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CREDIT UNIONS

The Failure of Capital Corporate Federal Credit Union

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Summary of Statement by
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Capital Corporate Federal Credit Union (Cap Corp), one of the largest of the nation's 45 corporate credit unions, failed in January 1995 and was placed into conservatorship by the National Credit Union Association (NCUA). As interest rates increased sharply beginning in February 1994, many collateralized mortgage obligations (CMOs) in Cap Corp's portfolio lengthened in expected average maturity and dropped in value. Rather than liquidating these investments at a loss to meet member withdrawals, Cap Corp borrowed in excess of regulatory limits. GAO's analysis indicates that Cap Corp's failure was, in part, the result of inadequate board oversight of an inappropriate investment strategy.

As of February 1995, NCUA projected the total loss on Cap Corp's portfolio to be about $60 million. This loss will be borne by member credit unions through loss of Cap Corp's retained earnings and membership capital share deposits--a special, at-risk category of uninsured deposits. No charge to the Share Insurance Fund should be necessary, according to NCUA. NCUA analysis also indicated that the member's losses--probably lessened by NCUA's decision to guarantee uninsured member deposits--would not cause any of the member credit unions to fail.

NCUA's supervision of Cap Corp was ineffective on several fronts. For four years, NCUA essentially tolerated weaknesses in Cal Corp's internal controls; also, examiners who lacked investment expertise evaluated individual securities rather than securities portfolios, overlooking aggregate interest rate risk. NCUA's oversight was also limited because corporate credit unions' call report data lacked needed detail about the maturity structure and the market value of assets. Finally, the capital standards to which Cap Corp was subject did not provide capital against risks other than credit risk.

Cap Corp's failure raises concerns about interest rate risk being taken on by credit unions, especially in CMO investments. Corporate credit unions are more likely to hold CMOs in their portfolios than are their members, "natural person" credit unions. At year-end 1994, most corporate credit unions held CMOs, and the total book value of those CMOs was about 25 percent of the corporates' total combined assets. However, only about 9 percent of "natural person" credit unions reported holding CMOs, and the total book value of those was only about 2 percent of the credit unions' total combined assets.

GAO is making one recommendation to Congress and eight to NCUA to improve the safety and soundess of credit unions.

Mr. Chairman,

It is a pleasure to appear before the committee today to discuss Capital Corporate Federal Credit Union (Cap Corp) and its regulator, the National Credit Union Administration (NCUA).[1] As you requested, we are reporting on the causes of Cap Corp's failure, the effectiveness of NCUA's supervision of Cap Corp, who will bear the cost of the failure, and the extent of similar problems in the rest of the credit union industry. We are also recommending actions that NCUA and Congress can take to enhance the safety and soundness of the credit union industry.

CAUSES OF THE FAILURE

Cap Corp's failure resulted from a number of factors, including an inappropriate investment strategy, an inadequate risk management system and insufficient board oversight, lax regulatory supervision and examination, and inadequate capital. As of December 31, 1994, Cap Corp was one of the largest of the nation's 45 corporate credit unions, with 483 member credit unions, reported assets of $ 1.6 billion, shares (deposits) of $840 million and total capital of $

[1]Corporate credit unions are nonprofit cooperatives that are owned by their respective member credit unions. They serve their member credit unions, providing liquidity loans, investment products, and other services such as share draft (i.e., check) processing. Member credit unions, called "natural person" credit unions, are not-for-profit cooperative associations that offer a variety of financial services. Their member/owners have a "common bond," such as working for the same employer, which is specifically defined in the credit union's charter.

70 million. Over the five year period 1989-1994, Cap Corp invested an increasing portion of its assets in collateralized mortgage obligations (CMOs), a form of mortgage derivative, in an apparent attempt to increase the return paid to its member credit unions. At the time of its September, 1990 examination, NCUA noted that Cap Corp had about $63 million in CMOs. By 1992 Cap Corp's CMO holdings were over $500 million. By September 1994, Cap Corp's CMO holdings had increased to over $1 billion which was about 68 percent of its assets.

The sharp increase in interest rates that began in February 1994 caused many of Cap Corp's CMOs to lengthen in expected average maturity. Some of the more volatile CMOs lengthened substantially, which caused their market values to fall dramatically. What began as a mild mismatch between longer term assets and shorter term liabilities turned into a substantial mismatch.

In the fall of 1994, many member credit unions began withdrawing shares they held in Cap Corp. In part, this reflected increased demand for loans to customers of the member credit unions and improved returns in alternative investment vehicles. However, it may also have reflected growing concerns about Cap Corp's liquidity and solvency. To avoid realizing the losses on its CMO portfolio, Cap Corp funded these withdrawals by borrowing an amount of funds that NCUA believed was well in excess of its regulatory borrowing limits. When this excess borrowing was detected by NCUA, Cap Corp was directed not to borrow any more. This meant that Cap Corp would be forced to liquidate its investments at substantial losses to fund member withdrawals.

On December 7, 1994, Cap Corp placed a 60-day moratorium on further withdrawals by its members. On January 31, 1995, NCUA placed Cap Corp in conservatorship and arranged to cover all uninsured deposits. NCUA estimated the loss on Cap Corp's investment portfolio to be $100 million at that time, which exceeded Cap Corp's capital by $30 million.

Lack of an Effective Risk Management System and Board Oversight

Although Cap Corp's investments in CMOs increased substantially over the 1989-1994 period, Cap Corp did not develop and implement a risk management system that was capable of effectively monitoring and responding to rapid and unanticipated changes in their market values. In particular, Cap Corp lacked a model to test the overall sensitivity of its investment portfolio to potential changes in interest rates, and thus was unable to react readily to the growing mismatch between its assets and liabilities.[2]

Cap Corp's Board of Directors not only failed to ensure that an adequate risk management system was established and functioning, it also did not appear to adequately oversee Cap Corp's investment activities. Virtually all responsibility for Cap Corp's investment activities was delegated to an investment committee that was comprised of Cap Corp's senior management. The August 31, 1993 examination report noted that minutes documenting investment decisions were not maintained by the committee. Investment committee minutes were formally presented to the board beginning in early 1994, and then only at the insistence of NCUA examiners. Even after these minutes were presented to the board on a monthly basis, the board's minutes generally reflected no discussion or questioning of the investment committee's strategies or activities.

In addition, the supervisory committee of the board of directors, which was responsible for oversight of the audit function and the related review of internal controls, did not establish an internal audit function at Cap Corp. Instead, the supervisory committee relied solely on the annual financial statement audit and review of

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[2]The market value of a CMO tends to be more volatile than traditional corporate investments--such as U.S. Treasury obligations--in part because changes in interest rates affect the time pattern of mortgage repayments. When interest rates rise, people repay mortgages at a slower rate and the average maturity of these assets lengthens. Financial modeling, including stress testing, is important because it shows sensitivity of asset and liability values to potential changes in interest rates.

internal accounting controls performed by external auditors to fulfill its responsibility. While the annual external audit was a necessary part of the supervisory committee's oversight, it did not take the place of the continuous review of operating and accounting controls that an internal auditor could have performed to ensure compliance with established policies and procedures throughout the year.

Cap Corp's Accounting Did Not Reflect Declining Market Values

Generally Accepted Accounting Principles (GAAP) allow investment securities to be carried at historical cost only if the reporting entity has the positive intent and ability to hold such securities to maturity. Securities that may be sold in response to changes in market conditions are specifically prohibited from classification as "held to maturity". Securities that the entity does not have the ability and intent to hold to maturity should be carried at market value, with the change in market value recorded either in earnings or a special equity account.

Despite these requirements--which became effective for Cap Corp beginning January 1, 1994--Cap Corp recorded the vast majority of its investment portfolio, including most of its CMOs, at historical cost. Even after interest rates rose and market values declined, only a small portion of the decline was reflected in Cap Corp's financial results. For example, Cap Corp continued to record over 95 percent of its portfolio at historical cost on its September 30, 1994 internal reports. Although the market value of investments was approximately $40 million below cost, only $4.6 million of this decline was reflected in Cap Corp's financial results as a reduction in the equity account.

NCUA regulations generally require credit unions to follow GAAP in accounting for investments. During the September 30, 1994 examination, the examiner questioned the classification of Cap Corp's investment securities. The examination report directed Cap Corp to establish a policy for classifying securities as held to maturity only if they were specifically matched to a corresponding liability with the same maturity, to primary capital, or to core deposits. The examiner noted that the remainder of Cap Corp's capital could be eliminated if they complied with GAAP requirements. Based on Cap Corp's December 31, 1994 internal reports, it made little or no change to its investment classifications in response to the examination and continued to carry the bulk of its portfolio at historical cost.

NCUA's Examination and Supervision Were Inadequate

Although NCUA officials were aware that Cap Corp was making more risky investments than most other corporates, it failed to take prompt action to correct clear weaknesses in Cap Corp's risk management system. NCUA not only let Cap Corp take on substantial investment risk without sufficient controls, it also failed to evaluate the risk of Cap Corp's entire portfolio or to reflect that risk in assigning CAMEL ratings for Cap Corp.[3] NCUA also did not address identified corporate governance and accounting weaknesses. In addition, NCUA did not realize the extent of Cap Corp's outside borrowing until that borrowing had already exceeded regulatory limits.

As early as 1989, NCUA examiners noted that Cap Corp needed to have a stress test model to evaluate maturities of individual CMOs, both at acquisition and on an on-going basis. Cap Corp acquired such a model in 1992, but did not consistently perform or document the required tests of individual CMOs. This lack of consistency in performing the required testing was evidenced in the September 30, 1994 examination finding that Cap Corp had purchased a number of fixed rate CMOs in 1994 that failed the stress test at the time of purchase.

Additionally, Cap Corp did not have a model in place to assess the overall interest rate sensitivity of its assets and liabilities. Examiners recommended such an overall interest rate risk assessment model in the October 1992 examination report. This became increasingly important as Cap Corp began to invest heavily in CMOs.

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[3]The CAMEL rating system is one that evaluates an institution's capital, assets, management, earnings and liquidity.

Cap Corp ignored the examiner's recommendations and NCUA did not force it to comply.

NCUA raised Cap Corp's CAMEL rating from a 3 in 1989 to a one (the highest rating) in 1992, even though it had increased its exposure to CMOs and had failed to effectively address problems raised in previous exams.

In the August 31, 1993 examination report, Cap Corp's examiner noted the lack of an internal auditor. The minutes of a subsequent Board meeting indicated that the supervisory committee chairman discussed the need for an internal auditor with the external auditors, who did not believe an internal auditor was warranted. NCUA examiners did not pursue the issue.

Although NCUA's standards to qualify particular CMO securities as appropriate for purchase and retention are more conservative than the bank regulators, it imposed no limit on the aggregate interest rate risk being taken by an institution. Until late in 1994, NCUA was apparently unmindful of the increasing loss in market value of Cap Corp's total portfolio, concentrating instead on losses of specific CMOs. At Cap Corp, this narrow focus resulted in the forced sale of only two CMOs out of the entire portfolio.

NCUA began a special examination of Cap Corp, in late September, when it became clear that Cap Corp's portfolio had experienced a severe decline. Had NCUA focused earlier on the overall portfolio decline and required proper recognition of losses in Cap Corp's financial results, the impending liquidity crisis might have been recognized earlier. NCUA did not identify Cap Corp's excessive borrowing until the end of October.

Call Report Data Are Too Limited and Inaccurate

To conduct effective offsite monitoring of credit unions, NCUA needs an accurate and reliable information reporting system. Currently, the call reports submitted by credit unions contain insufficient and possibly inaccurate information. For example, the longest maturity category is "over 3 years" which is insufficient information on the maturity distribution. In addition, credit unions do not report market values or unrealized gains and losses by investment type.

Even the most complete information system is only as good as the data recorded and reported. During our work, we encountered numerous examples that lead us to question the reliability of the call report data submitted by corporate credit unions. For example, NCUA did not realize, until December 1994, that a very large corporate credit union was reporting the market value of its entire investment portfolio as $1. In other cases, information that we requested was subject to substantial correction.

NCUA's Capital Requirements Are Inadequate and Not Targeted to Corporate Risks

Another cause for Cap Corp's failure was the inadequacy of NCUA's capital standards. Unlike other federally insured depository institutions, NCUA's capital standards only take into account an asset's credit risk (probability of default). However, much of the risk at the corporate level is interest rate and liquidity risk, and NCUA's capital standards fail to account for these risks.

In 1991 we reported that NCUA was developing Membership Capital Share Deposits (MCSDs) as a form of secondary capital for corporates.[4] We suggested that these share deposits were at best an interim step because they can usually be withdrawn on one year's notice. As of December 31, 1994, the ratio of primary capital to assets for corporates was about 2.6 percent and the ratio of MCSDs to assets was about 4.3 percent.

A typical corporate requires its member credit unions to purchase MCSDs equal to 0.5 percent of the member's total assets. Cap Corp did not have such a requirement, but tried to attract MCSDs by offering a higher yield. The $37 million in MCSDs (2.3 percent of Cap Corp's assets) did provide a cushion to the insurance fund in

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[4]CREDIT UNIONS: Reforms for Ensuring Future Soundness, (GAO/GGD-91-85, July 10, 1991)

the Cap Corp case. However, had they been withdrawn, that cushion would have disappeared.

We are also concerned that there is no leverage requirement for corporates, requiring that a corporate's capital be at least a certain minimum percentage of assets. Federal bank regulators impose such a requirement on banks to provide capital against risks other than credit risk--such as, interest rate, liquidity, legal, or operations risk. We believe that a leverage requirement would provide important minimal protection for credit unions.

The Federal Deposit Insurance Corporation Improvement Act of 1991 also established a set of capital tripwires for banks and thrifts. These tripwires define levels of capital inadequacy that require regulators to take prompt corrective action before a financial institution exhausts its capital. Congress did not enact similar requirements for NCUA.

WHO WILL BEAR CAP CORP'S LOSSES?

Up to $70 million of Cap Corp's losses, originally projected to be $100 million, would be borne by its member credit unions through the loss of Cap Corp's total capital--approximately $33 million in retained earnings and $37 million in MCSDs held by its members. NCUA's analysis indicated that these losses could be absorbed by the member credit unions without causing any of them to fail. The losses to the member credit unions could have been even larger if NCUA had decided not to cover the approximately $700 million in uninsured member deposits because, in the absence of this support, a run on Cap Corp could have forced the sale of assets at lower than expected prices.

The amount of loss above $70 million, if any, will be borne by the Share Insurance Fund. The ultimate size of any loss depends primarily on the amounts actually realized from the sale of Cap Corp's CMO portfolio. Based on asset sales that have already occurred this month, NCUA currently projects the total loss to be about $60 million--$40 million less than its original estimate of $100 million in losses. Cap Corp's retained earnings and MCSDs should be more than sufficient to absorb this loss.

EXTENT OF THE PROBLEM

As of January 31, 1995, the National Credit Union Share Insurance fund had nearly $3.2 billion in assets, with total liabilities of only $98 million. According to NCUA, the Fund will reach its statutory maximum of 1.3 percent of insured deposits this year. If this target level is exceeded, as NCUA told us may occur, the overage must be distributed to the credit unions.

The recent history of losses to the Fund has been favorable. Before the Cap Corp failure, the Fund had experienced eight consecutive months with no losses, and Cap Corp may end up costing the fund nothing.

However, most corporate credit unions reported unrealized investment losses. As of December 31, 1994, according to NCUA, 40 corporates had total unrealized losses of about $600 million on their investment portfolios. Some of these unrealized losses were quite small, but others amounted to between 30 and over 40 percent of total capital, including MCSDs. One corporate had unrealized losses that were 77 percent of its total capital.

Like Cap Corp, some other corporate credit unions have invested heavily in CMOs that have declined in market value.[5] As of year-end 1994, 23 corporate credit unions reported aggregated CMO investments with a book value of over $8 billion, which is equal to about 24 percent of total corporate assets of $34 billion and 333 percent of total corporate capital of $2.4 billion.[6] Some of these corporates have much higher than average concentrations of CMOs. For example, three corporates held more than 40 percent of their

[5]Detailed market valuations are not reported to NCUA, but it is reasonable to expect that CMOs accounted for significant unrealized losses in the corporates that held them.

[6]These totals exclude Cap Corp and U.S. Central. U.S. Central, which provides the same services to corporate credit unions as corporates provide to their members, is excluded to avoid double counting because many corporate credit union assets are held at U.S. Central. U.S. Central, at year-end 1994, had assets of $18.7 billion, including CMOs of $123 million, and total capital of about $200 million.

assets in CMOs and four others held between 20 and 32 percent of their assets in CMOs.

Such broadbased exposures in other corporates call for close supervisory attention to such factors as matching of assets to liabilities and rules regarding early withdrawals of member investments. In addition, because of our concerns about the quality of call report data on market values, we cannot be sure of the extent of unrealized losses until NCUA completes field audits and has implemented a complete and reliable reporting system.

Most natural person credit unions do not invest in CMOs. As of December 31, NCUA reported that fewer than 1200 of the nation's 12,000 credit unions held CMOs. The total book value of these CMOs was about $6.7 billion compared to total credit union assets of about $290 billion and total capital of $26 billion. Thus, CMO holdings of natural person credit unions are generally less extensive than the holdings of corporates. However, like corporate credit unions, a few natural person credit unions also have high concentrations of CMO holdings. According to NCUA's data, two small credit unions have more than 50 percent of their assets in CMOs and fifty others have concentrations between 20 and 50 percent.

On average, the Nation's 12,000 natural person credit unions have a higher capital to assets ratio than the corporates. NCUA's latest data show that natural person credit unions' capital, which does not include any MCSDs, averages 9.8 percent of total assets. Delinquent loans and chargeoffs are relatively low and the ratio of net income to total assets is 1.2 percent.

Recommendations to NCUA

To respond effectively to Cap Corp's failure and to enhance the safety and soundness of the industry, we recommend that NCUA:

1. Closely monitor the financial condition and risk-taking of corporate credit unions and large natural person credit unions, especially those that have been substantially affected by declines in the market value of their assets;

2. Ensure that an appropriate risk management framework for corporate credit unions is established that includes appropriate requirements for an internal audit function, a strong supervisory role for boards of directors, consistent standards for calculating market values, and models for stress testing both individual investments and the entire portfolio;

3. Develop and enforce capital standards that adequately account for all risks and that include a minimum leverage ratio;

4. Ensure that GAAP accounting standards are followed for classifying investments as held to maturity or available for sale, so that investments are recorded at market value when required;

5. Increase the expertise of staff overseeing corporate credit unions, especially emphasizing training in investment analysis;

6. Assess the accuracy and completeness of call report data and take steps to ensure that data are accurate and useful for off-site supervision;

7. Establish a tripwire system which would require prompt corrective action before a failing credit union's capital is exhausted; and

8. Delay implementing any policy that would allow corporates to compete with each other for membership until necessary regulatory reforms, including adequate capital standards, are established and in force.

Recommendation to Congress

Congress should continue to oversee NCUA's actions to ensure that an effective regulatory framework for corporate credit unions exists, including adequate capital requirements, and consider legislative action if NCUA fails to implement the needed reforms.

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This concludes our statement. We would be pleased to answer any questions.

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