

**REPORT TO THE CONGRESS ON ACTIONS TAKEN IN RESPONSE TO THE U.S.
GOVERNMENT ACCOUNTABILITY OFFICE’S REPORT ENTITLED, “NATIONAL
CREDIT UNION ADMINISTRATION: EARLIER ACTIONS ARE NEEDED TO BETTER
ADDRESS TROUBLED CREDIT UNIONS”**

FINANCIAL STABILITY OVERSIGHT COUNCIL

Completed pursuant to Section 4(d) of the National Credit Union Authority Clarification Act

June 2012

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I. Introduction

The National Credit Union Authority Clarification Act (the Act) requires the Comptroller General of the United States (GAO) to conduct a study of the National Credit Union Administration's (NCUA) supervision of corporate credit unions and implementation of prompt corrective action (PCA). The Act further requires that the Financial Stability Oversight Council (the Council) submit a report to Congress on actions taken in response to the GAO report, including any recommendations issued to the NCUA under section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).

This report discusses the findings and recommendations of the GAO study, and outlines NCUA activities that relate to the GAO's recommendations, including the NCUA's: (1) continued evaluation of alternative approaches to PCA and the early identification of potentially troubled credit unions, and (2) maintenance of a robust process for the accurate and transparent valuation of the securities underlying the NCUA guaranteed notes backed by legacy assets of the failed corporate credit unions, and of the range of total potential corporate resolution costs.

II. GAO Study and Findings/Recommendations

In January 2012, the GAO issued its study titled, "National Credit Union Administration: Earlier Actions Are Needed to Better Address Troubled Credit Unions."

In its study, the GAO found that:

- Poor investment and business strategies contributed to the failures of five large corporate credit unions. Specifically, the five failed corporate credit unions concentrated their investments in private-label, mortgage-backed securities (MBS) and invested substantially more in private-label MBS than corporates that did not fail.
- NCUA took multiple actions to stabilize, resolve, and reform the corporate credit union system. These steps included placing failing corporates into conservatorship, reducing losses from the corporates' failures by the establishment of a securitization program to provide long-term funding for the distressed assets, and addressing weaknesses in corporate credit union regulations.
- NCUA's responses to the failures of the five large corporate credit unions included measures to reduce moral hazard, minimize the cost of resolving the corporates, and protect taxpayers.
- Poor management was the primary cause in 85 natural person or consumer credit unions failures studied by GAO.
- Credit unions that did not fail were more likely subject to earlier PCA action than failed credit unions. For many of the failed credit unions, other enforcement actions were initiated either too late or not at all.

- Extending the GAO research on the effectiveness of PCA for banks to the credit union industry, the GAO found PCA effectiveness is limited because of its reliance on capital, which can lag behind other indicators of financial health. GAO examined other potential financial indicators for credit unions, including measures of asset quality and liquidity, and found a number of indicators that could provide early warning of credit union distress. GAO states that incorporating such indicators into the PCA framework could improve its effectiveness.

The GAO report included two recommendations for executive action:

- To better ensure that NCUA determines accurate losses incurred from January 1, 2008, to June 30, 2011, GAO recommended that the Chairman of NCUA provide its Office of Inspector General (OIG) the necessary supporting documentation to enable the OIG to verify the total losses incurred as soon as practicable.
- To improve the effectiveness of the PCA framework, GAO recommended that the Chairman of NCUA consider additional triggers that would require early and forceful regulatory actions, including the indicators identified in the GAO's report. The GAO stated that in considering these actions, the Chairman should make recommendations to Congress on how to modify PCA for credit unions, and if appropriate, for corporates.

III. NCUA Activities Relating to the GAO's Recommendations

This section describes ongoing and planned NCUA activities that relate to the GAO's recommendations.

Supporting Documentation regarding Corporate Resolution Costs

As noted above, the GAO recommended that NCUA provide its OIG supporting documentation regarding the total losses incurred, i.e. audited financial statements and supporting materials for the Temporary Corporate Credit Union Stabilization Fund (Stabilization Fund), which was formed to absorb losses of the failed corporate credit unions. The Stabilization Fund was used as a part of the resolution of the five failed corporate credit unions. To resolve these credit unions, NCUA created a re-securitization program to provide long-term funding for the legacy assets inherited from the institutions. As a part of this program, NCUA Guaranteed Notes (NGNs) were issued. The NGNs are backed by over 2,000 investment securities that are legacy assets of the failed corporate credit unions, and are secured by approximately 1.6 million mortgages. NCUA issued approximately \$28.3 billion of NGNs.

Although the audited financial statements were not available during the period when GAO was performing its review, NCUA auditors completed their work and NCUA provided fully documented loss estimates prior to the release of the report. Subsequent to the report, the GAO affirmed that the report's findings and recommendation on the loss estimates for the Stabilization Fund should not be construed as a determination on the quality of the audited financial

statements. GAO has subsequently reviewed the audited financial statements and has determined that NCUA has fully addressed the recommendation.

More broadly, NCUA has taken actions to promote the accurate and transparent valuations of the legacy securities from the five failed corporate credit unions and the range of total potential corporate resolution costs. For example, NCUA has established a valuation process around the NGNs and the projection of the corporate resolution costs. In addition, the NCUA Board created the NGN Securities Management and Oversight Committee to ensure that NCUA meets all its statutory and legal obligations under the NGN Program.

On a quarterly basis, NCUA prepares updated loss estimates which include valuations of the underlying legacy assets and projections of legacy asset cash flows, NGN guaranty fees, guaranty payments required by NGNs, and legacy asset residual values, which together yield the net economic values associated with NGN program. To ensure the most accurate valuations and projections of the legacy assets NCUA has contracted with BlackRock Solutions to assist with the process of preparing the loss estimates and related valuations. The loss estimates that NCUA prepares for securitized assets are joined with valuations of the legacy assets that were not securitized to generate an updated evaluation of total costs and cash flows associated with the resolution of the corporate credit unions. In sum, this analysis provides an updated view of the range of losses, and ultimately assessments to credit unions to cover the cost of the losses, associated with the resolution of the failed corporate credit unions.

The performance of the assets underlying the NGNs will in large measure determine the ultimate resolution costs associated with the five failed corporate credit unions. The most recent estimate of total losses related to the resolution of the corporate credit union system is \$10.8 to \$15.1 billion. After accounting for \$5.6 billion in liquidated capital in corporates and \$3.3 billion in assessments collected to date, the remaining assessments are estimated to be between \$1.9 and \$6.2 billion.

The analyses discussed above will be made available to the public on a semi-annual basis.

The GAO report states that without well-documented cost information, NCUA faces questions about its ability to effectively estimate the total costs of the failures of five large corporate credit unions and the ability of the credit union industry to pay for these losses. As noted above, the NCUA has taken actions, including creating the NGN Securities Management and Oversight Committee and contracting with BlackRock Solutions to provide well-documented cost estimates and to put in place a process to track and evaluate costs going forward. While there is significant uncertainty about asset performance, the credit union system's combined net worth and ability to pay assessments far exceeds even the extreme upper bound of potential losses from the corporate failures. Therefore losses to taxpayers as a result of the resolution of the corporate failures are extremely unlikely.

Prompt Corrective Action

The PCA framework for credit unions was established by the Credit Union Membership Act in 1998 and is described in Part 702 of NCUA's Rules and Regulations. The NCUA's PCA

framework establishes five net worth ratios categories (see Table 1 below) with associated mandatory supervisory actions. As described in the GAO report, the PCA framework provides more stringent mandatory and discretionary actions to be taken by the NCUA in addressing the problems of a credit union as it falls into lower PCA categories. Table 1 sets out the PCA categories and associated triggers.¹

Table 1

PCA Category	Net Worth Ratio
Well-capitalized	7% or greater
Adequately-capitalized	6 to 6.99%
Undercapitalized	4 to 5.99%
Significantly undercapitalized	2 to 3.99% ²
Critically undercapitalized	Less than 2%

The GAO study of PCA in the context of credit unions built on a previous study of PCA in the context of banks.³ Both studies concluded that the main weakness of the PCA framework is the reliance on measures of capital adequacy. The GAO report notes that, “capital based indicators have weaknesses, notably that they can lag behind other indicators of financial distress.”⁴ The GAO report notes that other financial indicators could help identify troubled credit unions earlier than capital. Some of the indicators identified by GAO in the report include asset quality (such as loans as a percentage of total assets; payment-option, adjustable rate mortgage, and interest-only mortgage loans as a percentage of total assets; participation loans as a percentage of total assets; and member business loans as a percentage of total assets), management (such as operating expenses as a percentage of average total assets), and earnings (such as net income as a percentage of assets).

NCUA agreed with this recommendation and supports research into indicators that may be able to better assist in identifying troubled institutions earlier and with more precision. Compared with a capital-based PCA framework, alternative measures are attractive, because they have the potential to be more forward looking. However, a significant downside associated with alternative measures is the difficulty in precisely identifying credit unions before they become troubled. For example, while the alternative measures cited in the GAO report were correlated

¹ A alternative set of categories and triggers apply to “new” credit unions. A “new” credit union is a federally-insured credit union that both has been in operation for less than ten years and has total assets of not more than \$10 million. A credit union which is not “new” because its total assets exceed \$10 million may become “new” if its total assets subsequently decline below \$10 million while it is still in operation for less than 10 years. For purposes of PCA, new credit unions are classified as well capitalized, adequately capitalized, moderately capitalized, marginally capitalized, minimally capitalized, or undercapitalized based on the net worth ratio.

² A credit union (other than a “new” credit union) is significantly undercapitalized if it has a net worth ratio of between 2 percent and 3.99 percent, or if it has a net worth ratio between 4 percent and 4.99 percent and either fails to timely submit an acceptable net worth restoration plan or materially fails to implement a net worth restoration plan approved by the NCUA Board.

³ Government Accountability Office, Bank Regulation: Modified Prompt Corrective Action Framework Would Improve Effectiveness, GAO-11-612, June 2011.

⁴ GAO Report at 43.

with higher rates of credit union failure, the vast majority of credit unions that would have triggered PCA due to those alternative measures did not fail or experience severe distress.

NCUA is committed to a review of its PCA regulations, in particular the risk-based net-worth component. NCUA has established a task force comprised of NCUA and State supervisors to undertake the review. NCUA staff will produce any suggestions for legislative improvements for NCUA Board consideration as recommendations to Congress. NCUA also will continue to research approaches to early identification of troubled credit unions and will track related developments as the federal banking agencies consider enhancements to their PCA framework.

IV. Requirement for the Council to Report on Actions Taken

The Act also requires the Council to report on actions taken in response to the GAO report, including any recommendations made by the Council under section 120 of the Dodd-Frank Act. As of the date of this report, the Council has not made any such recommendations.

Notes

PUBLIC LAW 111-382—JAN. 4, 2011

SEC. 4. STUDY OF NATIONAL CREDIT UNION ADMINISTRATION.

(a) **STUDY.**—The Comptroller General of the United States shall conduct a study of the National Credit Union Administration’s supervision of corporate credit unions and implementation of prompt corrective action.

(b) **ISSUES TO BE STUDIED.**—In conducting the study required under subsection (a), the Comptroller General shall— (1) determine the reasons for the failure of any corporate credit union since 2008; (2) evaluate the adequacy of the National Credit Union Administration’s response to the failures of corporate credit unions, including with respect to protecting taxpayers, avoiding moral hazard, minimizing the costs of resolving such corporate credit unions, and the ability of insured credit unions to bear any assessments levied to cover such costs; (3) evaluate the effectiveness of implementation of prompt corrective action by the National Credit Union Administration for both insured credit unions and corporate credit unions; and (4) examine whether the National Credit Union Administration has effectively implemented each of the recommendations by the Inspector General of the National Credit Union Administration in its Material Loss Review Reports, and, if not, the adequacy of the National Credit Union Administration’s reasons for not implementing such recommendation.

(c) **REPORT TO COUNCIL.**—Not later than 1 year after the date of enactment of this Act, the Comptroller General shall submit a report on the results of the study required under this section to— (1) the Committee on Banking, Housing, and Urban Affairs of the Senate; (2) the Committee on Financial Services of the House of Representatives; and (3) the Financial Stability Oversight Council.

(d) **COUNCIL REPORT OF ACTION.**—Not later than 6 months after the date of receipt of the report from the Comptroller General under subsection (c), the Financial Stability Oversight Council shall submit a report to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on actions taken in response to the report, including any recommendations issued to the National Credit Union Administration under section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 U.S.C. 5330).