserved areas. According to NCUA officials, these changes were necessary to maintain the competitiveness of the federal charter with respect to state-chartered credit unions. While NCUA has stated its commitment to ensuring that credit unions provide financial services to all segments of society, NCUA has not developed indicators to determine if credit union services have reached the underserved.

In response to the growing concentration of industry assets and increased services offered by credit unions, NCUA recently adopted a risk-focused examination and supervision program but still faces a number of challenges, including lack of access to third-party vendors that are providing more services to credit unions. Further, credit unions are not subject to internal control and attestation reporting requirements applicable to banks and thrifts. GAO also found that the insurance fund’s rate structure does not reflect risks that individual credit unions pose to the fund, and NCUA’s estimation of fund losses is based on broad historical analysis rather than a current risk profile of insured institutions.

What GAO Recommends
With respect to the share insurance fund, GAO recommends that the Chairman of NCUA explore developing a risk-based funding system, improve the process for allocating overhead expenses, and refine the process for estimating future losses. To improve reporting, the Chairman should also use tangible indicators to determine whether credit unions are serving people in underserved areas. To help ensure safety and soundness, Congress may wish to consider making credit unions subject to internal control and attestation reporting requirements applicable to banks and thrifts and providing NCUA legislative authority to examine third-party vendors.


To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-9073 or hillmanr@gao.gov.
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Abbreviations

ASI American Share Insurance
ATM Automatic Teller Machines
BIF Bank Insurance Fund
BSA Bank Secrecy Act
CLF Central Liquidity Facility
CPA Certified Public Accountant
CRA Community Reinvestment Act
CUIC Credit Union Insurance Corporation
CUMAA Credit Union Membership Access Act of 1998
October 27, 2003

The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate

Dear Senator Sarbanes:

Credit unions have historically occupied a unique niche among depository institutions. Credit unions are not-for-profit, member-owned cooperatives that are exempt from paying federal income taxes on their earnings. Unlike banks, credit unions are subject to limits on their membership because members must have a “common bond”—for example, working for the same employer or living in the same community. However, over the years, these membership requirements have loosened considerably and credit unions have received expanded powers, which have raised questions about the extent that credit unions remain unique and serve a different population than banks. We last conducted a comprehensive review of the credit union industry, including the National Credit Union Administration (NCUA), in 1991. Since that time, the credit union industry has experienced substantial growth and expansion of activities. In addition, recent legislative and regulatory changes have blurred some distinctions between credit unions and other depository institutions—banks and thrifts. For example, the 1998 Credit Union Membership Access Act (CUMAA) expanded the definition of common bond and provided for reforms intended to strengthen the safety and soundness of credit unions, including instituting procedures for prompt corrective action (PCA) when credit unions’ capital levels fall below a certain threshold.

In 2002, there were about 10,000 credit unions with approximately 82 million members. Credit unions, like banks and thrifts, are chartered by both the federal government and state governments, also referred to as the dual-chartering system. NCUA has oversight authority for federally

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1U.S. General Accounting Office, Credit Unions: Reforms for Ensuring Future Soundness, GAO/GGD-91-85 (Washington, D.C.: July 10, 1991). This report contained a variety of recommendations to Congress and NCUA. See appendix II for information on the implementation of these recommendations.

chartered credit unions and requires its credit unions to obtain federal share (deposit) insurance for their members’ deposits from the National Credit Union Share Insurance Fund (NCUSIF). This fund, administered by NCUA, also provides share insurance to most state-chartered credit unions. Some states permit their credit unions to purchase private share insurance as an alternative to federal insurance.

In light of the evolution of the credit union industry and the passage of CUMAA, you asked us to review a variety of issues involving the credit union industry and NCUA. In response, we provided your staff information on how NCUA responded to recommendations made in our 1991 report and conducted preliminary research on the industry and NCUA. After discussing this information with your staff, we agreed that the objectives of this study were to evaluate (1) the financial condition of the credit union industry; (2) the extent to which credit unions “make more available to people of small means credit for provident purposes”; (3) the impact, if any, of CUMAA on credit union field of membership requirements for federally chartered credit unions; (4) how NCUA’s examination and supervision processes have changed in response to changes in the industry; (5) the financial condition of NCUSIF; and (6) the risks associated with the use of private share insurance. You also asked us to review issues associated with corporate credit unions, which we plan to address in a separate report.


4This quotation is taken from the title of the Federal Credit Union Act of June 26, 1934. In addition, in CUMAA the congressional findings stated among other things that credit unions “have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means (Pub. L. No. 105-219 § 2 (1998)). While these statutes have used “small means” and “modest means” to describe the type of people who credit unions might serve, in this report we used “low- and moderate-income,” as defined by banking regulators.

5A corporate credit union is one whose members are credit unions, not individuals. Corporate credit unions provide credit unions with services, investment opportunities, loans, and other forms of credit should credit unions face liquidity problems. See 12 C.F.R. Part 704 (2003).
To evaluate the financial condition of the credit union industry we performed quantitative analyses on credit union call report data for 1992–2002. Since NCUA lacked readily available data to assess the extent to which credit unions serve people of low and moderate incomes, we analyzed data from the 2001 Federal Reserve Survey of Consumer Finances (SCF) to identify the characteristics of credit union members. This survey is the only comprehensive source of publicly available data on financial institutions and consumer demographics that we could identify that is national in scope. We also analyzed 2001 mortgage data from the Home Mortgage Disclosure Act (HMDA) database, which allowed us to categorize the income levels of households receiving mortgages from credit unions and banks, and reviewed other industry studies. To determine how CUMAA affected field of membership requirements for federally chartered credit unions, we analyzed NCUA regulations and obtained data on field of membership trends from NCUA. In addition, we surveyed state regulators to obtain information about their chartering provisions, particularly for credit unions serving geographic areas. To determine how NCUA's examination and supervision process has changed, we reviewed NCUA documentation on its risk-focused program and conducted structured interviews of NCUA regional directors and examiners, as well as selected state credit union supervisors. We also analyzed NCUA data on examiner resources provided to states and progress in implementing PCA. To determine the financial condition of NCUSIF, we obtained and analyzed key financial data about the fund from NCUAs annual audited financial statements for 1991–2002. Finally, to assess the risks associated with the use of private share insurance, we identified and analyzed relevant federal and state statutes and regulations and surveyed the 50 state credit union regulators to determine which states permitted private share insurance. In addition, we conducted interviews with state supervisors from states where credit unions are permitted to choose private insurance—Alabama, California, Idaho, Illinois, Indiana, Maryland, Nevada, and Ohio. We also interviewed and obtained relevant documentation from representatives of American Share Insurance (ASI)—the remaining provider of private share insurance. Appendix I provides additional details on our scope and

We only reviewed federally insured credit unions—about 98 percent of all credit unions—because they were all required to submit call report data to NCUA, while not all privately insured credit union call report data were reported to NCUA. Call reports are submitted by credit unions to NCUA and contain data on a credit union’s financial condition and other operating statistics. Throughout the report, when we use the term “industry,” we are referring to federally insured credit unions and exclude the 212 privately insured credit unions.
methodology. We conducted our review from August 2002 through September 2003 in accordance with generally accepted government auditing standards.

Results in Brief

The overall financial condition of the credit union industry, as measured by capital ratios, asset growth, and regulatory ratings, has improved since our last report in 1991. An example of the improved condition of the credit union industry is the decline in the number of credit unions identified by NCUA as being in weak or unsatisfactory condition—578 (about 5 percent of all credit unions) in 1992 compared with 211 (about 2 percent of all credit unions) in 2002.\(^7\) While credit union profitability, as measured by the return on assets ratio, generally declined between 1992 and 1999, it has since stabilized. The number of credit unions declined between 1992 and 2002 while total industry assets have grown. This has resulted in two distinct groups of credit unions—larger credit unions, which are fewer in number and provide a wider range of services that more closely resemble those offered by banks, and smaller credit unions, which are greater in number and provide more basic financial services. Credit unions with over $100 million in assets represented about 4 percent of all credit unions and 52 percent of total credit union assets in 1992 compared with about 11 percent of all credit unions and 75 percent of total credit union assets in 2002. These larger credit unions were more likely to provide sophisticated financial services, such as Internet banking and electronic loan applications, and engage in mortgage lending than smaller credit unions.

As credit unions have become larger and expanded the range of services they offer, the question of who receives services from credit unions has been widely debated. While it has been generally accepted that credit unions have a historical emphasis on serving people of modest means, limited data exist that can be used to assess the income characteristics of credit union members. Our analysis of available data suggested that the income of credit union members is similar to that of bank customers; although credit unions may serve a slightly lower proportion of low- and moderate-income households than banks. Our analysis of the Federal Reserve’s 2001 Survey of Consumer Finances indicates that 36 percent of households that primarily or only used credit unions had low and moderate incomes.

\(^7\)NCUA rates credit unions using the CAMEL system, which stands for capital adequacy, asset quality, management, earnings, and liquidity. The ratings are 1 (strong), 2 (satisfactory), 3 (flawed), 4 (poor), and 5 (unsatisfactory).
incomes compared with 42 percent of households that used banks. Our analysis of HMDA 2001 loan application records indicated that credit unions provided a slightly lower percentage of their mortgages to low- and moderate-income households than banks—27 percent compared with 34 percent—of comparable asset size. However, relying on HMDA data to evaluate credit union service to low- and moderate-income households has limitations because most credit unions are (1) small and, therefore, not required to report HMDA data and (2) generally make more consumer loans (for example, for cars) than residential mortgage loans. An analysis of consumer loans or other services by household income would provide a more complete picture of credit union service to low- and moderate-income households. Other industry studies concluded that credit union members tended to have higher incomes than nonmembers, but indicated that this was likely due to credit union membership being primarily occupationally based.

CUMAA authorized preexisting NCUA policies that had enabled federally chartered credit unions to expand their membership over the last two decades. In response to a Supreme Court decision, Congress enacted provisions of CUMAA permitting federally chartered credit unions to form multiple-bond credit unions—consisting of groups, such as for employment, each with their own distinguishing characteristics—and permitted these credit unions to add communities underserved by financial institutions to their membership. NCUA permitted single- and community-bond, federally chartered credit unions to add underserved communities to their field of membership as well. CUMAA also amended a chartering provision authorizing community credit unions by specifying that the area in which their members are located should be “local.” However, NCUA regulations have made it easier for credit unions to qualify to serve larger geographic areas (for example, entire cities). According to NCUA officials, these changes were necessary to maintain the competitiveness of the federal charter with respect to what they perceived as less restrictive field of membership requirements allowed for state-chartered credit unions in some states. While CUMAA permitted multiple-bond credit unions to add underserved areas, and NCUA has stated its commitment to ensuring that credit unions provide financial services to all segments of society, NCUA has not developed indicators to determine if credit union services have reached the underserved. Instead, NCUA uses “potential membership,” the number of people who could join credit unions, as an indirect measure of credit union success in penetrating these areas.
In response to the growing concentration of assets in the credit union industry and increased services and activities offered by credit unions, NCUA adopted a risk-focused examination and supervision program similar to that of other depository institution regulators. While NCUA has taken a number of steps to ensure the successful implementation of its risk-focused program, it faces a number of challenges. NCUA has met with the other depository institution regulators, such as the Federal Deposit Insurance Corporation (FDIC), to learn about how they implemented their risk-focused programs. However, opportunities exist to further leverage the experiences of other depository institution regulators to more effectively deal with ongoing challenges such as ensuring that examiners have sufficient training and expertise to evaluate the more sophisticated activities of credit unions, such as Internet banking and member business lending. Furthermore, unlike the other depository institution regulators, NCUA lacks authority to review the operations of third-party vendors, which credit unions increasingly rely on to provide services such as Internet banking. However, these third-party arrangements present risks such as threats to security of information systems, availability and integrity of systems, and confidentiality of information. In addition, credit unions are not subject to the internal control reporting requirements that the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) imposed on banks and thrifts. NCUA implemented PCA, in 2000 as mandated by CUMAA, as another control for safety and soundness of the industry. To date, there have been very few credit unions subject to PCA partially because of a generally favorable economic climate for credit unions.

Indicators of the financial condition and performance of NCUSIF have generally been stable over the past decade. For example, the ratio of fund equity to insured shares—a measure of the fund's equity available to cover losses on insured deposits—was within statutory requirements at December 31, 2002, as it has been over the past decade. While NCUSIF's net income has remained positive through 2002, it experienced significant declines in 2001 and 2002 due to decreased yields from the investment portfolio, increases in the amount paid to NCUA's Operating Fund for administrative expenses (overhead transfer rate), and increasing insurance losses on failed credit unions. NCUA's external auditors reviewed the basis on which the transfer rate was determined and made several recommendations for improvement that, according to NCUA officials, are being assessed and implemented. While financial indicators have generally remained satisfactory, NCUSIF is the only share or deposit insurance fund that has not adopted a risk-based insurance structure. Currently, credit
unions are assessed a flat rate that does not reflect the risk that individual credit unions pose to the fund. Moreover, NCUA's process for estimating anticipated losses to the fund lacks precision, as it does not identify specific historical failure rates and related loss rates for the group of credit unions that have been identified as being in troubled condition. As a result, NCUA may be over or underestimating probable losses to the fund.

The overall system risk to the credit union industry that may be created by private primary share insurance appears to have decreased since 1990, although some concerns remain. The number of privately insured credit unions and providers of private primary share insurance have declined significantly since 1990. Specifically, in 1990, there were 1,462 privately insured credit unions—with $18.6 billion in insured shares—compared with 212 privately insured credit unions—with about $10.8 billion in insured shares, as of December 2002. This represented a 42 percent decrease in privately insured shares. Moreover, during the same period the number of private primary share insurers decreased from 10 to 1—ASI. Although the use of private share insurance has declined, some circumstances of the remaining private insurer raise concerns. First, ASI's insured risks are overly concentrated in a few large credit unions and in certain states. Second, ASI may have a limited ability to absorb catastrophic losses because it does not have the backing of any governmental entity and its lines of credit are limited. However, ASI has implemented a number of risk-management strategies, including increased monitoring of its largest credit unions to help mitigate concentration risk. In addition, state regulation of ASI and the privately insured credit unions it insures provides some additional assurance that ASI and the credit unions operate in a safe and sound manner. One additional concern, as we recently reported, is that many privately insured credit unions failed to make required disclosures about not being federally insured and, therefore, the members of these credit unions may not have been adequately informed that their deposits lacked federal deposit insurance.

This report contains recommendations to NCUA and matters for congressional consideration that, if implemented, would better ensure NCUA's ability to achieve its goal of ensuring that credit unions can safely provide financial services to all segments of society, promote greater consistency in federal oversight of depository institutions, and enhance share insurance management.

We requested comments on a draft of this report from the Chairman of the National Credit Union Administration and the President and Chief
Executive Officer of American Share Insurance. We received written comments from NCUA and ASI that are discussed in this report and reprinted in appendixes XI and XII respectively. NCUA generally agreed with most of the report's assessment regarding the challenges facing NCUA and credit unions since 1991 and planned to implement the majority of the report's recommendations. In commenting on a draft of the private share insurance section, ASI stated that this report did not adequately assess the private share insurance industry and objected to our conclusions that ASI's risks are concentrated in a few large credit unions and a few states; it has limited ability to absorb large losses because it does not have the backing of any governmental agency; and its lines of credit are limited in the aggregate as to amount and available collateral. In response, we considered ASI's positions and materials provided, including ASI's actuarial assumptions and ASI's past performance, and believe our report addresses these issues correctly as originally presented.

Background

Credit unions differ from other depository institutions because of their cooperative structure and tax exemption. Credit unions are member-owned cooperatives run by boards elected by their members. They do not issue capital stock; rather, they are not-for-profit entities that build capital by retaining earnings. However, like banks and thrifts, credit unions have either federal or state charters. Federal charters have been available since 1934 when the Federal Credit Union Act was passed. States have their own chartering requirements. As of December 2002, the federal government chartered about 60 percent of the nearly 10,000 credit unions, and about 40 percent were chartered by their respective states. Both federally and state-chartered credit unions are exempt from federal income taxes, with federally chartered and most state-chartered credit unions also exempt from state income and franchise taxes.

Another distinguishing feature of credit unions is that they may serve only an identifiable group of people with a common bond. A common bond is the characteristic that distinguishes a particular group from the general public. For example, a group of people with a common profession or living in the same community could share a common bond. Over the years, common-bond requirements at the state and federal levels have become less restrictive, permitting credit unions consisting of more than one group...
having a common bond to form “multiple-bond” credit unions. The term “field of membership” is used to describe all the people, including organizations, that a credit union is permitted to accept for membership. As previously noted, the loosening of common-bond restrictions, as well as expanded powers, have brought credit unions into more direct competition with other depository institutions, such as banks. In addition, credit unions can offer members additional services made available by third-party vendors and by certain profit-making entities with which they are associated, referred to as credit union service organizations (CUSO).

CUMAA was the last statute that enacted major provisions affecting, among other things, how federally chartered credit unions could define their fields of membership and how federally insured credit unions demonstrate the safety and soundness of their operations. In February 1998, the Supreme Court ruled that NCUA lacked authority to permit federal credit unions to serve multiple membership groups. In response, CUMAA authorized multiple-group chartering, subject to limitations NCUA must consider when granting charters. Also, the act limited new community charter applications to well-defined “local” communities. Moreover, CUMAA placed several additional restrictions on federally insured credit unions. It tightened audit requirements, established PCA requirements when capital standards were not met, and placed a cap on the percentage of funds that a credit union could expend for member business loans.

NCUA has oversight responsibility for federally chartered credit unions and has issued regulations that, among other things, guide their field of membership and the scope of services they can offer. NCUA also has responsibility for overseeing the safety and soundness of federally insured credit unions through examinations and off-site monitoring. In addition,

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8See GAO/GGD-91-85 for additional background on the history of NCUA and state field of membership regulatory policies.

9A CUSO is a corporation, limited liability corporation, or limited partnership that provides services such as insurance, securities, or real estate brokerage, primarily to credit unions or members of affiliated credit unions. NCUA specifies which types of activities a CUSO may undertake. Credit unions can invest up to 1 percent of paid-in and unimpaired capital and surplus in CUSOs. Credit unions can loan up to an aggregate of 1 percent of paid-in and unimpaired capital and surplus to CUSOs. The CUSO must maintain a separate identity from the credit union. See 12 C.F.R. Part 712 (2003).

NCUA administers NCUSIF, which provides primary share (deposit) insurance for 98 percent of the nation’s credit unions.¹¹ NCUA, in its role as administrator of NCUSIF, is responsible for overseeing federally insured, state-chartered credit unions to ensure that they pose no risk to NCUSIF.

State governments have responsibility for regulating state-chartered credit unions. State regulators oversee the safety and soundness of state-chartered credit unions; although, as mentioned above, NCUA also has responsibility for ensuring that state-chartered credit unions that are federally insured pose no risk to NCUSIF. States set their own rules regarding field of membership and the services credit unions can provide. In addition, some states allow the credit unions in their states the option of obtaining private primary share insurance. Currently, 212 credit unions in eight states have primary share insurance from a private company, ASI, located in Ohio. Primary share insurance for these privately insured credit unions covers up to $250,000.

Financial Condition of the Credit Union Industry Has Improved Since 1991

Between 1992 and 2002, the capital ratios of federally insured credit unions improved and remained higher than those of other depository institutions. The industry’s assets also grew over this period, coincident with an increased emphasis on mortgage loans. Credit union industry profitability, after declining from 1992 to 1999, has since stabilized. In addition, since 1991 there has been a significant drop in the number of problem credit unions as measured by regulatory ratings. Consolidation in the industry has continued while total industry assets have grown, which has in part resulted in two distinct groups of federally insured credit unions—larger credit unions, which are fewer in number and provide a wider range of services that more closely resemble those offered by banks, and smaller credit unions, which are larger in number and provide more basic financial services.

¹¹Generally, primary deposit insurance covers the first portion of members’ deposits up to a specified amount. For example, NCUSIF provides primary deposit insurance up to $100,000 per member per qualifying account. In contrast, excess deposit insurance is optional coverage above the amount provided by primary deposit insurance that credit unions may purchase from private insurers.
Credit Union Capital Ratios Have Improved Since 1991 and Remain Higher Than Those of Banks

The capital of federally insured credit unions as a percent of total industry assets—the capital ratio—increased steadily between 1992 and 1997 and has since remained mostly level. As shown in figure 1, the capital ratio of the industry was 8.1 percent in 1992, increased to 11.1 percent in 1997, and was 10.9 percent in 2002. As a point of comparison, the capital ratio of credit unions has remained higher than that of banks and thrifts since 1992. As a result, credit unions have a greater proportion of assets available to cover potential losses than banks and thrifts. This may be appropriate since credit unions, unlike banks, are unable to raise capital in the capital markets but must instead rely on retained earnings to build and maintain their capital levels.

Figure 1: Comparison of Credit Union and Bank Capital Ratios, 1992–2002

Table Data

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<tr>
<th>Year</th>
<th>Credit Union Capital Ratio (%)</th>
<th>Bank and Thrift Capital Ratio (%)</th>
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<tr>
<td>2002</td>
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<td>8.7</td>
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</table>

Source: Call report data.

Note: Bank and thrift data are from all FDIC-insured institutions filing call reports, excluding insured branches of foreign institutions.

Throughout the report we use the terms “banks,” “banks and thrifts,” and “FDIC-insured institutions” interchangeably.
Industry Assets Have Grown and Asset Composition Has Changed

Total loans as a percent of total assets of federally insured credit unions grew between 1992 and 2002. In 1992, 54 percent of credit union assets were made up of loans and 16 percent were in U.S. government and agency securities, while in 2002 loans represented 62 percent of industry assets, and U.S. government and agency securities represented 14 percent of total assets. The largest category of credit union loans was consumer loans (a broad category consisting of unsecured credit card loans, new and used vehicle loans, and certain other loans to members, but excluding real estate loans such as mortgage or home equity loans), followed by real estate loans. For example, in 2002, 31 percent of credit union total assets were classified as consumer loans and 26 percent were classified as real estate loans.

However, over time, holdings of real estate loans have grown more than holdings of consumer loans. For example, real estate loans grew from 19 percent of total assets in 1992 to 26 percent in 2002, while consumer loans grew from 30 percent to 31 percent over the same period. Despite a larger increase in real estate lending relative to consumer lending, credit unions still had a significantly larger percentage of consumer loans relative to total assets compared with their peer group banks and thrifts: consumer loan balances of peer group banks and thrifts were less than 8 percent of total assets in 2002. To provide context, in terms of dollar amounts, credit unions had $175 billion in consumer loans while peer group banks and thrifts had $190 billion in consumer loans. However, these banks and thrifts held a greater percentage of real estate loans than credit unions. See appendix III for additional details.

Credit Union Profitability Has Been Relatively Stable in Recent Years

The profitability of credit unions, as measured by the return on average assets, has been relatively stable in recent years. The industry's return on average assets was higher in the early to mid-1990s than in the late 1990s and early 2000s. While declining from 1.39 in 1993 to 0.94 in 1999, the return on average assets has since stabilized. It has generally hovered around 1, which, by historical banking standards, is a performance benchmark, and it was reported at 1.07 as of December 31, 2002. For comparative purposes, the return on average assets for peer group banks and thrifts was 1.24 in 2002. Earnings, or profits, are an important source of capital for financial

13The return on average assets is calculated as the current period's net income divided by the average of current period assets and prior year-end assets.
institutions in general and are especially important for credit unions, as they are mutually owned institutions that cannot sell equity to raise capital. As previously mentioned, credit unions create capital, or net worth, by retaining earnings. Most credit unions begin with no net worth and gradually build it over time.

**Regulatory Ratings Have Improved**

Since we last reported on the financial condition of credit unions, there has been a significant drop in the number of problem credit unions as measured by the regulatory ratings of individual credit unions. Regulatory ratings are a measure of the safety and soundness of credit union operations, and credit unions with an overall CAMEL rating of 4 (poor) or 5 (unsatisfactory) are considered problem credit unions. The number of problem credit unions declined by 63 percent from 578 (5 percent of all credit unions) in 1992 to 211 (2 percent of total) in 2002.

**Consolidation in Industry Has Widened the Gap between Larger and Smaller Credit Unions**

Total assets in federally insured credit unions grew from $258 billion in 1992 to $557 billion in 2002, an increase of 116 percent. During this same period, total member shares in these credit unions grew from $233 billion to $484 billion, an increase of 108 percent. At the same time, the number of federally insured credit unions fell from 12,595 to 9,688. As a result of the increase in total assets and the decline in the number of federally insured credit unions, the credit union industry has seen an increase in the average size of its institutions and a slight increase in the concentration of assets. At year-end 1992, credit unions with more than $100 million in assets represented 4 percent of all credit unions and 52 percent of total assets; at year-end 2002, credit unions with more than $100 million in assets represented about 11 percent of all credit unions and 75 percent of total assets. From 1992 to 2002, the 50 largest credit unions by asset size went from holding around 18 percent of industry assets to around 23 percent of industry assets. Despite the slight increase in concentration of assets in the credit union industry, it was neither as concentrated as the banking industry, nor did it witness the same degree of increased concentration. From 1992 to 2002, the 50 largest banks by asset size went from holding around 34 percent of industry assets to around 58 percent of industry assets. Appendix IV has additional information on assets in federally insured credit unions and banks.

This consolidation in the credit union industry has in part widened the gap between two distinct groups of federally insured credit unions—larger credit unions, which are relatively few in number and provide a wider
range of services, and smaller credit unions, which are greater in number and provide more basic banking services. Figure 2 illustrates institution size and asset distribution in the credit union industry as of 2002, with institutions classified by asset ranges; smaller credit unions are captured in the first category, while credit unions with assets in excess of $100 million are separated into additional asset ranges for illustrative purposes. For example, as of December 31, 2002, the 8,642 smaller credit unions—those with $100 million or less in total assets—constituted nearly 90 percent of all credit unions but held only 25 percent of the industry’s total assets (see right-hand axis of fig. 2). Conversely, the 71 credit unions with assets of between $1 billion and $18 billion, held 27 percent of total industry assets (see right-hand axis of fig. 2) but represented less than 1 percent of all credit unions.¹⁴

¹⁴There were 68 credit unions with assets between $1 billion and $5 billion, which held 21 percent of industry assets, and three credit unions with assets in excess of $5 billion, which held 6 percent of industry assets. As of December 31, 2002, the largest credit union held $17.6 billion in assets.
We observed that larger credit unions tended to hold a wider variety of loans than did smaller credit unions, and larger credit unions emphasized different loan types than smaller credit unions. For example, new and used vehicle loans have represented a relatively greater proportion of total assets for smaller credit unions, and nearly all smaller credit unions held such loans. However, while nearly all of the larger credit unions held new and used car loans, first mortgage loans represented a relatively greater proportion of total assets for larger credit unions. In fact, nearly all larger credit unions held first mortgage loans, junior mortgage and home equity loans.
loans, and credit card loans, while in general less than half of the smaller credit unions held these loans. Larger credit unions also tended to be more likely to provide more sophisticated services, such as financial services through the Internet and electronic applications for new loans. While nearly all larger credit unions offered automatic teller machines, less than half of smaller credit unions did. In fact, when compared with similarly sized peer group banks and thrifts, larger credit unions tended to appear very similar to their bank peers in terms of loan holdings. Appendixes IV and V provide further details.

Limited Comprehensive Data Are Available to Evaluate Income of Credit Union Members

As credit unions have become larger and offer a wider variety of services, questions have been raised about whether credit unions are more likely to serve households with low and moderate incomes than banks. However, limited comprehensive data are available to evaluate income of credit union members. Our assessment of available data—the Federal Reserve’s 2001 SCF, 2001 HMDA data, and other studies—provided some indication that credit unions served a slightly lower proportion of households with low and moderate incomes than banks. Industry experts suggested that credit union membership characteristics—occupationally based fields of membership and traditionally full-time employment status—could have contributed to this outcome. However, limitations in the available data preclude drawing definite conclusions about the income characteristics of credit union members. Additional information, especially with respect to the income levels of credit unions’ members receiving consumer loans, would be required to assess more completely whom credit unions serve.

Data Lacking on Income Characteristics of Credit Union Members and Users

It has been generally accepted, particularly by NCUA and credit union trade groups, that credit unions have a historical emphasis of serving people with modest means. However, there are currently no comprehensive data on the income characteristics of credit union members, particularly those who actually receive loans and other services. As credit unions have become larger and expanded their offerings of financial services, industry groups, as well as consumer advocates, have debated which economic groups benefit from credit unions’ services. Additionally, questions have been raised about credit unions’ exemption from federal income taxes. As stated in our 1991 report, and still true, none of the common-bond criteria available to federally chartered credit unions refers to the economic status of their members or potential members.
Information on the extent to which credit unions are lending and providing services to households with various incomes is scarce because NCUA, industry trade groups, and most states (with the exception of Massachusetts and Connecticut) have not collected specific information describing the economic status of credit union members who obtain loans or benefit from other credit union services.\textsuperscript{15} Credit unions, even those serving geographic areas, are not subject to the federal Community Reinvestment Act (CRA), which requires banking regulators to examine and rate banks and thrifts on lending and service to low- and moderate-income neighborhoods in their assessment area.\textsuperscript{16} As a consequence, credit unions are not required by NCUA or other regulators to maintain data on the extent to which loans and other services are being provided to households with various incomes.

However, two states—Massachusetts and Connecticut—collect information on the distribution of credit union lending by household income and the availability of services because their state-chartered credit unions are subject to examinations similar to those of federally regulated institutions. Modeled on the federal examination procedures for large banks, the state regulators apply lending and service tests to assess whether credit unions are meeting the needs of the communities they have set out to serve, including low- and moderate-income neighborhoods. Massachusetts established its examination procedures in 1982, and

\textsuperscript{15}The Credit Union National Association (CUNA) collects information about the characteristics (for example, income, race, and age) of credit union members but not specifically the income levels of members who actually receive mortgage and consumer loans or use other services.

\textsuperscript{16}The CRA requires all federal bank and thrift regulators to encourage depository institutions under their jurisdiction to help meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operations. See 12 U.S.C. §§ 2901, 2903, and 2906 (2000). CRA requires that the appropriate federal supervisory authority assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income areas. Federal bank and thrift regulators perform what are commonly known as CRA examinations to evaluate services to low- and moderate-income neighborhoods. Assessment areas, also called delineated areas, represent the communities for which the regulators are to evaluate an institution's CRA performance.
Connecticut in 2001. All credit unions in Massachusetts are subject to these examinations, including those whose field of membership is community-based. In contrast, in Connecticut, only state-chartered credit unions serving communities with more than $10 million in assets are subject to the examination. According to a Connecticut state official, the Connecticut legislature established its examination due to an increasing trend of multiple-bond credit unions to convert to community-chartered bonds, and the $10-million threshold was chosen because the legislature believed credit unions of that size would normally have the personnel and technological resources to appropriately identify and serve their market. In May 2003, Connecticut started to examine community-chartered credit unions with assets of more than $10 million.

Consumer and industry groups have debated if information that demonstrates whether credit unions serve low- and-moderate income households is necessary. Some consumer groups believe that credit unions should supply information that indicates they serve all segments of their potential membership. The Woodstock Institute—an organization whose purpose is to promote community reinvestment and economic development in lower-income and minority communities—recommended, among other things, that the CRA requirement should be extended to include credit unions, based on a study they believe demonstrated that credit unions are not adequately serving low-income households. Woodstock Institute officials noted that they would prefer to see CRA requirements applied to larger credit unions, those with assets over $10 million. The National Federation of Community Development Credit Unions (NFCDCU) has recommended that credit unions whose fields of

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17 Overall, State officials reported that credit union examination ratings have been similar to those of banks, except that credit unions have received a somewhat lower percentage of “outstanding,” the highest rating. As of July 2005, no Massachusetts credit union had a rating lower than “satisfactory” for Massachusetts’s version of the CRA examination. The officials also noted that analysis of HMDA data by itself is inadequate because loan application records do not capture all the information available in an application.

18 The State of Massachusetts permits a credit union not serving geographic areas to designate its membership as its assessment area. For example, one credit union, serving a major communications company, designated its membership as those who are employees or retired employees of the credit union itself; retirees and employees of other communication companies, including their affiliates and subsidiaries; and family members of eligible employees and retirees.

19 Woodstock Institute, “Rhetoric and Reality: An Analysis of Mainstream Credit Unions’ Record of Serving Low Income People” (Chicago: February 2002).
membership cover large communities should be affirmatively held accountable for providing services to all segments of those communities, and that NCUA publish annual reports on the progress and status of these expanded credit unions. In contrast, NCUA and industry trade groups have opposed these and related requirements largely because they state that no evidence suggests that credit unions do not serve their members.

Federal Reserve Board Data Suggest That Credit Unions Serve a Slightly Lower Proportion of Low- and Moderate-income Households

Our analysis of the Federal Reserve Board’s 2001 SCF suggested that credit unions overall served a lower percentage of households of modest means (low- and moderate-income households combined) than banks. More specifically, while credit unions served a slightly higher percentage of moderate-income households than banks, they served a much lower percentage of low-income households. The SCF is an interview survey of U.S. households conducted by the Federal Reserve Board that includes questions about household income and specifically asks whether households use credit unions or banks. Our analysis of the SCF indicated the following percentages for those households that used a financial institution:

- 8 percent of households only used credit unions,

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20 NFCDCU represents and provides, among other things, financial assistance, technical assistance, and human resources to about 215 community development credit unions for the purpose of reaching low-income consumers.

21 In 2000, NCUA required that any type of application related to expanding, converting, or chartering a community credit union include information known as a “community action plan,” which described the credit union’s plan for serving the entire community. In interim rules issued in December 2001 and final rules adopted in May 2002, NCUA repealed this requirement. In discussion of the final rule, NCUA stated: “It is an unreasonable practice to require only certain credit unions to adopt specific written policies addressing service to the entire community, without any evidence that these credit unions are failing to serve their entire communities.” CUNA and the National Federation of Credit Unions concurred with this decision. CUNA further noted that the imposition of this requirement could encourage federally chartered credit unions to convert to a state charter.

22 The SCF is conducted every 3 years and is intended to provide detailed information on the balance sheet, pension, income, and other demographic characteristics of U.S. households and their use of financial institutions. See appendix I for details.

23 These percentages reflect the percent of households using financial institutions as a percent of all financial institution users and does not include those households that are sometime referred to as unbanked.
• 13 percent of households primarily used credit unions,\textsuperscript{24} 

• 17 percent of households primarily used banks, and 

• 62 percent of households only used banks. 

To provide a more consistent understanding of our survey results, we used the same income categories used by financial regulators—low, moderate, middle, and upper—in their application of federal CRA examinations.\textsuperscript{25} 

To determine the extent to which credit unions served people of “modest means,” we first combined households with low or moderate incomes into one group and combined households with middle or upper incomes into another group. We then combined the SCF data into two main groups—households that only and primarily used credit unions versus households that only and primarily used banks. As shown in figure 3, this analysis indicated that about 36 percent of households that only or primarily used credit unions had low or moderate incomes, compared with 42 percent of households that used banks. Moreover, our analysis suggested that a greater percentage of households that only and primarily used credit unions were in the middle- and upper-income grouping than the proportion of households that only and primarily used banks. 

\textsuperscript{24}Those who “primarily” used credit unions placed more than 50 percent of their assets in credit unions and those who “primarily” used banks placed more than 50 percent of their assets in banks. The term “use” refers to a household’s placement of assets in a checking, savings, or money market account. Our methodology for determining these classifications was based on work performed by Dr. Jinkook Lee, a professor and researcher at Ohio State University. See Jinkook Lee and William A. Kelly Jr., in “Who Uses Credit Unions?” (Prepared for the Filene Research Institute and the Center for Credit Union Research, 1999, 2001). 

\textsuperscript{25}See appendix I for the income category definitions.
To better understand the distribution of households by income category, we also looked at each of the four income categories separately. As shown in figure 4, this analysis suggested that the percentage of households that only and primarily used credit unions in the low-income category was lower than the percentage of households that used banks in the same category (16 percent versus 26 percent). In contrast, households that only and primarily used credit unions were more likely to be moderate- and middle-income (19 percent and 22 percent) than those that only and primarily used banks (16 and 17 percent). Given that credit union membership has traditionally been tied to occupational- or employer-based fields of membership, the higher percentage of moderate- and middle-income households served by credit unions is not surprising.
Figure 4: Income Characteristics of Households Using Credit Unions versus Banks, by Four Income Categories

<table>
<thead>
<tr>
<th>Percentage</th>
<th>50</th>
<th>43</th>
<th>40</th>
<th>30</th>
<th>20</th>
<th>10</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Households only and primarily using credit unions</td>
<td>16</td>
<td>19</td>
<td>22</td>
<td>26</td>
<td>16</td>
<td>17</td>
<td>41</td>
</tr>
<tr>
<td>Households only and primarily using banks</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: 2001 SCF.

Note: We found no statistical difference in the percentage of upper-income households when the only and primarily using credit union group and the only and primarily using bank group were compared.

We also attempted to further explore the income distribution of credit unions’ members by separately analyzing households that only used credit unions or banks from those that primarily used credit unions or banks. However, the results were subject to multiple interpretations due to characteristics of the households in the SCF database. For example, when user groups are combined and compared, the results may look different than when the groups are separated and compared. Because such a high percentage of the U.S. population only uses banks (62 percent), the data obtained from the SCF is particularly useful for describing characteristics of bank users but much less precise for describing smaller population groups, such as those that only used credit unions (8 percent).
In addition to assessing the income characteristics of households using credit unions and banks, we also performed additional analysis by education, race, and age. The results of these analyses can be found in appendix VI.

Credit Unions Made a Slightly Lower Proportion of Mortgage Loans to Households with Low and Moderate Incomes Than Banks

As an indicator of the income levels of households that utilize credit union services, we used 2001 HMDA loan application records to analyze the income of households receiving mortgages for the purchase of one-to-four family homes from credit unions and peer-group banks. Our analysis indicated that credit unions reporting HMDA data made a lower proportion of mortgage loans to households with low and moderate incomes than peer group banks reporting HMDA data—27 percent compared with 34 percent. More specifically, credit unions made 7 percent of their loans to low-income households compared with 12 percent for banks, and credit unions made 20 percent of their loans to moderate-income households compared with 22 percent for banks (see fig. 5).

26HMDA, 12 U.S.C. §§ 2801-2811 (2000), was enacted to provide regulators and the public with information on home mortgage lending so that both could determine whether institutions were serving the credit needs of their communities. As required by the Federal Reserve Board's Regulation C (12 C.F.R. Part 203), lenders subject to HMDA are required to collect data containing information about the loan and the loan applicant. This information is submitted on files known as loan application registers (loan records). HMDA-reportable mortgages include those for home purchase, home improvement, and refinancing of home purchase loans, but we analyzed only those made for home purchases because these loans are a gateway to homeownership and other loans are easier to obtain. See appendix I for more information.

27We created a bank peer group that consisted of financial institutions with less than $16 billion in assets because the largest credit union held assets between $15 billion and $16 billion as of December 2001. We excluded financial institutions that only made mortgages. Our analysis included 4,195 peer group banks.

28To categorize the home purchaser's income, we used the 2001 HUD-estimated median income estimates for each Metropolitan Statistical Area (MSA) based on the 1990 U.S. Census, as supplied by the Federal Reserve Board. Results may have been more accurate if these estimates were based on the 2000 U.S. Census. In 2003, HUD must begin basing their median income estimates on the 2000 U.S. Census.
We also analyzed and compared the proportion of mortgage loans reported by peer group banks and credit unions for the purchase of homes by the median family income of the census tracts in which the homes were located. We found that credit unions made roughly the same proportion of loans for the purchase of homes, by census tract income category, as banks. For example, we found that both credit unions and banks made 1 percent of their loans for the purchase of homes in low-income census tracts and that credit unions made 9 percent of their loans for the purchase of properties in moderate-income census tracts compared with 10 percent by banks (see fig. 6). In addition, we found that both credit unions and banks made 54 percent of their loans for the purchase of homes in middle-
income census tracts, and that credit unions made about 37 percent of their loans in upper-income census tracts compared with 35 percent by banks. This analysis is a measure of whether all neighborhoods (census tracts within an assessment area) are receiving financial services, including low- and moderate-income ones.

Figure 6: Loans Made by Credit Unions and Banks, by Average Income in the Purchased Home’s Census Tract, 2001

<table>
<thead>
<tr>
<th>Percentage of loans</th>
<th>Credit unions</th>
<th>Peer group banks</th>
</tr>
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<tbody>
<tr>
<td>60</td>
<td>54</td>
<td>54</td>
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<tr>
<td>50</td>
<td>37</td>
<td>35</td>
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<td>0</td>
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</tbody>
</table>

Source: 2001 HMDA database.

Note: About 16 percent of the credit union and peer group bank loans reported to HMDA were excluded from this analysis because their loan records did not identify the census tract of the purchased property. Because we did not know the census tract, no census tract median income was available to categorize the loan. HMDA reporting requirements allow for the omission of the census tract locations under certain conditions; for example, when the property did not have an identified census tract for the 1990 census or was located in a county with a population of 30,000 or less. Also, percentages of loans made by credit unions do not add up to 100 percent due to rounding.

Because each HMDA loan record identified the income of the mortgage loan recipient and the location of the property, the HMDA database allowed us to determine the proportion of mortgages made within the four income
categories—low, moderate, middle, and upper—used by financial regulators for CRA examinations. However, not all financial institutions are required to report HMDA data—for example, depository institutions were exempt from reporting data in 2001 if they had assets less than $31 million as of December 31, 2000, and if they did not have a home or branch office in an MSA. Further, not all credit unions, including those that had more than $31 million in assets, made home purchase loans. As a result, most credit unions did not meet HMDA's reporting criteria—only about 14 percent of all credit unions submitted data included in our analysis. On the other hand, the credit unions that did report their loans to HMDA held about 70 percent of credit union assets and included about 62 percent of all credit union members.

HMDA Analysis Has Certain Limitations

Our analysis of HMDA data allowed us to determine the overall proportion of mortgage loans credit unions and peer group banks made to households and neighborhoods with low and moderate incomes. However, we would need information on the proportion of low- and moderate-income households within credit union fields of membership to actually make an evaluation of whether credit unions, collectively or individually, have met the credit needs of their entire field of membership. Similar to analyses used in federal CRA lending tests, this information could then be used as a baseline from which to evaluate an individual credit union’s actual lending record. In addition, information on factors (for example, a community’s economic condition, local housing costs) that could affect the ability of a

\[29\text{Our analysis of NCUA call report data indicated that 93 percent of credit unions with more than $31 million in assets, as of December 31, 2000, made first mortgage loans, loans that include home purchase loans, compared with only 34 percent of credit unions with fewer assets.}\]

\[30\text{In total, for 2001, 1,717 credit unions reported data to HMDA, but our analyses only included the 1,446 that made mortgage loans that met our criteria. For example, we only included mortgage loans for home purchases rather than refinancing.}\]

\[31\text{For larger institutions, those with more than $250 million in assets, CRA examinations generally consist of three parts—a lending test, a service test, and an investment test. The lending test entails a review of an institution’s lending record, including originations and purchases of home mortgages, small business, small farm, and, at the institution’s option, consumer loans throughout the institution’s assessment area, including low- and moderate-income areas. The lending test is weighted more heavily than the investment and service tests in the institution’s overall CRA rating. The service test requires the examiner to analyze an institution’s system for delivering retail banking services and the extent and innovativeness of its community development services. The investment test evaluates an institution’s investment in community development activities.}\]
credit union to make loans consistent with safe and sound lending would be necessary to evaluate an institution's lending record. If regulators were to make these types of evaluations for credit unions, they would be easier to implement for those serving geographic areas because demographic information (for example, on census tract median income levels) would be available to describe credit union field of membership. For credit unions with an occupational or associational membership, other ways of characterizing their field of membership would need to be determined.

In addition, as previously mentioned, using HMDA data to analyze credit union mortgage lending to members does not provide any information on smaller credit unions, because in 2001 credit unions with less than $31 million in assets as of December 31, 2000, were not required to report HMDA data. Because smaller credit unions did not report HMDA data, one group of credit unions—the roughly 3,800 credit unions that qualified for NCUA's Small Credit Union Program in December 2002—were largely excluded from our HMDA analysis. Credit unions qualifying for assistance from this program must have less than $10 million in assets or have received a "low-income" designation from NCUA. In addition, low-income credit unions must demonstrate that more than half of their current members meet one of NCUA's low-income criteria. Further, smaller credit unions are more likely than larger credit unions to make consumer loans than mortgages, making an evaluation of mortgage lending more relevant to larger credit unions than smaller ones. Because most credit unions can be classified as small, analyzing the distribution of consumer loans by household income would provide a more complete picture of credit union lending.

These credit unions receive special help from NCUA regional staff, including assistance in completing business plans and maintaining financial records. Low-income credit unions also qualify for low-interest loans and technical assistance grants and are permitted to accept nonmember deposits and secondary capital accounts. According to NCUA estimates, as of December 31, 2002, the median asset level of these credit unions was about $3.4 million. About 107 of these credit unions had more than $32 million in assets, the threshold for reporting lending data to HMDA in 2003.

As of December 31, 2002, there were 907 low-income credit unions. Credit unions can use a number of methods to document their low-income eligibility, such as reviewing loans to identify members' wages or household incomes, or written membership surveys that request the members' total household income and annual wages.

See appendix V for more detailed information on credit union services by asset size.
Other recently published studies—CUNA and the Woodstock Institute—generally concluded that credit unions served a somewhat higher-income population. The studies noted that the higher income levels could be due to the full-time employment status of credit union members.

The CUNA 2002 National Member Survey reported that credit union members had higher average income households than nonmembers—$55,000 compared with $46,000. The report provided several reasons for the income differential, including the full-time employment status of credit union members, credit union affiliation with businesses or companies, and weak credit union penetration among some of the lowest-income age groups—18 to 24 and 65 and older. However, the report noted that additional analyses, specifically those grouping consumers based on the extent to which they rely on banks and credit unions as their primary provider, should also be considered. In addition, a study sponsored by the Woodstock Institute, based on an analysis of 1999 and 2000 survey responses obtained from households in the Chicago, Illinois, metropolitan area concluded that credit unions in the Chicago region served a lower percentage of lower-income households than they did middle- and upper-income ones. For example, while 40 percent of surveyed households with incomes between $60,000–$70,000 contained a credit union member, only 23 percent of households earning between $30,000–$40,000 contained a credit union member.

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35CUNA 2002 National Member Survey and research and information from CUNA and affiliates. CUNA based its statistics on average household income on a survey of 1,000 randomly selected households conducted in February 2002. The data from this survey were weighted to accurately represent U.S. consumers age 18 and older.

36CUNA supplemented its average income analysis of members and nonmembers with one that divided consumers into four institution user groups—as similarly done by Jinkook Lee, in "Who Uses Credit Unions" in her analysis of the SCF and in our previous analysis—and calculated the average household income of each institution user group. CUNA determined that consumers who only used banks and only used credit unions had a lower average income than consumers who used both institutions. In addition, when comparing the average income of consumers who used both institutions, the analysis concluded that those who primarily used credit unions had a slightly lower average income than those who primarily used banks.

37The study cited is "Rhetoric and Reality: An Analysis of Mainstream Credit Unions' Record of Serving Low Income People" (February 2002). To determine the characteristics of credit union members, the Woodstock Institute analyzed 1999 and 2000 survey data collected by the Metro Chicago Information Center (MCIC). MCIC surveyed roughly 3,000 households in the Chicago area and asked respondents whether they were members of a credit union. However, the survey did not specifically ask whether the respondents held accounts at a bank or credit union.
The study also noted that household members working for larger firms, and those who were members of a labor union, were significantly more likely to be credit union members.

Officials from NCUA and the Federal Reserve Board also noted that credit union members were likely to have higher incomes than nonmembers because credit unions are occupationally based. An NFCDCU representative noted that because credit union membership is largely based on employment, relatively few credit unions are located in low-income communities. However, without additional research, especially on the extent to which credit unions with a community base serve all of their potential members, it is difficult to know whether full-time employment is the sole explanatory factor.

CUMAA Authorized NCUA to Continue Preexisting Policies That Expanded Field of Membership

The Credit Union Membership Access Act of 1998 authorized preexisting NCUA policies that had allowed credit unions to expand field of membership. In 1998, the Supreme Court ruled against NCUA’s practice of permitting federally chartered credit unions to consist of more than one common bond.\(^38\) In CUMAA, Congress specifically permitted credit unions to form multiple-bond credit unions and allowed these credit unions to serve underserved areas.\(^39\) CUMAA also specified that community-chartered credit unions serve a “local” area.\(^40\) However, after the passage of CUMAA, NCUA revised its regulations to make it easier for credit unions to serve communities larger than before CUMAA. To some extent, these NCUA policies appear to have been triggered by concerns about competing with the states to charter credit unions. While CUMAA permitted multiple-bond credit unions to add underserved areas to their membership, the impact of this provision will be difficult to assess because NCUA does not track credit union progress in extending service to these communities.


\(^{39}\)Pub. L. No. 105-219 § 101(2).

\(^{40}\)Id.
CUMAA Permitted NCUA Policies Expanding Field of Membership

CUMAA authorized several preexisting NCUA field of membership policies that had enabled federally chartered credit unions to expand their fields of membership. These policies had allowed credit unions to consist of more than one membership group and expand their membership to include underserved areas. In addition, CUMAA permitted credit unions to retain their existing membership.

Specifically, CUMAA affirmed NCUA’s 1982 policy of permitting credit unions to form multiple-bond credit unions, allowing these credit unions to retain their current membership and authorizing their future formation. A credit union with a single common bond has members sharing a single characteristic, for example, employment by the same company. In contrast, multiple-bond credit unions consist of more than one distinct group. Congressional affirmation of NCUA’s policy of permitting multiple-bond credit unions was important because earlier in 1998 the Supreme Court had ruled that federally chartered, occupationally based credit unions were required to consist of a single common bond. Figure 7 provides additional information since 2000 on the percent of federally chartered credit unions by charter type.

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41 CUMAA permitted the following common bonds: (1) the single common bond, defined as one group with a common bond of occupation or association; (2) the multiple common bond, defined as including more than one group, each with a common bond of occupation or association; and (3) the community bond, defined as persons or organizations within a well-defined local community, neighborhood, or rural district. Formation of multiple common-bond credit unions is limited to groups having fewer than 3,000 members unless NCUA grants an exception based on criteria contained in CUMAA. See 12 U.S.C. § 1759(b), (d), as amended.

42 According to NCUA officials, single-bond credit unions are more susceptible to failure because they are reliant on one type of occupational group. For example, if an occupational group were subject to layoffs, the credit union could lose its membership base or experience a decline in assets.


44 Although single-bond credit unions included about 38 to 40 percent of all federally chartered credit unions between 2000 and March 2003, during this time period they only held about 18 percent of all assets of federally chartered credit unions. In contrast, federally chartered multiple-bond credit unions held about 70 percent of federal assets in March 2000, and this percentage dropped to about 65 percent in 2003. Federally chartered community credit unions held about 13 percent of federal assets in 2000, and this percentage increased to about 17 percent of assets in March 2003.
In addition, CUMAA affirmed other preexisting NCUA policies. For example, CUMAA authorized multiple-bond credit unions to add individuals or organizations in “underserved areas” to their field of membership. This provision was similar to an NCUA policy that permitted multiple-bond credit unions, as well other federally chartered, single-bond, and community-chartered credit unions, to add low-income communities
to their field of membership.\textsuperscript{45} In addition, CUMAA affirmed NCUA’s “once a member, always a member policy,” which had been in effect since 1968. CUMAA authorized this policy such that credit union members may retain their membership even after the basis for the original bond ended.\textsuperscript{46} However, CUMAA still contained provisions encouraging the creation of new credit unions whenever possible.\textsuperscript{47}

NCUA Eased Requirements for Permitting Credit Unions to Serve Larger Geographic Areas

Despite the qualification in CUMAA that a community-chartered credit union’s members be within a well-defined “local” community, neighborhood, or rural district, NCUA eased requirements for permitting credit unions to serve larger geographic areas. CUMAA added the word “local” to the preexisting requirement that community-chartered credit unions serve a “well-defined community, neighborhood, or rural district,” but provided no guidance with respect to how the word “local” or any other part of this requirement should be defined.\textsuperscript{48}

\textsuperscript{45}In 1994, NCUA’s Interpretive Ruling and Policy Statement (IRPS) 94-1 authorized all federally chartered credit unions, regardless of bond, to include in their membership, without regard to location, communities and associational groups satisfying the definition of low income. This program should not be confused with NCUA’s “low-income designated program,” which permits credit unions who exclusively serve low-income areas to maintain secondary capital and accept nonmember deposits.

\textsuperscript{46}Pub. L. No. 105-219 § 101 (2), 12 U.S.C. § 1759 (e)(2), as amended. Under this provision, once a person becomes a member of a credit union, that person or organization may remain a member of that credit union until the person or organization chooses to withdraw from membership in the credit union.

\textsuperscript{47}The Federal Credit Union Act requires NCUA to encourage the formation of separately chartered credit unions instead of approving the inclusion of an additional common-bond group within the field of membership of an existing credit union. 12 U.S.C. § 1759(f)(1). From 1991 to March 2003, only 143 new federally insured credit unions were chartered, an average of about 11 to 12 new credit unions per year. NCUA said that small groups are generally not economically sustainable and prefer to join multiple-bond credit unions.

Following passage of CUMAA, NCUA expanded the ability of credit unions to serve larger geographic areas through its regulatory rulings. Interpretive Ruling and Policy Statement (IRPS) 99-1, issued soon after CUMAA, was the first regulation to set standards for what could be considered a “local” area. It required credit unions to document that residents of a proposed community area interact or have common interests. Credit unions seeking to serve a single political jurisdiction (for example, a city or a county) with more than 300,000 residents were required to submit more extensive documentation than jurisdictions with fewer than 300,000 residents. However, IRPS 03-1, which replaced IRPS 99-1, eliminated these documentation requirements, regardless of the number of residents. Further, IRPS 03-1 allowed credit unions to propose MSAs with less than 1 million residents for qualification as local areas. See table 1 for changes in “local” requirements. NCUA adopted these definitions of local community based on its experience in determining what constituted a local community charter.

Prior to CUMAA, NCUA regulations did not limit the size of the community a credit union could serve. However, NCUA required extensive documentation to establish the existence of a community. For example, up until March 1, 1998, credit unions were required to provide written evidence of community support for their applications, such as letters of support, petitions, or surveys. In March 1998, in IRPS 98-1, NCUA deleted the information requirement but noted that credit unions still had to demonstrate that residents of the proposed community interacted.

For example, in IRPS 99-1, if the population of a single political jurisdiction was less than 300,000, the credit union was only obligated to submit a letter describing how the area met standards for community interaction or common interests. However, if the population exceeded 300,000, the credit union would have to submit additional documentation; demonstrating, for example, the existence of major trade areas or shared facilities (such as educational).
Table 1: Regulatory Definitions of Local Community, 2000 and 2003

<table>
<thead>
<tr>
<th>IRPS 99-1, effective in November 2000, (as amended by IRPS 00-1)</th>
<th>IRPS 03-1, effective in May 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Areas in single political jurisdictions (for example, counties or cities) qualified as a local community if the number of residents did not exceed 300,000.</td>
<td>1. Any city, county, or political equivalent in a single political jurisdiction, regardless of population size, automatically meets the definition of a local community.</td>
</tr>
<tr>
<td>2. States, noncontiguous jurisdictions, and MSAs did not meet the definition of a local community.</td>
<td>2. MSAs may meet the definition of local community provided the population does not exceed 1 million.</td>
</tr>
<tr>
<td>3. Contiguous political jurisdictions qualified as a local community if they contained 200,000 or fewer residents.</td>
<td>3. Contiguous political jurisdictions qualify as a local community if they contain 500,000 or fewer residents.</td>
</tr>
<tr>
<td>4. A letter describing community interaction or common interests was required for conditions (1) and (3) above. Otherwise, the credit union had to provide additional documentation.</td>
<td>4. A letter describing community interaction or common interests is required for conditions (2) and (3) above. Otherwise, the credit union must provide additional documentation.</td>
</tr>
</tbody>
</table>

Source: IRPS 99-1 and IRPS 03-1.

Note: NCUA amended IRPS 99-1, the first field of membership regulation issued by NCUA after CUMAA, several times (IRPS 00-1 on Oct. 27, 2000; IRPS 01-1 on March 2001; and IRPS 02-2 on April 24, 2002.) This table only highlights key changes pertaining to the geographic and population criteria used by NCUA to approve community charters.

Specifically, NCUA officials said that they decided single political jurisdictions should automatically qualify as “local” areas based on their review of applications by credit unions for community charters. They reported that they came to this conclusion because credit unions converting to a community charter or expanding their service areas had generally been able to successfully supply the documentation required by NCUA. We asked NCUA officials what kind of relationships community-chartered credit union members could have if, for example, a local community were to be defined as all of New York City. NCUA officials said that the defining factors for them were that people lived in the same political jurisdiction—thus providing, for example, a common government and educational system—and noted that credit unions applying to serve these larger jurisdictions still had to meet other requirements related to safety and soundness. The officials also said that had CUMAA not introduced the word “local,” NCUA could have considered providing credit unions permission to expand their field of memberships statewide.
The regulatory changes in IRPS-03-1 pertaining to the definition of local community have made it easier for federally chartered credit unions to serve larger communities. Under IRPS-03-1, NCUA approved the largest community yet—the 2.3 million residents of Miami-Dade County, Florida.

NCUA had disapproved this same credit union’s request about 2 years earlier, under IRPS 99-1, as amended by IRPS 01-1. Prior to IRPS-03-1, some of the largest community field of memberships approved by NCUA included service to 836,231 residents on Oahu, Hawaii, and service to 710,540 residents in Montgomery County and Greene County, Ohio. In addition, over the last 3 years, potential membership—an estimate of the maximum number of members that could join a credit union—in community-chartered credit unions has come to exceed that in multiple-bond credit unions. According to NCUA estimates, in March 2003, community-chartered credit unions had 98 million potential members compared with multiple-bond credit unions with 92 million potential members (see fig. 8).

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51This multiple-bond credit union, located in Miami, Florida, originally applied to serve Miami-Dade County, Florida, in April 2001. However, NCUA officials denied both the original application and subsequent appeal on the grounds that the residents of this area (including two large cities and 28 other municipalities) did not have common interests or interactions. As required by IRPS 99-1 (as amended by IRPS 01-1), the credit union was required to supply documentation that residents within this area interacted but the evidence, while described as “voluminous” by NCUA officials, did not meet with their approval. Under the new rule (IRPS 03-1), approved in May 2003, this level of evidence was no longer required.

52While the examples in this paragraph represent some of the largest community-charter field of memberships approved by NCUA, the population sizes of these communities can vary tremendously. For example, in 2002, NCUA field of membership approvals ranged from a population of 695 in Delta County, Colorado, to a population of 1.1 million residents in the area surrounding Maple Grove, Minnesota. Since 1999, the average population of approved communities has increased—in 1999, this average was 134,000 and as of June 25, 2003, 357,000.

53Federally insured credit unions are required to report their potential membership on NCUAs call report. This number is expected to include current membership as well as potential members. While the instructions require that the estimates must be reasonable and supportable, no further instructions are provided. Two or more credit unions whose field of membership overlaps can count the same person as a potential member.
Figure 8: Actual and Potential Members in Federally Chartered Credit Unions, by Charter Type, 2000–2003

Number of members in millions

According to NCUA, a major reason for NCUA's recent regulatory changes was to maintain the competitiveness of the federal charter in a dual chartering system. They also characterized NCUA's field of membership regulations as more restrictive than those in some states. Officials in three of the states in which we conducted interviews—California, Texas, and Washington—said that the ability to expand field of membership more readily under state rules was a reason that federally chartered credit unions had converted to state charters.

Consistent with this assertion, we found that state-chartered credit unions have experienced greater membership growth, although federally chartered credit unions still had more members. Between 1990 and March 2003, state-chartered credit union membership increased by 88 percent,
from 19.5 million to 36.6 million, while membership in federally chartered credit unions increased by 24 percent, from 36.2 million to 44.9 million. In addition, if estimates of potential membership serve even as an approximation of future membership, state-chartered credit unions could be positioned to experience greater growth (see fig. 9). In March 2003, state-chartered credit unions had about 405 million potential members, almost twice the 208 million for federally chartered credit unions.

**Figure 9: Actual and Potential Members in Federally and State-chartered Credit Unions, 1990–2003**

Number of members in millions

<table>
<thead>
<tr>
<th>Year (through March)</th>
<th>Federal actual membership</th>
<th>State actual membership</th>
<th>Federal potential membership</th>
<th>State potential membership</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>50</td>
<td>50</td>
<td>250</td>
<td>250</td>
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<tr>
<td>2003</td>
<td>450</td>
<td>450</td>
<td>450</td>
<td>450</td>
</tr>
</tbody>
</table>

Source: NCUA.

Note: In 2001, the total population of the United States was about 285 million people. In contrast, between 2001 and 2003, the total number of potential credit union members ranged from 446 million to about 613 million. The total number of potential members exceeds the total population of the United States because credit unions can count the same individuals as potential members when their field of membership overlaps.
We also found that states had chartered a higher percentage of their credit unions to serve geographic areas (communities) than NCUA.54 In 2002, we estimated that about 1,146 state-chartered credit unions, 30 percent of all state-chartered credit unions, served geographic areas compared with 848 federally chartered credit unions, 14 percent of all federally chartered credit unions.55 However, this number increases to 1,096, 18 percent of all federally chartered credit unions, once federally chartered credit unions serving underserved areas are included. State-chartered credit unions serving geographic areas held about 59 percent of state-chartered credit union assets compared with 17 percent held by federally chartered credit union serving geographic areas, or 29 percent when the assets of credit unions with underserved areas were included.56

Credit Unions Have Added Underserved Areas, but No Information Available to Evaluate Actual Service

An NCUA objective is to ensure that credit unions provide financial services to all segments of society, including the underserved, but NCUA has not developed indicators to evaluate credit union progress in reaching the underserved.57 This type of evaluation could require information similar to that used to evaluate the extent of geographic area service.58

54We use the term "serving geographic areas" because some states (for example, California and Texas) permit their credit unions to serve a mix of occupational and associational groups and communities. Because NCUA could not provide us information on the number of state-chartered credit unions serving communities, we surveyed state regulators to obtain this information.

55The number of credit unions serving geographic areas varied by state. For example, in California, state-chartered credit unions serving geographic areas represented about 48 percent of state-chartered credit unions and held about 82 percent of state-chartered assets. In comparison, in New York, state-chartered credit unions serving geographic areas represented about 5 percent of state-chartered credit unions and held about 11 percent of state-chartered assets.

56Because chartering provisions among the states and the federal government vary, we would like to emphasize that these numbers are estimates only. For example, we had no way of knowing, short of contacting individual credit unions, whether state-chartered credit unions relied more extensively on a community or an occupational group for their membership. In addition, some state-chartered credit unions were excluded from our calculations, including those that were privately insured, because we could not identify them in the NCUA call report data.

57Part of NCUA's vision statement, included as part of its 2003-2008 Strategic Plan, is: "Ensure the cooperative credit union movement can safely provide financial services to all segments of American society." Further, in NCUA's 2003 Annual Performance Plan, NCUA states as a specific goal that it plans to "Facilitate credit union efforts to increase credit union membership and accessibility to continue to serve the underserved, and enhance financial services."
to that provided as part of CRA examinations—for example, information on the distribution of loans made by the income levels of households receiving mortgage and consumer loans—and provide comprehensive information on how credit unions have utilized opportunities to extend their services to underserved areas, including low- and moderate-income households. CUMAA had specifically provided that multiple-bond credit unions could serve underserved areas, and NCUA permitted single-bond and community-bond credit unions to add them as well. However, neither CUMAA nor NCUA required that credit unions report on services to these areas once they had been added. Figure 10 shows the number of underserved areas added before and after CUMAA.

The Federal Credit Union Act, as amended by CUMAA, provides NCUA criteria to use to determine if an area is “underserved.” See 12 U.S.C. § 1759 (c)(2). Among other things, these areas must qualify as “investment areas” as defined by section 103 (16) of the Community Development Banking and Financial Institutions Act of 1994 (12 U.S.C. § 4703(16)). Areas could qualify, for example, by having at least 20 percent of their population living in poverty. Second, areas must qualify as underserved based on data from the NCUA board and the federal banking agencies. NCUA officials, however, apply only the first criterion, presuming that areas qualifying as an investment area automatically qualify as underserved.
Instead of developing indicators to evaluate credit union progress in reaching the underserved, NCUA officials have claimed success based on the increase in the number of potential members added by credit unions in underserved areas and, recently, on the membership growth rate of federally chartered credit unions that have added underserved areas. As of March 2003, credit unions had added 48 million potential members in underserved areas. As noted previously, potential membership is an estimate of the maximum number of people who could be eligible to join a credit union. However, NCUA officials believe that potential membership is an appropriate measure because they view NCUA’s role as expanding membership opportunities for credit unions as opposed to the credit
unions’ role of actually extending services to new members. In addition, in June 2003, NCUA claimed success based on estimates indicating that annual membership growth in credit unions that expanded into underserved areas has been higher than that of all federally chartered credit unions—4.8 percent compared with 2.49 percent. However, they could not identify whether the increase in membership actually came from the underserved areas or provide any descriptive information (for example, the income level) about the new members.

Because NCUA does not collect information on credit union service to underserved areas, it would be difficult for NCUA or others to demonstrate that these credit unions are actually extending their services to those who have lower incomes or do not have access to financial services. As the number of credit unions adding underserved areas increases, this question becomes more important. For example, in 1999, the year after CUMAA, 13 credit unions added 16 underserved areas to their membership. In 2002, 223 credit unions added about 424 underserved areas. Further, the size of these communities can be substantial. For example, in May 2003, NCUA permitted one multiple-bond credit union to add an additional 300,000 residents within Los Angeles County, California, for a total of almost 1 million added residents in the last 2 years. In the same month, NCUA also approved a multiple-bond credit union’s (headquartered in Dallas, Texas) addition of 600,000 residents in underserved communities in Louisiana.

To promote adoption of these areas, NCUA developed a public relations program called “Access to America” that promotes awareness of NCUA programs that provide resources, or other support, to credit unions to expand their financial services to the underserved.

CUNA published a study, 2003 “Serving Members of Modest Means” Survey Report, on how credit unions served consumers having annual household incomes of $40,000 or less. While the survey findings cannot be generalized to all credit unions, the survey results indicated that most credit unions responding to the survey targeted at least one service (for example, money orders, check-cashing services) to lower- and moderate-income members, and that credit unions with underserved areas were likely to offer more of these services. About 35 percent of the credit unions responding to the survey indicated they would grant a loan for $100 or less and about 30 percent indicated they would open a certificate account for less than $100. The study noted that credit unions had difficulty responding to questions that asked them to estimate members’ or potential members’ income distributions.
NCUA Adopted Risk-focused Examination and Supervision Program, but Faces Challenges in Implementation

Industry consolidation and changes in products and services offered by credit unions prompted NCUA to move from an examination and supervision approach that was primarily focused on reviewing transactions to an approach that focuses NCUA resources on high-risk areas within a credit union. Prior to implementing its risk-focused program in August 2002, NCUA sought guidance from other depository institution regulators that had several years of experience with risk-focused programs. While this consultative approach helped NCUA, it still faces a number of challenges that create additional opportunities for NCUA to leverage off the experience of the other depository institution regulators. These challenges include ensuring that examiners have sufficient expertise in areas such as information systems, monitoring the risks posed by expansion into nontraditional credit union activities such as business lending, and monitoring the risks posed by the federal deposit (share) insurance fund by institutions for which states are the primary regulator. Moreover, unlike other depository institution regulators, NCUA currently lacks authority to inspect third-party vendors, which credit unions increasingly rely on to provide services such as electronic banking. Further, credit unions are not subject to the internal control reporting requirements that banks and thrifts are subject to under FDICIA. NCUA adopted prompt corrective action, a system of supervisory actions tied to the capital levels of an institution, in August 2000, as required by CUMAA; few actions have been taken to date due to a generally favorable economic climate for credit unions.

Changes in the Credit Union Industry Prompted NCUA to Revise Its Approach to Examination and Supervision

The credit union industry has undergone a variety of changes that prompted NCUA to revise its approach to examining and supervising credit unions. As described earlier, the credit union industry is consolidating, and more industry assets are concentrated in larger credit unions, those with assets in excess of $100 million. For example, in December 1992, credit unions with over $100 million in assets held 52 percent of total industry assets, but by December 2002, they held 75 percent of total industry assets. Furthermore, credit unions are providing more complex electronic services such as Internet account access and on-line loan applications to meet the demands of their members. Thirty-five percent of the industry offered financial services through the Internet as of December 2002; however, the rate increased to over 90 percent for larger credit unions. In addition, the composition of credit union assets has changed over time, with credit

unions engaging in more real estate loans (see fig. 11). For example, the number of first mortgage loans about doubled from 589,000 loans as of December 1992 to 1.2 million loans as of December 2002. During this same period, the amount of first mortgage loans more than tripled from $29 billion to $101 billion. From 1992 to 2002, the percentage of real estate loans to total assets grew from 19 percent to 26 percent, a greater rate of growth than that of consumer loans over the same time period. The longer-term real estate loans introduced a greater level of interest rate risk than that introduced through the shorter-term consumer loans credit unions traditionally made.  

Interest rate risk is the risk that changes in market rates will have a negative impact on capital and earnings. In September 2003, NCUA issued Letter to Credit Unions 03-CU-15, which discusses the interest rate risk for credit unions with large concentrations of fixed-rate mortgages.
As a result of these changes, NCUA found that its old approach of reviewing the entire operation of credit unions and conducting extensive transaction testing no longer sufficed, particularly for larger credit unions, because of the number of transactions in which they engaged and the variety of products and services they tended to provide. In contrast, under the risk-focused approach, NCUA examiners are expected to identify those activities that pose the highest risk to a credit union and to concentrate their efforts on those activities. For example, as credit unions engage in more complex electronic services, examiners are to focus their efforts on reviewing information systems and technology to ensure that credit unions have sufficient controls in place to manage operations risk. In addition, as credit unions engage in more real estate lending, examiners are to focus on ensuring that these credit unions have sophisticated asset-liability management models in place to properly manage interest rate risk. When transaction testing is used under the risk-focused approach, it is used to validate the effectiveness of internal control and other risk-management systems. Further, the risk-focused approach places more emphasis on preplanning and off-site monitoring of credit union activities, which helps ensure that once examiners arrive on site, they already will have identified those areas of the greatest risk in a credit union and where to focus their resources.

To compliment the risk-focused approach and allow NCUA to better allocate its resources, the agency adopted a risk-based examination program in July 2001. This program eliminates the requirement to perform annual examinations on low-risk credit unions, replacing annual exams with two examinations in a 3-year period.

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63 Operations risk is the risk that fraud or operational problems could result in an inability to deliver products, remain competitive, or manage information.

64 Asset-liability management is the process of evaluating balance sheet risk (interest rate and liquidity risk) and making prudent decisions, which enable a credit union to remain financially viable as economic conditions change.

65 These credit unions are defined as those with a CAMEL rating of 1 or 2 for the prior two examinations, and those exhibiting additional characteristics, such as having been in operation for at least 10 years, having a positive return on assets, having adequate internal controls, and having added no recent high-risk programs.
NCUA took various steps to ensure successful implementation of the risk-focused program. NCUA consulted with its Office of Corporate Credit Unions to inquire about their experiences with their risk-focused program that was implemented in 1998. As a result of this consultation, NCUA incorporated a greater level of examiner judgment in its risk-focused approach, specifically allowing examiners to determine the appropriate level of on-site versus off-site supervision. For example, if an examiner discovered a problem during off-site monitoring of a credit union, the examiner might adjust the schedule of the on-site examination to directly address the problem. In addition, in recognition that examiners would be required to assess the future risks that credit unions might be undertaking, NCUA, after consulting with its Office of Corporate Credit Unions, required that examiners review information beyond the financial statements. For example, under the risk-focused program, examiners might analyze due diligence reviews by management for new and existing products and services, internal controls, and measurements of actual performance against forecasted results, to determine what future risks a particular credit union might be undertaking.

NCUA's consultations with FDIC and its review of two FDIC Inspector General reports prompted NCUA to develop programs to address challenges that FDIC experienced in implementing its risk-focused program. For example, according to NCUA, FDIC did not conduct much training for its examiners prior to implementing its risk-focused program. NCUA, on the other hand, held training for all examiners, including state examiners, and once the risk-focused program was implemented, NCUA also provided additional training to help examiners assess risks more effectively. NCUA's review of the FDIC Inspector General reports found that some FDIC examiners resisted the move to the risk-focused program. NCUA's response was to develop a quality control program to ensure that examiners and supervisors were adopting the risk-focused approach and that documentation was completed consistently across NCUA's regions. Under the quality control program, NCUA officials reviewed a sample of examinations from each region for scope, conciseness of reports, appropriateness of completed work papers and application of risk-focused concepts. NCUA's development of the quality control program was timely and appropriate, because we found some NCUA examiners and state supervisors were reluctant to move to the risk-focused program. The examiners and supervisors were concerned that they would be blamed if a credit union later had a problem in an area they had not initially identified as high-risk.
NCUA's consultations with the Office of the Comptroller of the Currency (OCC) enabled NCUA to consider a different approach to improve its oversight of large credit unions under the risk-focused program. OCC had implemented a large bank program in recognition of the need for an alternative approach to oversight of large and sophisticated banks. NCUA likewise found the need for an alternative approach to oversight of large credit unions because its examiners traditionally examined a large number of small credit unions and very few larger ones and, thus, had been unable to gain sufficient comfort and expertise in examining the larger, more complex institutions. As a result of consultations with OCC, NCUA implemented its Large Credit Union Pilot Program in January 2003 to, among other things, develop a core of examiners with experience overseeing these larger credit unions. Under this program, NCUA has also experimented with different examination approaches, including targeted examinations, which focus on certain aspects of credit union operations such as the loans, investments, or asset-liability management. NCUA officials told us that they received some preliminary feedback from credit unions that found the pilot to be beneficial. However, because the pilot ended recently, NCUA officials stressed that it was too early to tell how effective this program will be in helping NCUA improve its examinations of large credit unions.

In recognition that the risk-focused program was a significant departure from NCUA's old approach to examination and supervision, NCUA also sought feedback from the industry on the risk-focused program by developing a survey for credit unions to complete once they had gone through their first risk-focused examination. NCUA reported that it had received preliminary results from the survey that indicated that the risk-focused program has been well received. Specifically, NCUA received the highest marks for examiners’ courteous and professional conduct, effective overall examination process, and effective communication with management and officials throughout the examination. Officials from some of the large credit unions we interviewed were pleased with the program because they felt that the examination was focused on the high-risk areas that credit union officials needed to monitor. Likewise, examiners with whom we spoke told us that adopting a risk-focused approach had made a bigger difference in their oversight activities at the larger credit unions because they could focus their resources on the high-risk areas of these institutions. In contrast, the examiners relied on the old approach of extensive transaction testing at the smaller credit unions that lacked sufficient resources to implement robust internal control structures and
tended to limit their activities to the basic or traditional services offered by credit unions.

<table>
<thead>
<tr>
<th>NCUA Has Further Opportunities to Leverage the Experiences of Other Regulators to Address Existing Challenges</th>
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<tbody>
<tr>
<td>NCUA faces a number of challenges in implementing its risk-focused approach that create additional opportunities for it to leverage the experiences of the other regulators that have been using risk-focused programs for several years. These challenges include ensuring that examiners have sufficient training to keep pace with changes in industry technologies and methods, adequately preparing for monitoring credit unions as they expand more heavily into nontraditional credit union activities such as business lending, and overseeing state-chartered institutions in states that lack sufficient examiner resources and expertise.</td>
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<table>
<thead>
<tr>
<th>NCUA Faces Challenges in Ensuring That Examiners Are Adequately Trained to Assess Changing Technology</th>
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</thead>
<tbody>
<tr>
<td>According to NCUA examiners who had recently implemented the risk-focused program, NCUA faces challenges in training its examiners in specialized areas such as information systems and technology. Likewise, as we found in prior reviews, other depository institution regulators also faced these challenges in implementing risk-focused programs. Some NCUA examiners with whom we spoke indicated that NCUA’s formal and on-the-job training of subject matter examiners, particularly in the areas of information systems and technology, payment systems, and specialized lending, was insufficient and did not help them keep pace with the changing technology in the industry. As a result, some examiners were not confident that they could assess the adequacy of information systems that were vital to the operations of some credit unions. NCUA officials sought to address concerns about specialist training by modifying their training manual to more clearly state what classes were appropriate for the different specialized areas. Further, as a member of the Federal Financial Institutions Examination Council (FFIEC), NCUA was aware of specialized training offered by other depository institution regulators under the auspices of FFIEC, and encouraged NCUA examiners</td>
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</tbody>
</table>


67 NCUA’s subject matter examiner program was created in February 2002 to train experienced and knowledgeable examiners in specialized areas, such as capital markets and information systems, to help examiners assess risks more effectively. The program also was designed to augment NCUA’s existing core of specialist examiners.
NCUA Faces Challenge of Ensuring That It Is Adequately Prepared to Monitor Credit Unions as They Expand into Nontraditional Activities

NCUA’s revised regulation on member business loans also presents NCUA with the challenge of ensuring that it is adequately prepared to monitor this growing area of lending. A recent NCUA final rule on member business loans relaxed certain requirements (allowing well-capitalized, federally insured credit unions to offer unsecured business loans) and introduced a new risk area for NCUA to monitor. (Appendix VII provides a detailed description of changes to this and other NCUA rules and regulations since 1992.)

While member business loans are still a relatively small percentage of credit union loans (2 percent) and there are statutory limits placed on these loans, NCUA’s recently revised rules could result in credit unions making more of these loans. The Department of the Treasury has raised concerns that allowing credit unions to engage in unsecured member business loans to take advantage of this training. However, NCUA had not specifically consulted with other depository institution regulators on how these regulators addressed the challenge of training their specialists as banks and thrifts had become more complex over time.

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68FFIEC is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision. FFIEC also serves to make recommendations to promote uniformity in the supervision of financial institutions.

69See 68 Fed. Reg. 56537 (Oct. 1, 2003). Under NCUA’s prior regulations, all business loans to members had to be secured by collateral. Under the revised rule, NCUA now allows well-capitalized credit unions that have addressed unsecured loans in their member business loan policies to make unsecured business loans to members. These loans are subject to the limit that (1) the aggregate unsecured business loans to one borrower not exceed the lesser of $100,000 or 2.5 percent of a credit union’s net worth and (2) the aggregate of all unsecured business loans not exceed 10 percent of a credit union’s net worth. The revised rule also permits the exclusion of participation interests—credit union purchases of an interest in a loan originated by another credit union—in member business loans from the aggregate business loan limit, provided that the loan was for a nonmember of the purchasing credit union. However, the total of nonmember and member business loans may only exceed the aggregate business loan limit if approved by NCUA regional directors. Finally, the revised rule expands preapproved CUSO activities to include business loan originations.

70Under CUMAA, credit unions had an aggregate business loan limit of the lesser of 1.75 times the credit union’s net worth or 12.25 percent of the credit union’s total assets.
Variability in State Oversight May Constrain NCUA's Ability to Monitor Risks to NCUSIF Posed by Federally Insured, State-chartered Credit Unions

Variability in levels of state oversight and resources, NCUA may face challenges in implementing the risk-focused program at the state level. Lack of examiner resources and expertise in some states, high state examiner turnover, and weakness of enforcement by some state regulators may affect oversight of federally insured, state-chartered credit unions, according to NCUA officials.

Due to variability in levels of state oversight and resources, NCUA may face challenges in implementing the risk-focused program at the state level. Since member business loans constitute only a small percentage of credit union lending, most NCUA examiners will not have significant experience looking at this type of lending activity. In contrast, banks and thrifts offer these loans to a much greater extent than credit unions and their regulators do have experience in this area.

Due to variability in levels of state oversight and resources, NCUA may face challenges in implementing the risk-focused program at the state level. Lack of examiner resources and expertise in some states, high state examiner turnover, and weakness of enforcement by some state regulators may affect oversight of federally insured, state-chartered credit unions, according to NCUA officials.

Variability in levels of state oversight and resources, NCUA may face challenges in implementing the risk-focused program at the state level. Lack of examiner resources and expertise in some states, high state examiner turnover, and weakness of enforcement by some state regulators may affect oversight of federally insured, state-chartered credit unions, according to NCUA officials.

While state officials with whom we met had adopted NCUA's risk-focused program and indicated they were generally pleased with NCUA's support, some of these officials indicated that they faced challenges related to oversight of their credit unions. For example, they indicated that budget problems had made it difficult to hire additional staff. In addition, some state officials indicated that they could not compete on pay with the industry, which led to high examiner turnover. A state official from a large state indicated that the increase in credit unions converting from federal to state charters had stretched her examiner resources.

The challenges faced by states are of particular concern given that state supervisors have primary responsibility for examining federally insured, state-chartered credit unions, which as of December 31, 2002, held 46 percent of industry assets. Inadequate oversight of these state-chartered institutions could have a negative impact on the financial condition of NCUSIF. The FDIC and Federal Reserve share oversight responsibility with state supervisors for state-chartered banks, and these regulators also face challenges similar to those faced by NCUA with regard to variability in state oversight.

71Department of the Treasury comment letter concerning NCUA's proposed rule on member business lending, dated June 2, 2003. Further, Treasury stated that excluding business participation loans and business loans originated by CUSOs from member business loan limits would undermine the intent of congressional limitations on credit union business loans established in CUMAA.
In commenting on how it addressed some of the issues facing states, NCUA officials told us that in cases where states lacked examiner resources or expertise, NCUA provided its own staff to ensure that federally insured, state-chartered credit unions were adequately examined. In addition, NCUA conducted joint examinations with state supervisors on selected federally insured, state-chartered credit unions to assess the risk they posed to NCUSIF. Some state officials with whom we met raised concerns over joint examinations, claiming that NCUA examiners tried to impose federal regulations on these state-chartered credit unions. These state officials also expressed concern over NCUA's process for developing its overhead transfer rate, which they claimed was not transparent. We discuss the overhead transfer rate more fully later in this report.

NCUA Lacks Authority to Examine Third-party Vendors

As we reported in July 1999, NCUA does not have the third-party oversight authority provided to other federal banking regulators, and the lack of such authority could limit NCUA's effectiveness in ensuring the safety and soundness of credit unions. Credit unions are increasingly relying on third-party vendors to support technology-related functions such as Internet banking, transaction processing, and funds transfers. While these third-party arrangements can help credit unions manage costs, provide expertise, and improve services to members, they also present risks such as threats to security of systems, availability and integrity of systems, and confidentiality of information. With greater reliance on third-party vendors, credit unions subject themselves to operational and reputation risks if they do not manage these vendors appropriately. Although NCUA received authority to examine third-party vendors as part of the year 2000 readiness effort, this authority was temporary and expired on December 31, 2001.

While NCUA has issued guidance regarding due diligence that credit unions should be applying to third-party vendors, NCUA must ask for permission to examine third-party vendors. Without vendor examination authority, NCUA has no enforcement powers to ensure full and accurate disclosure. For instance, in one case NCUA was denied access by a third-party vendor that provides record-keeping services for 99 federally insured credit unions.

72The overhead transfer rate is the percentage of NCUAs share insurance fund (NCUSIF) that is transferred to support the agency's expenses (operating fund).

Credit Unions with assets over $500 million are required to obtain an annual independent audit of financial statements by an independent certified public accountant, but unlike banks and thrifts, these credit unions are not required to report on the effectiveness of their internal controls for financial reporting. Under FDICIA and its implementing regulations, banks and thrifts with assets over $500 million are required to prepare an annual management report that contains

- a statement of management’s responsibility for preparing the institution’s annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness; and

- management’s assessment of the effectiveness of the institution’s internal control structure and procedures for financial reporting as of the end of the fiscal year and the institution’s compliance with the designated safety and soundness laws and regulations during the fiscal year.\(^74\)

Additionally, the institution’s independent accountants are required to attest to management’s assertions concerning the effectiveness of the institution’s internal control structure and procedures for financial reporting. The institution’s management report and the accountant’s attestation report must be filed with the institution’s primary federal regulator and any appropriate state depository institution supervisor and must be available for public inspection. These reports allow depository institution regulators to gain increased assurance about the reliability of financial reporting.

Banks reporting requirements under FDICIA are similar to the reporting requirement included in the Sarbanes-Oxley Act of 2002. Under Sarbanes-Oxley, public companies are required to establish and maintain adequate internal control structures and procedures for financial reporting and the company's auditor is required to attest to, and report on, the assessment made by company management on the effectiveness of internal controls. As a result of FDICIA and Sarbanes-Oxley, reports on management's assessment of the effectiveness of internal controls over financial reporting and the independent auditor's attestation on management's assessment have become normal business practice for financial institutions and many companies. Extension of the internal control reporting requirement to credit unions with assets over $500 million could provide NCUA with an additional tool to assess the reliability of internal controls over financial reporting.

NCUA Implemented PCA as Mandated by CUMAA, but Few Actions Taken to Date

In August 2000, NCUA initially implemented PCA for credit unions. CUMAA mandated that NCUA implement a PCA program in order to minimize losses to NCUSIF. Under the program, credit unions and NCUA are to take certain actions based on a credit union’s net worth. Other depository institution regulators were required to implement PCA in December 1992. PCA was intended to be an additional tool in NCUA’s arsenal and did not preclude NCUA from taking administrative actions, such as cease and desist orders, civil money penalties, conservatorship, or liquidation of credit unions.

CUMAA requires credit unions to take up to four mandatory supervisory actions—an earnings transfer, submission of an acceptable net worth restoration plan, a restriction on asset growth, and a restriction on member business lending—depending on their net worth ratios. Credit unions that are adequately capitalized (net worth ratio from 6.0 to 6.99 percent) are

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75 A credit union’s net worth represents the sum of the various reserve accounts—undivided earnings, regular reserves, and any other appropriations designated by management or regulatory authorities—and reflect the cumulative net retained earnings of the credit union since its inception.

76 The net worth ratio is defined as net worth divided by total assets.
required to take an earnings transfer. Credit unions that are
undercapitalized (net worth ratio from 4.0 to 5.99 percent), significantly
undercapitalized (net worth ratio from 2.0 to 3.99 percent), or critically
undercapitalized (net worth ratio of less than 2 percent) are required to
take all four mandatory supervisory actions.

CUMAA also required NCUA to develop discretionary supervisory actions,
such as dismissing officers or directors of an undercapitalized credit union,
to complement the prescribed actions under the PCA program. CUMAA
also authorized NCUA to implement an alternative system for new credit
unions in recognition that these credit unions typically start off with zero
net worth and gradually build their net worth through retained earnings.
Appendix IX provides more detail on NCUA's implementation of PCA.

To date, NCUA has taken few actions against credit unions under the PCA
program due to a generally favorable economic climate for credit unions.
As of December 31, 2002, NCUA took mandatory supervisory actions
against 2.8 percent (276 of 9,688) of federally insured credit unions. Of
these credit unions, the vast majority—92 percent or 253—had under $50
million in assets. Further, 41 percent (113 of 276) of these credit unions
were required to develop net worth restoration plans. However, it is too
erly to tell how effective these plans will be in improving the condition of
the credit unions or minimizing losses to NCUSIF.

Credit unions were similar to banks and thrifts with respect to PCA capital
categorization with 97.6 percent of credit unions considered well-
capitalized compared to 98.5 percent of banks and thrifts (see table 2).
However, a slightly higher percentage of credit unions were
undercapitalized, significantly undercapitalized, and critically
undercapitalized than banks and thrifts.

Credit unions are defined as new if they have been in operation for less than 10 years and
have less than $10 million in assets.
Table 2: Federally Insured Credit Unions Were Similar to Banks and Thrifts with Respect to Capital Categories, as of December 31, 2002

<table>
<thead>
<tr>
<th>Capital categorya</th>
<th>Credit unions (number)b</th>
<th>Percent</th>
<th>Banks/ thrifts (number)</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well-capitalized</td>
<td>9,363</td>
<td>97.6</td>
<td>9,210</td>
<td>98.5</td>
</tr>
<tr>
<td>Adequately capitalized</td>
<td>153</td>
<td>1.6</td>
<td>134</td>
<td>1.4</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>61</td>
<td>0.6</td>
<td>6</td>
<td>0.1</td>
</tr>
<tr>
<td>Significantly undercapitalized</td>
<td>10</td>
<td>0.1</td>
<td>2</td>
<td>0.0</td>
</tr>
<tr>
<td>Critically undercapitalized</td>
<td>10</td>
<td>0.1</td>
<td>2</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>9,597</strong></td>
<td><strong>100.0</strong></td>
<td><strong>9,354</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Sources: NCUA and FDIC.

Note: Does not include new credit unions.

aAlthough the categories triggering PCA actions are the same for both the bank regulators and NCUA, the capital requirements underlying these categories are different.

bNumbers reported by NCUA as of May 2003.

Some NCUA, state, and industry officials claimed that PCA was beneficial because it provided standard criteria for taking supervisory actions and was a good way to restrain rapid growth of assets relative to capital. However, many state officials expressed concern over PCA due to the limited ability of credit unions to increase their net worth quickly, because they can only do so through retained earnings. They indicated that if a credit union were subject to PCA, it would be difficult for that credit union, particularly a smaller one, to increase capital and graduate out of PCA. In contrast, other financial institutions are able to raise capital more quickly through the sale of stock.

Some of these state officials raised the issue of whether credit unions should likewise have a means to raise capital quickly by allowing credit unions to use secondary capital toward their capital requirement under PCA. Texas allowed its state-chartered credit unions to raise secondary capital even though the secondary capital could not count towards PCA.

Secondary capital can take the form of investments in an institution by nonmembers. The investments are subordinated to all other credit union debt. Currently, only credit unions designated as “low-income” by NCUA are eligible to raise secondary capital.

This secondary capital must be in accordance with generally accepted accounting principles.
According to the Texas credit union regulator, no credit unions had taken advantage of the state’s secondary capital provision. Currently there is a debate in the industry on whether secondary capital is appropriate for credit unions. While some in the industry favor secondary capital as a way to help credit union avoid actions under PCA, others have raised the concern that allowing credit unions to raise secondary capital (for example, in the form of nonmember deposits) could change the structure and character of credit unions by changing the mutual ownership. As of September 2003, NCUA had not taken a position on secondary capital.

Another concern raised by NCUA officials is in regard to the most appropriate measure of the net worth ratio for PCA purposes. NCUA officials have suggested using risk-based assets, rather than total assets, to calculate the net worth ratio of credit unions because they believe risk-based assets more clearly reflect the risks inherent in credit unions’ portfolios. NCUA officials recognize that, similar to banks, a minimum net worth ratio based on total assets (tangible equity for banks and thrifts) would still be needed for those institutions that are critically undercapitalized. For most credit unions, risk-based assets are less than total assets; therefore, a given amount of capital would have a higher net worth ratio if risk-based assets were used. While there may be some merit in using risk-based assets, credit unions have been subject to PCA programs for a short time, and the advantages and disadvantages of the current programs are not yet evident.

Finally, some NCUA officials raised the concern that PCA has led to more liquidations of problem credit unions. In the past, NCUA sought merger partners for problem credit unions. However, NCUA officials told us that it was more difficult to find merger partners because stronger credit unions were concerned that their net worth ratio would be lowered by merging with problem credit unions, thereby putting them closer to the 7.0 percent net worth ratio that triggers PCA. As a result, the cost of mergers has increased under PCA because NCUA would have to provide greater incentives to a potential partner, and that has forced the agency to liquidate credit unions to a greater extent than prior to PCA. While the initial costs of liquidations appear to be high, the purpose of PCA is to reduce the likelihood of regulatory forbearance and protect the federal deposit (share)
NCUSIF’s Financial Condition Appears Satisfactory, but Methodologies for Overhead Transfer Rate, Insurance Pricing, and Estimated Loss Reserve Need Improvement

Indicators of the financial condition and performance of NCUSIF have generally been stable over the past decade. NCUSIF’s fund equity ratio—a measure of the fund’s equity available to cover losses on insured deposits—was within statutory requirements at December 31, 2002, as it has been over the past decade.\textsuperscript{83}

CUMAA defines the “normal operating level” for the fund’s equity ratio as a range from 1.20 percent to 1.50 percent. CUMAA has designated the NCUA board to evaluate and set the specific operating level for the fund equity ratio. In setting the level, the board considers current industry and fund conditions, as well as the future economic outlook. For 2002, NCUA’s board

\textsuperscript{82}Regulatory forbearance occurs when regulators delay taking corrective action, assuming that problems will not occur in the short-term, or that economic conditions may change in a way favorable to the troubled institution.

\textsuperscript{83}The ratio is calculated as the fund balance (assets minus liabilities) of NCUSIF divided by the sum of all credit union members’ shares insured by the fund.
set the specific operating level at 1.30 percent. If the equity ratio exceeds the board's determined operating level, CUMAA requires NCUA to distribute to contributing credit unions an amount sufficient to reduce the equity ratio to the operating level. Also, should the equity ratio fall below the minimum rate of 1.20 percent, under CUMAA, NCUA's board must assess a premium until the equity ratio is restored to and can be maintained at 1.20 percent. (See appendix X for a more detailed discussion of the funding process and accounting for NCUSIF.)

Between 1991 and 2002, the equity ratio has fluctuated between 1.23 percent and 1.30 percent, a rate that has remained in line with legal requirements (see fig. 12). As of December 31, 2002, the ratio of fund equity to insured shares for NCUSIF as reported by NCUA was 1.27 percent.

**Figure 12: NCUSIF’s Equity Ratio, 1991–2002**

<table>
<thead>
<tr>
<th>Year</th>
<th>Equity Ratio</th>
</tr>
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<tbody>
<tr>
<td>1991</td>
<td>1.18</td>
</tr>
<tr>
<td>1992</td>
<td>1.22</td>
</tr>
<tr>
<td>1993</td>
<td>1.24</td>
</tr>
<tr>
<td>1994</td>
<td>1.26</td>
</tr>
<tr>
<td>1995</td>
<td>1.28</td>
</tr>
<tr>
<td>1996</td>
<td>1.30</td>
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<tr>
<td>1997</td>
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<td>2000</td>
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<tr>
<td>2001</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
</tr>
</tbody>
</table>

NCUSIF’s ratio can be usefully compared with the only other share or deposit insurance funds in the United States currently—FDIC’s Bank Insurance Fund (BIF), which insures banks, and its Savings Association Insurance Fund (SAIF), which insures thrifts; and ASI, which insures state-chartered credit unions that are not federally insured. The NCUSIF ratio
was comparable with the other share and deposit insurance funds as of December 31, 2002 (see fig. 13).

![Figure 13: Equity to Insured Shares or Deposits of the Various Insurance Funds](image)

NCUSIF’s earnings—principally derived from its investment portfolio, which has increased significantly since 1991—have been sufficient to

- cover operating expenses and losses from insured credit union failures;
- make additions to its equity with the net income that is retained by the fund;
- maintain its equity in accordance with legal requirements;
- maintain its allowance for anticipated losses on insured deposits;
- avoid assessing premiums, except for 1991 and 1992; and
- make, in some years, distributions to insured credit unions.

NCUSIF’s net income has remained positive through 2002 and had generally been increasing since 1993, until significant declines occurred in 2001 and 2002 (see fig. 14). The declines were due to a combination of
decreased yields from the investment portfolio, an increase in the overhead transfer rate, and larger insurance losses on failed credit unions. The investment portfolio of NCUSIF consists entirely of U.S. Treasury securities. Yields on these securities have declined—for example, from 6.07 percent in 2000 to 5.10 percent in 2001 and to 3.18 percent in 2002 on its 1-to 5-year maturities—following similar general declines in market yields for Treasury securities. Of the $40.2 million net income decline between 2000 and 2001, $22.2 million of the decline was attributable to increases in the overhead transfer rate, and $15.3 million was attributable to declines in investment income. Of the $47.5 million decline in net income between 2001 and 2002, $39.6 million was attributable to declines in investment income, while $12.5 million was attributable to provision for insurance losses. At the same time, operating expenses decreased by $5.1 million. For 2003, interest rates have continued to decline, which will likely continue to negatively affect investment earnings.

Figure 14: Net Income of NCUSIF, 1990–2002
Dollars in thousands

The sharp increase in the overhead transfer rate and its negative impact on NCUSIF’s net income have raised questions about NCUA’s process for determining the transfer rate. The Federal Credit Union Act of 1934 created the Operating Fund for the purpose of providing administration and service
to the credit union system—for example, the supervision and regulation of the federally chartered credit unions.

NCUA's Operating Fund is financed through assessment of annual fees to federally chartered credit unions as well as the overhead transfer from NCUSIF (see fig. 15). Federally chartered credit unions are assessed an annual fee by the Operating Fund based on the credit union’s asset size as of the prior December 31. The fee is designed to cover the costs of providing administration and service, as well as regulatory examinations to the Federal Credit Union System. NCUA’s board reviews the fee structure annually. The overhead transfer from NCUSIF for administrative services provides a substantial portion of funding for the Operating Fund. The annual rate for the overhead transfer is set by NCUA’s board based on periodic surveys of NCUA staff time spent on insurance-related activities compared with noninsurance-related, or regulatory, activities. An amount of overhead or administrative expense is transferred to NCUSIF in proportion to staff time spent on insurance-related activities. The overhead transfer is intended to account for NCUA staff being responsible for both insurance and supervisory-related activities.

**Figure 15: Financing Sources of NCUSIF and NCUA’s Operating Fund**

Between 1986 and 2000, the transfer rate was 50 percent, which, according to NCUA management, was based on surveys that indicated staff time was equally split between insurance and regulatory activities. For example, 50
percent of the Operating Fund’s $127.6 million, or $63.8 million, in expenses for 2000 were allocated to and paid by NCUSIF. For 2001, NCUA’s Board of Directors increased the overhead transfer rate to 67 percent on the basis that Operating Fund staff had increased their insurance-related activities. This resulted in a $24.7 million increase (almost 40 percent) from 2000 in the amount being allocated to NCUSIF. For 2002 and 2003, the NCUA board lowered the 67-percent overhead transfer rate to 62 percent by adjusting downward its allocation of what it considered “nonproductive” time factors such as employee administrative and education time used in the 2001 survey because it was reflective of regulatory rather than insurance-related activities.

In September 2001, NCUA management engaged its financial audit firm, Deloitte & Touche, to review the basis on which the transfer rate was determined. The auditor’s report contained several recommendations that indicated that NCUA’s 2001 survey of staff time spent on insurance-related functions—the primary basis on which NCUA allocates administrative expenses—may not have resulted in an accurate allocation. The lack of a clear separation of the insurance and supervisory functions had also been the focus of a recommendation in our 1991 report (still unimplemented) that NCUA should establish separate supervision and insurance offices. The 2001 recommendations from NCUA’s financial audit firm included improvements in communication with staff on the survey process and results, frequency and timing of the survey, methods of survey distribution, and updated documentation of survey definitions and purpose. The auditors also noted that individuals were allocating time after the fact, when recollection may have been faulty, rather than tracking their time concurrently as would be possible if provided the survey and guidelines prior to an assignment. Additionally, the auditors reported that, to provide reliable results, the survey should cover a greater period of time. The limited period used could significantly skew the resulting proportion of activities devoted to insurance versus regulatory activities. The auditor’s recommendations indicated that the survey’s lack of consistency and reliability may have resulted in a misallocation of overhead expenses between the operating and insurance funds. Any misallocation would affect NCUSIF’s financial condition because any increase in the overhead transfer rate results in a decrease of NCUSIF’s net income. Misallocations also can significantly affect the financial results of the Operating Fund. In addition to the auditor’s findings, some federally insured, state-chartered credit

84GAO/GGD-91-85, p. 197.
unions and trade groups have expressed concerns about NCUA’s calculation of its overhead transfer rate. Primarily, they say that NCUA has not clearly defined insurance and regulatory functions, and its methodology for determining the overhead transfer rate is not transparent or understandable to participating credit unions.

According to NCUA’s management, NCUA has begun implementing Deloitte & Touche’s recommendations. For example, selected field examiners are now completing surveys in a timely manner for periods covering a full year. However, headquarters staff are not required to complete the surveys as management asserts the split of their time mirrors that of field examiners. In addition, the transfer rate is calculated and approved by management every few years. However conditions can change that may result in the transfer rate not representing the current condition. Changing workloads and conditions can also cause a significant change in future rates.

Federal Credit Union Insurance Pricing Is Not Based on Risk to Insurer

The Federal Credit Union Act requires all federally insured credit unions to allocate 1 percent of their insured shares to NCUSIF. This flat rate does not take into consideration variations in risk posed by individual credit unions. Although FDIC had implemented a version of risk-based pricing in 1993, FDIC has continued to study options for improving deposit insurance funding. FDIC’s suggestions for improvement were issued in a 2001 report that noted the cost of insurance, regardless of type (property, casualty, or life), in the private sector is priced based upon the risk assumed by the insurer. Premiums and loss experience are generally actuarially determined, such that increased risk equates to increased cost. Since passage of FDICIA in 1991, deposit insurance for banks and thrifts are adjusted for some risk, and since December 31, 2000, private-sector insurance for credit union shares has been adjusted for risk. (See appendix X for additional information on accounting for insurance.) While BIF and SAIF are adjusted for some risk, FDIC has made additional proposals for enhancing the risk-based nature of its insurance pricing. For instance, the current BIF and SAIF funding does not require a fast-growing institution to pay premiums if it is well capitalized and CAMEL-rated 1 or 2. As a result, FDIC has proposed that the pricing structure for BIF and SAIF

be amended so that fast-growing institutions would be required to pay premiums.

NCUSIF is the only share or deposit insurer that has not adopted a risk-based insurance structure. Therefore, some credit unions could be overpaying while others could be underpaying if their current rates were compared to their risk profiles—with the cost of insurance not being equitable based on the level of risk posed to NCUSIF by individual credit unions. In contrast, FDIC's BIF and SAIF and ASI currently operate on a risk-based capitalization structure. Depository institutions insured by BIF and SAIF pay a premium twice a year based upon their capital levels and supervisory ratings, with institutions with the lowest capital levels and worst supervisory ratings paying higher premiums. ASI's insurance fund requires its insured credit unions to maintain deposits between 1.0 and 1.3 percent of their insured shares. The amount for each credit union is determined based upon its supervisory rating, with lower-rated credit unions maintaining higher deposits.

The risk-based structure has certain advantages. First, by varying pricing according to risk, more of the burden is distributed to those members that put an insurance fund at greater risk of loss. Second, risk-based pricing provides an incentive for member owners and managers of credit unions to control their risk. Finally, risk-based pricing helps regulators focus on higher-risk credit unions by enabling them to allocate their insurance activities in proportion to the price charged. During our review, members of NCUA's management told us that they believe that risk-based pricing would adversely affect small credit unions and suggested that an option would be to add risk-based pricing only for credit unions over a certain size. By not having risk-based insurance structure, NCUSIF puts a disproportionate share of the pricing burden on less-risky credit unions and does not provide an incentive through pricing for owners and managers to control their risk.

Management’s Estimation of Insured Share Losses Does Not Reflect Specific Loss Rates

NCUA's process for determining estimated losses from insured credit unions—the largest potential liability of the fund—does not reflect current economic conditions and loss exposures of credit unions with varying risk. The estimated liability balance is established to cover probable and estimable losses as a result of federally insured credit union failures. The estimated liability balance is reduced when the insurance claims are actually paid. NCUSIF's estimated liability for losses was $48 million at December 31, 2002.
In 2002, NCUA’s management analyzed historical loss trends over varying periods of time in order to assess whether the estimated liability for losses was adequate. It analyzed historical rates of insurance payouts for the past 3-year, 5-year, 10-year, and 15-year averages. The 15-year analysis encompassed an economic period of dramatic losses, which management contends may be cyclical and indicative of future exposure, although not necessarily indicative of current economic conditions. As a result of this analysis, in July 2002, management began building the estimated losses account balance by $1.5 million a month to $60 million (from $48 million at December 31, 2002), the amount the analysis determined would be needed to cover identified and anticipated losses.

NCUA’s estimation method does not identify specific historical failure rates and related loss rates for the group of credit unions that had been identified as troubled, but instead specifically calculates expected losses for each problem credit union, if it is determined that a particular credit union is likely to fail. This methodology essentially assigns a probability of failure of either zero or 100 percent to each individual credit union considered to be troubled. By not considering specific historical failure rates and loss rates in its methodology, NCUA is using an over-simplified estimation method. As a result, NCUA may not be achieving the best estimate of probable losses. Therefore, NCUA may be over or underestimating its probable losses because it does not apply more targeted and specific loss rates to currently identified problem institutions, but instead, makes a determination that essentially selects from two probabilities: zero or 100-percent probability of failure.

From 2000 to 2002, the amount of insured shares in problem credit unions doubled, going from $1.5 billion insured shares in 2000 to nearly $3 billion insured shares in 2002. The increase in insured shares of problem credit unions may be an indicator of larger future losses to the fund, since problem credit unions are more likely to fail. In addition, recent increases the share payouts show that the insurance fund is suffering from increasing losses that totaled $40 million in 2002. At the same time, the estimated loss reserve, which is intended to cover actual losses, has been declining since 1994. As a result the cushion between payouts for insurance losses and the reserve balance became increasingly smaller between 2001 and 2002 (see fig. 16). Given the recent trends, it is especially important to utilize specific data on failure rates for troubled institutions.
Figure 16: Share Payouts and Reserve Balance, 1990–2002

In contrast to NCUA’s method, FDIC’s method records estimated bank and thrift insurance losses based on a detailed analysis of institutions in five risk-based groups. The first group consists of institutions classified as having a 100-percent expected failure rate. This determination is based on the scheduled closing date for the institution, the classification of the institution as “critically undercapitalized,” or identification of the institution as an imminent failure. The remaining four risk groups are based on federal and state supervisory ratings and the institutions’ projected capitalization levels. Every quarter, FDIC meets with representatives from other federal financial regulatory agencies to discuss these groupings and ensure that each institution is appropriately grouped based on the most recent supervisory information. Also on a quarterly basis, FDIC’s Financial Risk Committee (FRC), an interdivisional committee, meets to discuss and determine the appropriate projected failure rates to be applied to each of
the four remaining risk-based groups.\textsuperscript{86} The projected failure rate for each risk-based group is multiplied by the assets of each institution in that group, which results in expected failed assets. Expected failed assets are then multiplied by an expected loss experience rate, the product of which results in the loss estimate for anticipated failures. The projected failure rates for the remaining four risk-based groups are based on historical failure rates for those categories. However, FRC has the responsibility for determining if the historical failure rates for each group are appropriate given the current and expected condition of the industry and may adjust failure rates, if necessary. The expected loss experience rates have been based on asset size and reflect FDIC’s historical loss experience for banks of different sizes. FRC may also use loss rates based on institution-specific supervisory information rather than the historical rates. This process, as implemented by FDIC, results in a more targeted estimation process that specifically captures current changes in the risk profile of insured institutions.

System Risk That May Be Associated with Private Share Insurance Appears to Have Decreased, but Some Concerns Remain

The amount of insured shares and the number of privately insured credit unions and providers of private primary share insurance have declined significantly since 1990. Specifically, 1,462 credit unions purchased private share insurance in 1990 compared with 212 credit unions as of December 2002. During the same period, the total amount of privately insured shares decreased by 42 percent ($18.6 billion to about $10.8 billion). Although the use of private share insurance has declined, some circumstances of the remaining private insurer, ASI, raise concerns. First, ASI’s risks are concentrated in a few large credit unions and in certain states. Second, ASI has a limited ability to absorb catastrophic losses because it does not have the backing of any governmental entity and its lines of credit are limited in the aggregate as to the amount and available collateral. To mitigate its risks, ASI has implemented a number of risk-management strategies, such as increased monitoring of its largest credit unions. State oversight mechanisms of the remaining private share insurer and privately insured credit unions also provide some additional assurance that ASI and the

\textsuperscript{86}The Financial Risk Committee consists of representatives from four divisions within FDIC: Insurance and Research, Resolutions and Receiverships, Supervision and Consumer Protection, and Finance. FDIC maintains statistics on the percentage of institutions within different risk categories that fail based on the ratio of failed institutions’ assets to total assets. For purposes of this report the term “failure rate” is used to describe this statistic. A 100-percent projected failure rate is always applied to the first risk-based group.
credit unions it insures operate in a safe and sound manner. One additional concern, as we recently reported, is that many privately insured credit unions failed to make required disclosures about not being federally insured and, therefore, the members of these credit unions may not have been adequately informed that their deposits lacked federal deposit insurance.

**Few Credit Unions Are Privately Insured**

Compared with federally insured credit unions, relatively few credit unions are privately insured. As of December 2002, 212 credit unions—about 2 percent of all credit unions—chose to purchase private primary share insurance. These privately insured credit unions were located in eight states and had about 1.1 million members with shares totaling about $10.8 billion, as of December 2002—a little over 1 percent of all credit union members and 2 percent of all credit union shares. In contrast, as of December 2002, there were 9,688 federally insured credit unions with about 81 million members and shares totaling $483 billion.

Through a survey of 50 state regulators and related follow-on discussions with the regulators, we identified nine additional states that could permit credit unions to purchase private share insurance. Figure 17 illustrates the states that permit or could permit private share insurance as of March 2003 and the number of privately insured credit unions as of December 2002.

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87Our review focuses on primary share insurance. Generally, primary share (or deposit) insurance is mandatory for all depository institutions and covers members’ deposits up to a specified amount. Excess share (deposit) insurance is optional coverage above the amount provided by primary share insurance. NCUSIF provides primary share insurance up to $100,000 per member; while ASI provides primary share insurance up to $250,000 per account and excess share insurance. ASI is chartered by Ohio statute. ASI’s coverage is subject to a $250,000 statutory cap under Ohio law. Ohio Rev. Code Ann. § 1761.09(A), (Anderson, 2003).

88States that “could permit” private share insurance include those with state laws permitting credit unions to purchase private share insurance, but that have no credit unions in the state that currently carry private share insurance.
The number of privately insured credit unions and private share insurers has declined significantly since 1990. In 1990, 1,462 credit unions in 23 states purchased private share insurance from 10 different nonfederal, private insurers, with shares at these credit unions totaling $18.6 billion. Between 1990 and 2002, the amount of privately insured shares decreased 42 percent to about $10.8 billion. Shortly after the failure of Rhode Island Share and Depositors Indemnity Corporation (RISDIC), a private share insurer in Rhode Island in 1991, almost half of all privately insured credit unions converted to federal share insurance voluntarily or by state...
mandate. As a result of the conversions from private to federal share insurance, most private share insurers have gone out of business due to the loss of their membership since 1990; only one company, ASI, currently offers private primary share insurance.

In states that currently permit private share insurance, a comparable number of credit unions have converted from federal to private share insurance and from private to federal share insurance since 1990—31 and 26, respectively. Most of the conversions from federal to private share insurance (26 of 31) occurred since 1997. According to management at many privately insured credit unions, they converted to private share insurance to obtain higher coverage and avoid federal rules and regulation. Additionally, management at these credit unions noted that they were satisfied with the service they received from the private share insurer and all but one planned to remain privately insured. According to NCUA—in states that currently permit private share insurance—since 1990, 26 credit unions converted from private to federal share insurance; the majority did so in the early 1990s, following the RISDIC failure and widespread concern over the safety and soundness of private share insurance. Most of the 26 credit unions planned to continue to purchase federal share insurance.

Several factors precipitated the closure of RISDIC in 1991. For example, weaknesses existed in the Rhode Island bank regulator's and RISDIC's oversight of institutions. Furthermore, some of the institutions insured by RISDIC engaged in high-risk activities. In 1991, RISDIC depleted its reserves because of the failure of one institution. As a result, runs occurred at several other institutions insured by RISDIC; it was not able to meet its insurance obligations and was forced to call in a conservator. The Governor of Rhode Island closed all institutions insured by RISDIC and required institutions to purchase federal deposit insurance. According to NCUA, it did not insure all Rhode Island credit unions following the Governor's closure of institutions insured by RISDIC.

As of December 2002, we identified two companies that provided private primary share insurance in the 50 states and the District of Columbia—ASI and Credit Union Insurance Corporation (CUIC) in Maryland. However, CUIC was in the process of dissolution and, therefore, we did not include it in our analysis. As of August 2003, of the five credit unions that CUIC insured, four purchased private share insurance from ASI, and one converted to federal share insurance.

Generally, credit unions that converted from federal to private share insurance since 1990 were larger than credit unions that switched from private to federal share insurance during the same period. Specifically, as of December 2002, about a third of the credit unions that converted to private insurance had shares between $100 and $500 million; on the other hand, the majority of credit unions that converted to federal insurance had shares totaling up to $50 million. Only two of the 26 conversions occurred since 1995—one because the private insurer went out of business and the other because of a merger with a federally insured credit union.
either because they were reasonably satisfied or because they viewed having their share insurance backed by the federal government as a benefit.

**Risks Exist at Remaining Private Share Insurer, but Certain Factors Help to Mitigate Concerns**

Although the use of private share insurance has declined, we found two aspects of the remaining private insurer that raise potential safety and soundness concerns. First, ASI faces a concentration of risk in a few large credit unions and certain states. Second, ASI has limited borrowing capacity and could find it difficult to cover catastrophic losses under extreme economic conditions because it does not have the backing of any governmental agency, its lines of credit are limited in the aggregate as to the amount and available collateral, and it has no reinsurance for its primary share insurance. To help mitigate these risks, ASI has taken steps to increase its monitoring of its largest credit unions and is using other strategies to limit its risks. In addition, as a regulated entity, state regulation of ASI and the credit unions it insures provides some additional assurance that ASI and the credit unions operate in a safe and sound manner.

**Risks of Remaining Private Insurer Concentrated in a Few Credit Unions and States**

ASI is chartered in Ohio statute as a credit union share guaranty corporation. As specified in Ohio statute, the purpose of such a corporation includes guaranteeing payment of all or a part of a participating credit union share account. Although ASI is commonly referred to as a provider of insurance, it is not subject to all of Ohio’s insurance laws. For example, ASI is not subject to Ohio’s insurance law that limits the risk exposure of an insurance company. Specifically, while Ohio insurance companies are subject to a “maximum single risk” requirement—“no insured institution’s coverage should comprise more than 20 percent of the admitted assets, or three times the average risk or 1

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93Ohio Rev. Code Ann. § 1761.03. Under Ohio law, other purposes of a credit union share guaranty corporation are to (1) aid and assist any participating credit union that is in liquidation or incurs financial difficulty in order that the credit union share accounts are protected or guaranteed against losses, and (2) cooperate with participating credit unions, the superintendent of credit unions, the appropriate credit union supervisory authorities, and the NCUA for the purpose of advancing the general welfare of credit unions in Ohio and in other states where participating credit unions operate.

94In Ohio, credit union guaranty corporations are subject to many Ohio insurance laws; however, they apply only to the extent that such laws are otherwise applicable and are not in conflict with Ohio laws for credit union guaranty corporations. See Ohio Rev. Code Ann. 1761.04(A).
percent of insured shares, whichever is greater”—Ohio has not imposed this requirement on ASI. Although ASI is not subject to this requirement, we found that ASI exceeded this concentration limit. For example, one credit union made up about 25 percent of ASI’s total insured shares, as of December 2002. In contrast, the largest federally insured credit union accounted for only 3 percent of NCUSIF’s total insured shares. Other concentration risks exist; for example, we found that 45 percent of ASI’s total insured shares were located in one state (California). Further, all of ASI’s insured credit unions were located in only eight states, with almost half being located in one state (Ohio), which represents 14 percent of all ASI-insured shares. In contrast, 14.3 percent of federally insured credit union shares were located in one state (California). The credit unions that NCUSIF insures are located in 50 states and the District of Columbia, with the largest percentage (8 percent) of credit unions located in one state (Pennsylvania), which represents about 4 percent of NCUSIF’s insured shares.

While we remain concerned about ASI’s concentration of risks, ASI employs a number of risk-management strategies—intended to mitigate its risk exposure in individual institutions—including being selective about which credit unions it insures, conducting regular on- and off-site monitoring of all its insured institutions, implementing a partially adjusted, risk-based insurance pricing policy, and establishing a 30-day termination policy. More specifically, ASI employs the following risk-management strategies:

- To qualify for primary share insurance with ASI, a credit union must meet ASI’s insurance eligibility criteria, which include an analysis of the financial performance of the credit union over a 3-year period and an evaluation of the institution’s operating policies. For example, to qualify for ASI coverage, a credit union’s fixed assets must be limited to 5 percent of the institution’s total assets or the amount permitted by its supervisory authority, whichever is greater, and credit unions must maintain a minimum net capital-to-asset ratio of 4 percent of total assets. In contrast, federal PCA requirements compel federally insured credit unions to maintain a minimum capital to assets ratio of 7 percent.

95 Under Ohio law, insurers licensed by the state are subject to a “maximum single risk” requirement. See Ohio Rev. Code Ann. § 3941.06(B).

96 According to ASI, the average net capital-to-assets ratio of all ASI’s primary insured credit unions was 10.88 percent, as of December 31, 2002.
The credit union also must submit its investment, asset-liability management, and loan policies for ASI’s review. In addition, ASI obtains and reviews the most recent reports from the credit union’s regulator and certified public accountant (CPA) or supervisory committee. Between 1994 and July 2003, ASI denied share insurance coverage to eight credit unions while approving coverage for 31 credit unions.

- ASI also regularly monitors all credit unions it insures. ASI routinely conducts off-site monitoring and conducts on-site examinations of privately insured credit unions at least once every 3 years. It also reviews state examination reports for the credit unions it insures and imposes strict audit requirements. For example, ASI requires an annual CPA audit for credit unions with $20 million or more in assets, while NCUA only requires the annual CPA audit for credit unions with more than $500 million in assets. Further, after insuring a large credit union, ASI implemented a special monitoring plan for its largest credit unions in light of its increased risk exposure. For larger credit unions (those with more than 10 percent of ASI’s total insured shares or the top 5 credit unions in asset size), ASI increased its monitoring by conducting semiannual, on-site examinations, as well as monthly and quarterly off-site monitoring, which included a review of the credit unions’ most recent audits (monthly) and financial information (quarterly). ASI also annually reviews the audited financial statements of these large credit unions. In January 2003, five credit unions with about 40 percent of ASI’s total insured assets qualified for this special monitoring. ASI also began a monitoring strategy intended to increase its oversight of smaller credit unions, due in part to experiencing larger-than-expected losses at

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97For example, federal PCA regulations require supervisory action when federally insured credit unions’ capital to assets ratio is less than 6 percent of total assets.

98Twenty-eight of these credit unions converted from federal insurance, while two were newly chartered credit unions and one was an uninsured credit union.

99As of June 2003, the total shares of these credit unions ranged from $297.6 million to $2.5 billion. Though the plan targeted only ASI’s five largest credit unions, ASI may increase the number of monitored credit unions at any time so that it continually reviews at least 25 percent of total insured shares.
a small credit union in 2002.\textsuperscript{100} ASI determined that 98 smaller credit unions qualified for increased monitoring, with shares from the largest of these smaller credit unions totaling about $23 million.

- ASI also has implemented a partially adjusted, risk-based insurance pricing policy, which produces an incentive for the institutions insured by ASI to obtain a better CAMEL rating, which in turn lowers the risk to ASI’s insurance fund. Like NCUSIF, ASI’s insurance fund is deposit-based; that is, ASI requires credit unions it insures to deposit a specified amount with ASI.\textsuperscript{101} As of December 2002, these deposits with ASI totaled $112 million. Unlike NCUSIF, ASI’s insurance fund is partially adjusted for risk, which acts as a positive, risk-management strategy to mitigate against losses. Specifically, a credit union with a higher, or worse, CAMEL rating is required to deposit more into ASI’s insurance fund.\textsuperscript{102} Conversely, NCUA requires federally insured credit unions to deposit 1.0 percent of insured shares into NCUSIF regardless of their CAMEL ratings.\textsuperscript{103} According to ASI, it also has the contractual ability to reassess all member credit unions up to 3 percent of their total assets to raise additional funds to cover catastrophic loss.

- ASI’s credit union termination policy provides another risk-mitigating strategy that ASI can use to manage its risk exposure to an individual credit union. ASI’s insurance contract identifies several circumstances that would enable ASI to terminate insurance coverage. For example, ASI may terminate a credit union’s insurance with 30 days notice to the

\textsuperscript{100}ASI assigned a risk level to the credit unions it insured (low, moderate, or high) and then used this assessment to determine the extent of oversight at the credit union, which might include conducting face-to-face interviews with the chair of the supervisory audit committee, confirming checks over $1,000 have cleared, or verifying the value of loans, investments, and share accounts with credit union members in writing or over the phone.

\textsuperscript{101}ASI deposit-based insurance fund is funded through capital contributions to ASI from member credit unions. The member credit unions record this capital contribution as a deposit (asset) on their financial statements.

\textsuperscript{102}ASI’s insurance fund is funded through the credit unions it insures depositing between 1.0 and 1.3 percent of a credit union’s insured shares with ASI. The credit unions’ CAMEL ratings determine the rate at which credit unions are assessed (the ratings are 1-strong, 2-satisfactory, 3-flawed, 4-poor, and 5-unsatisfactory). For example, credit unions with a CAMEL score of 1 must deposit 1.0 percent of total insured shares into ASI’s insurance fund; credit unions with a CAMEL score of 4 or 5 must deposit 1.3 percent of their total insured shares.

\textsuperscript{103}12 U.S.C. § 1782a(c).
credit union and its state regulator, if the credit union fails to comply with ASI requirements to remedy any unsafe or unsound conditions or remedy an audit qualification in a timely manner. According to ASI management, it has not terminated a credit union’s share insurance, although ASI has used its termination policy as leverage to force changes at a credit union.¹⁰⁴

When its largest insured credit union applied for primary share insurance, ASI undertook an assessment of its financial and underwriting considerations for insuring this institution.¹⁰⁵ ASI had previously provided excess share insurance to the credit union and was familiar with its financial condition. ASI’s independent actuaries determined that the ASI fund could withstand losses sustained during adverse economic conditions for up to 5 years, with or without insuring this large credit union. Ultimately, ASI’s assessment concluded that the credit union’s financial condition was strong and, although it would increase ASI’s concentration of risks, insuring the credit union would have a favorable financial impact on ASI. According to regulators from the Ohio Department of Commerce, Division of Financial Institutions (Ohio Division of Financial Institutions), they did not take exception to ASI insuring the large credit union and had reviewed ASI’s underwriting assessment and asked to be updated periodically.

Unlike federal share insurance, which is backed by the full faith and credit of the United States, ASI’s insurance fund is not backed by any government entity. Therefore, losses on member deposits in excess of available cash, investments, and other assets of ASI-insured institutions would only be covered up to ASI’s available resources and its secured lines of credit, which serve as a back-up source of funds. According to ASI documents, the terms of ASI’s secured lines of credit required collateralization between 80 and 115 percent of current market value of the U.S. government or agency

¹⁰⁴ASI’s involuntary termination procedure, unlike NCUA’s, does not require a credit union to notify its members that its share insurance has been terminated. According to ASI, because states generally prohibit credit unions from operating without share insurance, the states would require notification to credit union members of the change in the credit union’s insured status. NCUA’s involuntary termination policy, on the other hand, requires 30 days notice and also requires a credit union to issue “prompt and reasonable” notice to its members that it will cease to be insured. 12 U.S.C. §§1786(b), (c).

¹⁰⁵According to ASI documents, this credit union would have represented 22 percent of ASI’s insured shares; at the time of the assessment, ASI’s largest credit union represented only 6 percent of the fund’s insured shares.
securities ASI holds. As a result, ASI's borrowing capacity is essentially limited to the securities it holds. ASI officials also explained that due to the high cost of reinsurance, it has not purchased reinsurance on its primary share insurance, although it has reinsurance for its excess share insurance.

ASI has not had large losses since 1975. ASI has expended funds for 118 claims and its loss experience—from the credit unions that have made claims—has averaged 3.95 percent of the total assets of these credit unions. If ASI's historical loss average of 3.95 percent was tested and proved true for a failure at the largest credit union ASI insured, as of December 2002, the loss amount would be about $119 million. While this would be a major loss, ASI would most likely be able to sustain this loss. ASI's historical loss rate is nearly 60 percent less than the loss rate experienced by NCUSIF for the same period. However, under more stressful conditions, ASI could have difficulty fulfilling its obligations. For example, ASI's five largest credit unions represent nearly 40 percent of insured shares, for which a collective loss at 3.95 percent of the assets of these credit unions would exceed ASI's equity by approximately $30 million. According to ASI, it could raise additional funds to cover catastrophic loss by reassessing all member credit unions up to 3 percent of their total assets, which excluding the top five credit unions, would generate approximately $214 million of additional capital, while maintaining minimum capital levels at 4 percent of total assets. Further, by Ohio statute, the Superintendent of the Division of Financial Institutions can order ASI to reassess its insured credit unions up to the full amount of their capital, which, excluding the top five credit unions, would generate approximately $794 million of funds for ASI with which to pay claims. This recapitalization process is generally similar to that required of NCUSIF before accessing its Treasury line of credit. However, if ASI reassessed its member credit unions during a catastrophic failure, it would further negatively affect these credit unions at a time that they were already facing stressful economic conditions.

State Oversight of ASI and the Credit Unions It Insures Provides Additional Assurance

State regulation of ASI and the privately insured credit unions it insures provides some additional assurance that ASI and privately insured credit unions operate in a safe and sound manner. As a share guaranty

106This estimate is based on using December 2002 financial data on the largest credit union insured by ASI. According to a capital adequacy analysis performed for ASI, ASI's independent actuaries determined that the ASI fund could withstand losses sustained during adverse economic conditions for up to 5 years, with or without insuring this large credit union.
corporation, ASI is subject to state oversight and regulation in those states where ASI insures credit unions. ASI was chartered in Ohio statute, with the Ohio Division of Financial Institutions and the Ohio Department of Insurance dually regulating it. ASI is licensed by the Ohio Superintendent of Insurance and is subject to routine oversight by that department and Ohio's Superintendent of Credit Unions. The Ohio Division of Financial Institutions conducts annual assessments of ASI, which evaluate ASI's underwriting and monitoring procedures, financial soundness, and compliance with Ohio laws. Under Ohio law, its Department of Insurance also is required to examine ASI at least once every 5 years. The last Ohio Department of Insurance exam of ASI was completed in March 1999, which covered January 1995 through December 1997. When we met with Ohio officials in June 2003, they told us that the Ohio Department of Insurance planned to examine ASI in the third quarter of calendar year 2003. ASI is also required to submit annual audited financial statements, including management's attestation, and quarterly unaudited financial statements to Ohio insurance and credit union regulators. Ohio law also requires ASI to provide copies of written communication with regulatory significance to Ohio regulators, obtain the opinion of an actuary attesting to the adequacy of loss reserves established, and apply annually for a license to do business in Ohio. In our discussions with officials from the Ohio Division of Financial Institutions and the Ohio Department of Insurance, we found that, to date, ASI has complied with all requirements and regulations, and no regulators have taken corrective actions against ASI or limited ASI's ability to do business in Ohio.

Generally, state financial regulators have taken the primary lead for monitoring ASI's actions, while state insurance regulators were not as involved in overseeing ASI's operations. All states where ASI insures credit unions have, at some point, formally certified ASI to conduct business in that state. Ohio and Maryland have certified ASI in the past year—as required by governing statutes in those states. Regarding the other states in which ASI operates, while they have not formally recertified ASI, Ohio's


108 While Ohio law requires ASI to submit annual audited financial statements, Ohio law permits the superintendent of insurance to require the submission of quarterly reports. The superintendent of insurance imposes this requirement on ASI. See Ohio Rev. Code Ann. §§ 1761.16 and 3901.42.

109 The states are Alabama, California, Idaho, Illinois, Indiana, Maryland, Nevada, and Ohio.
annual examination process of ASI involves regulators from most states. State credit union regulators from Idaho, Illinois, Indiana, and Nevada commonly participate in this assessment; according to ASI officials, their acceptance of the final examination report infers that they approve of ASI’s continuing operation in their respective states. State credit union regulators from California and Alabama, however, have not participated in the annual on-site assessment of ASI. Regarding monitoring efforts by state insurance regulators, according to ASI, the Ohio Department of Insurance is the only state insurance department that imposes requirements and insurance regulators from Idaho, Illinois, and Nevada only request information.

Most state credit union regulators with whom we met told us they had regular communication with ASI about the credit unions ASI insured. ASI officials reported that they commonly conducted joint, on-site exams of credit unions with state regulators. State credit union regulators imposed safety and soundness standards and carried out examinations of state-chartered credit unions in a way similar to how the federal government oversees federally insured credit unions. According to state regulators, state regulations, standards, and examinations apply to all state-chartered credit unions, regardless of their insurance status (whether federal, private, or noninsured). State credit union regulators reported that they had adopted NCUA’s examination program, and their examiners had received training from NCUA. However, as previously discussed, some state officials with whom we met indicated that they faced challenges related to oversight of their credit unions; for example, some states lacked examiner resources and had high examiner turnover.

Additionally, privately insured credit unions—as compared with federally insured credit unions—are not subject to identical requirements and regulations. For example, while federally insured, state-chartered credit unions are subject to PCA—as discussed earlier, privately insured, state-chartered credit unions are not subject to these federally mandated supervisory actions. Although, as a matter of practice, many state regulators reported that they have the authority to impose capital requirements on privately insured credit unions and could take action when a credit union’s capital levels are not safe and sound. However, state officials in California, Idaho, Illinois, Indiana, Ohio, and Nevada said that their states required privately insured credit unions to maintain specified reserve levels, which were codified in statute or regulation. Additionally, Alabama requires credit unions seeking private insurance to meet certain capital levels.
While some states had specific requirements for credit unions seeking to purchase private share insurance, many states regulators reported that they have the authority to “not approve” the conversion of credit unions to private share insurance. Alabama, Illinois, and Ohio have written guidelines for credit unions seeking to purchase private share insurance and regulators reported that they have the authority to “not approve” a credit union’s purchase of private insurance. The other five states that permitted private share insurance do not have written guidelines for credit unions seeking to purchase private share insurance, but Idaho, Indiana, and Nevada state regulators also noted that they have the authority to “not approve” a credit union’s purchase of private share insurance.

Moreover, NCUA supervised the conversions of federally insured credit unions to private share insurance. Specifically, NCUA has imposed notification requirements on federally insured credit unions seeking to convert to private share insurance and requires an affirmative vote of a majority of the credit union members on the conversion from federal to private share insurance. NCUA has required these credit unions to notify their members, in a disclosure, that if the conversion were approved, the federal government would not insure shares. We reviewed six recent conversions to private share insurance, and found that, prior to NCUA’s termination of the credit union’s federal share insurance, these credit unions, including the large credit union that recently converted to ASI, had generally complied with NCUA’s notification requirements for conversion.

Members of Many Privately Insured Credit Unions Are Not Receiving Required Disclosures about the Lack of Federal Share Insurance

Although actions taken by ASI and some state regulators provide some assurances that ASI is operating in a safe and sound manner, ASI’s concentration risks and limited borrowing capacity raise concerns that under stressful economic conditions it may not be able to fulfill its responsibilities to its membership. Congress determined that it was important for members of privately insured credit unions to be informed

110 Specifically, under the Federal Credit Union Act, if a federally insured credit union terminates federal share insurance or converts to nonfederal (private) insurance, the institution must give its members “prompt and reasonable notice” that the institution has ceased to be federally insured. 12 U.S.C. § 1786(c). NCUA rules implement these provisions by prescribing language to be used in (1) the notices of the credit union’s proposal to terminate federal share insurance or convert to nonfederal (private) insurance, (2) an acknowledgement on the voting ballot of the member’s understanding that federal share insurance will terminate, and (3) the notice of the termination or conversion. See 12 C.F.R. Part 708b (2003).
that their deposits in such institutions were not federally insured. Specifically, among other things, section 43 of the Federal Deposit Insurance Act requires depository institutions lacking federal deposit insurance, which includes privately insured credit unions, to conspicuously disclose to their membership that deposits at these institutions are (1) not federally insured and (2) if the institution fails, the federal government does not guarantee that depositors will get back their money.111 These institutions are required to conspicuously disclose this information on periodic statements of account, signature cards, and passbooks, and on certificates of deposit, or instruments evidencing a deposit (deposit slips). These institutions are also required to conspicuously disclose that the institution is not federally insured at places where deposits are normally received (lobbies) and in advertising (brochures and newsletters).

The Federal Trade Commission (FTC) is responsible for enforcing compliance with section 43.112 However, FTC has never taken action to enforce these requirements, and has sought and obtained in its appropriations authority a prohibition against spending appropriated funds to carry out these provisions. We recently reported that because of a lack of federal enforcement of this section, many privately insured credit unions did not always make required disclosures.113 We conducted unannounced site visits to 57 locations of privately insured credit unions (49 main and 8 branch locations) in five states—Alabama, California, Illinois, Indiana, and Ohio and found that 37 percent of the locations we visited did not conspicuously post signage in the lobby of the credit union. During these site visits, we also obtained other available credit union materials (brochures, membership agreements, signature cards, deposit slips, and newsletters) that did not include language to notify consumers that the credit union was not federally insured—as required by section 43. Overall, 134 of the 227 pieces of materials we obtained from 57 credit union locations—or 59 percent—did not include specified language. As part of our review, we also reviewed 78 Web sites of privately insured credit unions and found that many Web sites were not fully compliant with section 43 disclosure requirements. For example, 39 of the 78 sites


112 12 U.S.C. § 1831t (g).

reviewed had not included language to notify consumers that the credit union was not federally insured.

Our primary concern, resulting from the lack of enforcement of section 43 provisions, was the possibility that members of privately insured, state-chartered credit unions might not be adequately informed that their deposits are not federally insured and should their institution fail, the federal government does not guarantee that they will get their money back. The fact that many privately insured credit unions we visited did not conspicuously disclose this information raised concerns that the congressional interest in this regard was not being fully satisfied. In our August 2003 report, we concluded that FTC was the best among candidates to enforce and implement section 43 and provided suggestions on how to provide additional flexibility to FTC to enforce section 43 disclosure requirements. The House Committee on Appropriations, Subcommittee on Commerce, Justice, State, the Judiciary, and Related Agencies, is currently considering adding language in FTC’s 2004 appropriations bill that would require FTC to enforce and implement section 43 disclosure provisions.

Conclusions

The financial condition of the credit union industry has improved since 1991. Between 1992 and 2002, changes in the industry have resulted in two distinct groups of credit unions—smaller credit unions providing their members with basic banking services and larger credit unions that seek to provide their members with a full range of financial services similar to other depository institutions. These larger credit unions control a larger percent of industry assets than they did in 1991. This concentration of industry assets creates the need for greater risk management on the part of credit union management and NCUA with respect to monitoring and controlling risks to the federal share insurance fund.

Among the more significant changes that have occurred in the credit union industry over the past two decades have been the weakening or blurring of the common bond that traditionally existed between credit union members. The movement toward geographic-based fields of membership, and other expansions of the common-bond restrictions in conjunction with expanded lines of financial services, have made credit unions more competitive with banks. These changes have raised questions about the extent to which credit unions are fulfilling their perceived historic mission of serving individuals of modest means. However, no comprehensive data are available to determine the income characteristics of those who receive credit unions services, especially with respect to consumer loans and other
financial services. Available data, such as that provided by the SCF and HMDA, provide some indication that credit unions serve low- and moderate-income households but not to the same extent as banks. If credit unions, as indicated by NCUA and the credit union industry, place a special emphasis on serving low- and moderate-income households, more extensive data would be needed to support this conclusion. These data would need to include information on the distribution of consumer loans because smaller credit unions are more likely to make consumer than mortgage loans. Lack of data especially impairs NCUA's ability to determine if credit unions that have adopted underserved areas are reaching the households in the communities most in need of financial services.

As the industry has changed and larger credit unions have become more like banks in the services they have provided, NCUA has adopted a supervisory and examination approach that more closely parallels that of the other depository institution regulators. While it is too soon to determine whether the risk-focused approach being implemented by NCUA will allow it to more effectively monitor and control the risks being assumed by credit unions, our work suggests that further opportunities exist for NCUA to further leverage off the approaches and experiences of the other federal depository institution regulators. For example, as NCUA is addressing challenges in implementation of its risk-focused program, it has the opportunity to use forums such as the FFIEC to learn how other depository institution regulators dealt with similar challenges in implementing their risk-focused programs. Also, NCUA might gain an evaluation of an institution's internal controls, comparable to other depository institution regulators, if credit unions were required, like banks and thrifts, to provide management evaluations of internal controls and their auditor's assessments of such evaluations. Finally, NCUA could gain better oversight of third-party vendors if it had the same ability to examine the activities of third-party vendors as do other depository institution regulators.

As of December 2002, NCUSIF's financial condition appeared satisfactory based on its fund-equity ratio and positive net income. However, it is not clear whether or to what extent NCUSIF's recent decline in net income will continue. Improvements in NCUA's processes for determining the overhead transfer rate, pricing, and estimated losses could help to promote future financial stability by providing more accurate information for financial management. As currently determined by NCUA, the overhead transfer rate may not have accurately reflected the actual time spent by NCUA staff on
insurance-related activities. Recent fluctuations are the result of adjustments being made because of surveys that had not been conducted regularly or over sufficient periods of time. In addition, NCUSIF's pricing for federal share insurance coverage does not reflect the risk that an individual credit union poses to the fund. Moreover, the process used by NCUA to estimated losses to the insurance fund—the fund's most significant liability and management estimate—has been based on overly broad historical analysis. The risk-based pricing structure that is the norm across the insurance industry and, for loss estimates, the more detailed, risk-based historical analysis used by FDIC in insuring banks and thrifts may provide useful lessons for NCUA in improving its management of insurance for credit unions.

While systemic risks that might be created by private share insurance appear to have decreased since 1990, the recent conversion of a large credit union from federal to private share insurance has introduced new concerns. Because the remaining private insurer's (ASI) insured shares are overly concentrated in one large credit union and in certain states, and because it does not have the backing of any governmental entity and it has limited borrowing capacity, ASI may have a limited ability to absorb catastrophic losses. This raises questions about the ability of ASI, under severe economic conditions, to fulfill its obligations if its largest credit unions were to fail. Given this risk, we believe it is important that the members of privately insured credit unions are made aware that their shares are not federally insured. As we previously reported, since no federal entity currently enforces compliance with federal disclosure requirements for privately insured credit unions, and with the high level of noncompliance that we found in on-site visits to privately insured credit unions, we believe that members of privately insured credit unions might not be adequately informed that their shares are not federally insured. As a result, we have previously recommended that Congress consider providing additional flexibility to FTC to ensure compliance with the federal disclosure requirements.  

Recommendations for Executive Action

To promote NCUA's ability to meet its goal of assisting credit unions in safely providing financial services to all segments of society, to enable more consistent federal oversight of financial institutions, and to enhance

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share insurance management (for example, improving allocation costs, providing insurance according to risk, and improving the loss estimation process), we recommend that the Chairman of the National Credit Union Administration

- use tangible indicators, other than “potential membership,” to determine whether credit unions have provided greater access to credit union services in underserved areas;

- consult with other regulators through FFIEC more consistently about risk-focused programs to learn how these regulators have dealt with past challenges (for example, training of information technology specialists);

- continuously improve the process for and documentation of the overhead transfer rate by consistently calculating and applying those rates, updating the rates annually, and completing the survey with full representation;

- evaluate options for implementing risk-based insurance pricing. In its evaluation, the NCUA Chairman should consider the potential impact of risk-based insurance pricing to the ability of credit unions to provide services to various constituencies; and

- evaluate options for stratifying the industry by risk profile and applying probable failure rates and loss rates, based in part on historical data, for each risk profile category when estimating future losses from institutions.

### Matters for Congressional Consideration

Should Congress be concerned that federally insured credit unions, especially those serving geographical areas, are not adequately serving low- and moderate-income households, Congress may wish to consider requiring NCUA to obtain data on the proportion of mortgage and consumer loans provided to low- and moderate-income households within each federally insured credit union’s field of membership and obtain descriptions of services specifically targeted to low- and moderate-income households.

To ensure the safety and soundness of the credit union industry, Congress may wish to consider making credit unions with assets of $500 million or more subject to the FDICIA requirement that management and external
Auditors report on the internal control structure and procedures for financial reporting, as well as compliance with designated safety and soundness laws.

To improve oversight of third-party vendors, Congress may wish to consider granting NCUA legislative authority to examine third-party vendors that provide services to credit unions and are not examined through FFIEC.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Chairman of the National Credit Union Administration and the President and Chief Executive Officer of American Share Insurance. We received written comments from NCUA and ASI that are summarized below and reprinted in appendixes XI and XII respectively. In addition, we received technical comments from NCUA and ASI that we incorporated into the report as appropriate.

NCUA concurred with most of the report’s assessment regarding the challenges facing NCUA and credit unions since 1991. For example, NCUA concurred with the report’s assessment that overall the financial health and stability of the credit union industry has improved since 1991. NCUA also agreed with our recommendation to consult with other regulators through FFIEC more consistently to leverage the knowledge and experience the other regulators have gained in administering risk-focused programs. NCUA stated that it plans to continue its coordination with its FFIEC counterparts as it makes ongoing improvements to its approach to supervising federally insured credit unions.

NCUA also concurred with our matter for congressional consideration that credit unions with assets of $500 million or more should provide annual management reports assessing the effectiveness of their internal controls over financial reporting and their external auditor’s attestation to management’s assertions. NCUA stated that it is providing guidance for credit unions on the principles of the Sarbanes-Oxley Act that will, among other things, strongly encourage large credit unions to voluntarily provide this reporting on internal controls. However, NCUA believed that legislation was not necessary because NCUA has the authority to implement regulations requiring credit unions to provide these reports should it become necessary. While we acknowledge NCUA’s authority to issue regulations on this issue, we note that regulations can be changed unilaterally by the agency, whereas legislation is binding unless changed by
Congress. Our intent in developing this matter for congressional consideration was to ensure parity between credit unions, banks, and thrifts with regard to internal control reporting requirements; therefore, we have left this as a matter for congressional consideration in our report.

NCUA also indicated that it did not oppose our recommendation that it be given statutory authority to examine third-party vendors that provide services to credit unions and are not examined through FFIEC, provided that appropriate discretion was extended to the agency in the allocation of agency resources and evaluation of risk parameters in using this authority. NCUA stated that given that many of these third-party vendors service numerous credit unions, a failure of a vendor poses systemic risk issues. However, NCUA suggested that it be changed to a matter for congressional consideration because it was a statutory issue rather than one involving the use of existing NCUA regulatory authority. We agreed with NCUA's assessment and have modified the report accordingly.

NCUA concurred with the report's recommendation to make improvements to the process for determining the overhead transfer rate and indicated that management is in the process of improving the methodology for calculating this rate. NCUA also concurred in part with our report's conclusion that the NCUSIF loss reserve methodology warrants study, in order to further refine NCUSIF's estimates. Regarding our recommendation that NCUA study options for improving its estimates of future insurance losses, NCUA stated that it is awaiting the receipt of recommendations that FDIC received on revising its insurance process, and NCUA will review the details of the revised FDIC process and how to integrate those practices within NCUA's system.

In its response, NCUA proposed an alternative to risk-based insurance pricing by using the adoption of a PCA approach where required net worth levels would be tied to an institution's risk profile. While NCUA's proposal may be one option to consider, we continue to recommend that NCUA evaluate and study various options for achieving a risk-based pricing of insurance to fairly distribute risk, provide incentives for member credit unions to control their risk, and focus regulators on higher-risk credit unions. While it is possible that the option suggested by NCUA would achieve the objectives, we believe that NCUA should study the costs, benefits, and risks associated with various options in order to determine the most effective and cost-beneficial means of achieving a risk-based system of insurance.
NCUA disagreed with our recommendation that it should use indicators, other than “potential membership,” to determine whether credit unions have provided greater access to credit union services in underserved areas. NCUA officials stated that they believe that their data indicated that credit unions have reached out to underserved communities; implementation of this recommendation could result in significant and unnecessary data collection; and Congress has not imposed CRA-like requirements on credit unions in the past. We agree that federally chartered credit unions have added underserved areas in record numbers, increasing the numbers of potential members in these areas, and that membership growth in credit unions with underserved areas has been greater than for credit unions overall. However, this information does not indicate whether underserved individuals or households have received greater access to services (for example, by using check-cashing services, opening no-fee checking accounts, or receiving loans) as a result of these field of membership expansions. Further, while we agree that documenting service to the underserved would result in additional administrative requirements, the magnitude and scale of this effort does not necessarily require imposition of CRA as implemented for banks and thrifts, and could result in information benefitting future credit union expansion efforts. At a minimum, it would be useful to know whether membership growth in credit unions that have added underserved areas has come from the underserved areas themselves and the extent to which those census tracts within these areas have been identified as low- or moderate-income. This type of information, collected uniformly by a federal agency like NCUA, could serve as first step towards documenting the extent to which credit unions have reached for members outside of their traditional membership base. Finally, without this information, it will be difficult for NCUA or others that are interested to determine whether credit unions have extended services of any kind to underserved individuals as authorized in CUMAA.

Finally, NCUA also concurred with the report’s identification of possible systemic risk that could be associated with private share insurance that lacks the full faith and credit backing of a state or the federal government. NCUA believed that the asset concentration, limited borrowing capacity, and the lack of any reinsurance of the private insurer present unique challenges for the eight state supervisory authorities where private insurance exists today.

In commenting on the private share insurance section of a draft of this report, ASI stated that we failed to adequately assess the private share
insurance industry. In summary, as discussed below, ASI raised objections to the report statements that ASI’s risks are concentrated in a few large credit unions and a few states; ASI has limited ability to absorb large losses because it does not have the backing of any governmental agency; and ASI’s lines of credit are limited in the aggregate as to amount and available collateral. In response, we considered ASI’s positions and materials provided, including ASI’s actuarial assumptions and ASI’s past performance, and believe our report addresses these issues correctly as originally presented.

First, in regard to ASI’s concentration risks, ASI stated that the inclusion of a single large, high-quality credit union provided financial resources that improved, not diminished, the financial integrity of ASI. Our report acknowledges this fact. However, our report also notes that this credit union made up about 25 percent of ASI’s total insured shares, and that ASI’s five largest credit unions represent nearly 40 percent of ASI’s insured shares, as of December 2002. While not disputing that the large credit union would improve ASI’s current financial position, we continue to believe that this level of concentration in a few credit unions, under adverse economic conditions, could expose ASI to a potentially high level of losses. ASI also stated that ASI’s coverage and the geographic distribution of ASI’s insured credit unions is a matter of state law. The report points out this fact, and we acknowledge that it limits ASI’s ability to diversify its risks. However, the fact remains that ASI’s risks are currently concentrated in eight states.

Second, in response to our report’s assessment of ASI’s limited ability to absorb catastrophic losses, ASI noted “its sound private deposit insurance program builds on a solid foundation of careful underwriting, continuous risk management and the financial backing of its mutual member credit unions, capable of absorbing large (catastrophic) losses.” In addition, ASI noted that over its 29-year history, it has paid over 110 claims on failed credit unions, and that no member of an ASI-insured credit union has ever lost money. ASI also noted that it could assess its member credit unions up to 3 percent of their total assets in order to obtain more capital. We acknowledge these facts in this report; however, our point remains that ASI has limited borrowing capacity and, under stressful economic conditions, may have difficulty securing funds from others to meet its obligations. ASI also objected to the report’s comparison of private share insurance to the federal insurance program. As the last remaining private share insurer, ASI has no peer on which to base a comparison and the only alternative to private share insurance for credit unions is NCUSIF.
Third, ASI commented that the draft report incorrectly views the company’s lines of credit as a source of capital. ASI noted that their lines of credit are solely in place to provide emergency liquidity. We do not disagree with ASI’s statement. When incorporating ASI’s previously received technical comments, we clarified in the report that losses on member deposits, in excess of available cash, investments, and other assets of ASI-insured institutions, would only be covered up to ASI’s available resources and its secured lines of credit, which serve as a back-up source of funds. Further, the report notes that ASI’s lines of credit required collateralization between 80 and 115 percent of current market value of the U.S. government or agency securities ASI holds. As a result, ASI’s borrowing capacity is essentially limited to the securities it holds and therefore, in a time of stressful economic conditions, ASI may have difficulty maintaining its own liquidity if its insured credit unions were failing and unable to meet the withdrawal requests of depositors.

Lastly, ASI supported our previous conclusion that FTC is the appropriate agency for monitoring and defining private share insurance consumer disclosure requirements and believed that privately insured credit unions would benefit from FTC’s enforcement of such provisions. In our concluding discussions with ASI officials, they emphasized that they were undertaking efforts to educate their member credit unions on the required consumer disclosures and taking steps, in conjunction with state credit union leagues, to ensure compliance.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies of this report to the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, the Chairman and Ranking Minority Member of the House Committee on Financial Services, and other congressional committees. We also will send copies to the National Credit Union Administration and American Share Insurance and make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.
This report was prepared under the direction of Debra R. Johnson and Harry Medina, Assistant Directors. If you or your staff have any questions regarding this report, please contact the Assistant Directors or me at (202) 512-8678. Key contributors are acknowledged in appendix XIII.

Sincerely yours,

[Signature]

Richard J. Hillman
Director, Financial Markets
and Community Investment
Objectives, Scope, and Methodology

Our report objectives were evaluate (1) the financial condition of the credit union industry; (2) the extent to which credit unions “make more available to people of small means credit for provident purposes;”\(^1\) (3) the impact, if any, of the Credit Union Membership Access Act of 1998 (CUMAA) on the credit union industry with respect to membership provisions; (4) how the National Credit Union Administration’s (NCUA) examination and supervision processes have changed in response to changes in the industry; (5) the financial condition of the National Credit Union Share Insurance Fund (NCUSIF); and (6) issues concerning the use of private share (deposit) insurance.

Financial Condition of Industry

To assess the financial condition of the credit union industry, we obtained and analyzed annual call report financial data (Form 5300) and regulatory ratings (CAMEL scores) for all federally insured credit unions from 1992 to 2002.\(^2\) NCUA requires federally insured credit unions to submit a quarterly call report, which contains information on the financial condition and operations of the institution. Using the call reports, we calculated descriptive statistics and key financial ratios and determined trends in financial performance. NCUA provided us with a copy of the electronic Form 5300 database for our analysis. The database contained year-end information for December 1992–December 2002. We reviewed NCUA established procedures for verifying the accuracy of the Form 5300 database and found that the data that forms this database are verified on an annual basis, either during each credit union’s examination, or through off-site supervision. We determined that the data were sufficiently reliable for the purposes of this report. In addition we received a database of regulatory ratings (CAMEL) from NCUA for 1992–2002, on which we (1) reviewed the data by performing electronic testing of required data elements, (2) reviewed existing information about the data and the system that produced them, and (3) interviewed agency officials knowledgeable

\(^1\)While credit union legislation (see the Federal Credit Union Act at 12 U.S.C. § 1751) uses “small means” and the credit union industry has not defined the term, in this report, we used “low- and moderate-income,” as defined by banking regulators, to describe the type of people who credit unions might serve.

\(^2\)As do banking regulators, NCUA and state regulators use the “CAMEL” rating system, a composite score, to help evaluate the safety and soundness of institutions. CAMEL scores rate capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and overall condition.
about the data. We determined that the data were sufficiently reliable for the purposes of this report.

In addition to using call report data for credit unions, we also used data collected by the Federal Financial Institutions Examination Council (FFIEC) and Office of Thrift Supervision (OTS) to compare the financial condition of and services offered by credit unions with those of other depository institutions insured by the Federal Deposit Insurance Corporation (FDIC). We used call report (reporting forms FFIEC 031 and FFIEC 041 for banks and OTS Form 1313 for thrifts) data obtained from FDIC’s Statistics on Depository Institutions Web site, which contains consolidated bank and thrift data stored on FDIC’s Research Information System database. To assess the reliability of these data, we randomly cross-checked selected data obtained from this Web site with selected individual call reports and compared our calculations with aggregate figures provided by FDIC. Given the context of the analyses, we determined that these data were sufficiently reliable for the purposes of our report. For broad, industrywide comparisons with banks involving industry concentration and capital ratios, we used total assets and equity capital data for all FDIC-insured institutions, excluding insured branches of foreign-chartered banks. In order to determine bank and thrift institutions for our more detailed review, we constructed five peer groups in terms of institution size as measured by total assets, reported as of December 31, 2002. See table 3 for the definitions we used to create peer groups.

3FDIC is responsible for overseeing insured financial institution adherence to FFIEC’s reporting requirements, including the observance of all bank regulatory agency rules and regulations, accounting principles, and pronouncements adopted by the Financial Accounting Standards Board and all other matters relating to call report submission. Call reports are required by statute and collected by FDIC under the provision of Section 1817(a)(1) of the Federal Deposit Insurance Act. FDIC collects, corrects, updates, and stores call report data submitted to it by all insured national and state nonmember commercial banks and state-chartered savings banks on a quarterly basis. Throughout the report, we use the terms, “banks,” “banks and thrifts,” and “FDIC-insured institutions” interchangeably.

4As of August 31, 2003, the address for this Web site was www3.fdic.gov/sdi/.
Table 3: Peer Group Definitions

<table>
<thead>
<tr>
<th>Group</th>
<th>Asset size of institution</th>
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<tbody>
<tr>
<td>I</td>
<td>Total assets of $100 million or less</td>
</tr>
<tr>
<td>II</td>
<td>Total assets greater than $100 million, but less than or equal to $250 million</td>
</tr>
<tr>
<td>III</td>
<td>Total assets greater than $250 million, but less than or equal to $500 million</td>
</tr>
<tr>
<td>IV</td>
<td>Total assets greater than $500 million, but less than or equal to $1 billion</td>
</tr>
<tr>
<td>V</td>
<td>Total assets greater than $1 billion, but less than or equal to the asset size, rounded up to the nearest billion dollars, of the largest credit union (for example, $16 billion for 2001 and $18 billion for 2002)</td>
</tr>
</tbody>
</table>

Source: GAO.

We specified the maximum total assets of $18 billion by rounding up the total assets of the largest credit union in our database as of December 31, 2002, to the nearest billion dollars. We also classified bank and thrift institutions as to whether they emphasized credit card or mortgage loans; this was done by determining if a given bank had (1) a total loans to total assets ratio of at least 0.5 and (2) either a credit card loans to total loans ratio of at least 0.5 or a mortgage loans to total loans ratio of at least 0.5. The call report data that we used for our financial condition and services analyses consisted of information on total assets and total loans, as well as more specific loan holdings data (for example, consumer loans and real estate loans). We also obtained additional data to calculate bank capital ratios and return on average assets, including equity capital, net income, and average assets.

Service to People with Low and Moderate Incomes

To evaluate the extent to which credit unions serve people with low and moderate incomes, we analyzed existing data on the income levels of credit union members, reviewed available literature, and interviewed regulatory and industry officials. We analyzed 2001 Home Mortgage Disclosure Act (HMDA) data, the Federal Reserve’s 2001 Survey of Consumer Finances (SCF), NCUA program literature, and statistical reports of industry trade and consumer groups. To present our findings, we relied on the combined message of all these studies and data sources because we found no single source that contained data on the incomes of credit union and other depository institution consumers. To compare the income characteristics of households and neighborhoods that obtain mortgages from credit unions and banks, we used four income categories—low, moderate, middle, and
upper—used by financial regulators as part of the Community Reinvestment Act (CRA) exams. See table 4 for definitions.

<table>
<thead>
<tr>
<th>Categories</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low income</td>
<td>For an individual income, when income is less than 50 percent of the metropolitan statistical area's (MSA) median family income, and for a geographic area, when the median family income is less than 50 percent</td>
</tr>
<tr>
<td>Moderate income</td>
<td>For an individual income, when income is at least 50 percent and less than 80 percent of the MSA's median family income, and for a geographic area, when the median family income is at least 50 percent and less than 80 percent</td>
</tr>
<tr>
<td>Middle income</td>
<td>For an individual income, when income is at least 80 percent and less than 120 percent of the MSA's median family income, and for a geographic area, when the median family income is at least 80 percent and less than 120 percent</td>
</tr>
<tr>
<td>Upper income</td>
<td>For an individual income, when income is at least 120 percent or more of the MSA's median family income, and for a geographic area, when the median family income is 120 percent or more</td>
</tr>
</tbody>
</table>

Source: 12 C.F.R. 228.12 (n).

We analyzed loan application records (LAR) from the HMDA database to compare the proportion of mortgage loans made by credit unions and peer group banks with households and communities with various income levels. We used 2001 HMDA data, the most recent data set available from the Federal Reserve Bank at the time of our review. For the purposes of comparing credit union lending with that of banks, we included only those banks with assets of $16 billion or less on December 31, 2001, which was the size of the largest credit union in 2001, rounded up to the nearest billion. In addition, we excluded lending institutions that only made mortgages. Our HMDA analysis included records from 4,195 peer group banks. We obtained the asset size and total membership for credit unions reporting to HMDA from NCUA’s 2001 call report database and obtained the asset size of other lenders (to identify the peer group banks) from the

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5 In passing the CRA, Congress required federal financial supervisory agencies, except NCUA, to assess an institution's record of helping to meet the credit needs of the local communities in which the institution is chartered.
HMDA Lender File, which contains data on the characteristics of institutions reporting to HMDA, supplied to us by the Federal Reserve.

Our HMDA analysis did not include all credit unions and banks because only institutions that meet HMDA's reporting criteria, such as having a certain amount of assets, must report their mortgage loans to HMDA. For example, in 2001, depository institutions with more than $31 million in assets as of December 31, 2000, were required to report loans to HMDA. Largely because of this criterion, most credit unions—86 percent—were not required to report mortgage loans to HMDA and, thus, were excluded from our analysis. However, we believe our analysis is still of value because, in 2001, reporting credit unions held about 70 percent of credit union assets and included 62 percent of credit unions’ members.

For our analysis, we only analyzed LARs for originated loans for the purchase of one-to-four family homes that served as the purchaser's primary dwelling. Our analysis included about 71,000 loans reported by credit unions and about 807,000 loans reported by peer group banks. We determined that the data were sufficiently reliable for the purposes of this report by performing electronic testing of the required data elements, reviewing existing information about the data and the system that produced them, and interviewing agency officials knowledgeable about the data. We did not independently verify the accuracy of the contents of the LARs reported to the HMDA database or the accompanying lender file.

After selecting the records, we determined what proportion of credit union and bank loans were made to purchasers with low, moderate, middle, and upper incomes. To do so, we categorized the purchaser's gross annual income, as identified on the LAR, into one of four income categories based on the median family income of the MSA in which the purchased home was located. We did this by matching the Metropolitan Statistical Area (MSA) on the HMDA LAR with the appropriate Department of Housing and Urban Development (HUD)-estimated 2001 median family income. We used SAS version 8.02 version, which is a computer-based data analysis and reporting software application, to perform all of these analyses. We did not analyze about 16 percent of the credit union and bank LARs because they did not contain a MSA. While it is possible that this information was simply not recorded, lenders must only report MSAs for properties located in MSAs where their institution has a home or branch office.

In addition, we determined what proportion of credit union and bank loans were made for the purchase of properties in census tracts by the median
family income of the census tract. The Federal Reserve Board, in
categorizing each census tract level, used the four income categories used
by the financial regulators (low, moderate, middle, and upper) and used
definitions corresponding to the ones identified in table 4. Because the
median income of each census tract is labeled within HMDA, we did not
have to determine the income category ourselves. We did not analyze about
16 percent of the credit union and bank LARs because they did not contain
a census tract. While it is possible that this information was simply not
recorded, lenders are not responsible for identifying census tract
information if the property is located in a county with less than 30,000
people or if the property was located in an area that did not have census
tracts for the 1990 census.

Finally, we analyzed the race and ethnicity data in HMDA to compare the
lending records of credit unions and banks whose loans met our criteria. As
noted in appendix VI, about 15 percent of records for credit unions lacked
race and ethnicity data and 6 percent of records for banks. While it is
possible that this information was simply not recorded, applicants filing
loan applications by mail or by telephone are not obligated to provide this
information.

We also analyzed the Federal Reserve’s 2001 SCF, a triennial survey of U.S.
households sponsored by the Board of Governors of the Federal Reserve
System with the cooperation of Treasury, and reviewed secondary sources
to identify the characteristics of credit union members. We analyzed the
SCF because it is a respected source of publicly available data on financial
institutions and consumer demographics that is nationally representative
and because it was the only comprehensive source of publicly available
data with information on financial institutions and consumer demographics
that we could identify. We analyzed the SCF to develop statistics on the
income, race, age, and education of credit union members and bank
customers. Because some customers use both credit unions and banks, we
performed our income analysis based on the assumption that households
can be divided into four user categories—those who use credit unions only,
those who primarily use credit unions, those who use banks only, and those
who primarily use banks. Dr. Jinkook Lee of Ohio State University
developed these categories. In addition, to identify existing research on
credit union research, we asked officials at NCUA and industry groups (for
example, the Credit Union National Association (CUNA) to identify
relevant studies and performed a literature search.
Appendix I
Objectives, Scope, and Methodology

Impact of CUMAA

To study the impact of CUMAA on credit union field of membership regulations, we reviewed and analyzed CUMAA and compared its provisions with NCUA interpretive rulings and policy statements (IRPS) in effect before and after CUMAA. In addition, we interviewed NCUA officials and industry representatives to obtain their viewpoints on how NCUA interpreted CUMAA's membership provisions. To obtain information about state field of membership regulations in general and how many state-chartered credit unions serve geographical areas, we surveyed regulators in the 50 states and received responses from the 46 that actively charter credit unions. This allowed us to compare the number of federally chartered and state-chartered credit unions serving geographical areas. Finally, we obtained historical trend data from NCUA on the charter types of federally chartered credit unions, “potential” (that is, people within a credit union’s field of membership but not members of the credit union) and actual membership, and service to underserved areas.

Regulatory Oversight

To evaluate how NCUA's supervision and examination of credit unions has evolved in response to changes in the industry since 1991, we identified changes in the types of products, services, and activities in which credit unions engage as well as key changes to NCUA regulations. We also identified changes to NCUA's examination and supervision approach, and evaluated oversight procedures of federally insured, state-chartered credit unions. Finally, we studied NCUA's implementation of prompt corrective action (PCA).

To identify changes in the types of products, services, and activities in which credit unions engage, we analyzed 1992–2002 Form 5300 call report data and conducted structured interviews with NCUA examiners, state supervisory officials, and officials from seven large credit unions. To identify key regulatory changes, we (1) reviewed the Federal Credit Union Act and amendments made by Congress since 1991; (2) interviewed NCUA officials, including NCUA's General Counsel and officials from NCUA's Division of Examination and Insurance, NCUA and state examiners, and officials from seven large credit unions; (3) reviewed NCUA legal opinions and letters to credit unions; and (4) reviewed final rules published in the Federal Register.

To identify changes to NCUA's examination and supervision approach, we reviewed NCUA's examiner guide for key elements of the risk-focused examination approach and compared current exam documentation.
Appendix I
Objectives, Scope, and Methodology

requirements with previous requirements. We conducted structured
interviews with six of NCUA's regional directors, 23 NCUA examiners
covering all NCUA regions, and 13 state supervisory officials from
Alabama, California, Idaho, Illinois, Indiana, Maryland, Massachusetts,
Michigan, Nevada, Ohio, Texas, Washington, and Wisconsin. These states
contained 51 percent of the total number of federally insured, state-
chartered credit unions and 58 percent of the total assets of federally
insured, state-chartered credit unions as of December 31, 2002. In addition,
we interviewed officials from seven large credit unions; selecting at least
one credit union from NCUA's six regions. To obtain information on the
experiences of other depository institution regulators with the risk-focused
examination and supervision approach, we interviewed officials from the
FDIC, OTS, Office of the Comptroller of the Currency, and the Federal
Reserve Bank. Finally, to obtain information on other NCUA initiatives
intended to compliment the risk-focused program, we reviewed NCUA
documents on the large credit union pilot program, and the subject matter
examiner program.

To evaluate oversight procedures of federally insured, state-chartered
credit unions, we obtained information about the oversight procedures
during our structured interviews with the 13 states supervisory officials
and NCUA examiners. We also reviewed NCUA's examiner guide and
memorandum of understanding between NCUA and states describing
NCUA's procedures for conducting joint examinations of federally insured,
state-chartered credit unions with state regulators.

Finally, to study NCUA's implementation of PCA, we reviewed CUMAA,
NCUA rules and regulations pertaining to PCA, and NCUA's examiner
guide. We also analyzed data from NCUA on the number of credit unions
subject to PCA as of December 31, 2002. We interviewed agency officials
knowledgeable about this data and found that NCUA headquarters, as well
as the region, conducted reasonableness checks against the Form 5300
database, which contains the net-worth ratio used for PCA. When data
outliers were found, examiners were required to review the data for
accuracy and make any necessary corrections. We determined that the data
were sufficiently reliable for the purposes of this report. In addition, we
interviewed NCUA officials and examiners, state supervisory officials,
credit union officials, and officials of other federal financial regulatory
agencies to obtain their perspectives on PCA.
Status of NCUSIF

To evaluate the financial condition of NCUSIF, we obtained key financial data about the fund from NCUA's annual audited financial statements for 1991–2002. For 2002, we compared NCUSIF's key performance measure, which is the ratio of fund equity to insured shares (deposits), to key performance measures of the Bank Insurance Fund, Savings Association Insurance Fund, and American Share Insurance, the remaining private insurer. We also reviewed NCUSIF's estimated loss and overhead administrative expenses transfer process and applicable internal controls. We reviewed other relevant industry studies on deposit-insurance pricing and loan-loss allowance. In addition, we interviewed NCUA officials, industry trade groups, and officials of other federal financial regulatory agencies to obtain their perspectives on the funding of NCUSIF, the overhead transfer rate, and the loan-loss allowance.

Private Share Insurance

To better understand the issues around share (deposit) insurance, we reviewed and analyzed relevant studies on federal and private insurers for both credit unions and other depository institutions. In addition, we interviewed officials at NCUA, the Department of the Treasury, and FDIC to obtain perspectives specific to private share insurance. We also obtained views from credit union industry groups including the National Association of Federal Credit Unions, National Association of State Credit Union Supervisors, and CUNA.

To determine the extent to which private share insurance is permitted and utilized by state-chartered credit unions, we conducted a survey of state credit union regulators in all 50 states. Our survey had a 100-percent response rate. In addition to the survey, we obtained and analyzed financial and membership data of privately insured credit unions from a variety of sources (NCUA, Credit Union Insurance Corporation, CUNA, and ASI—the only remaining provider of primary share insurance). We found this universe difficult to confirm because in our discussions with state regulators, NCUA and ASI officials, and our review of state laws, we identified other states that could permit credit unions to purchase private share insurance.

The scope of our work was limited to primary share insurance, which is generally mandatory for all credit unions (whereas excess share insurance is optional coverage above primary share insurance).
Appendix I
Objectives, Scope, and Methodology

To determine the regulatory differences between privately insured credit unions and federally insured, state-chartered credit unions, we identified and analyzed statutes and regulations related to share insurance at the state and federal levels. In addition, we interviewed officials at NCUA and conducted interviews with officials at the state credit union regulatory agencies from Alabama, California, Idaho, Indiana, Illinois, Maryland, Nevada, New Hampshire, and Ohio. Finally, we analyzed NCUA's application of its conversion policies and looked at the cases of six credit unions that terminated their federal share insurance and converted to private share insurance in 2002 and 2003.

To identify factors influencing a credit union's decision to obtain private or federal share insurance, we conducted structured interviews with officials of both federally insured and privately insured credit unions. Specifically, we interviewed management at 29 credit unions that, since 1990, had converted from federal to private share insurance and management at 26 credit unions that had converted from private to federal share insurance. We did not interview credit union management in states that did not permit private insurance.

To determine the extent to which privately insured credit unions met federal disclosure requirements, we identified and analyzed federal consumer disclosure provisions in section 43 of the Federal Deposit Insurance Act, as amended, and conducted unannounced site visits to 57 privately insured credit unions (49 main and 8 branch locations) in Alabama, California, Illinois, Indiana, and Ohio. The credit union locations were selected based on a convenience sample using state and city location coupled with random selection of main or branch locations within each city. About 90 percent of the locations we visited were the main institution rather than a branch institution. This decision was based on the assumption that if the main locations were not in compliance, then the branch locations would probably not be in compliance either. Although neither these site visits, nor the findings they produced, render a statistically valid sample of all possible main and branch locations of privately insured credit unions necessary in order to determine the “extent” of compliance, we believe that what we found is robust enough, both in the

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7 We limited our analysis to those states with privately insured credit unions—Alabama, California, Idaho, Indiana, Illinois, Maryland, Nevada, and Ohio.

aggregate and within each state, to raise concern about lack of disclosure in privately insured credit unions. During each site visit, using a systematic check sheet, we noted whether or not the credit union had conspicuously displayed the fact that the institution was not federally insured (on signs or stickers, for example).

In addition, from these same 57 sites visited, we collected a total of 227 credit union documents that we analyzed for disclosure compliance. While section 43 requires depository institutions lacking federal deposit insurance to disclose they are not federally insured in personal documents, such as periodic statements, we did not collect them. We also conducted an analysis of the Web sites of 78 privately insured credit unions, in all eight states where credit unions are privately insured, to determine whether disclosures required by section 43 were included. To identify these Web sites, we conducted a Web search. We attempted to locate Web sites for all 212 privately insured credit unions; however, we were able to identify only 78 Web sites. We analyzed all Web sites identified. Finally, we interviewed FTC staff to understand their role in enforcement of requirements of section 43 for depository institutions lacking federal deposit insurance.

To understand how private share insurers operate, we conducted interviews with officials at three private share insurers for credit unions—ASI (Ohio), Credit Union Insurance Corporation (Maryland), and Massachusetts Credit Union Share Insurance Corporation (Massachusetts). Because ASI was the only fully operating provider of private primary share insurance, ASI was the focus of our review.\(^9\) We obtained documents related to ASI operations such as financial statements and annual audits and analyzed them for the auditor’s opinion noting adherence with accounting principles generally accepted in the United States. Additionally, to understand the state regulatory framework for this remaining private share insurer, we interviewed officials at the Ohio Department of Insurance.

\(^9\)As of December 2002, we identified two entities that provide private primary share insurance to credit unions in the 50 states and the District of Columbia—ASI and Credit Union Insurance Corporation (CUIC). However, CUIC in Maryland was in the process of dissolution and, therefore, we did not include it in our analysis. During our review, we learned that Massachusetts Credit Union Share Insurance Corporation only provides excess deposit insurance, and therefore we did not include it in our analysis.
Status of Recommendations from GAO’s 1991 Report

We made 52 recommendations to Congress and the National Credit Union Administration (NCUA) in our 1991 report on the credit union industry and NCUA. Of these, 28 were made to Congress, of which 8 were implemented or partially implemented as of September 2003. We made 24 recommendations to NCUA, and 19 were implemented as of September 2003. In addition, we issued one matter for congressional consideration. Congress partially addressed this matter.

Our recommendations spanned the range of issues addressed in our 1991 report, including

- the condition of the credit union industry and the National Credit Union Share Insurance Fund (NCUSIF),
- credit union law and regulation,
- supervision of credit unions,
- NCUA’s management of failed credit unions,
- corporate credit unions,
- share insurance issues,
- structural changes in NCUA, and
- the evolution of credit unions’ role in the financial marketplace.

NCUA implemented most of our recommendations to the agency. The key changes implemented by NCUA affected (1) corporate credit unions, (2) reporting requirements for credit unions, and (3) supervision of state-chartered credit unions. With respect to corporate credit unions, NCUA implemented various recommendations that established minimum capital requirements, limited investment powers of state-chartered corporate credit unions, increased detail and frequency of reporting requirements, and established a new unit in NCUA that is responsible for oversight, examination, and enforcement of corporate credit unions. We expect to review corporate credit unions following this study and to report in greater

depth on issues affecting corporate credit unions. In the area of reporting requirements, NCUA implemented a requirement in 1993 that all federally insured credit unions with assets greater than $50 million file financial and statistical reports (call reports) on a quarterly basis and as of July 1, 2002, required all federally insured credit unions to file quarterly call reports. Finally, NCUA affirmed its supervision of state-chartered and federally insured credit unions by establishing examination goals, as well as conducting examinations, at almost 16 percent of all state-chartered and federally insured credit unions in 2002.

NCUA told us that it chose not to implement five of our recommendations because it either disagreed with the recommendations (see recommendation 24 in table 5), or believed it had already addressed the recommendations (see recommendations 9, 11, 16, 17 in table 5). For example, NCUA disagreed with our recommendation to separate its supervision and insurance functions (see recommendation 24) and believed it was unnecessary for credit unions to submit copies of their supervisory committee audit reports to NCUA, as NCUA examiners routinely review the reports as part of the examination process (see recommendation 9).

Congress implemented or partially implemented 8 of the 28 recommendations we made, which (1) established minimum capital levels for credit unions, (2) tightened commercial lending, and (3) established annual audit requirements for credit unions with assets greater than $500 million. As discussed in table 5, among those not implemented are recommendations dealing with NCUA’s Central Liquidity Facility (CLF) (see recommendations 49-52) and the structure of NCUA (see recommendations 43-48).^2^ See table 5 for our recommendations to NCUA and Congress and their status as of August 31, 2003.

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^2^ CLF was created in 1978 to improve the general financial stability of credit unions by serving as a liquidity lender to credit unions experiencing unusual or unexpected liquidity shortfalls. The NCUA board oversees the CLF.
## Appendix II
Status of Recommendations from GAO’s 1991 Report

Table 5: Status of GAO Recommendations to NCUA and Congress, as of August 31, 2003

<table>
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<tr>
<th>Issue</th>
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<th>Status</th>
<th>Comments</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Condition of credit unions and NCUSIF&lt;br&gt;Require credit unions with assets greater than $50 million to file financial and statistical reports quarterly.</td>
<td>Implemented</td>
<td>Implemented in the March 31, 1993, quarterly call reports for federally insured credit unions with assets greater than $50 million. Effective July 1, 2002, NCUA expanded rule to cover all federally insured credit unions.</td>
</tr>
<tr>
<td>2</td>
<td>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.</td>
<td>Implemented</td>
<td>According to NCUA, it established a reporting system for common bond data in January 2002. The system monitors the approvals of field of membership and is called Generated Efficient National Information System for Insurances Services. Also, NCUA investment rules require credit unions that make certain investments to perform shock tests on interest rate sensitivity. According to NCUA, it performs shock tests of credit unions using call report data and expects examiners to make contact with credit unions if potential problems are identified.</td>
</tr>
<tr>
<td>3</td>
<td>Law and regulation&lt;br&gt;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.</td>
<td>Implemented</td>
<td>In June 1991, NCUA issued comprehensive guidelines and since then issued a series of letters to credit unions to address this issue.</td>
</tr>
<tr>
<td>4</td>
<td>Restrict the exclusions from its commercial lending limit established in 1987 to help ensure that credit unions are not used as vehicles underwriting large commercial ventures.</td>
<td>Implemented</td>
<td>A final rule addressing all of our concerns and recommendations went into effect in January 1992. The rule established a limit on the amount of loans that may be made to one borrower to the greater of 15 percent of reserves or $75,000.</td>
</tr>
<tr>
<td>5</td>
<td>Supervision&lt;br&gt;Clarify the purposes, unique values, and requirements for use of each of its off-site monitoring tools. Determine the appropriate recipients of the tools and distribute them accordingly, within each region.</td>
<td>Implemented</td>
<td>According to NCUA, the Office of Examination and Insurance completed the requirements for the use of off-site monitoring tools, such as the use of risk reports, in fiscal year 1995. Since then, NCUA has adopted additional off-site monitoring tools, such as the consolidated balance sheet and scope workbook.</td>
</tr>
<tr>
<td>6</td>
<td>Require documentation at the regional office level of examiners’ reviews of all credit union call reports.</td>
<td>Implemented</td>
<td>NCUA requires this review as part of the examination process and requires documentation of the review in the examination report.</td>
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## Appendix II
### Status of Recommendations from GAO's 1991 Report

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<tr>
<td>7</td>
<td>Invoke its statutory authority to refuse to accept state supervisors' examinations when a state regulatory authority lacks adequate independence from the credit union industry. Examine all NCUSIF-insured credit unions in such states.</td>
<td>Implemented</td>
<td>According to NCUA, its examiner guide addresses oversight of federally insured, state-chartered credit unions, including processes to make an independent assessment of these credit unions. NCUA affirms it is empowered by the Federal Credit Union Act to examine any federally insured credit union, including those where questions are raised regarding the independence of the state from the industry. NCUA claims that use of this authority is evidenced by having conducted exams at 15.6 percent of all federally insured, state-chartered credit unions in 2002.</td>
</tr>
<tr>
<td>8</td>
<td>Establish a policy goal for examination frequency of state-chartered credit unions.</td>
<td>Implemented</td>
<td>NCUA affirms that its regions have established goals that include monitoring the examination cycles and supervision efforts of each state. State examinations not conducted within 18 months are tracked and agreements are made and followed to bring the state into compliance.</td>
</tr>
<tr>
<td>9</td>
<td>Require all credit unions to submit copies of their supervisory committee audit reports to NCUA upon completion.</td>
<td>Not implemented</td>
<td>This recommendation pertains to federally insured credit unions with less than $500 million in assets. NCUA believes that the 1991 recommendation is unnecessary. NCUA claims it reviews the supervisory committee audits as a required step during the risk-focused examination process.</td>
</tr>
<tr>
<td>10</td>
<td>Conduct an Inspector General 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.</td>
<td>Implemented</td>
<td>The Inspector General completed quality assurance reviews of each NCUA region as of July 1994.</td>
</tr>
<tr>
<td>11</td>
<td>NCUA's management of failed credit unions</td>
<td>Require that waivers and special charges be authorized by the Director of the Office of Examination and Insurance, the General Counsel, and the regional director.</td>
<td>Not implemented</td>
</tr>
<tr>
<td>12</td>
<td>Develop policy guidance concerning the use of these provisions and monitor their use.</td>
<td>Implemented</td>
<td>NCUA maintains rules regarding waivers and special charges in Section 702 of its rules and regulations.</td>
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<tr>
<td>13</td>
<td>Adhere to the criteria for assisting credit unions.</td>
<td>Implemented</td>
<td>NCUA claims that the implementation of prompt corrective action in February 2000 greatly changed its ability to assist credit unions. To address the issue of assistance to credit unions, NCUA affirms that the board approved a Special Assistance Program in February 2001, and that it maintains a Special Assistance Manual regarding the documentation and quality of requests for assistance. Finally, NCUA claims it has implemented an approval process for different levels of assistance to credit unions.</td>
</tr>
<tr>
<td>14</td>
<td>Corporate credit unions Establish minimum capital requirements for corporate credit unions and U.S. Central Credit Union, 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 membership capital share deposits.</td>
<td>Implemented</td>
<td>Section 704 of NCUA regulations requires a minimum 4 percent capital ratio for retail, as well as wholesale, corporate credit unions, such as U.S. Central Credit Union.</td>
</tr>
<tr>
<td>15</td>
<td>Restrict the investment powers of state-chartered corporate credit unions to the limits imposed on federal corporate credit unions.</td>
<td>Implemented</td>
<td>NCUA’s corporate credit union rules apply to all federally insured corporate credit unions. NCUA requires all nonfederally insured corporate credit unions to adhere to the same rules as a condition of receiving shares or deposits from federally insured credit unions.</td>
</tr>
<tr>
<td>16</td>
<td>Limit the investments of corporate credit unions and U.S. Central Credit Union in a single obligor 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 corporate credit unions in U.S. Central Credit Union.</td>
<td>Not implemented</td>
<td>NCUA believes it is more appropriate to establish concentration limits on capital rather than assets and established a regulation limiting aggregate investments in any single obligor to the greater of 50 percent of capital or $5 million.</td>
</tr>
<tr>
<td>17</td>
<td>Limit loans to one borrower by corporate credit unions and U.S. Central Credit Union to 1 percent of the lender’s assets. NCUA should be authorized to make exceptions on a loan-by-loan basis.</td>
<td>Not implemented</td>
<td>NCUA believes it is more appropriate to set limits based on capital instead of assets. In October 1997, the loan limit was 10 percent of capital—an amount we determined could exceed 1 percent of assets. As of January 2003, NCUA rules capped the maximum aggregate loan amount to any one member to 50 percent of capital for unsecured loans, and 100 percent of capital for secured loans, with exceptions. We view this as a departure from the 1991 recommendation.</td>
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<tr>
<td>18</td>
<td>Obtain more complete and timely information about corporate financial operations.</td>
<td>Implemented</td>
<td>According to NCUA, it requires corporate credit unions to submit monthly call reports to NCUA as well as information to examiners. Also, NCUA affirms that it revises the corporate call reports annually to ensure proper supervision of corporate credit unions.</td>
</tr>
<tr>
<td>19</td>
<td>Establish a unit at NCUA headquarters that would be responsible for corporate oversight, examination, and enforcement actions.</td>
<td>Implemented</td>
<td>According to NCUA, the NCUA board separated corporate credit union supervisory responsibility from the Office of Examination and Insurance and created the Office of Corporate Credit Unions in August 1994.</td>
</tr>
<tr>
<td>20</td>
<td>Review the CAMEL rating system for corporate credit unions to reduce the inconsistencies and focus more clearly on the component being rated.</td>
<td>Implemented</td>
<td>In January 1999, NCUA implemented a system for evaluating the risk associated with corporate credit unions that is different from the CAMEL ratings used for other credit unions. The system, known as the Corporate Risk Information System, has 12 component ratings regarding financial risk and risk management.</td>
</tr>
<tr>
<td>21</td>
<td>Share insurance</td>
<td>Place NCUSIF's fiscal year on a calendar year.</td>
<td>Implemented</td>
</tr>
<tr>
<td>22</td>
<td>Reduce the time lag in adjusting NCUSIF's financing.</td>
<td>Implemented</td>
<td>According to NCUA, establishing a fiscal year based on the calendar year for NCUSIF reduced time lags in collection of assessments from 7 to 3 months.</td>
</tr>
<tr>
<td>23</td>
<td>Require credit unions to exclude their 1 percent deposit in NCUSIF from both sides of their balance sheet when assessing capital adequacy. Then, that amount would not be counted as credit union capital.</td>
<td>Implemented</td>
<td>Action taken by Congress addressed our concern. Minimum net worth ratios established in the 1998 Credit Union Membership Access Act (CUMAA), which is 7 percent for well-capitalized credit unions, compensated for the NCUSIF deposit (1 percent of assets) that credit unions account for on their balance sheet. The minimum capital ratio for banks insured by FDIC is 6 percent.</td>
</tr>
<tr>
<td>24</td>
<td>NCUA structural changes</td>
<td>Immediately establish separate supervision and insurance offices that report directly to the board.</td>
<td>Not implemented</td>
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<td>25</td>
<td>Condition of credit unions and NCUSIF</td>
<td>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.</td>
<td>Not implemented</td>
</tr>
<tr>
<td>26</td>
<td>Law and regulation</td>
<td>Amend Federal Credit Union Act (FCUA) to require NCUA 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.</td>
<td>Implemented</td>
</tr>
<tr>
<td>27</td>
<td>Amend the FCUA to limit 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 credit union, to not more than 1 percent of the credit union’s total assets. Limits permitted in 1991 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. Authorize NCUA to set a higher limit for secured consumer loans made by small credit unions and for overnight funds deposited with correspondent institutions.</td>
<td>Not implemented</td>
<td>NCUA’s position has changed since 1994, when it believed a 5 percent of assets limitation on exposure to single obligors would be satisfactory. According to NCUA, the 5-percent limitation is too restrictive for some credit unions, especially for smaller credit unions. According to NCUA, its current regulations for credit unions do not provide specific limits, but provides flexibility to well-run and managed credit unions. NCUA believes that setting obligor limitations is better handled through the agency’s regulation process because it permits prompt changes, is considerate of the fluid financial environment, and maintains emphasis on overall risk.</td>
</tr>
<tr>
<td>28</td>
<td>Amend the FCUA to require NCUA to tighten the commercial lending regulation and include an overall limit.</td>
<td>Implemented</td>
<td>Implemented as part of CUMAA in 1998 and promulgated as NCUA regulation in May 1999. NCUA established the aggregate limit on a credit union’s outstanding member business loans to the lesser of 1.75 times the credit unions’ net worth or 12.25 percent of total assets.</td>
</tr>
<tr>
<td>29</td>
<td>Amend the FCUA to modify borrowing authority and specify that credit unions may not borrow for the purpose of growth, unless prior approval of NCUA is obtained.</td>
<td>Not implemented</td>
<td>NCUA believes that this recommendation is not necessary because Congress indirectly addressed this issue through PCA provisions in CUMAA in 1998. According to NCUA, if a credit union is undercapitalized under PCA, then growth can be restricted. Also according to NCUA, PCA requirements indirectly influence borrowing because borrowing could impact net worth classification. For clarification, we intended this recommendation to apply to all credit unions, not just those under PCA.</td>
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<tr>
<td>30</td>
<td>Amend the FCUA to require credit unions to adequately disclose that dividends on shares and other accounts cannot be guaranteed in advance but are dependent on earnings.</td>
<td>Implemented</td>
<td>Implemented as part of comprehensive banking reforms in 1991. NCUA issued a regulation under the Truth in Savings Act.</td>
</tr>
<tr>
<td>31</td>
<td>Amend the FCUA to require all insured credit unions to obtain NCUA permission before opening a new branch.</td>
<td>Not implemented</td>
<td>NCUA is opposed to this recommendation and believes that current regulations are appropriate. NCUA’s regulations require federally insured credit unions with over $1 million in assets to obtain NCUA approval to invest in fixed assets, including branch offices, if the aggregate of all such investments exceeds 5 percent of shares and retained earnings. Credit unions eligible under NCUA’s Regulatory Flexibility Program are exempt from this requirement.</td>
</tr>
<tr>
<td>32</td>
<td>Amend the FCUA to require 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.</td>
<td>Partially implemented</td>
<td>Implemented as part of CUMAA in 1998 and promulgated as NCUA regulation in July 1999. Credit unions with assets greater than $500 million are required to obtain annual independent certified public accountant audits. However, no requirement has been made requiring annual management reports on internal controls and compliance with laws and regulations.</td>
</tr>
<tr>
<td>33</td>
<td>Amend the FCUA to authorize and require NCUA to compel a federally insured, state-chartered union to follow the federal regulations in any area in which the credit union’s powers go beyond those permitted federally chartered credit unions and are considered to constitute a safety and soundness risk.</td>
<td>Not implemented</td>
<td>NCUA agrees with this recommendation.</td>
</tr>
<tr>
<td>34</td>
<td>NCUA’s management of failures 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.</td>
<td>Not implemented</td>
<td>According to NCUA, it maintains a policy of assisting failing credit unions at the least cost. Also, NCUA believes that changes to the FCUA are unnecessary because NCUA has enough flexibility to assist failing credit unions when the benefits of preserving the credit union outweigh the cost.</td>
</tr>
<tr>
<td>35</td>
<td>Require NCUA to maintain documentation supporting its resolution decisions, including the statistical and economic assumptions made.</td>
<td>Not implemented</td>
<td>According to NCUA, its policies and practices emphasize the importance of maintaining documentation of resolutions and that decisions are supported. In addition, and according to NCUA, it actively updates expectations and processes for retrieving and maintaining data through the revision of the Examiner’s Guide, Accounting Manual, Directives, Special Actions Manual, and Guidance to Credit Unions.</td>
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<tr>
<td>36</td>
<td>Amend the FCUA to confine insured credit union investments in corporate credit unions and U.S. Central Credit Union to those that have obtained deposit insurance from NCUSIF.</td>
<td>Not implemented</td>
<td>While not expressly implemented, NCUA has taken some action in this area. NCUA regulations require nonfederally insured corporate credit unions to agree to adhere to its corporate credit union rule and to submit to NCUA examinations as a condition of receiving shares or deposits from federally insured credit unions. According to NCUA, there is only one corporate credit union that is not federally insured.</td>
</tr>
<tr>
<td>37</td>
<td>Require NCUA to establish a program to promptly increase the capital of corporate credit unions and establish minimum capital standards.</td>
<td>Implemented</td>
<td>NCUA's regulations require corporate credit unions to maintain a minimum capital ratio of 4 percent. In addition, NCUA may issue a capital directive to corporate credit unions to achieve adequate capitalization within a specified time frame by taking any action deemed necessary, including increasing the amount of capital to specific levels. NCUA's corporate credit union rule also imposes an earnings retention requirement of either 10 or 15 basis points per annum if a corporate credit union's retained earnings ratio falls below 2 percent.</td>
</tr>
<tr>
<td>38</td>
<td>Require credit unions to expense the 1 percent deposit in NCUSIF over a reasonable period of time—to be determined by NCUA. At the same time, 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.</td>
<td>Implemented</td>
<td>We determined that Congress' passage of CUMAA, which set net worth levels for credit unions 1 percent higher to compensate for NCUSIF's accounting of the deposit as an asset, addressed our concerns about the double counting of capital at NCUSIF and credit unions. We determined that the recommendation regarding NCUSIF's access to the assets of a failed credit union has not been implemented, but we determined that this recommendation is implemented because our greatest concern was addressed regarding the double counting of capital between NCUSIF and credit unions.</td>
</tr>
</tbody>
</table>
### Appendix II
Status of Recommendations from GAO’s 1991 Report

(Continued From Previous Page)

<table>
<thead>
<tr>
<th>Issue</th>
<th>GAO Recommendation to Congress</th>
<th>Status</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>39</td>
<td>Amend the FCUA to establish an available assets ratio for NCUSIF.</td>
<td>Implemented</td>
<td>In passing CUMAA in August 1998, Congress amended the FCUA to establish a minimum 1.0 percent available assets ratio for NCUSIF. In addition, the NCUA board is to make a distribution to insured credit unions after each calendar year if, at the end of the calendar year: the NCUSIF’s available assets ratio exceeds 1.0 percent, any loans from the federal government as well as interest on those loans have been repaid, and NCUSIF’s equity ratio exceeds the normal operating level.</td>
</tr>
<tr>
<td>40</td>
<td>Amend the FCUA to 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.</td>
<td>Implemented</td>
<td>Under CUMAA, Congress authorized NCUA to assess a premium charge on insured credit unions if NCUSIF’s equity ratio was less than 1.3 percent and the premium charge would not exceed the amount necessary to restore the equity ratio to 1.3 percent. Congress also defined NCUSIF’s normal operating level as an equity ratio to be specified by the NCUA board between 1.2 and 1.5 percent. However, Congress set the available assets ratio at 1.0 percent with no authority given to NCUA to change it.</td>
</tr>
<tr>
<td>41</td>
<td>Amend the FCUA to provide for additional NCUA borrowing from Treasury on behalf of NCUSIF.</td>
<td>Not implemented</td>
<td>NCUA believes that borrowing authority is appropriate so long as the CLF and NCUSIF continue to have borrowing authority.</td>
</tr>
<tr>
<td>42</td>
<td>Amend the FCUA to place NCUSIF in a position second to general creditors but rank this position ahead of uninsured shares.</td>
<td>Not implemented</td>
<td>NCUA sees no compelling reason to make this change.</td>
</tr>
<tr>
<td>43</td>
<td>NCUA structural changes</td>
<td>Not implemented</td>
<td>NCUA believes there is no need for legislative change, as PCA provisions in CUMAA address declining net worth levels in credit unions.</td>
</tr>
<tr>
<td>44</td>
<td>Amend the FCUA to require NCUA to take appropriate enforcement action when unsafe and unsound conditions or practices, as specified in law or NCUA regulations, are identified.</td>
<td>Not implemented</td>
<td>Same as above.</td>
</tr>
</tbody>
</table>
### Appendix II
Status of Recommendations from GAO’s 1991 Report

(Continued From Previous Page)

<table>
<thead>
<tr>
<th>Issue</th>
<th>GAO Recommendation to Congress</th>
<th>Status</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>Amend the FCUA to 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.</td>
<td>Not implemented</td>
<td>NCUA is opposed to this recommendation.</td>
</tr>
<tr>
<td>46</td>
<td>Consider placing credit union's examination and supervision functions under a single federal regulator once such an entity is operating effectively, if there is broad reform of the depository institution regulatory structure. The insurance function could then be placed under FDIC or under a separate entity.</td>
<td>Not implemented</td>
<td>NCUA opposes this recommendation because it believes the change would affect the identity of credit unions, limit the financial choices for consumers, create competing and conflicting priorities for the single regulator, and stifle the financial marketplace.</td>
</tr>
<tr>
<td>47</td>
<td>Remove the power of federally chartered credit unions to borrow from Farm Credit Banks, as provided for in FCUA.</td>
<td>Not implemented</td>
<td>NCUA has no objection to this recommendation.</td>
</tr>
<tr>
<td>48</td>
<td>Amend the Community Development Credit Union Revolving Fund Transfer Act to designate an entity other than NCUA as administrator of the revolving fund.</td>
<td>Not implemented</td>
<td>NCUA opposes this recommendation because such a change would create additional bureaucratic requirements for small financial institutions. According to NCUA, the agency does not receive appropriations for administering the program and funds the program through the operating and overhead transfer fees collected from both federally chartered and federally insured credit unions.</td>
</tr>
<tr>
<td>49</td>
<td>Dissolve the CLF, as established by Title III of the FCUA.</td>
<td>Not implemented</td>
<td>NCUA opposes this recommendation.</td>
</tr>
<tr>
<td>50</td>
<td>If CLF continues to operate, sharply reduce CLF borrowing authority from the current level of 12 times subscribed capital and surplus.</td>
<td>Not implemented</td>
<td>NCUA opposes this recommendation and believes that restricting CLF’s capacity could undermine its purpose.</td>
</tr>
<tr>
<td>51</td>
<td>If CLF continues to operate, require the terms and conditions of CLF loans to be no more liberal than those made by the Federal Reserve.</td>
<td>Not implemented</td>
<td>NCUA believes that the rates of CLF loans are prudent. According to NCUA, rates on CLF loans to credit unions are based on the Federal Financing Bank (FFB) fixed rate, as the CLF borrows from the FFB. Furthermore, according to NCUA, FFB rates are related to U.S. Treasury rates.</td>
</tr>
</tbody>
</table>
(Continued From Previous Page)

<table>
<thead>
<tr>
<th>Issue</th>
<th>GAO Recommendation to Congress</th>
<th>Status</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>52</td>
<td>If CLF continues to operate, prohibit 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.</td>
<td>Not implemented</td>
<td>According to NCUA, CLF and NCUSIF are distinct entities and CLF does not extend loans or guarantees to NCUSIF.</td>
</tr>
</tbody>
</table>

**Matter for congressional consideration**

| Credit unions’ role in the financial marketplace | 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, 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. | Partially implemented | In passing CUMAA in August 1998, Congress established membership limits for federally chartered credit unions with respect to common-bond and community-chartered credit unions. Furthermore, Congress established numerical limitations for groups to be eligible for inclusion in multiple common-bond credit unions and established geographical guidelines for community credit unions. However, the legislation only applied to federally chartered credit unions. It did not apply to federally insured, state-chartered credit unions, which held 46 percent of total industry assets as of December 31, 2002. Therefore, this recommendation is partially implemented. |

Sources: GAO; NCUA; Department of Treasury; Federal Register; CUMAA.

*U.S. Central Credit Union, founded in 1974, solely assists corporate credit unions with financial services, including investment, liquidity, and cash management products and services; risk management and analytic capabilities; settlement, funds transfer and payment services; and safekeeping and custody services. It is owned and directed by its member corporate credit unions.*
As we reported earlier, the financial condition of federally insured credit unions—the industry—has improved since 1991, based on various measures such as capital ratios, assets, and regulatory ratings. This appendix provides greater detail on these measures. We used annual call reports from December 31, 1992, to December 31, 2002, as well as a database of regulatory ratings from the National Credit Union Administration (NCUA) for the same time period. In addition, we used consolidated data based on annual call reports for banks and thrifts in order to compare them with credit unions.

Industry Capital Ratios Have Increased over Time

The capital of federally insured credit unions as a percentage of total industry assets—the capital ratio—grew from 8.10 to 10.86 percent from December 31, 1992, to December 31, 2002 (see fig. 18). Over this period, larger credit unions had consistently higher capital ratios than smaller credit unions.
Appendix III
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Figure 18: Capital Ratios in Federally Insured Credit Unions, 1992–2002

Capital ratios

16
14
12
10
8
6
4
2
0


All credit unions

Small
Medium
Large

Source: Call report data.

Note: In this figure, small credit unions are defined as those with less than $10 million in assets; medium credit unions are those with assets ranging from $10 million to less than $50 million in assets; and large credit unions are those with $50 million or more in assets. The capital ratio of a given size category is calculated as the total equity of all credit unions in that size category divided by the total assets of all credit unions in that size category.

Growth of the Industry

The credit union industry grew dramatically since December 31, 1992, as measured by assets and the value of shares (see table 6). From December 31, 1992, to December 31, 2002, assets in federally insured credit unions increased from $258 billion to $557 billion, or 116 percent, while shares increased from $233 billion to $484 billion, or 108 percent. From December 31, 1992, to December 31, 2000, the annual percentage growth rates of assets and shares generally fluctuated from around 3 percent to around 7 percent, with a significant rise in 1998 to over 10 percent. In the last 2 years (2001–2002), however, the annual percentage growth in assets and shares again rose sharply. According to NCUA officials, the more recent growth in assets and shares reflected a “flight to safety” on the part of consumers.
seeking low-risk investments in reaction to the generally depressed condition of the securities market.

Table 6: Federally Insured Credit Union Growth in Assets and Shares, 1992–2002

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dollar value</td>
<td>Percentage growth</td>
</tr>
<tr>
<td>December 31</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>$258.37</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>277.13</td>
<td>7.26</td>
</tr>
<tr>
<td>1994</td>
<td>289.45</td>
<td>4.45</td>
</tr>
<tr>
<td>1995</td>
<td>306.64</td>
<td>5.94</td>
</tr>
<tr>
<td>1996</td>
<td>326.89</td>
<td>6.60</td>
</tr>
<tr>
<td>1997</td>
<td>351.17</td>
<td>7.43</td>
</tr>
<tr>
<td>1998</td>
<td>388.70</td>
<td>10.69</td>
</tr>
<tr>
<td>1999</td>
<td>411.42</td>
<td>5.84</td>
</tr>
<tr>
<td>2000</td>
<td>438.22</td>
<td>6.51</td>
</tr>
<tr>
<td>2001</td>
<td>501.54</td>
<td>14.45</td>
</tr>
<tr>
<td>2002</td>
<td>557.07</td>
<td>11.07</td>
</tr>
</tbody>
</table>

Source: Call report data.

As noted earlier, the industry has consolidated and become slightly more concentrated. As of December 31, 1992, there were 12,595 credit unions, but by December 31, 2002, that number had declined to 9,688 (see table 7). The number of credit unions with less than $10 million in assets declined during this period, while the number of credit unions with more than $30 million in assets grew. Those credit unions with over $100 million in assets had around 52 percent of total industry assets as of December 31, 1992, but by December 31, 2002, credit unions of this size had around 75 percent of total industry assets. The 50 largest credit unions held 18 percent of industry assets in 1992, but by 2002 the 50 largest credit unions held 23 percent of industry assets.
### Appendix III
Financial Condition of Federally Insured Credit Unions

#### Table 7: Distribution of Credit Unions by Asset Size, 1992 and 2002

<table>
<thead>
<tr>
<th>Asset size (dollars in millions)</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Less than .5</td>
</tr>
<tr>
<td>1992</td>
<td>1,696</td>
</tr>
<tr>
<td></td>
<td>13.47</td>
</tr>
<tr>
<td>Total assets (dollars in millions)</td>
<td>$433,203</td>
</tr>
<tr>
<td>Percent of total assets</td>
<td>0.17</td>
</tr>
<tr>
<td>2002</td>
<td>620</td>
</tr>
<tr>
<td></td>
<td>6.40</td>
</tr>
<tr>
<td>Total assets (dollars in millions)</td>
<td>$165,054</td>
</tr>
<tr>
<td>Percent of total assets</td>
<td>0.03</td>
</tr>
</tbody>
</table>

Source: Call report data.

As industry assets have increased, the composition of these assets has changed. Total loans as a percentage of total assets increased from 54 percent as of December 31, 1992, to 62 percent as of December 31, 2002 (see table 8). While consumer loans, which broadly consist of unsecured credit card loans, new and used vehicle loans, and certain other loans to members, remained the largest category of credit union loans, the most significant growth in credit union loan portfolios was in real estate loans. These loans grew from 19 percent of total assets as of December 31, 1992, to 26 percent of total assets as of December 31, 2002.
### Table 8: Asset Composition of Credit Unions as a Percentage of Total Assets, 1992–2002

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2.42</td>
<td>2.27</td>
<td>2.18</td>
<td>2.32</td>
<td>2.22</td>
<td>2.25</td>
<td>2.28</td>
<td>6.39</td>
<td>7.64</td>
<td>10.09</td>
<td>9.62</td>
</tr>
<tr>
<td>Consumer loans</td>
<td>29.77</td>
<td>31.35</td>
<td>35.83</td>
<td>37.70</td>
<td>39.01</td>
<td>38.57</td>
<td>35.59</td>
<td>36.31</td>
<td>37.61</td>
<td>33.91</td>
<td>31.47</td>
</tr>
<tr>
<td>Other loans</td>
<td>5.19</td>
<td>4.94</td>
<td>4.97</td>
<td>4.82</td>
<td>4.76</td>
<td>4.66</td>
<td>4.30</td>
<td>4.43</td>
<td>4.55</td>
<td>4.11</td>
<td>3.63</td>
</tr>
<tr>
<td><strong>Total loans</strong></td>
<td><strong>54.01</strong></td>
<td><strong>54.96</strong></td>
<td><strong>60.76</strong></td>
<td><strong>62.66</strong></td>
<td><strong>65.40</strong></td>
<td><strong>66.15</strong></td>
<td><strong>63.24</strong></td>
<td><strong>66.02</strong></td>
<td><strong>68.77</strong></td>
<td><strong>64.29</strong></td>
<td><strong>61.51</strong></td>
</tr>
<tr>
<td>Investments in corporate credit unions</td>
<td>13.33</td>
<td>11.41</td>
<td>8.28</td>
<td>8.07</td>
<td>6.97</td>
<td>7.41</td>
<td>9.29</td>
<td>5.15</td>
<td>3.36</td>
<td>3.85</td>
<td>4.77</td>
</tr>
<tr>
<td>Bank and thrift deposits</td>
<td>0.00</td>
<td>0.00</td>
<td>5.52</td>
<td>5.43</td>
<td>4.87</td>
<td>4.71</td>
<td>5.46</td>
<td>3.78</td>
<td>2.85</td>
<td>3.71</td>
<td>4.18</td>
</tr>
<tr>
<td>Other investments</td>
<td>1.05</td>
<td>1.13</td>
<td>1.08</td>
<td>1.02</td>
<td>0.85</td>
<td>0.92</td>
<td>1.29</td>
<td>1.44</td>
<td>1.35</td>
<td>1.47</td>
<td>1.56</td>
</tr>
<tr>
<td>Fixed and other assets</td>
<td>12.93</td>
<td>12.17</td>
<td>3.85</td>
<td>4.09</td>
<td>4.06</td>
<td>4.04</td>
<td>4.77</td>
<td>4.03</td>
<td>4.04</td>
<td>4.27</td>
<td>4.47</td>
</tr>
<tr>
<td><strong>Total assets ($ in billions)</strong></td>
<td><strong>$258.37</strong></td>
<td><strong>$277.13</strong></td>
<td><strong>$289.45</strong></td>
<td><strong>$306.64</strong></td>
<td><strong>$326.89</strong></td>
<td><strong>$351.17</strong></td>
<td><strong>$388.70</strong></td>
<td><strong>$411.42</strong></td>
<td><strong>$438.22</strong></td>
<td><strong>$501.54</strong></td>
<td><strong>$557.07</strong></td>
</tr>
</tbody>
</table>

Source: Call report data.
Despite the growth in credit union real estate loans, credit unions had a lower percentage of real estate loans to total assets (26 percent) than their peer group banks and thrifts, which had 37 percent of real estate loans to total assets (see table 9). Credit unions had a significantly higher percentage of consumer loans to total assets (31 percent) compared with their peer group banks and thrifts (8 percent). These banks and thrifts, however, had a significantly higher percentage of agricultural and commercial loans to total assets (12 percent) compared with credit unions (slightly more than 1 percent).

Table 9: Comparison of the Loan Portfolios of Federally Insured Credit Unions with Peer Group Banks and Thrifts, as of 2002

<table>
<thead>
<tr>
<th>Loan types</th>
<th>Credit unions</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Dollar value</td>
<td>Percent</td>
</tr>
<tr>
<td>Consumer loans</td>
<td>175,300,187,240</td>
<td>31.47</td>
</tr>
<tr>
<td>Real estate loans</td>
<td>147,131,474,868</td>
<td>26.41</td>
</tr>
<tr>
<td>Agricultural and commercial loans</td>
<td>6,644,982,024</td>
<td>1.19</td>
</tr>
<tr>
<td>Other loans</td>
<td>13,571,878,174</td>
<td>2.44</td>
</tr>
<tr>
<td><strong>Total loans</strong></td>
<td>342,648,522,306</td>
<td>61.51</td>
</tr>
<tr>
<td>Other assets</td>
<td>214,426,042,531</td>
<td>38.49</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>557,074,564,837</td>
<td>100</td>
</tr>
<tr>
<td>Number of institutions</td>
<td>9,688</td>
<td></td>
</tr>
</tbody>
</table>

Note: Data are as of December 31, 2002, and are based on all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered banks, banks with more than $18 billion in assets, and banks we determined had emphases in credit card or mortgage loans are excluded.

Credit Union Profits Have Been Relatively Stable in Recent Years

The profitability of credit unions, as measured by the return on average assets, has been relatively stable in recent years. According to this measure, credit union profitability was higher in the early to mid-1990s than in the late 1990s and early 2000s. While declining from 1993 through 1999, the return on average assets has since stabilized. It has generally hovered around 1 percent, which, by historical banking standards, is a performance benchmark, and it was reported at 1.07 as of December 31, 2002 (see fig. 19). Profits are an especially important source of capital for credit unions because they are mutually owned institutions that cannot sell equity to raise capital.
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Figure 19: Profitability of Federally Insured Credit Unions, 1992–2002

Percentage

1.6
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0


Source: Call report data.

Notes: Profitability is measured by the return on average assets, in which average assets are the
simple average of total assets as of the current period and prior yearend. The return on average assets
was not available for 1992 since we did not have 1991 total assets data.

Credit Unions’ Regulatory Ratings Have Improved Since December 1992

The number of credit unions with a CAMEL rating of 1 (strong) increased from 1,082 (9 percent) in 1992 to 2,186 (23 percent) in 2002 (see fig. 20).
During the same time period, institutions classified as problem credit unions—those with CAMEL ratings of 4 (poor) or 5 (unsatisfactory)—decreased from 578 (5 percent) in 1992 to 211 (2 percent) in 2002.
## Figure 20: Federally Insured Credit Unions, by CAMEL Rating, 1992–2002

<table>
<thead>
<tr>
<th>Year</th>
<th>Strong</th>
<th>Satisfactory</th>
<th>Flawed</th>
<th>Poor</th>
<th>Unsatisfactory</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>8.59</td>
<td>54.65</td>
<td>32.17</td>
<td>4.18</td>
<td>0.41</td>
</tr>
<tr>
<td>1993</td>
<td>9.46</td>
<td>57.42</td>
<td>29.87</td>
<td>3.14</td>
<td>0.11</td>
</tr>
<tr>
<td>1994</td>
<td>11.53</td>
<td>58.86</td>
<td>27.1</td>
<td>2.45</td>
<td>0.06</td>
</tr>
<tr>
<td>1995</td>
<td>13.69</td>
<td>58.9</td>
<td>25.10</td>
<td>2.18</td>
<td>0.14</td>
</tr>
<tr>
<td>1996</td>
<td>17.91</td>
<td>57.63</td>
<td>22.00</td>
<td>2.34</td>
<td>0.11</td>
</tr>
<tr>
<td>1997</td>
<td>20.44</td>
<td>56.15</td>
<td>20.62</td>
<td>2.7</td>
<td>0.10</td>
</tr>
<tr>
<td>1998</td>
<td>21.17</td>
<td>55.85</td>
<td>20.26</td>
<td>2.57</td>
<td>0.16</td>
</tr>
<tr>
<td>1999</td>
<td>20.56</td>
<td>56.51</td>
<td>19.87</td>
<td>2.86</td>
<td>0.20</td>
</tr>
<tr>
<td>2000</td>
<td>22.91</td>
<td>57.54</td>
<td>17.61</td>
<td>1.85</td>
<td>0.09</td>
</tr>
<tr>
<td>2001</td>
<td>24.17</td>
<td>55.74</td>
<td>18.04</td>
<td>1.97</td>
<td>0.08</td>
</tr>
<tr>
<td>2002</td>
<td>22.57</td>
<td>55.67</td>
<td>19.58</td>
<td>2.08</td>
<td>0.10</td>
</tr>
</tbody>
</table>

Source: NCUA.
Appendix IV

Comparison of Bank and Credit Union Distribution of Assets

Figures 21, 22, and 23 illustrate the marked size disparity between credit unions and institutions insured by the Federal Deposit Insurance Corporation (FDIC), with figure 21 highlighting how small most credit unions are.1 At the end of 2002, the largest credit union had less than $18 billion in assets, while the largest bank, with over $600 billion in assets, was larger than the entire credit union industry.

Figure 21: Total Assets of All Credit Unions and All Banks, as of 2002

Note: Data are as of December 31, 2002, and include all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered institutions are excluded. This figure depicts the number of institutions in a particular asset size category. Each category represents a range—for example, the first category includes all institutions with assets of $100 million or less, while the second category includes all institutions with assets greater than $100 million and less than or equal to $250 million, up to the last category, which includes all institutions with assets greater than $500 million and less than or equal to $750 billion.

Source: Call report data.

1Throughout the report, we refer to institutions insured by the FDIC interchangeably as “banks,” “banks and thrifts,” and “FDIC-insured institutions.”
Figure 22: Total Assets of Credit Unions and Banks with Less Than $100 Million in Assets, as of 2002

Number of institutions

Total assets (in thousands)

Source: Call report data.

Note: Data are as of December 31, 2002, and include all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered institutions are excluded. This figure depicts the number of institutions in a particular asset size category. Each category represents a range—for example, the first category includes all institutions with assets of $5 million or less, while the second category includes all institutions with assets greater than $5 million and less than or equal to $10 million, up to the last category, which includes all institutions with assets greater than $95 million and less than or equal to $100 million.
Figure 23: Total Assets of Credit Unions with Less Than $5 Million in Assets, as of 2002

Number of credit unions

Note: Data are as of December 31, 2002, and include all federally insured credit unions filing call reports. This figure depicts the number of institutions in a particular asset size category. Each category represents a range—for example, the first category includes all institutions with assets of $250,000 or less, while the second category includes all institutions with assets greater than $250,000 and less than or equal to $500,000, up to the last category, which includes all institutions with assets greater than $4.75 million and less than or equal to $5 million.

Given the disproportionate size of the banking industry relative to the credit union industry, peer groups were defined to mitigate the effects of this discrepancy. Therefore, for our more detailed reviews, we constructed five peer groups in terms of institution size as measured by total assets, reported as of December 31, 2002. We further refined the sample of FDIC-insured institutions to exclude those banks and thrifts we determined had emphases in credit card or mortgage loans. The largest bank included in our analyses had total assets of nearly $18 billion in 2002. See appendix I for details.

Figures 24, 25, 26, and 27 illustrate that differences in services (as measured by the number of institutions holding various consumer, mortgage, and business loans) between credit unions and peer group banks...
are manifested in terms of institution size. Overall, the credit union industry in aggregate did not appear to be that similar to the banking industry (as captured by our sample of peer group banks) in terms of services; however, when broken out by size, the larger credit unions (those with more than $100 million in assets, or credit unions in Groups II, III, IV, and V) appeared to be offering very similar services to peer banks. Moreover, as nearly 90 percent of all credit unions had less than $100 million in assets as of December 31, 2002, the results depicted in Figure 24 are influenced more heavily by these institutions.

**Figure 24: Percentage of All Credit Unions and All Banks Holding Various Loans, as of 2002**

<table>
<thead>
<tr>
<th>Percentage of institutions</th>
<th>Credit unions</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>First mortgage loans</td>
<td>98</td>
<td>50</td>
</tr>
<tr>
<td>Junior mortgage and home equity loans</td>
<td>86</td>
<td>59</td>
</tr>
<tr>
<td>Credit card loans</td>
<td>98</td>
<td>50</td>
</tr>
<tr>
<td>Other consumer loans</td>
<td>98</td>
<td>29</td>
</tr>
<tr>
<td>Agricultural and business loans</td>
<td>98</td>
<td>16</td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31, 2002, and are based on all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered institutions and banks we determined had emphases in credit card or mortgage loans are excluded. Bank data on mortgages exclude thrifts. Credit union data on other consumer loans may include member business and agricultural loans.
Appendix IV
Comparison of Bank and Credit Union Distribution of Assets

Figure 25: Percentage of Credit Unions and Banks with Assets of $100 Million or Less Holding Various Loans, as of 2002

Percentage of institutions

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Credit Unions</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>First mortgage loans</td>
<td>44</td>
<td>97</td>
</tr>
<tr>
<td>Junior mortgage and home equity loans</td>
<td>55</td>
<td>78</td>
</tr>
<tr>
<td>Credit card loans</td>
<td>45</td>
<td>18</td>
</tr>
<tr>
<td>Other consumer loans</td>
<td>100</td>
<td>97</td>
</tr>
<tr>
<td>Agricultural and business loans</td>
<td>96</td>
<td></td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31, 2002, and are based on all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered institutions and banks we determined had emphases in credit card or mortgage loans are excluded. Bank data on mortgages exclude thrifts. Credit union data on other consumer loans may include member business and agricultural loans.
Figure 26: Percentage of Credit Unions and Banks with Assets between $1 Billion and $18 Billion Holding Various Loans, as of 2002

Percentage of institutions

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Credit Unions</th>
<th>Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>First mortgage loans</td>
<td>100</td>
<td>96</td>
</tr>
<tr>
<td>Junior mortgage and home equity</td>
<td>100</td>
<td>95</td>
</tr>
<tr>
<td>Other consumer loans</td>
<td>100</td>
<td>97</td>
</tr>
<tr>
<td>Agricultural and business loans</td>
<td>100</td>
<td>96</td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31, 2002, and are based on all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered institutions and banks we determined had emphases in credit card or mortgage loans are excluded. Bank data on mortgages exclude thrifts. Credit union data on other consumer loans may include member business and agricultural loans.
**Figure 27: Percentages of Credit Unions and Banks Holding Various Loans, by Institution Size, as of 2002**

<table>
<thead>
<tr>
<th>Group</th>
<th>Number</th>
<th>Total assets (dollars in billions)</th>
<th>First mortgage loans</th>
<th>Junior mortgage and home equity loans</th>
<th>Credit card loans</th>
<th>Other consumer loans</th>
<th>Agricultural and business loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>8,642</td>
<td>$139.70</td>
<td>43.6%</td>
<td>54.5%</td>
<td>44.7%</td>
<td>99.9%</td>
<td>12.3%</td>
</tr>
<tr>
<td></td>
<td>4,083</td>
<td>$205.98</td>
<td>97.3%</td>
<td>77.6%</td>
<td>17.5%</td>
<td>97.5%</td>
<td>96.3%</td>
</tr>
<tr>
<td>II</td>
<td>602</td>
<td>$93.57</td>
<td>97.2%</td>
<td>98.5%</td>
<td>91.7%</td>
<td>100%</td>
<td>43.5%</td>
</tr>
<tr>
<td></td>
<td>2,086</td>
<td>$327.96</td>
<td>98.9%</td>
<td>95.9%</td>
<td>35.7%</td>
<td>98.8%</td>
<td>97.4%</td>
</tr>
<tr>
<td>III</td>
<td>240</td>
<td>$83.83</td>
<td>99.2%</td>
<td>98.3%</td>
<td>91.3%</td>
<td>100%</td>
<td>57.1%</td>
</tr>
<tr>
<td></td>
<td>858</td>
<td>$297.79</td>
<td>97.8%</td>
<td>96.9%</td>
<td>45.8%</td>
<td>98.1%</td>
<td>97.1%</td>
</tr>
<tr>
<td>IV</td>
<td>133</td>
<td>$89.73</td>
<td>100%</td>
<td>99.2%</td>
<td>93.2%</td>
<td>100%</td>
<td>57.1%</td>
</tr>
<tr>
<td></td>
<td>418</td>
<td>$289.54</td>
<td>97.6%</td>
<td>97.6%</td>
<td>44.5%</td>
<td>98.1%</td>
<td>96.7%</td>
</tr>
<tr>
<td>V</td>
<td>71</td>
<td>$150.24</td>
<td>100%</td>
<td>100%</td>
<td>90.1%</td>
<td>100%</td>
<td>76.1%</td>
</tr>
<tr>
<td></td>
<td>384</td>
<td>$1,399.98</td>
<td>96.2%</td>
<td>94.8%</td>
<td>51.8%</td>
<td>96.9%</td>
<td>95.8%</td>
</tr>
<tr>
<td>Total</td>
<td>9,688</td>
<td>$557.07</td>
<td>49.5%</td>
<td>59.3%</td>
<td>49.8%</td>
<td>99.9%</td>
<td>16.4%</td>
</tr>
<tr>
<td></td>
<td>7,829</td>
<td>$2,521.25</td>
<td>97.7%</td>
<td>86.4%</td>
<td>28.6%</td>
<td>97.9%</td>
<td>97.5%</td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31, 2002, and are based on all federally insured credit unions and banks and thrifts filing call reports. Insured U.S. branches of foreign-chartered institutions and banks we determined had emphases in credit card or mortgage loans are excluded. Bank data on mortgages exclude thrifts. Credit union data on other consumer loans may include member business and agricultural loans. Group I credit unions had assets of $100 million or less; Group II credit unions had assets greater than $100 million and less than or equal to $250 million; Group III credit unions had assets greater than $250 million and less than or equal to $500 million; Group IV credit unions had assets greater than $500 million and less than or equal to $1 billion; and Group V credit unions had assets greater than $1 billion and less than or equal to $18 billion, which is the asset size, rounded up to the nearest billion dollars, of the largest credit union as of December 31, 2002.
In the absence of detailed time series data on the provision of services by credit unions, we used holdings of various loans, including mortgage and consumer loans, as well as other variables, as rough measures of credit union services over time. We also separated credit unions by asset size to illustrate any differences in provision of services by this criterion. For illustrative purposes, we compared the smallest credit unions (those with assets of $100 million or less) with the largest credit unions (those with more than $1 billion in assets).

The percentage of all credit unions holding first mortgage loans has increased every year since 1992 (see fig. 28). However, nearly twice as many credit unions hold new and used vehicle loans as first mortgage loans.
Figure 28: Percentage of Credit Unions Holding Various Loans, 1992–2002

Source: Call report data.

Note: Data are as of December 31 and are based on all federally insured credit unions filing call reports.
Calculating the percentage of loan amounts held to total assets can reveal the relative importance of each type of loan to credit unions. Figure 29 shows that first mortgage loans have increased in importance, surpassing each of the other loan holdings.
Figure 29: Percentage of Assets Held in Various Loans by All Credit Unions, 1992–2002

Source: Call report data.

Note: Data are as of December 31 and are based on all federally insured credit unions filing call reports.
Although nearly all credit unions have offered regular shares (savings accounts), over the years, the percentage of those offering share drafts (checking accounts) and money market shares has increased, as illustrated in figure 30.
Figure 30: Percentage of Credit Unions Offering Various Accounts, 1992–2002

**Regular shares**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>100</td>
</tr>
<tr>
<td>1993</td>
<td>100</td>
</tr>
<tr>
<td>1994</td>
<td>100</td>
</tr>
<tr>
<td>1995</td>
<td>100</td>
</tr>
<tr>
<td>1996</td>
<td>100</td>
</tr>
<tr>
<td>1997</td>
<td>100</td>
</tr>
<tr>
<td>1998</td>
<td>100</td>
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<tr>
<td>1999</td>
<td>100</td>
</tr>
<tr>
<td>2000</td>
<td>100</td>
</tr>
<tr>
<td>2001</td>
<td>100</td>
</tr>
<tr>
<td>2002</td>
<td>100</td>
</tr>
</tbody>
</table>

**Share drafts**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>0</td>
</tr>
<tr>
<td>1993</td>
<td>10</td>
</tr>
<tr>
<td>1994</td>
<td>30</td>
</tr>
<tr>
<td>1995</td>
<td>50</td>
</tr>
<tr>
<td>1996</td>
<td>60</td>
</tr>
<tr>
<td>1997</td>
<td>65</td>
</tr>
<tr>
<td>1998</td>
<td>70</td>
</tr>
<tr>
<td>1999</td>
<td>75</td>
</tr>
<tr>
<td>2000</td>
<td>80</td>
</tr>
<tr>
<td>2001</td>
<td>85</td>
</tr>
<tr>
<td>2002</td>
<td>90</td>
</tr>
</tbody>
</table>

**Money market shares**

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>0</td>
</tr>
<tr>
<td>1993</td>
<td>0</td>
</tr>
<tr>
<td>1994</td>
<td>0</td>
</tr>
<tr>
<td>1995</td>
<td>0</td>
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<td>1996</td>
<td>0</td>
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<td>1997</td>
<td>0</td>
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<tr>
<td>1998</td>
<td>0</td>
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<tr>
<td>1999</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>0</td>
</tr>
<tr>
<td>2001</td>
<td>0</td>
</tr>
<tr>
<td>2002</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31 and are based on all federally insured credit unions filing call reports. Regular shares are savings accounts and share drafts are checking accounts.
The number of employees could have an effect on the provision of services as well. Figure 31 shows that industry consolidation has not adversely affected employment. Even though the industry shrank in terms of the number of institutions from 12,595 in 1992 to 9,688 in 2002, a decline of 23 percent, the number of full-time employees went from 119,480 in 1992 to 180,401 in 2002, an increase of 51 percent.

Figure 31: Credit Union Employees and Number of Credit Unions, 1992–2002

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Credit Unions</th>
<th>Full-time Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>12,595</td>
<td>119,480</td>
</tr>
<tr>
<td>1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31 and are based on all federally insured credit unions filing call reports.

The differences between the smallest credit unions (those with $100 million or less in assets) and the largest credit unions (those with more than $1 billion in assets) are also apparent in the types of loans held and their relative importance for each group over time (see figs. 32 and 33). Nearly all of the smallest credit unions have emphasized new and used vehicle loans, but typically less than one-half of these credit unions have held other loan types. As of December 31, 2002, used vehicle loans were the relatively most important loan holding for the smallest credit unions, surpassing new vehicle loans. Almost all of the largest credit unions have
held most types of loans over the past decade, with the exception of member business loans—but the percentage of the largest credit unions holding these has been steadily growing and, as of December 31, 2002, roughly three out of four of these credit unions held them. First mortgage loans have consistently been the most important loan holding of the largest credit unions, and they now represent nearly one-quarter of the asset mix of these credit unions.
Figure 32: Percentage of Credit Unions, Smallest versus Largest, Holding Various Loans, 1992–2002

Source: Call report data.

Note: Data are as of December 31 and are based on all federally insured credit unions filing call reports. The smallest credit unions (Group I) are those with $100 million or less in assets while the largest credit unions (Group V) are those with more than $1 billion in assets.
Figure 33: Percentage of Assets Held in Various Loans, Smallest versus Largest Credit Unions, 1992–2002

Source: Call report data.

Note: Data are as of December 31 and are based on all federally insured credit unions filing call reports. The smallest credit unions (Group I) are those with $100 million or less in assets while the largest credit unions (Group V) are those with more than $1 billion in assets.
As of December 31, 2002, we observed a gap in services offered by smaller credit unions and larger credit unions (see fig. 34). While larger credit unions—those with assets of more than $100 million—accounted for just over 10 percent of all credit unions, they offered more services than smaller credit unions. For example, nearly all of the larger credit unions held mortgage loans and credit card loans, while only around one-half of the smaller credit unions held these loans.

The discrepancy in the services offered by smaller and larger credit unions is more accurately illustrated through an analysis of more recently collected data on more sophisticated product and service offerings, such as the availability of automatic teller machines (ATM) and electronic banking (see fig. 35). While less than half of the smallest credit unions offered ATMs
and one-third offered financial services through the Internet, nearly all larger credit unions offered these services.

Figure 35: Credit Union Size and Offerings of More Sophisticated Services, as of 2002

<table>
<thead>
<tr>
<th>Group</th>
<th>Number of credit unions in the sample</th>
<th>Percentage of credit unions in the sample offering:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Financial services through the Internet</td>
</tr>
<tr>
<td>I</td>
<td>8,642 (89.2% of entire sample)</td>
<td>28.4%</td>
</tr>
<tr>
<td>II</td>
<td>602 (6.2% of entire sample)</td>
<td></td>
</tr>
<tr>
<td>III</td>
<td>240 (2.5% of entire sample)</td>
<td></td>
</tr>
<tr>
<td>IV</td>
<td>133 (1.4% of entire sample)</td>
<td></td>
</tr>
<tr>
<td>V</td>
<td>71 (0.7% of entire sample)</td>
<td></td>
</tr>
<tr>
<td>Entire sample</td>
<td>9,688</td>
<td>35.5%</td>
</tr>
</tbody>
</table>

Source: Call report data.

Note: Data are as of December 31, 2002, and are based on all federally insured credit unions filing call reports. Group I credit unions had assets of $100 million or less; Group II credit unions had assets greater than $100 million and less than or equal to $250 million; Group III credit unions had assets greater than $250 million and less than or equal to $500 million; Group IV credit unions had assets greater than $500 million and less than or equal to $1 billion; and Group V credit unions had assets greater than $1 billion and less than or equal to $18 billion, which is the asset size, rounded up to the nearest billion dollars, of the largest credit union as of December 31, 2002.
This appendix provides additional information on the characteristics—age, education, and race/ethnicity—of households that use banks and credit unions. For figures 36, 37, and 38, we analyzed data from the Federal Reserve’s 2001 Survey of Consumer Finances (SCF). The categories we used to describe these households—credit union users and bank users—included those who only and primarily used each of these institutions. To supplement our analyses of households by race, we also analyzed 2001 loan application records from the Home Mortgage Disclosure Act database (HMDA) (see fig. 39). As we did with our analysis of HMDA income data, we only analyzed records for home purchase loans actually made for the purchase of one-to-four family homes.

**Figure 36: Households Using Credit Unions and Banks, by Education Level, 2001**

<table>
<thead>
<tr>
<th>Education Level</th>
<th>Households only and primarily using credit unions</th>
<th>Households only and primarily using banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than high school</td>
<td>8</td>
<td>18</td>
</tr>
<tr>
<td>High school graduate</td>
<td>34</td>
<td>27</td>
</tr>
<tr>
<td>Some college</td>
<td>27</td>
<td>28</td>
</tr>
<tr>
<td>College/graduate degree</td>
<td>31</td>
<td>23</td>
</tr>
</tbody>
</table>

Source: 2001 SCF.
Figure 37: Households Using Credit Unions and Banks, by Age Group, 2001

Percentage of households

Source: 2001 SCF.

Note: Percentages do not add to 100 percent due to rounding.
Figure 38: Households Using Credit Unions and Banks, by Race and Ethnicity, 2001

Percentage of households

Source: 2001 SCF.

Note: Percentages do not add to 100 percent due to rounding.
Figure 39: Mortgages Made by Credit Unions and Banks, by Race and Ethnicity, 2001

Percentage

Source: 2001 HMDA database.

Notes: The “other” category includes data reported for American Indians, Alaskan natives, Asian or Pacific islanders, and those from the HMDA “other” category. We collapsed these categories to create groups similar to the ones used by the SCF. However, in our HMDA analysis, we only included mortgages made by peer group banks (banks with less than $16 billion in assets) whereas the SCF did not exclude households using banks with more than $16 billion in assets.

Fifteen percent of the HMDA data reported by credit unions and 6 percent of the HMDA data reported by banks lacked race and ethnicity data. As such, the data in this figure may not represent the exact proportion of mortgage loans by race. We also found that the proportion of loans without data varied by the asset size of institutions. For example, race data were missing for 23 percent of credit unions with assets of more than $500 million compared with about 3 percent for credit unions with less than $50 million in assets. Similarly, race data were missing for about 8 percent of peer group banks with more than $500 million in assets compared with about 4 percent of banks with less than $50 million in assets. However, since these larger institutions made most of the loans, missing data from these institutions account for more than 80 percent of all the missing data.
Appendix VII


Since 1992, changes to the National Credit Union Administration’s (NCUA) rules and regulations governing credit unions generally expanded the powers of credit unions to offer products and services, and broadened the activities in which they could engage. With the exception of member business lending, which NCUA constrained during the 1990s, federally chartered credit unions gained authority to, among other things, (1) invest in a wider variety of financial instruments, (2) offer services through the Internet, and (3) profit from referring members to products, such as insurance and investments, sold by third parties. Also, NCUA increased the number of activities in which credit union service organizations (CUSO) could engage, including student loan and business loan origination. In September 2003, NCUA expanded credit union powers in member business lending to permit well-capitalized credit unions to make unsecured member business loans within certain limits, among other things. See table 10 for a timeline of key changes to NCUA rules and regulations.

<table>
<thead>
<tr>
<th>Effective date</th>
<th>Key change</th>
</tr>
</thead>
<tbody>
<tr>
<td>January 1992</td>
<td>NCUA limited member business loans in response to losses to credit unions, their members, and the National Credit Union Share Insurance Fund. NCUA established loan security requirements, limits on loans to one borrower, and an aggregate portfolio cap on construction and development loans at 15 percent of reserves for federally insured credit unions.</td>
</tr>
<tr>
<td>September 1996</td>
<td>NCUA allowed credit unions serving predominantly low-income members to raise secondary capital from foundations and other philanthropic-minded institutional investors, to help credit unions make more loans, and improve services to low-income members. NCUA required credit unions to establish certain uninsured or other form of nonshare accounts for secondary capital.</td>
</tr>
<tr>
<td>January 1998</td>
<td>NCUA codified additional powers of federally chartered credit unions to act as trustees and custodians of Roth Individual Retirement Accounts (IRA) and Education IRAs, which is in addition to those trustee and custodian services they had been authorized to provide for other kinds of pension and retirement plans for approximately the previous 23 years. NCUA changed its investment rule to focus on risk management (previous focus was on specific financial instruments for federal credit unions). NCUA established new requirements for assessing and managing risk associated with federally chartered credit union investment activities.</td>
</tr>
<tr>
<td>April 1998</td>
<td>NCUA codified additional preapproved CUSO activities to include student loan origination, disaster recovery services, additional checking and currency services, and electronic income tax filing services, among others.</td>
</tr>
<tr>
<td>August 1998</td>
<td>Credit Union Membership Access Act (CUMAA) became law. CUMAA provisions cap the aggregate portfolio amount of member business loans for federally insured credit unions, with exceptions.</td>
</tr>
<tr>
<td>March 2000</td>
<td>NCUA allowed federally chartered credit unions in specified locations outside the United States to offer trustee or custodian services for IRAs.</td>
</tr>
</tbody>
</table>
### Key Changes in NCUA Rules and Regulations, 1992–2003

<table>
<thead>
<tr>
<th>Effective date</th>
<th>Key change</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 2001</td>
<td>NCUA issued legal opinion that permitted a federally chartered credit union employee to be a shared employee with a third party and, while acting in the capacity of an employee of the third party, to sell nondeposit investment products and provide investment advice. NCUA continued to restrict federally chartered credit union employees, acting as an employee of the credit union, from selling nondeposit investment products or providing investment advice.</td>
</tr>
<tr>
<td>September 2001</td>
<td>NCUA’s Incidental Powers Regulation became effective. This rule codified a broad range of activities, products, and services that federally chartered credit unions could offer directly to members, and which NCUA had previously recognized in legal opinions or had recognized in other regulations. One change, which permits federally chartered credit unions to earn income directly from finder activities (the referral of members to outside vendors, such as investment and insurance brokers), had the effect of making it unnecessary to use a CUSO in third-party networking arrangements in order to receive income. Key powers codified in the regulation include: electronic financial services, finder activities, loan-related products, such as debt suspension agreements, and trustee services. There is overlap of the activities in which federally chartered credit unions and CUSOs may engage (for example, consumer mortgage origination), but there are also activities only permissible for CUSOs (for example, general trust services and travel agency services).</td>
</tr>
<tr>
<td>February 2002</td>
<td>NCUA issued a legal opinion on how federally chartered credit unions can provide nonmembers, such as agricultural workers with familial ties to foreign countries, with wire transfer services. While expressly restricting unlimited services to nonmembers, NCUA permitted federally chartered credit unions to (1) establish nondividend-bearing accounts for people within its field of membership, (2) provide wire transfer services as a promotional activity on a limited basis, and (3) provide services as a charitable activity, so long as the recipients of the charitable services were within the credit union’s field of membership.</td>
</tr>
<tr>
<td>March 2002</td>
<td>NCUA’s Regulatory Flexibility Program became effective. NCUA relieved eligible federally and state-chartered credit unions from certain NCUA regulations relating to permissible investments and investment management requirements, limits on share deposits from public entities and nonmembers, approval processes for charitable contributions, and limits on ownership of fixed assets.</td>
</tr>
<tr>
<td>July 2003</td>
<td>NCUA expanded investment powers of certain federally chartered credit unions to allow them to purchase financial instruments that were previously prohibited, including commercial mortgage-related securities and equity options.</td>
</tr>
<tr>
<td>September 2003</td>
<td>NCUA amended its CUSO rule to permit CUSOs to originate business loans.</td>
</tr>
</tbody>
</table>

Sources: GAO, NCUA, Federal Register.

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*Note:*

1. Secondary capital can take the form of investments into an institution by nonmembers, such as foundations, corporations, and other financial institutions. The investments are subordinated to all other credit union debt, and are used to absorb losses.

2. Debt suspension agreements are contracts between a lender and a borrower where the lender agrees to suspend scheduled installment payments for an agreed period in the event the borrower experiences financial hardship.

3. Equity options are limited to those that would be purchased for the sole purpose of offering dividends based on the performance of an equity index.
Appendix VIII

NCUA’s Budget Process and Industry Role

The National Credit Union Administration (NCUA) changed its budget process in 2001 to allow outside parties, including credit unions and trade organizations, to submit comments on the budget. While outside parties can submit their budget suggestions and concerns at any time, NCUA has a formal budget briefing where these parties can officially submit their comments. This briefing takes place at the latter stage of NCUA’s budget process. The changes NCUA has made to its budget process come during a period in which NCUA has been reducing the growth in its budgets.

NCUA has two main sources of funding for its operating costs. According to NCUA, 62 percent of the funds for operating costs in their 2002 budget came from the National Credit Union Share Insurance Fund (NCUSIF), administered by NCUA. NCUSIF is principally financed from earnings (income) on investments purchased using the deposits of federally insured credit unions. Funds are transferred from the insurance fund through a monthly accounting procedure known as the overhead transfer to cover costs associated with ensuring that insured deposits are safe and sound. The remaining 38 percent of NCUA’s funds for its operating costs came primarily from operating fees assessed on federally chartered credit unions, for which NCUA has oversight responsibility.

NCUA budgets on a calendar-year basis, and its board sets the policies and overall direction for the budget. In July and August prior to the next budget year, the NCUA regional offices submit their workload and program needs. NCUA’s examination and insurance officials in headquarters assess the information and formulate proposed program hours, which along with historical actual expenditures are the basis for the proposed budget. In September and October, the Chief Financial Officer (CFO) reviews and analyzes the figures, conducts briefings with office directors, and makes adjustments. In November, NCUA holds a public briefing where interested parties, including credit unions and trade associations, have the opportunity to comment. Later in November, the CFO briefs the board prior to final budget adjustments. Additionally, in July of the budget year, there is a midyear budget review to determine if any adjustments need to be made to the budget. According to NCUA officials, NCUA also conducts a variance analysis on the budget on a monthly basis and a more comprehensive review at the end of the year.

According to NCUA, credit unions and other stakeholders can submit their budget suggestions and concerns at any time. Normally, suggestions come between August and November while NCUA is working on the budget. For
NCUA's Budget Process and Industry Role

the public budget hearing, credit unions can address the board for 5 minutes or submit a written document.

Recent budget concerns by credit unions have centered on lessening the costs to credit unions for NCUA oversight. Credit unions have raised specific concerns about the number of NCUA staff or full-time equivalents, the salaries of NCUA staff, and the overhead transfer rate from the insurance fund. According to NCUA data, its average full-time equivalent cost is less than that of the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) and equal to that of the Office of Thrift Supervision (OTS). Nevertheless, NCUA has responded to concerns over its salary levels by deciding to undertake a pay study.

NCUA Has Reduced Its Budget Growth in Recent Years

In recent years, NCUA has been successful in slowing its budget growth. After 10-percent annual growth from 1998 to 2000, NCUA budget growth has decreased to an average of about 3 percent in 2000–2003 (see fig. 40). The NCUA board’s budget priorities have been to streamline business processes, increase efficiencies, control budget growth, and match resources to mission requirements, while maintaining effective examination processes and products. NCUA is seeking budget savings by adopting a risk-focused examination approach, extending the examination cycle, adopting more flexible rules and regulations, increasing efficiencies from technology (such as videoconferencing), and consolidating two of their regions into one.
NCUA’s authorized full-time equivalent staff level decreased over 7 percent from 1,049 in 2000 to 971 in 2003 (see fig. 41). This level of staff reductions has been partly in response to changes in the industry. Since 1998, the number of federally insured credit unions has decreased steadily by about 3 percent per year.
Figure 41: NCUA-authorized Staffing Levels, 1992–2003

Number of staff

Source: NCUA.
Section 301 of the Credit Union Membership Access Act (CUMAA) amended the Federal Credit Union Act to require the National Credit Union Administration (NCUA) to adopt a system of prompt corrective action (PCA) for use on credit unions experiencing capitalization problems.¹ The goal of requiring PCA is to resolve the problems of insured credit unions with the least possible long-term loss to the National Credit Union Share Insurance Fund (NCUSIF). In that regard, NCUA was required to prescribe a system of PCA consisting of three principal components: (1) a comprehensive framework of mandatory supervisory actions and discretionary supervisory actions, (2) an alternative system of PCA for “new” credit unions, and (3) a risk-based net worth (RBNW) requirement for “complex” credit unions.² Furthermore, section 301 also required NCUA to report to Congress on how PCA was implemented and how PCA for credit unions differs from PCA for other depository institutions. NCUA submitted this report in May 2000. In addition, NCUA submitted a further report to Congress that described how NCUA carried out the RBNW requirements for credit unions and how these requirements differed from RBNW requirements of other depository institutions (see table 11).

²CUMAA defines a “new” credit union as one that has been in operation for less than 10 years and having less than $10 million in assets. 12 C.F.R. §702.2(h). NCUA defines a credit union as “complex” when its total assets at the end of a quarter exceed $10 million and its RBNW calculation exceeds 6 percent net worth. 12 C.F.R. §702.103.
Appendix IX
NCUA’s Implementation of Prompt Corrective Action

Table 11: CUMAA Mandates and NCUA Actions on PCA Regulation Implementation

<table>
<thead>
<tr>
<th>CUMAA mandates to NCUA</th>
<th>PCA actions:</th>
<th>RBNW requirements actions:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>CUMAA deadlines</td>
<td>NCUA action dates</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Issue PCA proposed rule</td>
<td>May 1999</td>
<td>Issued May 1999</td>
</tr>
<tr>
<td>Issue the PCA final rule</td>
<td>February 2000</td>
<td>Issued February 2000</td>
</tr>
<tr>
<td>Issue PCA report to Congress</td>
<td>February 2000</td>
<td>Issued May 2000</td>
</tr>
<tr>
<td>Implement PCA</td>
<td>August 2000</td>
<td>Implemented August 2000 a</td>
</tr>
<tr>
<td>Issue RBNW requirements proposed rule b</td>
<td></td>
<td>Issued February 2000</td>
</tr>
<tr>
<td>Issue RBNW requirements final rule</td>
<td>August 2000</td>
<td>Issued July 2000</td>
</tr>
<tr>
<td>Issue RBNW requirements report to Congress c</td>
<td></td>
<td>Issued November 2000</td>
</tr>
<tr>
<td>Implement RBNW requirements final rule</td>
<td>January 2001</td>
<td>Implemented January 2001</td>
</tr>
</tbody>
</table>


Note:

aThe PCA final rule applied to credit unions beginning in the fourth quarter of 2000.
bCUMAA did not set any deadline for NCUA to issue the RBNW requirement proposed rule and did not require NCUA to issue a RBNW report to Congress.
cNot mandated by CUMAA.

After NCUA implemented the initial PCA and RBNW regulations, it formed a PCA Oversight Task Force to review at least a full year of PCA implementation and recommend necessary modifications. The task force reviewed the first six quarters of PCA implementation. It made several recommendations to improve PCA, including revising definitions of terms and clarifying implementation issues. In June 2002, NCUA issued a proposed rule setting forth revisions and adjustments to improve and simplify PCA. In November 2002, after incorporating public comments on the proposed rule, NCUA issued the final PCA rule adopting the proposed

bNCUA established a PCA Oversight Task Force in February 2000. This task force consisted of NCUA staff and state regulators. See Federal Register 65, no. 140 (20 July 2000): 44964.
PCAs Implementation of Prompt Corrective Action

revisions and adjustments. The final rule became effective on January 1, 2003.

The PCA rule consists of a comprehensive framework of mandatory and discretionary supervisory actions for all federally insured credit unions except “new” credit unions. The PCA system includes the following five statutory categories and their associated net worth ratios:

- well-capitalized—7.0 percent or greater net worth,
- adequately capitalized—6.0 to 6.99 percent net worth,
- undercapitalized—4.0 to 5.99 percent net worth,
- significantly undercapitalized—2.0 to 3.99 percent net worth, and
- critically undercapitalized—less than 2.0 percent net worth.

As noted earlier in the report, mandatory supervisory actions apply to credit unions that are classified adequately capitalized or lower. The PCA system also includes conditions triggering mandatory conservatorship and liquidation.

CUMAA also authorized NCUA to develop a comprehensive series of discretionary supervisory actions to complement the mandatory supervisory actions. Some or all of these 14 discretionary supervisory actions can be applied to credit unions that are classified undercapitalized or lower (see table 12).

The final PCA rule contains 17 revisions and adjustments. See Federal Register 67, no. 230 (29 November 2002): 71078.

NCUA issued staff instructions on discretionary supervisory actions in April 2003, but has yet to impose a discretionary supervisory action against any credit union.
Appendix IX
NCUA’s Implementation of Prompt Corrective Action

Table 12: Discretionary Supervisory Actions

<table>
<thead>
<tr>
<th>Discretionary supervisory actions</th>
<th>Statutory net worth category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Require NCUA prior approval for acquisitions, branching, new lines of business</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Restrict transactions with and ownership of CUSOs</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Restrict dividends paid</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Prohibit or reduce asset growth</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Alter, reduce, or terminate any activity by credit union or its CUSO</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Prohibit nonmember deposits</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Other actions to further the purpose of part 702</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Order new election of board of directors</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Dismiss directors or senior executive officers</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Employ qualified senior executive officers</td>
<td>“Undercapitalized” and lower</td>
</tr>
<tr>
<td>Restrict senior executive officers’ compensation and bonus</td>
<td>“Significantly Undercapitalized” and lower</td>
</tr>
<tr>
<td>Require merger if grounds exist for conservatorship or liquidation</td>
<td>“Significantly Undercapitalized” and lower</td>
</tr>
<tr>
<td>Restrict payments on uninsured secondary capital</td>
<td>“Critically Undercapitalized”</td>
</tr>
<tr>
<td>Require NCUA prior approval for certain actions</td>
<td>“Critically Undercapitalized”</td>
</tr>
</tbody>
</table>

Source: Federal Register 64, no. 95 (18 May 1999): 27096-27098.

The discretionary supervisory actions are tailored to suit the distinctive characteristics of credit unions.

An Alternative System for New Credit Unions

CUMAA required NCUA to develop an alternative PCA system for “new” credit unions. In doing so, NCUA recognized that new credit unions (1) initially have no net worth, (2) need reasonable time to accumulate net worth, and (3) need incentives to become adequately capitalized by the time they are no longer new. Accordingly, the PCA system for new credit unions has relaxed net worth ratios, allows regulatory forbearance, and offers incentives to build net worth. The PCA system for new credit unions includes six net worth categories and their associated net worth ratios (see table 13).
Table 13: Net Worth Category Classification for New Credit Unions

<table>
<thead>
<tr>
<th>New credit union net worth category</th>
<th>Net worth ratio (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>&quot;Well-Capitalized&quot;</td>
<td>7.0 or above</td>
</tr>
<tr>
<td>&quot;Adequately Capitalized&quot;</td>
<td>6.0 to 6.99</td>
</tr>
<tr>
<td>&quot;Moderately Capitalized&quot;</td>
<td>3.5 to 5.99</td>
</tr>
<tr>
<td>&quot;Marginally Capitalized&quot;</td>
<td>2.0 to 3.49</td>
</tr>
<tr>
<td>&quot;Minimally Capitalized&quot;</td>
<td>0.0 to 1.99</td>
</tr>
<tr>
<td>&quot;Uncapitalized&quot;</td>
<td>Less than 0</td>
</tr>
</tbody>
</table>

Source: Federal Register 64, no. 95 (18 May 1999): 27099.

Risk-based Net Worth Requirement for “Complex” Credit Unions

CUMAA also required NCUA to formulate the definition of a “complex” credit union according to the risk level of its portfolios of assets and liabilities. Well-capitalized and adequately capitalized credit unions classified as complex are subject to an additional RBNW requirement to compensate for material risks against which a 6.0 percent net worth ratio may not provide adequate protection. (We describe the RBNW requirement in more detail elsewhere in this appendix.)

NCUA Submitted Required PCA Report to Congress

CUMAA mandated that NCUA submit a report to Congress addressing PCA. The report, dated May 22, 2000, explains how the new PCA rules account for the cooperative character of credit unions and how the PCA rules differ from the Federal Deposit Insurance Act’s (FDIA) “discretionary safeguards” for other depository institutions as well as the reasons for the differences.

The report discusses how the PCA rules account for credit unions’ cooperative character in three areas: their not-for-profit nature, their inability to issue stock, and their board of directors consisting primarily of volunteers. First, the final rule accounts for credit unions’ not-for-profit nature by permitting a less-than-well-capitalized credit union to seek a reduction in the statutory earnings retention requirement to allow the continued payment of dividends sufficient to discourage an outflow of shares. In addition, a well-capitalized credit union whose earnings are

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6Credit unions cannot issue capital stock and, therefore, must rely on retained earnings to build net worth.
Appendix IX
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depleted may be permitted to pay dividends from its regular reserve provided that such payment would not cause the credit union to fall below the adequately capitalized level. Secondly, to account for the inability of credit unions to issue capital stock, the final rule relies on the Net Worth Restoration Plan, which must be submitted by credit unions classified as undercapitalized or lower. Finally, to recognize that credit unions’ boards of directors consist primarily of volunteers, the rule exempts credit unions that are near to being adequately capitalized from the discretionary supervisory action authorizing NCUA to order a new election of the board of directors.

NCUA reported that the final rule established discretionary supervisory actions that are essentially comparable to section 38 of FDIA, which specifies “discretionary safeguards” for other depository institutions. The report notes that NCUA adopted discretionary supervisory actions that are similar to all but two of FDIA’s 14 discretionary safeguards.

NCUA did not adopt FDIA’s safeguards requiring selling new shares of stock and prior approval of capital distributions by a bank holding company. NCUA’s rationale for these exclusions was that, unlike banks, credit unions cannot sell stock to raise capital and are not controlled by holding companies.

NCUA departed from FDIA discretionary safeguards in fashioning three of the discretionary supervisory actions: (1) dismissals of senior officers or directors, (2) exemption of officers from discretionary supervisory actions, and (3) ordering a new election of the boards of directors. NCUA reported that the discretionary supervisory action for director dismissals departs significantly from its FDIA counterpart. The FDIA safeguard protects from dismissal of officials with office tenures of 180 days or less, when an institution becomes undercapitalized. In contrast, NCUA contends that such a “safe harbor” is unnecessary for credit unions. Moreover, NCUA field experience supports the view that short-tenured officers can be as responsible as others for rapidly declining net worth.

With regard to exempting officers from discretionary supervisory actions, NCUA provides conditional relief to credit unions in contrast to the FDIA. For example, the report notes that FDIA allows 11 discretionary safeguards to be imposed on undercapitalized institutions. On the other hand, NCUA’s comparable discretionary supervisory actions can be imposed against undercapitalized credit unions in the first tier of that category only when they fail to comply with any of CUMAA’s four mandatory supervisory
Appendix IX
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actions or fail to implement an approved Net Worth Restoration Plan. NCUA’s rationale for granting relief from the relevant discretionary supervisory actions is to avoid treating credit unions that are just short of adequately capitalized as harshly as those that are almost significantly undercapitalized.

NCUA’s report states that it modified the discretionary supervisory action ordering a new election of the board of directors. Specifically, NCUA excludes undercapitalized credit unions from this requirement but applies it to significantly undercapitalized and critically undercapitalized credit unions. NCUA’s exception was based on the belief that the safeguard would undermine a defining characteristic of credit unions—membership election of directors—and possibly discourage members from volunteering to serve as directors. Moreover, NCUA noted that its discretionary supervisory action does not compel a credit union to replace its board with a NCUA-designated slate; it simply requires the membership to reconsider its original choice of directors. Finally, the report states that ordering a wholesale election of the board of directors may be an overreaction when a credit union’s net worth is within reach of becoming adequately capitalized.

NCUA submitted a report to Congress addressing its RBNW provisions on November 3, 2000. In general, the report describes NCUA’s comprehensive approach to evaluating a credit union’s individual risk exposure. It explains the RBNW requirement that applies to complex credit unions. The RBNW requirement takes into account whether credit unions classified as adequately capitalized provide adequate protection against risks posed by contingent liabilities, among other risks. According to the RBNW report, NCUA’s approach (1) targets credit unions that carry an above-average level of exposure to material risk, (2) allows an alternative method to calculate the amount of net worth needed to remain adequately capitalized or well-capitalized, and (3) makes available a risk mitigation credit to reflect quantitative evidence of risk mitigation.

NCUA reported that its final rule targets credit unions that have higher material risk levels, thus warranting an extra measure of capital to protect them and NCUSIF from losses. As noted previously, credit unions do not

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7The net worth ratio of credit unions in the undercapitalized category is 4.0-5.99 percent. The first tier of the undercapitalized net worth category is 5.0-5.99 percent, and the second tier of that net worth category is 4.0-4.99 percent.
issue stocks that create shareholder equity. Without shareholder equity to absorb losses, the RBNW requirement serves to mitigate most forms of risk in a complex credit union’s portfolio. Specifically, the RBNW measures the risk level of on- and off-balance sheet items in the credit union’s “risk portfolios.” The requirement applies only if a credit union’s total assets at the end of a quarter exceed $10 million, and its RBNW requirement under the standard calculation exceeds 6 percent. The $10 million asset floor eliminates the burden on credit unions that are unlikely to impose a material risk.

NCUA uses two methods to determine whether a complex credit union meets its RBNW requirement. Under the “standard calculation,” each of eight risk portfolios is multiplied by one or more corresponding risk weightings to produce eight “standard components.” The sum of the eight standard components yields the RBNW requirement that the credit union’s net worth ratio must meet for it to remain either adequately capitalized or well-capitalized. If the RBNW requirement is not met, the credit union falls into the undercapitalized net worth category. NCUA allows a credit union that does not meet its RBNW requirement under the standard calculation to substitute for any of the three standard components, a corresponding “alternative component” that may reduce the RBNW requirement. The alternative components recognize finer increments of risk in real estate loans, member business loans, and investments.

Finally, in reporting on the RBNW requirement, NCUA recognized that credit unions, which failed under the standard calculation and with the alternative components, nonetheless might individually be able to mitigate material risk. In such instances, a risk mitigation credit is available to credit unions that succeed in demonstrating mitigation of interest rate or

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8The RBNW report notes that the “risk portfolios” of balance sheet assets consist of long-term real estate loans, member business loans outstanding, investments, low-risk assets, and average-risk assets. The “risk portfolios” of off-balance sheet assets are loans sold with recourse and unused member business loan commitments.

9According to the report, the principal banking industry trade association advocated $10 million as an appropriate minimum asset “floor.”

10Risk portfolios include real estate loans, member business loans (MBL) outstanding, investments, low-risk assets, average-risk assets, loans sold with recourse, unused MBL commitments, and allowances. See Federal Register 65, no. 34 (18 February 2000): 8606.
credit risk. If approved, a risk mitigation credit will reduce the RBNW requirement a credit union must satisfy to remain classified as adequately capitalized or above.

According to NCUA data, as of May 2003, no credit union failed to meet an RBNW requirement under the standard calculation and with the alternative component, and so none has applied for a risk mitigation credit to date.
The National Credit Union Share Insurance Fund (NCUSIF) capitalizes its insurance fund differently than the Federal Deposit Insurance Corporation (FDIC) capitalizes the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). For NCUSIF, a cash deposit in the fund equal to 1 percent of insured shares, adjusted at least annually, must remain on deposit with the fund for the period a credit union remains federally insured. This deposit is treated as an asset on the credit union's financial statements, and as part of equity on NCUSIF's financial statements in an account entitled “Insured credit unions’ accumulated contributions.” If a credit union leaves federal insurance, for example to become privately insured, the deposit with NCUSIF is refunded. However, if the National Credit Union Administration’s (NCUA) board assesses additional premiums in order to maintain the minimum required equity ratio, the premiums are treated as an operating expense on the credit unions’ financial statements and would not be refunded. Since 2000, NCUA has not made any distributions to contributing credit unions because the fund did not exceed the NCUA board’s specific operating level. And, between 1990 and 2002, federally insured credit unions were assessed premiums only in 1991 and 1992, when the fund’s equity declined below the mandated minimum normal operating level of 1.20 percent of insured shares.\(^1\)

However, unlike federally insured credit unions, federally insured banks and thrifts operate exclusively under a premium-based insurance system. This system requires banks and thrifts to remit a premium payment of a specified percent of their balance of insured deposits twice a year to FDIC to obtain federal deposit insurance. Each bank or thrift treats the premium as an expense in its financial statements, while FDIC recognizes the premium as income in its financial statements. If a bank or thrift elects to not continue its federal deposit insurance, its premiums are, unlike the NCUSIF insurance deposit, nonrefundable.

The Federal Deposit Insurance Corporation Improvement Act (FDICIA), enacted in December 1991, contained some important provisions including risk-based premiums for BIF and SAIF. FDIC developed and then implemented the risk-based premium system on January 1, 1993. Under the system, institutions were categorized according to a capital subgroup (1, 2, 3).\(^2\)

\(^1\)Federal Credit Union Act.
Appendix X
Accounting for Share Insurance

or 3) and a supervisory subgroup (A, B, or C).\(^2\) This resulted in the best-rated institutions being categorized as 1-A and the worst institutions as 3-C. These categorizations result in a range of premium costs, with the best-rated institutions paying the lowest premium and the worst-rated institutions paying the highest premium.

In August 2000, FDIC issued a report that discussed the current deposit insurance system, including the existence of two separate funds, an insurance pricing system that may provide inappropriate incentives for risk and growth, and issues of fairness and equitable insurance coverage, and offered possible solutions. The report warned that this system might require banks to fund insurance losses when they can least afford it. Solutions offered in the report included (1) merging BIF and SAIF, (2) improving the pricing of insurance premiums through a number of options, and (3) setting a “soft” target for the reserve ratio, which would allow the deposit insurance fund balances to grow during favorable economic periods, thereby smoothing premium costs over a longer period of time. As a result of FDIC’s report, legislation is pending that may provide additional reforms of the deposit insurance system, including pricing of insurance.

As did BIF and SAIF, American Share Insurance (ASI), the private primary share insurer, adopted a form of risk-based insurance plan at the end of 2000. As does NCUSIF, ASI’s member credit unions pay a deposit rather than an annual premium assessment to purchase their insurance coverage. Prior to December 31, 2000, all of ASI’s insured credit unions were required to maintain a deposit of 1.3 percent of each member’s total insured share amounts, compared with 1.0 percent that federally insured credit unions maintain with NCUSIF. With its change to a risk-based system, ASI’s insurance coverage now requires a range—a minimum deposit of 1.0

\(^2\)The capital subgroup is assigned on the basis of the institution’s total risk-based capital ratio, tier 1 risk-based capital ratio, and tier 1 leverage capital ratio. The institutions report this data quarterly to FDIC on their Report of Income and Condition (call report). For instance, according to FDIC Risk-Based Assessment System – Overview, Group 1 (“Well-Capitalized”) has a “Total Risk-Based Capital Ratio equal to or greater than 10 percent, and Tier 1 Risk-Based Capital Ratio equal to or greater than 6 percent, and Tier 1 Leverage Capital Ratio equal to or greater than 5 percent.” Each semiannual period, FDIC assigns the supervisory subgroup based on various factors including results of the most recent examination report, the amount of time since the last examination, and statistical analysis of call report data. For example, according to the FDIC’s Risk-Based Assessment System - Overview, a subgroup A institution is “financially sound institution with only a few minor weaknesses and generally corresponds to the primary federal regulator’s composite rating of ‘1’ or ‘2.’"
percent up to a maximum of 1.3 percent for each credit union depending on the credit union’s CAMEL rating.\(^3\)

The FDIC study of risk-based pricing indicated that one of the negative aspects of not pricing to risk is that new institutions and fast-growing institutions are benefiting at the expense of their older and slower-growing competitors. Rapid deposit growth lowers a fund’s equity ratio and increases the probability that additional failures will push a fund’s equity ratio below the minimum requirements, resulting in a rapid increase in premiums for all institutions.

\(^3\)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.
National Credit Union Administration

October 10, 2003

Office of the Chairman

Richard J. Hilman, Director
Financial Markets and Community Investment
United States General Accounting Office
Washington, D.C.

Re: Draft GAO Report 04-91

Dear Mr. Hilman:

Thank you for the opportunity to review and comment on GAO's draft report entitled Credit Unions' Financial Condition Has Improved But Opportunities Exist to Enhance Oversight and Share Insurance Management. On behalf of the National Credit Union Administration (NCUA), I would like to express our appreciation for the professionalism exhibited by your staff, our gratitude for the dialogue between NCUA and GAO throughout your study, and our concurrence with most of your assessments regarding the challenges facing the National Credit Union Administration (NCUA) and credit unions since 1991. The discussion below responds specifically to your report's conclusions and recommendations.

Financial Condition of Industry

NCUA concurs with the report's assessment that overall the financial health and stability in credit unions has significantly improved since 1991. NCUA has made notable progress in ensuring the safety and soundness of the National Credit Union Share Insurance Fund (NCUSIF) and providing proactive oversight of federally-insured credit unions. Problem credit unions have declined and capital has substantially increased. As noted in your report, the number of problem credit unions declined since 1992 by 63 percent. During this same period assets grew by 116 percent. Despite the strong asset growth, net worth in relation to assets increased by a third. Net worth grew by 196 percent, adding 39 billion more dollars in protection to the credit union system.

Your report also correctly identifies the increasing concentration of assets in larger, complex credit unions. Recognizing this trend, NCUA responded by implementing the risk-focused examination (RFE) program. As your report notes, the RFE program enables NCUA to focus our resources on areas of risk. Further, the subject matter examiner (SME) program, a key component of the RFE program, is enabling us to develop staff with the necessary expertise and allocate them where needed. In addition, NCUA is continuing to study the means to further enhance our supervision of larger, complex credit unions, while maintaining our ongoing effective supervision of the 80 percent of credit unions that have less than $50 million in assets.

1 The primary example of this is the Large Credit Union Pilot program.
NCUA also concurs with the report’s recommendation to continue to work closely with the Federal Financial Institutions Examination Council (FFIEC) agencies to leverage the knowledge and experience the other regulators have gained in administering a risk-focused examination program. Your report notes that NCUA coordinated closely with our FFIEC counterparts in developing and implementing the RFEC program, and we will continue this coordination as we make ongoing improvements in our approach to supervising federally-insured credit unions.

Credit Union Mission of Serving Individuals of Modest Means

NCUA respectfully does not concur with the report’s recommendation that the agency initiate a program or requirement to undertake the collection of additional data beyond that presently being provided on the extent to which credit unions are serving low and moderate income members in underserved areas. Implementation of this recommendation would impose significant and unnecessary data collection and reporting burdens on credit unions and would be especially problematic and burdensome for small credit unions that generally operate with limited resources and rely heavily on volunteers. Also, given their democratic control and not-for-profit organizational structure, credit unions are uniquely positioned to reach out and serve these low-income consumers, and have neither motive to do otherwise nor a record of failing to do so. Indeed, Congress has amended both the Community Reinvestment Act (CRA) and the Federal Credit Union Act on numerous occasions since enactment of CRA in 1977. However, they have chosen not to impose CRA-like requirements on credit unions, specifically having rejected such proposals when offered.

Your report draws conclusions based on an analysis primarily drawn from limited mortgage lending data, as well as demographic data representative of what has primarily been an occupational based (thus employed and tending to have better income levels) credit union membership. However, as demonstrated in the marketing and business plans in the applications of the growing number of credit unions requesting community charters and underserved area expansions, there is ample evidence to demonstrate that credit unions are both seeking to serve, and are indeed serving, the un-banked as well as their low and moderate income members. Credit unions accomplish this not only through low-cost loans, but also through providing basic financial services such as check cashing, direct deposit, no-minimum balance and no-fees checking accounts, financial counseling and financial literacy programs, bi-lingual operations, among other products and services. The important entry point for this segment of the population is access to savings and transaction services, eventually maturing into lending, as some of these consumers are initially not capable of qualifying for loans that meet appropriate safety and soundness criteria.

2 The information would need to include not just demographic (income) information related to members with loans, but to be truly meaningful this would need to be captured for all members. Further, the data would need to include information on the specific demographics of each credit union’s field of membership.
Available data, some of which is included in your report, already indicates that credit unions in record numbers have added underserved areas, reached out to entire communities through field-of-membership conversions, and received low-income designations. In the last few years, underserved area expansions have represented the majority of all field-of-membership expansions approved. Further, access to credit union service has been made available to 61.1 million people in underserved areas through the 965 underserved area expansions granted since January 2000. The number of federal credit unions serving communities has more than doubled since 1998, from 6.2% to 16.5% of all federal credit unions. Generally speaking, community charters provide credit unions with more opportunities to serve underserved people than traditional occupational-based charters. The number of low-income designated credit unions has increased dramatically in the last ten years, from 1.2% of all federally-insured credit unions in 1993 to 10.2% currently.

NCUA has been very active in encouraging credit unions to reach out and provide service to those with limited access to financial services. Our “Access Across America” initiative is one such example. This program has focused on creating economic empowerment through expanded credit union service into underserved neighborhoods and communities and facilitating the sharing of resource information for credit unions expanding into these areas. The results of this initiative, now with three years of call report data available to make it possible for NCUA to track membership growth trends in federal credit unions adopting underserved areas in comparison to the membership growth trends in the credit union community as a whole, clearly demonstrate that the membership growth rate in credit unions with underserved areas increased an average of 4.80% annually from 2000 to 2002, a 92.8% higher rate than the 2.49% annual membership growth rate for credit unions nationwide during the same three year period.

**Requiring Report on Internal Controls**

NCUA concurs with your report’s recommendation that large credit unions (over $500 million in assets) should provide an annual management report assessing the effectiveness of the institution’s internal control structure, and the independent auditor’s attestation to management’s assertions. This is consistent with expectations and best practices already established, such as the requirements in place for banks via the Federal Deposit Insurance Corporation Improvement Act and for public companies under the Sarbanes-Oxley Act of 2002. Further, such a requirement would further leverage the ability of NCUA’s RFE program to focus attention on areas of risk. Your report includes this recommendation for congressional consideration. NCUA is providing guidance for credit unions on the principles of the Sarbanes-Oxley Act that will, among other things, strongly encourage large credit unions to voluntarily provide this reporting on internal controls. We expect that all large credit unions will follow this guidance, but note that NCUA has the authority to implement regulations requiring this should it become necessary. Therefore, in our view, legislation regarding this subject is not necessary.

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3 Indicating more than 50% of the membership is low income.
Third-Party Vendor Review Authority

Included among your recommendations is one encouraging NCUA to seek the same legislative authority other depository institution regulators have to examine third-party vendors. Credit unions often rely heavily on third-party vendors for various mission critical or otherwise important services and functions (e.g., data processing, technology-based service delivery channels, etc.). Given that many of these third-party vendors service numerous credit unions, a failure of a vendor poses systemic risk. In addition to the financial risk, interruptions of these services provided by third-party vendors subject credit unions and their members to issues involving privacy, security, and reputation risk. While NCUA to date has not experienced insurmountable problems associated with the lack of direct authority over third-party vendors and has had considerable and effective influence over third-party vendors through our supervision of the credit unions who are their customers, NCUA would not oppose legislation if brought before Congress to provide this authority, provided appropriate discretion is extended to the agency in the allocation of agency resources and evaluation of risk parameters in utilizing this authority. Because this is a statutory issue and not one of existing NCUA regulatory authority without being provided a specific congressional authorization, NCUA recommends that your report include this as a matter for congressional consideration.

Overhead Transfer Rate

NCUA concurs with your report's recommendation to make improvements to the process for determining the overhead transfer rate (OTR). In fact, we initiated such an endeavor in November 2002. The report suggests recent fluctuations in the rate, and concerns regarding its accuracy, are the result of surveys that have not been conducted regularly or over sufficient periods of time, and that NCUA is still in the process of implementing the recommendations made by the external auditor review. NCUA fully implemented all of the external auditor recommendations in 2002, and the agency now has an entire year's worth of survey results based on the revised process.

Your report recommends we improve our process for determining the OTR by consistently applying the rate (i.e., settling on and using the same method over time), updating the rate annually, and completing the survey with full representation. NCUA is in the process of researching a more consistent method of calculating the OTR that will incorporate the recommendations of the external auditor review into a more thorough and updated calculation method. Among various refinements, any new method will incorporate the use of the most current information, including the ongoing revised time survey, to enable the rate to be set annually. Further, NCUA will continue to ensure the sample of examiners completing time surveys is of sufficient size to be statistically valid.
Page Five

Risk-Based Pricing for Federal Share Insurance

Your report accurately states that the NCUSIF, as the only deposit insurer that has not adopted a risk-based pricing scheme, does not allocate costs to institutions based on the relative risk they pose to the fund. NCUA feels it must point out that despite the fact all other deposit insurers have adopted risk-based pricing, it is not a foregone conclusion that this approach outweighs the disadvantages. Some of the issues that would need to be carefully considered with such an approach are the impact on smaller institutions, designing an appropriate measure of relative risk, and avoiding a system that is pro-cyclical. Also, any risk-based pricing would require action by Congress to amend the Federal Credit Union Act, which currently requires uniform pricing with respect to the one percent deposit and any insurance premium.

NCUA suggests that a preferable way to provide incentives, impose discipline on the industry in this area, and align risk with cost would be through adoption of a Prompt Corrective Action (PCA) system based on risk-based net worth. A PCA system where required net worth levels are tied to an institution’s risk profile would provide for self-regulation and impose a higher cost (albeit indirect) on those institutions with high growth and/or riskier operations. This would also achieve the goal of linking the insurance fund’s protection to the risk each institution poses, as higher credit union net worth provides for additional cushion against losses to the NCUSIF.

Insurance Fund Loss Estimation Methodology

NCUA concurs in part with your report’s conclusion that the NCUSIF’s loss reserve methodology warrants study to seek ways to further refine our estimates. While we are always interested in applying best practices in how we determine the amount of the liability for losses from insured credit unions, the current process has proven reasonable. Our external auditor has found our loss reserve funding to be consistent with generally accepted accounting principles, and never to be materially underfunded or overfunded. The precision of the process is consistent with the relative materiality of the account and the impact on the NCUSIF. Since reserving for losses is an accounting exercise in matching current revenues with expenses, our primary focus is in ensuring our overall equity level is sufficient to cover the risks to the NCUSIF.

NCUA has been in regular contact with the FDIC regarding their reserving process. FDIC recently received the recommendations of their consultant and are revising their procedures based upon that review. We are awaiting receipt of the results of the evaluation, and will review the details of the revised FDIC process and our ability to integrate their practices within our system.

FDIC’s and ASI’s model use CAMEL ratings as part of the risk-based pricing determination. Our experience has been that CAMEL ratings are not the best proxy of risk because they tend to be lagging indicators and have only a modest correlation to actual losses to the fund. In addition, linking CAMEL ratings to direct costs would create additional conflict regarding the ratings. A more objective model involving the risk on an institutions’ balance sheet and inherent in the complexity of their operations has more intuitive appeal.

Federal Reserve Board Chairman Alan Greenspan’s April 2002 testimony before the Senate Committee on Banking, Housing, and Urban Affairs supports the need to avoid a pro-cyclical insurance pricing system.

Though PCA currently includes a Risk-based Net Worth requirement for credit unions, it is in addition to the standard requirement applicable to all credit unions.
Appendix XI
Comments from the National Credit Union Administration

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Private Share Insurance

NCUA concurs with the report's identification of possible systemic risk that could be associated with inadequately capitalized or improperly managed private share insurance that lacks the full faith and credit backing of a state or the federal government. The asset concentration risk with limited borrowing capacity of the private insurer along with the lack of any reinsurance presents unique challenges for the eight state supervisory authorities where private insurance exists today. Additionally, while the 30-day notice termination policy that may be employed is a risk mitigation strategy for the private insurer, it could become a significant challenge to the state supervisors when such an event occurs in a larger credit union. The likelihood of a credit union qualifying for federal insurance upon receiving a 30-day private insurance termination notice would be doubtful. Finally, the high rate of failure to disclose the lack of federal share insurance noted in your report presents a unique reputation risk for the state supervisors and could also have an impact on federally-insured credit unions due to confusion by consumers. It is also important to note that, for credit unions insured by the NCUSIF, should insurance termination be required, in addition to NCUA's requirement that all members be notified, federally-insured credit unions are afforded a hearing and other due process rights before termination of insurance, and coverage on member deposits remains in place for one year after termination of a credit union's federally-insured status.

NCUA concurs with GAO's previous conclusions as stated in the report Federal Deposit Insurance Act – FTC Best Among Candidates to Enforce Consumer Protection Provisions that members of privately-insured credit unions may not be adequately informed that their savings are not federally insured and Congress should remove the prohibition in the Federal Trade Commission's appropriations preventing their enforcing the legally required disclosures.

Thank you again for the opportunity to comment on the draft report. If you have any questions or need further information, please feel free to contact NCUA Executive Director J. Leonard Skiles at (703) 518-6321.

Sincerely,

[Signature]

Dennis Dollar
Chairman
October 14, 2003

Mr. Richard J. Hillman
Director, Financial Markets and Community Investment Issues
US General Accounting Office
441 G Street NW
Washington, DC 20548

Dear Mr. Hillman:

Thank you for the opportunity to comment on the draft of the Private Share Insurance component (the “Study Section”) of your organization’s broader study of the Credit Union System, titled: Credit Unions: Financial Condition Has Improved But Opportunities Exist to Enhance Oversight and Share Insurance Management (the “Study”).

After reviewing the draft of the Study Section, it is our opinion that the GAO has failed to adequately assess the private share insurance industry and has drawn conclusions based on assumptions regarding future outcomes that lack foundation in actuarial science and fail to give credit to the past performance of the sole remaining credit union private share insurer, American Share Insurance (ASI). Further, the GAO repeatedly, and erroneously, compares private share insurance to that of the federal share insurance program, without any consideration being given to other private sector insurers or the original principles of private share insurance.

Private share insurance for credit unions is an alternative, enabled by state, not federal statute that has brought various financial innovations to the credit union system which has helped in the system’s growth and expansion of services to consumers, while providing competitive balance in share insurance in those states that have authorized its operation.

The Study Section states that the following concerns exist regarding private share insurance in the credit union movement, to which we offer our rebuttals. The four primary concerns noted are as follow:

A. ASI’s risks are concentrated in a few large credit unions and in certain states.

The Study Section’s conclusions that a “large” credit union creates inordinate risk in a private fund and that a limited market naturally infers concentration risk are unfounded and presumptuous. A single large, high-quality credit union actually provides financial resources that improve, not diminish, the financial integrity of the private share insurer. Also, the geographic distribution of ASI’s insured credit unions is a matter of state law. Of the almost 20 states that statutorily permit the private share insurance option, nine have approved ASI. In the aggregate, ASI insures 19% of the 1,095 state-chartered credit unions in those states, which in any other private sector business would be considered a significant market share, especially given the competition. Also, a 19% market presence helps diversify the risk assumed by the private program.
B. ASI has limited ability to absorb large (catastrophic) losses because it does not have the backing of any government entity.

In its 29-year history, ASI has paid over 110 claims on failed credit unions, and more importantly, no member of a privately insured credit union has ever lost money in an ASI-insured account. Also, ASI’s statutory ability to reassess its member credit unions provides a significant amount of committed equity for catastrophic losses. Further, the company employs numerous programs to mitigate the risk of large losses and field examines more than 60% of its insured risk annually. Therefore, a sound private deposit insurance program, built upon a solid foundation of careful underwriting, continuous risk management and the financial backing of its mutual member credit unions, can absorb large (catastrophic) losses.

With regard to the government backing, the GAO fails to consider that ASI is a private business, licensed at the state level, owned by the credit unions it insures, and managed by a board of directors elected by such member credit unions. Private share insurance was never intended to have any state or federal guarantees.

C. ASI’s lines of credit are limited in the aggregate as to amount and available collateral.

The Study Section erroneously views the company’s lines of credit as a source of capital, when they are solely in place to provide emergency liquidity. Proportionately, ASI’s committed lines of credit with third parties, as a percentage of fund assets, are greater than that of the federal share insurer. Comparisons throughout the Study Section are often provided on an absolute basis, not a proportionate basis, which we believe skews many of the results included in the Study Section.

D. Many privately insured credit unions have failed to make required consumer disclosures about the absence of federal insurance of member accounts as required under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the Federal Trade Commission (FTC) is the appropriate federal agency to enforce such compliance.

FDICIA was passed in December 1991, and not long thereafter, the FTC sought and received an exemption from Congress from enforcing the consumer disclosure provisions of FDICIA. We concur with the Study Section’s observations in this regard, and believe privately insured credit unions would benefit from FTC’s enforcement of such provisions.

Detailed comments supporting and supplementing our above comments are attached as Exhibit A.

Very truly yours,

DENNIS R. ADAMS
President/CEO

DRA/krb
Attachment
EXHIBIT A

DETAILED COMMENTS ON THE GAO’S DRAFT STUDY OF PRIVATE SHARE INSURANCE

A Component of the GAO’s Study Titled:
Credit Unions: Financial Condition Has Improved But Opportunities Exist
To Enhance Oversight and Share Insurance Management

Submitted By:
American Share Insurance
October 14, 2003

A. ASI’s risks are concentrated in a few large credit unions and in certain states.

All businesses face some degree of concentration risk. For example, 55% of all federally insured shares are on deposit at only 230 NCUSIF-insured credit unions -- this represents less than 3% of all federally insured credit unions nationally. Despite this natural phenomena, the GAO proceeds to raise concern over ASI’s risk distribution.

Geographic Risk

The Study Section states that compared to federally insured credit unions, “…relatively few credit unions are privately insured.” As of December 31, 2002, about 2% of all credit unions are privately insured. ASI is currently authorized in nine states and insuring credit unions in eight nationally, and is limited to insuring only state-chartered credit unions in those states in which the company is authorized to do business. In its current states of operation, the company insures 212 credit unions, comprising $10.8 billion in insured shares. What the Study Section fails to report is that these credit unions represent 19% of all 1,095 state-chartered credit unions within that limited market, and 13.67% of the $80 billion in shares in those same 1,095 credit unions. Clearly, private share insurance is more significant to those affected states than the Study Section’s 2% statistic infers.

The Study Section also reports that 45% of all shares insured by ASI are in credit unions chartered in California, as compared to 14.7% for the NCUSIF. These facts can be misleading given that ASI has a limited market, and the NCUSIF operates in all 50 states. An entirely different, but more comparable, result is achieved when one isolates the relative risk in these eight states only. Under an assumption that both entities are limited to doing business in just the eight ASI states, ASI’s 45% concentration in California looks significantly less daunting when compared to 55% for the NCUSIF. This should offer evidence that when placed on equal footing, the relative risk concentration variances are reduced materially.

While eight states represent a limited market, they do not necessarily represent a geographic concentration risk, as inferred by the Study Section. We argue that the company’s states of operation represent a diverse cross-section of our nation, for example: East Coast – Maryland; Midwest – Ohio, Indiana and Illinois; West Coast – California and Nevada; Northwest – Idaho; and, Southeast – Alabama.

Statutory Factors

As a private company, ASI faces various admission obstacles when seeking new markets. First, a state must have a state statute that allows for an option in share insurance. According to the Study Section, a total of approximately 20 state statutes currently allow for the share insurance option for their state-chartered credit unions. Based on this data, ASI is operating in about 40%-50% of the available markets. Furthermore, the actual power to approve such coverage, when permitted by statute, is generally resident with the specific state’s credit union supervisory authority. So, as a private company, to do business in any state requires that three basic conditions exist: (1) credit union demand; (2) a permissible statute; and, (3) regulatory acceptance of the option.
Appendix XII
Comments from American Share Insurance

Based on these legislative and regulatory barriers, we take exception to the GAO constantly using the federal share insurer, the NCUSIF, as a benchmark in evaluating a private company’s geographic concentration risk. Due to the agency’s federal franchise, none of the above conditions need be present for the NCUSIF to do business in a state.

Mitigating Concentration Risk

The business of insuring credit union member deposits is a business of risk assumption. Accordingly, the type of risk one assumes drives the cost of the program and the risk of ultimate loss to the fund. ASI has been very selective in assuming the risk it underwrites, and does a thorough job of monitoring and field examining its insured institutions on a recurring basis as reported in the Study Section. In addition, the Study Section reports that the company has denied insurance coverage to certain credit unions representing inordinate risk to the fund, and conversely has approved many that satisfy the company’s Risk Eligibility Standards. Of the 29 credit unions that have converted to private share insurance during the past decade, all were at the time, and are now, safe and sound credit unions, and all strictly complied with the federal requirements to convert insurance. These were not problem credit unions fleeing federal supervision. Included in these federal requirements is a mail ballot vote of the credit union’s entire membership.

Risk in a Few Large Credit Unions

The Study Section reports that ASI has one insured institution that represents approximately 25% of its total insured shares, and that its “Top Five” credit unions represent 40% of total insured shares. The first statistic compares unfavorably to the NCUSIF’s reported concentration risk in a single institution of 3%, to which we take no exception. The risk of a single institution, however, has been significantly misrepresented in the Study Section. A large, well managed credit union contributes significantly to the financial stability of a share insurance program.

When underwriting its current largest institution in 2002, ASI considered several risk-mitigating factors, and, as with all applicant credit unions, performed a careful analysis of the institution. First, the subject institution received (and continues to receive) the highest rating available for credit unions. Second, ASI’s independent actuaries evaluated the adequacy of ASI’s capital prior to, and following, the underwriting of this credit union, and determined that ASI would continue to have a sufficiently high probability of sustaining runs even with this credit union in its insurance fund. Lastly, the federal insurer and state regulator both approved of the credit union’s insurance conversion, but only after the credit union took a full mail ballot vote of its almost 200,000 members and agreed to satisfy all the requirements of consumer disclosure under FDICIA.

With regard to the risk concentrated in a few large credit unions, the Study Section fails to report the concentration risk in what would be the equivalent of the NCUSIF’s “Top Five” federally insured credit unions. Proportionately, this would equate to the NCUSIF’s top 230 federally insured credit unions. In terms of asset size, this group of 230 credit unions represents 45% of the NCUSIF’s total insured shares. Clearly, the two funds compare on this statistic, when measured on a proportionate, not absolute basis.

B. ASI has limited ability to absorb large (catastrophic) losses because it does not have the backing of any government entity.

The credit union movement introduced share insurance on the state level long before Title II of the Federal Credit Union Act was enacted in 1971, providing the first federal deposit insurance for credit unions. However, private share insurance didn’t come of age until the mid 1970s, as states began to realize the loss of sovereignty in a state charter under an all-federal insurance setting.
Appendix XII
Comments from American Share Insurance

It was never envisioned that private share insurance would seek, or need, any guarantee from a state or federal government to operate. In the cooperative spirit of the credit union movement, private share insurance was designed to be a credit union-owned and credit union-operated private fund. Nor was it ever the intent of the framers of private share insurance for it to operate without supervision, or financial capacity. Accordingly, various state laws were proactively sought and passed to permit the private share insurance option, subject to admission standards and required approvals. Private share insurance was designed to provide credit unions with a comparable -- not identical -- alternative means for protecting member share accounts. Accordingly, a government backing for private share insurance was never anticipated, and to use the lack of such a guarantee as a criticism of private share insurance does not take into account its legislative intent, past performance or founding principles.

To our knowledge, no private insurance company, licensed by individual states, has a guarantee from the federal government. Further, no private insurance company in the U.S. would be able to meet the “deep pockets” test of the federal or state governments inferred in the Study Section. As evidence of this, the largest insurance company in the country reports just under $32 billion in capital from all of its various insurance product lines. This is barely 50% of the aggregate capital available to the NCUSIF. (Note: This amount is the estimated sum of the NCUSIF’s balance sheet capital plus the off-balance sheet recapitalization liability of its insured credit unions).

Credit union-only insurance funds have a stable history that does not track with insurers of thrifts or a combination of thrifts and credit unions. Funds that have insured only credit unions (like ASI and the NCUSIF) have had very successful track records when it comes to loss and risk management. In over 29 years, ASI’s loss ratio has been significantly below that of its federal counterpart, and ASI has never had a year with an operating loss, nor has it ever had to seek any form of recapitalization from its member credit unions to bolster the fund due to losses.

The reality is that a sound deposit insurance program, built upon a solid foundation of careful underwriting, continuous risk management and the financial backing of its mutual member credit unions, can exist as long as consideration is given to an actuarial analysis of the capital adequacy of the program in terms of sufficiently high probabilities (over 90%) of being able to withstand runs and multiple runs on the system. This is a common analysis that is accepted in the insurance industry for various kinds of low frequency, high-severity risk programs and is the foundation that the ASI insurance program is built upon. Our actuarial analyses and independent actuarial reports were provided to the GAO during its investigation. Alternative share insurance can be comparable to the NCUSIF, and still not have a government backing.

C. ASI’s lines of credit are limited in the aggregate as to amount and available collateral.

With regard to ASI’s committed bank lines of credit, the Study Section infers that ASI’s ability to absorb losses is reduced since its lines of credit are limited in the aggregate as to amount and available collateral. We disagree with this inference. The company’s lines of credit are designed to be solely a liquidity facility. The committed lines ensure liquidity of ASI’s invested funds; i.e., they provide a mechanism for ASI to quickly generate cash to meet liquidity needs, without having to liquidate the portfolio. Resources available for funding losses are not the same as resources available for providing liquidity. Lines of credit are not intended to be a source for funding insurance losses. In fact, banks would not provide a loan for such a purpose. ASI’s assets and its off-balance sheet sources of funding (i.e., the power to recapitalize the fund by insured credit unions under the ASI’s governing statute and insurance policy) are its capital sources for funding losses, not the bank lines of credit.

Proportionately, ASI’s lines of credits are greater than that of the NCUSIF. ASI’s $90 million in committed lines of credit equates to approximately 47% of the company’s total assets. NCUSIF’s $1.6 billion maximum borrowing capacity ($100 million from the U.S. Treasury and $1.5 billion from the Central Liquidity Facility, as disclosed in the NCUSIF’s and CLF’s audited financial statements for the year ended December 31, 2002), equates to approximately 28% of its total assets.
ASI has other sources of liquidity when it liquidates a credit union -- that is the credit union’s own liquid assets. Approximately 42% of ASI’s primary insured credit unions’ total assets are comprised of cash and investments -- we believe this is significant. In addition, the non-liquid assets (namely loans and fixed assets) of a failed institution can be pledged as collateral for additional borrowings to generate short-term liquidity until such loans and other assets can be collected and/or sold. In essence, a failed credit union’s total assets over time often generate sufficient liquidity to pay shareholders. Any shortage (historically less than 4% of total assets of the failed institution) is usually funded as a loss by ASI’s assets. This is the same principle under which NCUSIF operates.

D. Many privately insured credit unions have failed to make required consumer disclosures about the absence of federal insurance of member accounts as required under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), and the Federal Trade Commission (FTC) is the appropriate federal agency to enforce such compliance.

The Study Section reference to the GAO’s August 20, 2003 study titled Federal Deposit Insurance Act: FTC Best Among Candidates to Enforce Consumer Protection Provisions (GAO-03-971) reiterates the GAO’s earlier concern that “…members of privately insured credit unions might not be adequately informed that their deposits are not federally insured…”

Although the statement may be accurate, any implication that ASI and its member credit unions are purposefully misleading consumers fails to directly implicate the Federal Trade Commission (FTC) who, with the concurrence of Congress, has totally disregarded its statutory responsibility to regulate the disclosure requirements as defined by Section 151 (g) of FDICIA, codified at 12 U.S.C. § 1831 (0)(g).

We believe that the GAO’s earlier study brought to light the problems that arise when a federal law effectively lacks an enforcement agency, and we support the GAO’s previous conclusion that the FTC is the appropriate agency for monitoring and defining private share insurance consumer disclosure requirements.

This concludes ASI’s detailed comments in response to the GAO’s draft report on its study of private share insurance in the credit union movement -- a component of the GAO’s broader study titled, Credit Unions: Financial Condition Has Improved But Opportunities Exist to Enhance Oversight and Share Insurance Management.
Appendix XIII

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