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CUNA's Summary of GAO Report on NCUA

Shortly after the Government Accountability Office issued its important report, "National Credit Union Administration, Earlier Actions Are Needed to Better Address Troubled Credit Unions," GAO-12-247, on January 4, 2012, CUNA provided an initial summary of the report. In response to your request, this memorandum discusses the GAO report in greater detail and provides analyses that can be shared with Leagues and credit unions. In general, we believe the serious issues GAO raises in connection with the documentation of the costs of the corporate credit union crisis should be dealt with expeditiously. However, we believe GAO's analysis of the application of PCA to credit unions is not particularly revealing or useful.

In this report, we first describe the content of the report in Sections I to V before discussing our analysis and next steps in Sections VI to VIII.

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• Summary of GAO's Conclusions

GAO reviewed NCUA's supervision of corporate credit unions and 85 natural person credit unions that failed during the two and a half year period that began on January 1, 2008. The report concludes that poor investment and business strategies led to the failure of the corporate credit unions reviewed and that poor management generally was the primary reason for the failure of the natural person credit unions GAO studied. While the corporate credit unions that failed represented 75% of all corporate credit union assets as of December 31, 2007, the natural person credit unions that failed held less than 1% of all credit union assets at that time. In addition:

- The report is critical of prompt corrective action and other NCUA enforcement actions in dealing with the natural person credit unions that failed.
- The report states that for 16 of the failed natural person credit unions, PCA was not triggered at all. For the other natural person credit unions reviewed, PCA was triggered prior to their failure but at net worth levels that were lower than for credit unions as a whole that came under PCA for the same time period.
- The report states that the main weakness of the PCA framework is that it ties mandatory corrective actions to a credit unions' net worth level, which GAO feels is a lagging indicator. This is similar to a report GAO recently wrote on the effectiveness of PCA for banks.
- GAO examined other potential financial indicators for credit unions, including measures of asset quality and liquidity, and identified a number of indicators that it believes could provide early warning of credit union distress, and that should therefore be considered for inclusion in a PCA framework.
- On a separate issue, GAO said NCUA failed to provide sufficient documentation and information to it prior to the completion of the report to support NCUA's estimates of the losses of the failed corporate credit unions. This is a serious issue and CUNA, Leagues, and credit unions have been raising concerns about the agency's inability to verify the estimates for some time.

- **Why the GAO Report Was Developed and What it Covers**

The GAO report on NCUA was required by Congress under a law enacted in January 2011. GAO has issued reports on NCUA in the past and regularly reviews other agencies, such as the FDIC. Nonetheless, the provisions reflect that lawmakers felt more information was needed about NCUA's supervisory efforts and management of the Temporary Corporate Credit Union Stabilization Fund.

The law directs GAO to examine NCUA's supervision of the credit union system, including corporate credit unions, its use of prompt corrective action (PCA), and whether NCUA has effectively implemented recommendations of NCUA's Office of Inspector General (OIG) contained in the OIG's Material Loss Review Reports (MLRR), which the Federal Credit Union Act requires for losses to the NCUSIF that exceed $25 million. (The NCUA's OIG reviews all other losses to determine if a MLRR is needed because of the circumstances.)

In that connection, the GAO report addressed these areas:

- What is known about the causes of the failures of 5 corporate and 85 natural person credit unions;
- Steps NCUA took to resolve the failures and the extent to which its actions were designed to protect taxpayers and minimize the cost of corporate credit union resolutions;
- The effectiveness of PCA and other enforcement actions; and
- NCUA's progress in implementing pending recommendations from NCUA's OIG, which are addressed in Appendix I, page 48 of the report.

- **NCUA's Failure to Provide Adequate Information to Verify its Corporate Credit Union Loss Estimates**

A major deficiency that the report flags is NCUA's failure to provide adequate documentation to support its total loss estimates related to the legacy assets of failed corporate credit unions. GAO said that while it requested this information, "NCUA was not able to provide the documentation we required." The report adds, "The NCUA OIG was provided with the same information that we obtained and told us that they were unable to verify NCUA's loss estimates. Absent this documentation, it is not possible to determine the full extent of losses resulting from corporate credit union failures," the report said.

CUNA has also raised serious concerns with NCUA about this issue and continues to press for greater transparency from NCUA regarding the verification of its loss estimates.

"Without well-documented cost information, NCUA faces questions about its ability to effectively estimate the total costs for the failures and determine whether the credit unions will be able to pay for these costs."

- **GAO's Review of Specific Problems in the Failed Corporate Credit Unions**

GAO concludes that failed corporate credit unions made poor investment decisions concerning private-label mortgage-backed securities. The report notes that corporates had significant deposits in U.S. Central, leading to indirect exposure to U.S. Central's high concentration of private-label MBS and losses when it failed. The report also states the failed corporate credit unions pursued business strategies that contributed to their failures, such as aggressive growth strategies in some cases. The report also points out that the financial crisis exposed the problems in the failed corporate credit unions and led to a "severe liquidity crisis within the credit union system."

- **GAO's Review of the Deficiencies in the 85 Failed Credit Unions**

The report catalogues the various factors that it found contributed to the credit unions' failures. In general the report cites "poor management" as the primary cause of the failures. More specifically, the report finds that failure to control the following risks contributed to the credit unions' failures:

Incidence of Factors Contributing to Credit Union Failures*

Risk Factor	Cases in Which the Factor Contributed to the Failure
Operational Risk	76
Credit Risk	58
Liquidity Risk	31
Fraud	29
Concentration Risk	27
Business Lending	13
Total Factors Mentioned	234

*Note. Each credit union failure could have more than one associated risk factor.
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- **GAO recommendations to NCUA**

Because NCUA failed to provide the requested documentation to verify NCUA's estimate of the corporate credit union losses and because of GAO's concerns about shortcomings in PCA, GAO made two general recommendations to NCUA, neither of which called for new regulations on credit unions to address specific problems. They do direct NCUA to take steps to address the lack of documentation of its estimates of the corporate credit union losses and to improve PCA. The recommendations are below.

A. Documentation to Support NCUA's Corporate CU Loss Estimates

- To better ensure that NCUA determines accurate losses incurred from January 1, 2008 to June 30, 2011, GAO recommended that the NCUA Chairman provide its OIG the necessary supporting documentation to enable the OIG to verify the total losses insured as soon as "practicable."

B. Improvements to PCA

- To improve the effectiveness of PCA, GAO recommended that the NCUA Chairman consider additional triggers that would require "early and forceful regulatory actions. "These would include using other financial indicators that could help identify troubled credit unions earlier than relying on net worth levels, such as factors relating to asset quality, management, earnings and liquidity. GAO added that the NCUA Chairman should make recommendations to Congress on how to modify PCA for credit unions.

VIII. CUNA's Evaluation of the GAO Report

The report addresses two quite different issues: NCUA's role in and handling of the failure of corporate credit unions before and after the corporate credit union crisis broke, and the examination and supervision of troubled credit unions, especially as it relates to the application of Prompt Corrective Action (PCA). In general we find much to agree with in GAO's analysis of NCUA's handling of the corporate credit unions, but there are

major shortcomings in GAO's understanding of and prescriptions for PCA as it applies to credit unions.

A. NCUA and the Corporate Credit Union Crisis

There is very little new in the GAO's analysis of the corporate credit union crisis (most of which was covered previously by NCUA's Office of Inspector General). GAO reports that despite frequent contacts with corporates and knowledge of their investment activities, NCUA failed to take early enough action to avoid the subsequent losses. Many sophisticated investors worldwide did not anticipate the losses that would eventually occur in private label mortgage-backed securities. Nevertheless, NCUA examiners allowed very significant concentrations in these assets. The substantial losses that credit unions are currently paying in the form of Corporate Stabilization assessments would have been lower had NCUA taken corrective action at the troubled corporates sooner. However, decisions that appear clear in hindsight are always much more difficult in real time.

GAO's assessment of NCUA's actions following the corporate credit union crisis is more positive. The agency receives generally favorable marks for dealing with the failed corporates once it conserved them, for its new corporate rule, and for managing corporates' legacy assets in a way that will control long-term costs to credit unions.

GAO highlights a serious lack of transparency in NCUA's failure to reveal to its own OIG and the GAO sufficient documentation to back up its estimates of the eventual losses on the legacy assets. This lack of documentation presents a serious and unnecessary burden on credit unions. It adds to the uncertainty surrounding a difficult situation.

Credit unions currently have two concerns about the costs of the Corporate Stabilization program. First, the cost so far has been large, and substantial assessments remain. This fact is unavoidable.

The second issue is avoidable. It is that credit unions do not have much confidence in estimates of the amount of this eventual loss. NCUA has reported that its current range of estimated remaining assessments lies between $1.9 billion and $6.1 billion, with a midpoint of $4 billion. However, it has provided very little explanation to credit unions on how it produced those estimates, or about the assumptions it used to perform the valuations of the legacy assets. Also, the GAO report indicates that NCUA did not provide sufficient documentation to GAO on the same issues.

That fact that there are now finally audited financial statements for the Corporate Stabilization Fund simply means that NCUA has convinced its auditing firm that there is a reasonable basis behind its valuations of the legacy assets. That does not mean that the agency has provided sufficient information to the institutions that will bear the cost of the remaining legacy asset losses, the credit unions, on what lies behind its estimates. Describing for credit unions the types of assumptions behind the legacy asset valuations, and how the valuations depend on the outcome of important variables like the future course of the economy and home values would go far in helping credit unions understand a situation that they are certainly entitled to be informed about.

It is important to note that we do not doubt that the eventual losses will fall somewhere in the range of NCUA's latest published estimates. This is based on analyses we and others have performed on the bulk of the legacy assets. However, we find it unfathomable that NCUA will not provide more information to back-up its estimates to reduce the concern credit unions and others have about the uncertainty surrounding the remaining losses. Finally, the fact that it took the agency so long to produce audited financial statements for the Corporate Stabilization Fund, a fact noted with apparent disapproval by GAO, contributes to the view a number of credit union officials hold that the agency may not be handling the situation as well as it might be.

B. NCUA's Implementation of Prompt Corrective Action

The GAO report reveals a basic misunderstanding -- on the part of GAO -- of the purpose and nature of PCA as it applies to credit unions. First, PCA was mandated by Congress in the Credit Union Membership Access Act of 1998. That act explicitly specifies what PCA is, and how it is to work. Indeed, the whole rationale for PCA as it was created almost a decade earlier in response to the Federal Savings and Loan Insurance Corporation Crisis was to reduce regulatory prerogative, substituting direct Congressional mandates. Because FSLIC had not acted with sufficient alacrity in response to deteriorating conditions at thrift institutions, Congress imposed PCA on bank regulators to remove the option of forbearance, instead requiring prompt and corrective actions to minimize losses to deposit insurance funds.[1]

Second, the purpose of PCA is not to minimize or avoid the failure of credit unions. Instead it is to minimize losses to the National Credit Union Share Insurance Fund resulting from troubled credit unions. Of course reducing failures can lower insurance losses, but PCA is designed to also achieve this goal by requiring the early conservatorship and liquidation of institutions while still solvent. This is a very important distinction that GAO does not seem to appreciate. GAO's entire critique of NCUA's implementation of PCA deals with actions NCUA took with respect to credit unions that eventually failed, and on whether those actions were sufficient to prevent failure, rather than on actions the agency took to reduce losses to the share insurance fund. An appropriate evaluation of the effectiveness of NCUA's application of PCA would have judged it on the basis of the intended goal, i.e., on the level of losses sustained by the share insurance fund from troubled credit unions during the recent financial crisis, not simply on the number of failures.

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[1] The language that GAO uses in faulting NCUA for lack of timely application of PCA suggests this misunderstanding of the statutory underpinnings of PCA. The fact that a credit union triggers PCA at a capital classification below the "undercapitalized" classification is not because NCUA has delayed the application of PCA. By law it can't delay the application of PCA once it discovers that the capital ratio has fallen below 6%. Instead, what has happened in these cases is NCUA first discovered the undercapitalized situation when the capital ratio had already dropped below 4%, either because of a rapid decay in the credit union's financial condition, or an extended period since the credit union's previous exam or accurate Call Report submission. Rather than the inference drawn by GAO (that tardy application of PCA lead to some failures), a more accurate interpretation is that a credit union whose financial condition deteriorates very rapidly is more likely to fail than one whose condition worsens more gradually.

It is revealing that in discussing the causes of the 85 credit union failures during 2008 to the middle of 2011, as we list above on page 4, GAO identifies 6 different factors that contributed to the failures, and reports 234 linkages between one or more of these factors to the 85 failures. However, except for a general mention in the introduction to its report, GAO does not ascribe any of these failures to the worst financial crisis and recession the country has experienced since the 1930s.

We believe GAO's analysis of the application of PCA to credit unions would have been much more useful had it placed the incidence of credit union failures during the financial crisis in some context, and had it focused more on insurance losses incurred or avoided by NCUSIF than simply on the number of failures. Insurance loss data is readily available. Context can be provided by comparing NCUSIF's results to prior periods, and to those of the other federally insured deposit system, the FDIC. Had they performed that analysis, GAO would have found the following:

Comparative Failure Rates:

- Over the three and a half year period covered by GAO's report, credit unions insured by NCUSIF failed at an annual rate of 23. That is up, but only slightly, from the rate of 18 per year recorded from 2000 through 2007.
- Over the three and a half year period covered by GAO's report, banks insured by FDIC failed at an annual rate of 105. That is up considerably from the rate of only 4 per year recorded from 2000 through 2007.
- At the beginning of the period, the number of insured credit unions (8,101) and insured banks (8,545) were roughly the same.
- Placed in this context, the "testing" by the financial crisis of PCA as applied to credit unions does not suggest significant shortcomings or need for major revision in the supervision of credit unions. The number of credit union failures barely increased during a very severe financial crisis.

Comparative Insurance Loss Rates:

- Over the period covered by GAO's report, the total of NCUSIF insurance expense was $1.7 billion, representing 0.23% of the average of insured shares over the period, or an annual insurance loss rate of 0.06% (6 basis points) of insured shares. NCUSIF's annual insurance loss rate during the preceding eight years of the decade averaged just under 1 basis point.
- Over the period covered by GAO's report, the total of FDIC provision for insurance losses was $93.5 billion, representing 1.61% of the average of insured deposits over the period, or an annual insurance loss rate of 0.38% (38 basis points) of insured deposits. FDIC's annual insurance loss rate during the preceding eight years of the decade averaged 0.2 basis points.
- Placed in this context, one could reasonably conclude that the application of PCA to credit unions during the recent financial crisis produced insurance losses dramatically lower than similarly calculated losses at FDIC, and not even very high in absolute terms.

We believe that the relatively low insurance loss rates at natural person credit unions during the financial crisis owes as much if not more to the cooperative structure of credit unions than to any legislated prompt corrective action regime as implement by NCUA. The cooperative structure militates against excessive risk taking by credit unions. Risky behavior at investor owned firms can occasionally be rewarded with outsized gains for owners and managers. This creates an incentive to take on risk. That effect is much less prevalent at cooperative enterprises. Mangers of cooperatives such as credit unions face much lower incentives to take on risks, and therefore tend to behave in a much more risk-averse fashion.

Whatever the causes, the fact that the NCUSIF survived the worst financial and economic crisis the US has seen for over 80 years with an average annual loss rate of only 6 bp of insured shares certainly does not suggest major enhancements are needed to PCA or to the broader palate of NCUA's powers to deal with potentially troubled credit unions.

To the contrary, the more legitimate question is whether the actions NCUA took against some potentially troubled credit unions were excessive in light of the very low loss rates.

Because credit unions ultimately have to pay all insurance losses from failed institutions, we are not arguing for laxity in the supervision of credit unions. However, a system **should not** seek to avoid losses at all costs, since those costs, in terms of excessive supervision, can be considerable. GAO's view on this is perhaps revealed by a statement on page 8 that describes NCUA's supervisory authority over federally insured state credit unions: "In addition, NCUA shares responsibility for overseeing state-chartered credit unions to help ensure they pose **no** risk to the insurance fund." (Emphasis added). This is clear evidence that the GAO has the balance wrong.

CUNA favors fair and effective examination and supervision of credit unions. However, policy makers must guard against excessively impeding the operation of healthy credit unions that show some signs of stress. A system whose goal is the elimination of almost all insurance losses is likely to produce many such actions.

We are particularly concerned about the possible inclusion of a number of alternate indicators in a PCA framework that would trigger mandatory supervisory actions. A credit union's capital ratio is indeed a lagging indicator, but it has the benefit of serving as a measure of the cushion protecting the share insurance fund from losses due to that credit union. Avoidance of such losses is after all the purpose of PCA. GAO's discussion of possible alternate indicators that could identify troubled credit unions does not reveal a deep understanding of the financial operation of a credit union. Once one moves away from capital ratios, the interrelationships among other indicators mean that taking any one or a few of them out of context can be very misleading. Constructing a formal system of mandatory supervisory actions based on a few additional indicators would likely do much more harm than good.

We are not suggesting that NCUA should limit its analysis to capital ratios. They should, and already do, consider a host of other indicators in the context of each credit union's exam, and often require corrective actions on the basis of those other indicators.

But expanding the system of PCA to incorporate some of these other ratios as mandatory triggers for supervisory actions would be detrimental.

C. Implications of the GAO Report

In all candor, all of the implications of this report are not knowable at this point, as discussed below. However, the report does raise serious concerns in several areas.

- **NCUA's Failure to Provide Information to GAO**

One concern is that GAO, an office of Congress, requested information from NCUA that NCUA did not provide to the extent GAO wanted. That is, GAO requested that NCUA provide sufficient documentation to verify its loss estimates on the legacy assets of the failed corporate credit unions. It is not known at this point whether any members of Congress will be concerned that the requested information was not forth coming.

The GAO report also indicates that the full effect of NCUA's actions to address the failure corporates is not yet known, and GAO concludes that as a result, it is also unknown as to whether credit unions will be able to repay the Stabilization Fund.

> Although NCUA officials have stated that the credit union system will bear the ultimate costs of corporate and credit union failures, risks to the taxpayers remain. However, many of the reforms are ongoing and NCUA continues to resolve the failure of U.S. Central and Wescorp, as will be discussed. Moreover, the ultimate effectiveness of NCUA's actions and associated costs remain unknown. As a result, whether the credit union system will be able to bear the full costs of the losses or how quickly NCUA will repay Treasury is unknown. (GAO Report, page 30.)

Following the release of GAO's report, NCUA issued a statement that indicates it has now provided the audited financial statements for the Temporary Corporate Credit Union Stabilization Fund for 2010 to GAO and that has satisfied GAO's request for information.

We have talked with the GAO staff who wrote the report, and they said they still feel more information is needed to verify NCUA's estimates. NCUA has agreed with the recommendation included in the GAO report that it will provide more data to the NCUA Office of Inspector General. Yet, there is no deadline by which that information has to be provided.

GAO said it will be following up with NCUA's OIG to see how this matter is handled. CUNA also will be following up with NCUA and with the NCUA OIG. Meanwhile, we are continuing to urge NCUA to provide more detailed information that can be used to support the agency's loss estimates.

- **The Report Highlights PCA Deficiencies That Could Lead NCUA to Impose Further Regulations**

The report implies that the failure to apply PCA earlier contributed to the failure of at least some of the failed natural person credit unions. However, the report seems to reflect a misunderstanding of how PCA works. As required by the Federal Credit Union Act, serious PCA sanctions generally cannot be imposed on a credit union until the credit union's net worth has fallen to certain levels. Also, all federal financial regulators utilize other indicators when assessing a financial institutions condition and do not just rely on net worth.

However, the fact that GAO highlights PCA deficiencies as implemented by NCUA could have implications for the credit union system in a several ways. First, there would be a tendency on the part of NCUA to over-correct for these problems and to change the perception it is ineffective. Based on its past actions, NCUA will do that by adopting examiner practices and procedures, and perhaps new regulations that will be universally applied and more intrusive for credit unions.

NCUA should address examination deficiencies and improve its capabilities to identify problems and apply corrective measures in a timely manner, but without making it more difficult for well-managed credit unions to operate.

Second, NCUA has agreed to strengthen PCA and consider other financial indicators that will boost its ability to deal with problem credit unions. It is not clear at this point whether NCUA will develop those changes with much input from the credit union system. While PCA is implemented through a regulation, it is possible NCUA could supplement its rule through new examiner procedures that would not require the agency to seek comments and reaction from the credit union system. This could be problematic if NCUA is not mindful of credit union concerns before PCA changes are implemented. Also, some of the supervisory recommendations made by the NCUA OIG that have not yet been implemented would be onerous for credit unions, and it is not clear that NCUA needs to use all of them, especially if less intrusive approaches could be adopted.

On a separate note, almost regardless of what NCUA does to respond to the GAO's criticisms regarding PCA and the failed credit unions, the report can be cited by critics that challenge the need for an independent credit union regulator and want credit unions to be treated as second class banks. (A similar point can be made about GAO's criticisms about the bank regulators' use of PCA.) The report could be used to support claims that credit unions need stronger supervision and regulations or to undermine NCUA's independence. Also, it is not clear how members of Congress or other policymakers will react, if at all, to the report. The report was provided to the Senate Banking Committee, the House Financial Services Committee, the Financial Stability Oversight Council, which includes federal bank regulators, and separately to the U.S. Treasury. The report was publicly released by GAO and remains available on GAO's website. The *Wall Street Journal* and Bloomberg covered the report.

- **Regulation of State Credit Unions**

Even though no credit unions likely feel favored by NCUA, state chartered credit unions are increasingly feeling there is a bias at NCUA against them. The GAO report's description of the role of state regulators, likely reinforced by NCUA, will help to

memorialize NCUA as the primary regulator and enforcer for the credit union system, which could have negative ramifications for dual chartering.

IX. CUNA's Follow Up On the GAO Report

It could create more problems for credit unions if too much public attention is drawn to NCUA's deficiencies addressed in the GAO report. Nonetheless, appropriate follow up by CUNA regarding the report is warranted.

Below is a list of actions CUNA will be pursuing to mitigate any possible negative impact of the report and encourage NCUA to address concerns raised in the report in a reasonable and appropriate manner.

- Continue to urge NCUA to provide more information to credit unions on its loss estimates and following up with GAO and NCUA's OIG;
- Urge NCUA not to overreact to the report and not to take supervisory measures that will be harsh for well managed credit unions;
- Raise concerns with Treasury and other policymakers about the lack of verification for NCUA's loss estimates and that detractors of NCUA or the credit union system may try to use the report to pursue their own agendas;
- Update the white paper CUNA and CUNA Mutual developed last year to help explain and evaluate the costs associated with failed corporate credit unions' legacy assets; and
- Review the GAO report with CUNA's Examination and Supervision Subcommittee to identify and develop recommendations to help improve NCUA's dealings with problem credit unions without constraining well-managed credit unions.

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