

The U.S. Mortgage Crisis

**Causes, Effects and Outlook
Including Suggested Credit Union Responses**

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January 31, 2008**

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Executive Summary

The U.S. sub-prime mortgage crisis spawned severe financial market dislocations. These dislocations, including the widely-reported “credit crunch”, have intensified what otherwise might have been a mild economic slowdown. The U.S. economy is now most likely in the early stages of a recession. In the best of outcomes, economic growth in the first half of 2008 will be disappointing and unemployment will be rising. Some regions of the country will experience disproportionately harsh economic conditions.

These developments will have significant financial and operational consequences for credit unions. The effects, most of which already are observable, will become more pronounced going forward and some may be seen for years to come. They include:

- Faster savings and asset growth
- Significant increases in loan delinquencies and losses
- Substantial downward pressure on net income
- Falling net worth ratios

Understandably, these sorts of trends get the attention of credit union boards and senior management. A natural reaction is to jump into action to quickly take whatever steps are necessary to reverse results like these. But, in this case we urge caution in your response. It is certainly appropriate to closely monitor this situation and evaluate the cause of any negative results in your credit union. However, for most credit unions the current and near term deterioration of financial results stemming from the mortgage crisis and the economic slowdown is best described as neither the fault of the credit union nor likely to be very long term. In many cases, the appropriate actions needed to deal with these challenges will be modest.

Most credit unions now have very strong balance sheets and near-record-high capital levels. The appropriate course of action for most credit unions is therefore to let the capital cushion do its work: temporarily let net income fall as a result of the loan losses. This will require a careful review of the credit union’s budget and financial situation and a clearly delineated plan. But it is imperative to avoid doing unnecessary harm to the credit union that would result from trying to maintain net income in the current environment. This means:

- Credit unions that have more than adequate capital should not find it necessary to penalize members of the credit union with higher loan rates, more and higher fees, lower dividend rates, service cutbacks or layoffs just to keep net income from falling for a year or two.
- Rising delinquency and loan losses require close monitoring and active collections, but they do NOT necessarily call for a tightening of credit standards.
- The best response to a decline in net income caused by rising loan losses may be to adjust your budget and then carefully let it happen.

There are often opportunities for well-positioned market participants in times of financial dislocation. With their strong capital positions and very stable balance sheets, we believe that many credit unions should consider the positive opportunities in the current situation. By keeping an even keel and letting capital absorb much of the short-term dislocation, credit unions can show both members and non-members the unique and substantial benefits of the cooperative structure.

The U.S. Mortgage Crisis

This paper describes the recent U.S. credit market crisis, housing market and economic conditions and explores how these influences will shape credit union finances and operations. More important, it offers observations and practical advice to credit union decision-makers who are trying to navigate through the significant challenges these trends represent.

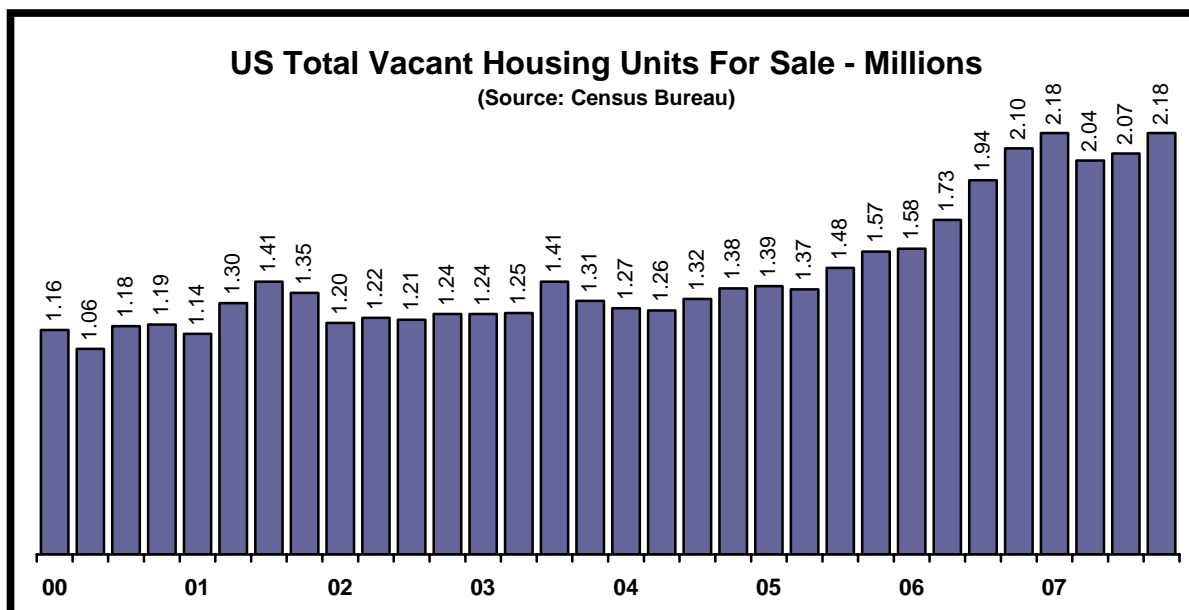
Readers with a primary interest in advice and strategic considerations are urged to skip to Section III -- “Formulating Your Response” (page 11). Our description of what led to the current situation follows (Section I -- “Anatomy of a Credit Market Crisis”). We then provide our near-term outlook, Section II -- “Economic and Credit Union Outlook” (page 9).

I. Anatomy of a Credit Market Crisis

Over the last few years, many home buyers purchased high-priced homes with non-traditional mortgage products which were funded by over-eager mortgage lenders. The recent slowdown in housing sales, lower home prices and the resetting of adjustable rate mortgages have created a meltdown in the mortgage market. The troubles are especially pronounced in the “sub-prime” sector and are reflected in rapidly rising delinquency, default and foreclosure rates. The major concern now is whether this sub-prime crisis will bleed into the prime mortgage market and ultimately slow the broader economy over the next two years as secondary economic effects work their way through the system.

Deteriorating credit quality has put the subprime mortgage market into a downward spiral. Foreclosure filings surged 75% in 2007 amid declining home values and tighter credit, according to RealtyTrac. Banks and other lenders reported 2.2 million foreclosure filings during 2007, representing 1% of all U.S. households, up from 0.58% in 2006. Foreclosure activity is expected to rise in 2008 due to a record number of ARMs resetting in the first half of the year.

The dramatic increase in the number of vacant homes for sale is one factor pushing up the number of home foreclosures. The Census Bureau reported 2.18 million vacant homes available for sale during the fourth quarter of 2007, up from 1.24 million five years earlier. The large inventory of unsold vacant homes makes it difficult for financially strapped homeowners to sell when their ARM resets to higher unaffordable interest rates.



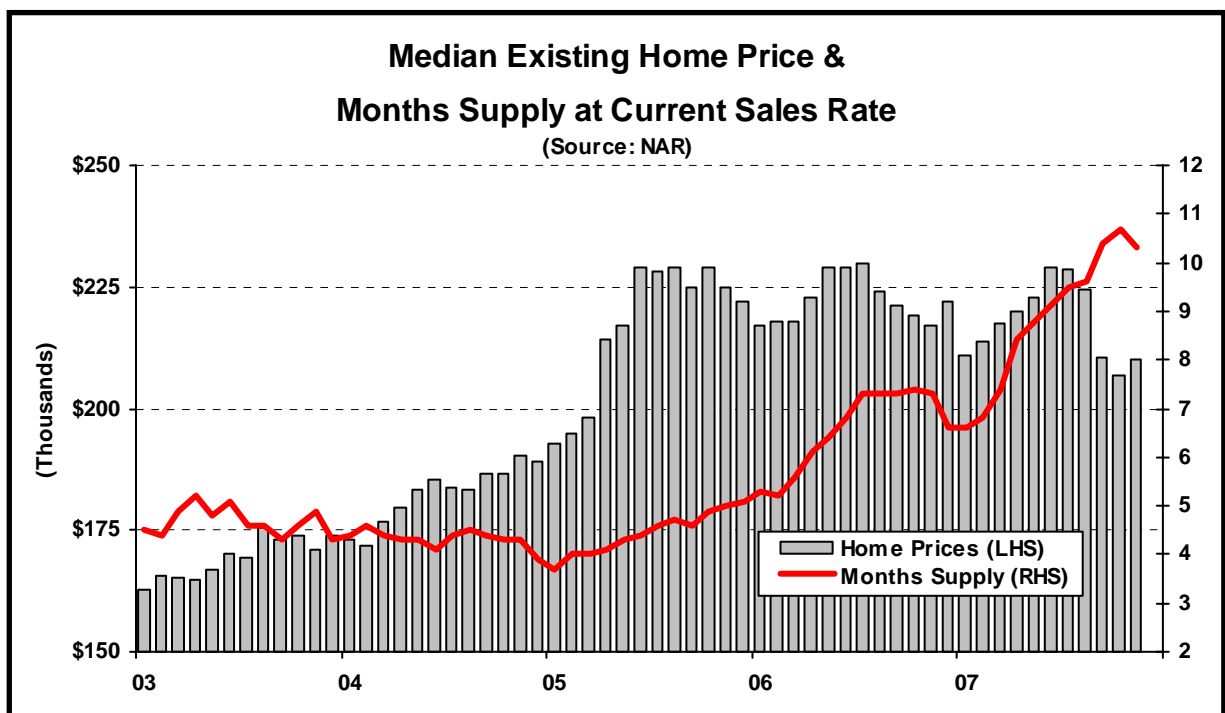
What is the root cause of the current crisis? Over the 2003-2006 time period unusually low interest rates and buyers expectations of double-digit home-price increases facilitated a record \$3.2 trillion in home mortgages being written by U.S. lenders, with about 20% of this amount considered subprime. The subprime mortgage sector serves borrowers with poor credit histories at higher interest rates. The fast pace of mortgage originations was greater than long-term mortgage demand levels. As a result there will be much lower housing demand in the coming few years.

One of the major developments leading to the large increase in subprime lending over the last few years was the adoption of new credit scoring techniques. This allowed lenders to sort applicants by creditworthiness and set risk-based loan interest rates. A large percentage of these loans were originated by mortgage brokers who then sold the loans to Wall Street investment banks. The investment banks, in turn, packaged the loans into collateralized debt obligations and sold these to investors around the world.

As with any new credit product, investors had difficulty evaluating the subprime debt default risk. Historical data suggested that if the unemployment rate remained low, so too would default risk. But the quantitative models ignored two factors keeping defaults low over the 2002-2005 periods. Rising home prices allowed subprime borrowers the opportunity to refinance the loan or sell the property whenever they were unable to make their monthly payments. Second, falling interest rates from 2001 to 2004 reduced ARM indexes which limited the teaser interest rate increases.

The Housing Market

The drop in housing demand and rise in inventories have put downward pressure on home prices. The national median existing home price was \$210,200 in the November of 2007, down 3.3% from the same period in 2006, according to the National Association of Realtors. The current large housing inventory overhang (10.3 months of inventory at the current sales pace) will force further price corrections. Moreover, the recent large presence of real estate investors, speculators, and flippers will make a price decline more severe as expectations of falling home prices substantially reduce purchases by this class of buyers.

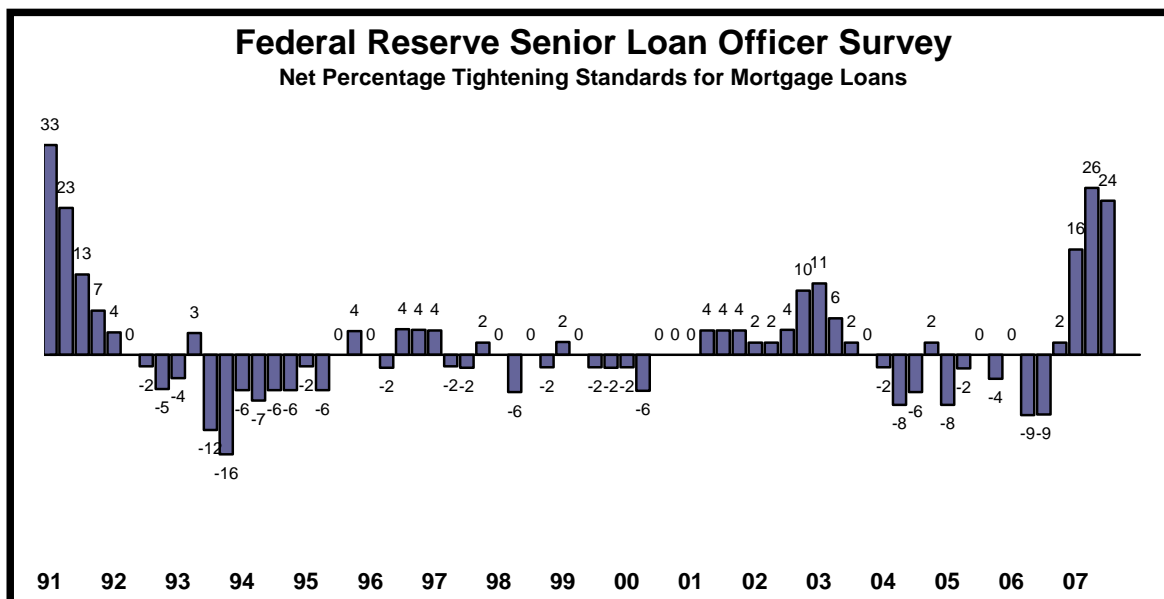


The large number of nontraditional mortgages has intensified the current housing market slowdown. A record number of ARMs, option ARMs, and interest-only loans are expected to reset in 2008. Many of these loans, particularly those with teased initial rates and inadequate caps, will default as borrowers find they can't afford the higher payments and are unable to refinance because house prices are falling and they now owe more than their homes are worth.

Until recently, subprime borrowers were able to refinance into another subprime loan and avoid the payment reset. Most subprime loans over the last few years were of the 2/28 variety, fixed for 2 years and then adjust every six months thereafter. But the 2005-2006 subprime borrowers who are now facing payment resets and are having difficulty refinancing due to tighter underwriting standards and lower home prices. For many small down payment borrowers, the recent decline in home prices has more than eliminated their home equity and put their loans underwater—with home values less than the loan amount.

There are two channels though which deteriorating subprime mortgage credit quality will affect the housing market and home prices over the next couple of years. First, foreclosed property could increase the supply of housing by 500,000 units each year. In a market already experiencing excess inventory, this will put additional downward pressure on home prices. Moreover, foreclosed homes typically sell at a discount relative to existing market prices. This will further reduce home prices and exacerbate the credit problems of other borrowers wishing to refinance their resetting mortgage. These borrowers moving into foreclosure will set in motion a self-reinforcing cycle which could spiral downward the housing market.

Second, tighter credit standards will make it harder for potential homebuyers to purchase homes, reducing the demand for homes and further depressing home prices. More restrictive underwriting standards for those borrowers with less than perfect credit could reduce the number of potential homebuyers by 500,000. Federal Reserve surveys of senior loan officers found more banks tightened mortgage loan lending standards in 2007 than in any other year since the early 1990s, see chart. Also, less favorable loan terms in the form of higher interest rates and down payments will reduce the amount buyers will have to spend on new homes.

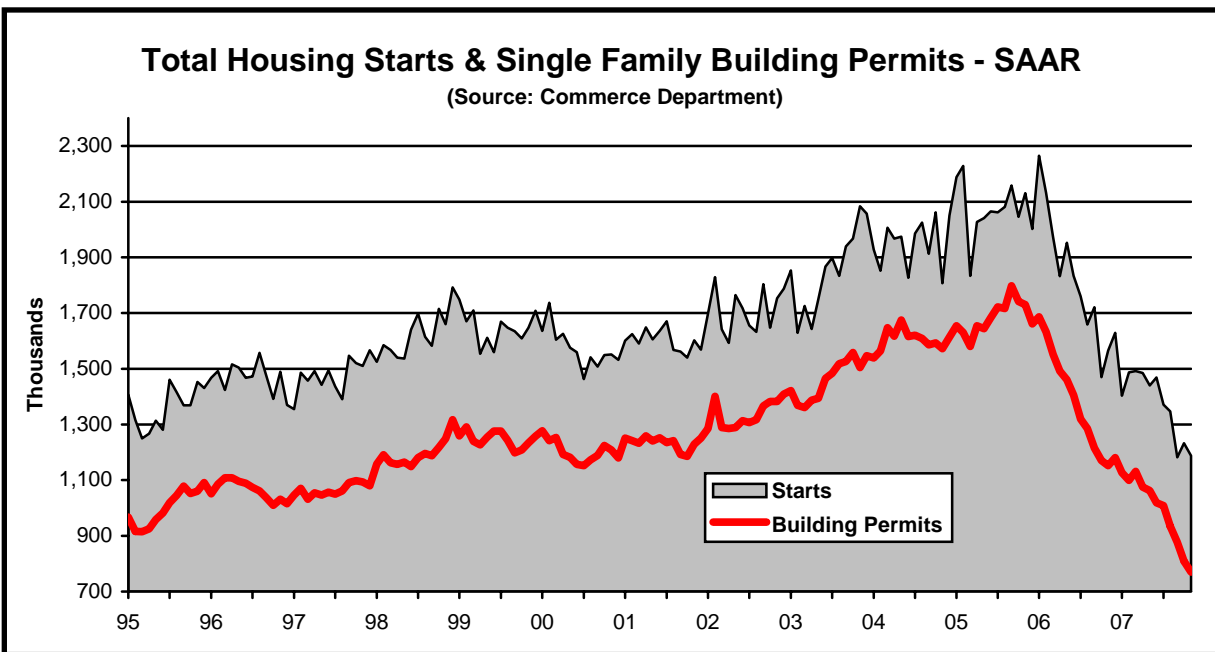


The prime mortgage market is also seeing a decline in credit quality. The delinquency rate for adjustable-rate mortgages (ARMs) to prime borrowers jumped to 5% in the fourth quarter of 2007, from 3.1% in the

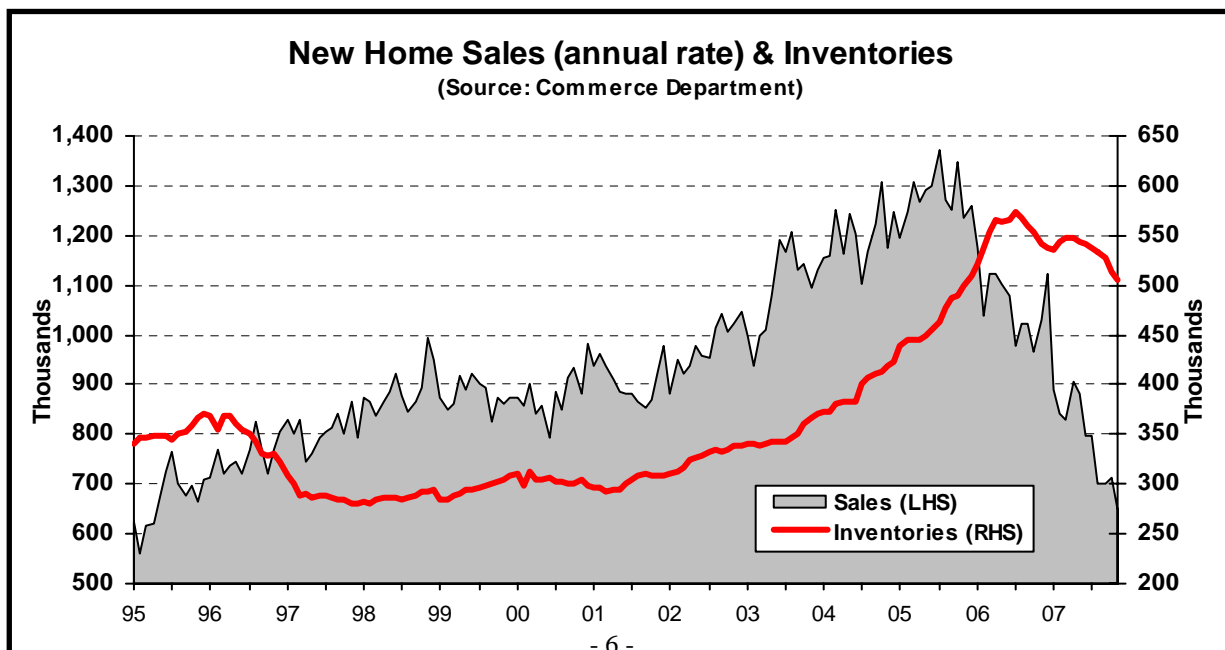
same period a year earlier and the highest rate in four years, according to the Mortgage Bankers Association. The national average delinquency rate on subprime loans is over 16%, while 3.1% of prime mortgage loans are delinquent. Overall mortgage delinquency rates are expected to peak at more than 5% over the next few years.

Housing and the Economy

The housing market slowdown has already affected the overall economy. The drop in housing demand and the corresponding rise in home inventories have put the residential construction industry into a recession.



Housing starts fell 50% over the last 2 years (see chart), according to the Commerce department, and new home sales plunged 47 percent, pushing new home inventories to over 500,000 (see chart).



This decline in new home residential construction shaved 1.2% off GDP growth in the fourth quarter of 2007, and is expected to do the same for the first half of 2008. But the housing market affects more than just the residential construction sector of the economy. Surging home prices over the last four years produced large capital gains for households which created a strong wealth effect for consumer spending and helped reduce the national savings rate. Since 2003, the average annual growth rate of real consumer spending was a strong 3.2%, with consumer durable spending (furniture, appliances, autos) increasing 5.7% annually. Since personal consumption expenditures makes up more than 71% of the total economy, rising home prices were a major catalyst for overall economic growth. Rising home prices were also a contributing factor to the nearly negative U.S. household savings rate over the last two years. If nationwide home prices fall by 5 percent in 2008, a negative wealth effect will decrease consumption spending, increase the national savings rate and reduce economic activity.

Over the last few years, many households treated their home as an ATM and withdrew equity every time a new car, a home remodeling project or college tuition needed financing. But falling home prices will reduce mortgage equity withdrawals in 2008, putting additional brakes on consumer spending and the economy.

Economic growth could thus slow to a 1% annual rate in 2008, down from 2.5% in 2007. In the first half of the year, the economy may well dip into a recession.

Government Responses

Policy makers – both at the state and national levels – have stepped in to attempt to soften the economic blow of the credit market crisis and the deteriorating housing sector. A wide variety of proposals have been introduced and/or adopted. Several of these are especially important.

First, in order to short-circuit the downward economic spiral, the Federal Reserve is **easing monetary policy** by injecting liquidity into the banking sector. Over the last six months, the Fed has reduced their fed funds interest rate target from 5.25% to 3.00%. More rate reductions are expected by the fed funds futures market. Nevertheless, with consumer debt ratios at record levels, the decline in interest rates may have a limited effect on consumer spending this time around.

The Fed is also pushing lenders to **tighten their lending standards**. They propose lenders evaluate borrowers' ability to repay, document income and assets, eliminate prepayment penalties within a certain time period of an ARM reset date and establish escrow accounts for taxes and insurance. In the short-run this will increase the strain in the mortgage credit markets and put additional downward pressure on housing demand and home prices.

In order to deal with the sub-prime ARM crisis, Secretary of the Treasury Henry Paulson is pushing for a system-wide **mortgage restructuring plan** (rate, term, balance) wherein large groups of borrowers could be helped. Treasury believes mortgage servicers do not have the capital and labor resources to recast each loan on a case by case basis. In a similar vein, California governor Arnold Schwarzenegger is working with 4 large loan servicers to extend teaser interest rates for several years and FDIC director Sheila Bair would like extend teaser interest rates for 30 years, effectively making ARMs fixed rate loans. These approaches reflect the belief that modification plans are better than the alternative of higher defaults and foreclosures which can be much more costly for lenders. There are some concerns about these initiatives. First, it is not clear just how many stressed borrowers will be helped. Second, in the long run if this alteration of loan contracts is perceived as a bailout of excessive risk taking, future moral hazard may be the consequence.

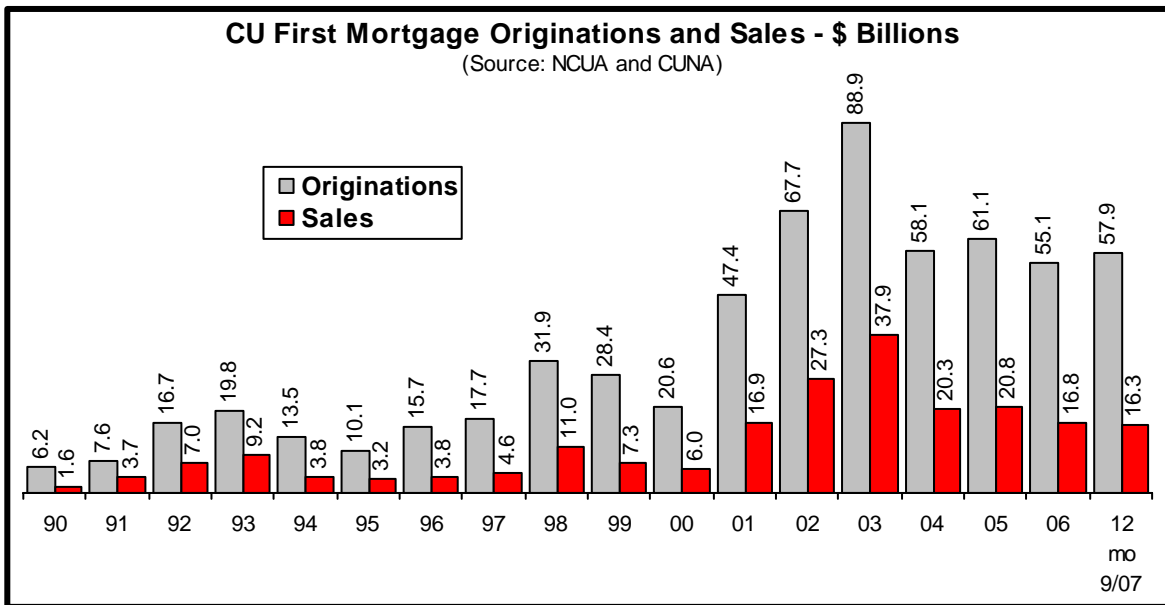
Not surprisingly, Congress also is taking action to shore up the troubled housing market. One initiative would allow low-income borrowers to refinance their loans with **FHA loans**. Another gives states the authority to issue tax-exempt bonds to help troubled homeowners refinance.

Congress and the administration also are looking at increasing the Freddie Mac and Fannie Mae conforming loan limits from the current \$417,000 to \$625,000. This will increase the number of borrowers who qualify for lower cost mortgages or refinance existing loans. This should slow the decline in high-end home prices.

And lawmakers also are currently drafting the **Emergency Home Ownership and Mortgage Equity Protection Act** which could allow chapter 13 bankruptcy judges to rewrite terms of mortgage contracts. In the short run, this would reduce the number of foreclosed homes for sale in the housing market, mitigating the decline in home prices. In the long run, giving bankruptcy courts the authority to modify mortgage contracts between borrowers and lenders would increase the uncertainty and therefore the risk related to mortgage investing. This would have the unintended effect of reducing future mortgage funding flows, pushing up mortgage interest rates and increasing loan underwriting terms. However, if the bankruptcy modifications were only temporary, these longer-term negative effects would be minimized.

Recent Credit Union Mortgage Lending

The deteriorating housing market has thus far had a limited impact on credit union mortgage operations. In fact, there is some evidence that members have come to credit unions to refinance the toxic mortgages they received from other lenders. Indeed while the mortgage market reflects weakness credit union lending is increasing. In the year ending September 2007, credit unions originated 57.9 billion in first mortgages up 5% from full-year 2006 results (see chart). This was the slowest origination pace since 2001. Credit unions then sold 30.4% of their mortgage originations into the secondary market, the lowest percentage since 2000.



Credit Union Credit Quality

Credit unions appear to be managing their mortgage portfolios responsibly. Specifically, subprime issues do not appear to be on the radar screen: the national credit union first mortgage net chargeoff rate was 0.02% in the first half of 2007. Similarly, the national credit union net chargeoff rate for "other mortgages" was 0.11% and all states had ratios below 0.75%. (More broadly, the annualized 1st half 2007 net chargeoff rate for all loans at credit unions was 0.44%).

The low delinquency and chargeoff rates at credit unions are not the result of inactivity: Compared to other lenders, credit union mortgage originations to low/moderate income represent a larger percentage of total mortgage originations. Furthermore, the most recent HMDA data (2006) shows that credit unions approved 69% of 1st mortgage loans to low/moderate income applicants, whereas other lenders approved just 47% of such loans.

Annual and quarterly asset quality trends for all types of loans through September are shown in the tables below. As of September, there have been some negative trends in delinquency, but net charge-offs were still very low. However, preliminary indications are that there was further deterioration in both delinquency and charge-offs in the fourth quarter. As soon as that data is available, we will post it here. State-by-state results are available on the CUNA web site at: <http://advice.cuna.org/>

Annual Asset Quality Results

60+ Day Dollar Delinquencies as a % of Loans Outstanding

Year	All Loans	Consumer Loans			Mortgage Loans			Member Business Loans		
		Total	Credit	All Other	Total	First	All Other	Total	Agricultural	All Other
		Consumer	Cards	Consumer	Mortgage	Mortgage	Mortgages	MBLs	MBLs	MBLs
1997	1.004	1.290	0.000	1.477	0.461	0.493	0.403	1.334	1.932	1.238
1998	0.880	1.186	0.000	1.359	0.364	0.367	0.358	1.067	1.921	0.922
1999	0.754	1.046	1.346	1.004	0.295	0.296	0.293	0.773	1.565	0.646
2000	0.744	1.032	1.273	0.999	0.294	0.310	0.263	0.944	1.219	0.905
2001	0.821	1.173	1.463	1.134	0.307	0.309	0.301	1.332	1.544	1.304
2002	0.800	1.192	1.401	1.165	0.304	0.310	0.291	0.719	1.620	0.622
2003	0.766	1.176	1.351	1.154	0.279	0.278	0.282	0.782	1.463	0.724
2004	0.720	1.172	1.268	1.161	0.252	0.259	0.238	0.444	N/A	N/A
2005	0.730	1.220	1.176	1.225	0.267	0.274	0.254	0.382	N/A	N/A
2006	0.681	1.070	1.045	1.073	0.340	0.349	0.322	0.501	0.568	0.498
Sep 07	0.817	1.006	1.198	0.979	0.570	0.543	0.623	1.665	1.232	1.685

Chargeoffs Net of Recoveries as a % of Loans Outstanding

Year	All Loans	Consumer Loans			Mortgage Loans			Member Business Loans		
		Total	Credit	All Other	Total	First	All Other	Total	Agricultural	All Other
		Consumer	Cards	Consumer	Mortgage	Mortgage	Mortgages	MBLs	MBLs	MBLs
1997	0.565	0.852	0.000	0.977	0.046	0.035	0.066	0.177	0.366	0.147
1998	0.575	0.911	0.000	1.044	0.034	0.020	0.065	0.075	0.150	0.062
1999	0.469	0.759	1.854	0.605	0.028	0.017	0.053	0.118	0.339	0.082
2000	0.401	0.658	1.570	0.533	0.021	0.012	0.038	0.052	0.154	0.037
2001	0.443	0.755	1.761	0.621	0.022	0.011	0.043	0.096	0.366	0.061
2002	0.499	0.890	1.978	0.749	0.021	0.011	0.044	0.086	0.150	0.079
2003	0.537	0.992	2.142	0.850	0.024	0.013	0.051	0.081	0.179	0.073
2004	0.507	0.980	2.013	0.855	0.025	0.013	0.052	0.105	N/A	N/A
2005	0.512	1.036	2.126	0.904	0.024	0.012	0.049	0.055	N/A	N/A
2006	0.436	0.911	1.492	0.833	0.031	0.017	0.059	0.085	-0.057	0.092
Sep 07	0.452	0.952	1.603	0.860	0.061	0.016	0.149	0.064	0.023	0.066

II. CUNA's Economic and Credit Union Forecast

The key influences credit unions face from the recent decline in the performance of the subprime lending market and the overall slowing in the housing market include: a decline in mortgage loan collateral value; rising delinquencies and charge-offs; less home-equity lending; spillover effects into their credit card portfolio and a slowing of overall credit demand as economic activity moderates. Expect nominal home prices to fall further in 2008 and 2009 and for it to take many years for prices to reach inflation adjusted highs. The severity of these effects will vary in different parts of the country. Those areas that had the sharpest home price appreciation earlier in the decade will see the most negative effects now.

Our best assessment is that the economy slipped into recession in December. Our baseline economic forecast calls for the following in 2008:

- **Economic growth will slow in 2008 to 1.8%, well below the long-term sustainable trend growth rate of 3%.** Rapidly cooling housing and manufacturing sectors and a negative income effect from high energy prices will slow the economy in 2008. Falling home prices will reduce consumer spending and increase household savings rates over the next two years. Growth in the first half of the year will be close to zero.
- **Core inflation will moderate in 2008 to around 2.0%.** Rising energy prices will keep headline inflation around 2.3%, in 2008. Core inflation (excluding food and energy prices) will gradually decline over the next two years as below-potential economic growth reduces wage and price pressures.
- **The unemployment rate will remain rise above the natural unemployment rate of 5.0%, increasing to an average of 5.5% in 2008.** Falling residential construction activity and durable goods production should ease wage pressures moving in the year.
- **The Federal Funds interest rate target will average 3.00% in 2008.** Instability in the credit markets will spill over into the real economy reducing economic activity and employment. The Federal Reserve will respond by lowering the federal funds interest rate target to 2.50% or lower by mid-year.
- **The 10-year treasury interest rate will drift marginally lower in 2008.** A slowing economy moderating inflation pressures and the flight to safety push long-term interest rates marginally lower. The quantity of foreign capital channeled into the U.S. Treasury market is the big question as we progress through 2008. If Asian and Middle-eastern central banks switch their foreign exchanges reserves to higher yielding assets, the drop in supply will put upward pressure on long-term interest rates.
- **The Treasury yield curve will maintain a modestly positive slope in 2008.** Short-term rates will remain below longer-term interest rates in the year, providing credit unions with modest margin pressure relief.

Credit union operating results will change markedly in 2008.

- **Credit Union saving growth will rise in 2008 to 9%** due mainly to a slowing economy and falling home prices. We expect the national savings rate (personal savings to disposable personal income) to rise to 3% in 2008 after two years of near zero levels.
- **Credit union loan growth will slow in 2008 to approximately 5%.** If this happens it will be the slowest annual loan growth since 1998. The slowing economy, falling consumer confidence, tighter underwriting standards and low pent-up consumer demand will reduce member demand for loans.
- **Credit quality will deteriorate in 2008.** Falling home prices and the continued sub-prime mortgage credit crisis will increase delinquency rates in 2008 to over 1.0% from an average of 0.74% in 2007. The largest increases will be concentrated in regions with the biggest housing price corrections (e.g., California, Nevada, Florida). Moreover, lower loan growth, loan seasoning and a weaker economy will increase net loan charge-offs and provisions for loan loss. The net charge-off rate will rise from 0.45% in 2007 to as much as 0.7% in 2008, again by more in those areas most affected by housing.

- Credit union **return on assets will fall to 0.70% in 2008**. Deteriorating credit quality and slower loan growth will lower credit union ROA numbers to around 0.70%. A steeper yield curve in 2008, however, should remove some downward pressure on credit union net interest margins. Credit unions in the housing affected areas of the country will see stronger downward pressure on earnings.
- **Capital-to-asset ratios will decline slightly in 2008 to 11.2%**. Capital contributions will keep pace with asset growth in 2007 and 2008, maintaining net worth ratios at current or slightly lower levels.

III. Formulating Your Response

As we have just seen, 2008 is likely to bring some negative trends in credit union financial performance indicators. Specifically, delinquency and loan losses will rise, net income will be under downward pressure and net worth ratios are likely to fall.

Understandably, these sorts of negative trends get the attention of a board and senior management. A natural reaction is to jump into action to quickly take whatever steps are necessary to reverse the bad results. In this case we urge caution in responding to the bad news. It is certainly entirely appropriate to closely monitor the situation and evaluate the cause of any negative results in your credit union. However, in many cases, the actions by your credit union that will be appropriate to deal with the problem will be modest.

Summary

Before getting into the details, here is the gist of our advice for most credit unions:

- Most credit unions have built very strong capital cushions over the past decade. This is the time to let that cushion do its work, to protect the credit union during a temporary decline in net income.
- If your credit union has more than adequate capital, it should not be necessary to penalize members of the credit union with higher loan rates, more and higher fees, and lower dividend rates just to keep net income from falling for a year or two.
- Rising delinquency and loan losses require close monitoring and active collections, but they do NOT necessarily call for a tightening of credit standards.
- Most credit unions have done a great job of building very strong capital positions for a rainy day. Well, the precipitation has begun, and it's likely to rain quite hard for a year or two. Your umbrella won't work for you if you don't let it get wet.
- Or, in English, the purpose of building capital is to allow a credit union to absorb a loss without doing unnecessary damage to the rest of the credit union. The "loss" in this case is very low, or even negative, net income. The "damage" would be unnecessary pricing changes, service cutbacks, or layoffs.
- The best response to a decline in net income caused by rising loan losses may be to adjust your budget and then carefully let it happen.

Background

In principle, there are three types of situations that can lead to poor results in a credit union. How best to respond depends on the nature of the cause of the problem. :

- **It's the credit union's fault.** It could be that the credit union either has poorly crafted policies, or poor execution of those policies. This often occurs when the credit union initiates a new program too aggressively.

- **It's not the credit union's fault, but it's permanent.** An example might be the demise of the sponsor of a single-group credit union.
- **It's not the credit union's fault, and it's temporary.** Something external to the credit union is hurting performance, and it is not likely to last very long.

Obviously, the credit union's response should vary with the type of problem.

If the fault lies with the credit union, the number one job of the board and management is to fix the problem. However, the solution should be targeted to the problem, doing as little damage to rest of the credit union as possible. For example, say a credit union embarked on a new lending program that was not properly thought out and that grew quite large and then performed poorly, causing rising loan losses and pulling down net income. The appropriate response would be to focus on the problem, not the overall operation of the credit union. Immediate action would need to be taken to fix or suspend the new lending program, minimizing any damage in the process. But, a specific problem with a new lending program does not necessarily mean all the rest of the credit union's lending (which let's say is performing well) needs to be changed. And, so long as the credit union has adequate capital, it should not need to lower dividend rates and add new fees to counteract the negative affects on net income of the narrow loan problem, which is being actively fixed.

If the fault does not lie with the credit union, but is likely to be long lasting, the board and management will need to take a new strategic direction to deal with the problem. If the sponsor of a single-group credit union gets into trouble, or the local economy surrounding a community credit union appears to be in permanent decline, the credit union will need to take action to expand its field of membership to be able to thrive in the future.

If the fault does not lie with the credit union, AND is likely to be fairly short lived, the wisest course of action for the credit union may well be take no remedial action beyond actively monitoring the situation.

The Current Situation

We believe that for most credit unions (there will of course be exceptions, but they will be very few) the current and near term deterioration of financial results stemming from the mortgage crisis and the economic slowdown is best described as neither the fault of the credit union nor likely to be very long term. As we have described, credit unions are largely the collateral damage of a subprime mortgage debacle. This has had two effects on credit unions. First, some members with toxic mortgage loans from other lenders are finding it difficult to pay their credit union loans. Second, the broader economic slowdown that is spreading from the subprime mortgage mess is causing other members to have economic difficulty, and therefore to fall behind on their loans.

So, for virtually all credit unions, the deterioration of financial results is not the result of credit union actions that need to be corrected. That still leaves the question of how long lived the problem will be. That is a much more difficult question. The ten U.S. recessions since World War II lasted an average of 11 months from peak to trough, and 22 months until the previous peak employment level was regained. The last two recessions were relatively short, 9 months each, but it took over 30 months for the pre-recession level of employment to be regained in each case. If the most recent patterns repeat, and there is no guarantee of that, we could expect a recession lasting about a year, followed by a recovery that would require about two more years before the pre-recession level of economic activity had been restored. Of course, in some regions of the country the recession will be more severe, and in others less so.

It is likely that credit union indicators will suffer the most during the actual downturn phase of any recession. After that, things should begin to gradually improve. So, if the one-year-recession, two-year-recovery scenario plays out, credit unions can expect rising loan losses and falling net income this year, flattening (but still high) loan losses and stable (but still low) net income next year followed by falling loan losses and improving net income in the third year.

Analyzing Responses

Let's consider two cases of this, one quite severe, the other more moderate, for two cases of initial capital ratio. We begin with a credit union that has been performing the way U.S. credit unions have on average for the past few years. At the end of 2007 it has an 11.5% capital ratio, and has been growing (in assets) at about 5% with an ROA of about 80 basis points. In the modest case, net income falls to 50 bp for two years before returning to 80 bp in the third year. In the more severe case, net income falls to 20 basis points for the first two years, before rising to only 50 bp in the third. In both cases, we assume asset growth rises to 10% for two years before falling back to 8% in the third. This would be the result of an increase in savings growth as members become concerned about the slowing economy.

As the first table below shows, in the "moderate" case, the net worth ratio would fall to 10.9% the first year, and would stabilize at 10.4% in the second and third years. This is still a very, very well capitalized credit union. Under the "severe" case, where the loan loss increase is greater so that net income falls all the way to 20 bp for two years, the capital ratio would of course fall by more. At the end of 2008, the net worth ratio would be 10.7%. In the following two years it would fall further to 9.9% and 9.6%. If growth continued at 8% in the fourth year (not shown in the table), so long as ROA recovered to 70 basis points or more, the net worth ratio would level off or rise. Although a net worth ratio of 9.6% at the bottom is well below the initial 11.5%, it is still well above the 7% well-capitalized level of the Prompt Corrective Action rule. After the equivalent of a twenty or thirty year flood, that would not be a bad place to be.

Possible Futures for Credit Union Earnings and Capital Ratios

Assuming a 2007 Net Worth Ratio of 11.5%

Year	Asset Growth	Moderate		Severe	
		ROA	Ending Net Worth Ratio	ROA	Ending Net Worth Ratio
2008	10%	50 bp	10.93%	20 bp	10.65%
2009	10%	50 bp	10.41%	20 bp	9.87%
2010	8%	80 bp	10.41%	50 bp	9.62%

Of course, not all credit unions are as heavily capitalized as the average. As we have been saying for some time, most credit unions could reasonably operate with much lower net worth ratios than the movement's average. Imagine now the situation of a credit union that has a net worth ratio of 8% at the end of 2007, instead of 11.5%. Let's consider the same two cases of moderate and severe effects on net income of the economic contraction.

Referring to the table below, a credit union entering the current stressful period with a net worth ratio of 8% would also see its capital ratio fall. Even then, the ending capital ratios would represent an acceptable, post-shock situation. In the moderate case, where net income falls to 50 bp in 2008 and 2009 before rising to 80 bp in 2010, the net worth ratio would bottom out at 7.5% at the end of 2009 before recovering to 7.95% (looks a lot like the initial 8%) at the end of the third year. In the more severe case, the net worth ratio would fall to 7.5% in one year, and would reach just below 7% in 2009 and 2010. So long as net income remained at or above 50 bp in the fourth year (not show in the table) the net worth ratio was level off or rise from 6.9%. Again, at the end of a really severe event, a net worth ratio just piercing the top end of the adequately-capitalized range of PCA (6% to 7%) is evidence of a stable, well run credit union.

Possible Futures for Credit Union Earnings and Capital Ratios

Assuming a 2007 Worth Ratio of 8%

Year	Asset Growth	Moderate		Severe	
		ROA	Ending Net Worth Ratio	ROA	Ending Net Worth Ratio
2008	10%	50 bp	7.75%	20 bp	7.46%
2009	10%	50 bp	7.52%	20 bp	6.97%
2010	8%	80 bp	7.95%	50 bp	6.94%

If you'd like to create a table like these for your credit union, you can use our PCA calculator at http://advice.cuna.org/pca_calc.html. It runs out five years with a constant growth rate and ROA. If you'd like to vary the growth rate or ROA, simply start a new period when growth or ROA change. In any event, the calculator will show you how much your capital ratio will react to any given ROA and growth rate.

Opportunities

There are often opportunities for well-positioned market participants in times of financial dislocation. With their strong capital positions and very stable balance sheets, we believe that many credit unions should consider the positive opportunities in the current situation. The for-profit sector is facing the same challenges that credit unions are, but for many of them it will be worse than it is for credit unions. First, many banks or their subsidiaries were involved in making troublesome sub-prime loans. The negative effects on their operations will therefore be greater than for credit unions. Second, as for-profit institutions that have to report quarterly earnings to stockholders, even very well capitalized banks will not be able to let their profits fall for a while as we are suggesting for credit unions. In the short run they will have to embark on customer-alienating actions such as service cutbacks, fee increases and offering less attractive rates on both sides of the balance sheet. There is already evidence of this in recent ATM fee increases at banks.

By keeping an even keel and letting capital instead of current net income absorb much of the short-term dislocation, credit unions can show both members who also use banks and even non-members the benefits of the cooperative structure. There will be a rise in disgruntled bank customers in the coming year. This may help overcome their inertia in considering another financial institution.

By its very name, a "credit crunch" implies that applicants for loans of all sorts—consumer, mortgage and small business, will either face higher borrowing costs or have a harder time getting their loans approved. Many of these frustrated applicants will be willing to look elsewhere for a lender. Although caution must be exercised here, some of these applicants will make good quality borrowers, and therefore present an opportunity for credit unions.

We are not suggesting that now is the time for credit unions embark on aggressive expansion efforts at the expense of banks. However, with their strong positions, credit unions should be willing to accept more business from those faced with deteriorating service or pricing elsewhere.

Coordinating with Examiners

A natural concern of credit unions considering our advice is what the reaction of examiners might be. Given their overriding concern for safety and soundness, examiners typically like to see stable net worth ratios and net income levels. We are suggesting that you can responsibly let both of these important measures fall for a while.

Examiners will view a planned and controlled temporary decline in net income and net worth ratios very differently than they will view negative results that appear to happen by accident and without the prior knowledge of the credit union's board and management. In fact, there has been a very substantial change

in federal examiners' approach to earnings evaluation in credit unions over the past few years. This new approach is demonstrated in the August 2006 letter to credit unions from NCUA Chair JoAnn Johnson which can be found at <http://www.ncua.gov/letters/2006/FCU/06-FCU-04.pdf>. Credit unions considering our advice should carefully read this letter and the accompanying Supervisory Letter 06-01 to NCUA field staff. For example, page three of the Supervisory Letter contains the following statement: "Thus, credit unions need not engage in reactive or extraordinary measures simply because earnings levels decline as a result of broader economic conditions when net worth levels meet or exceed their needs."

Of course, for examiners to be made comfortable with the course of action we are suggesting, the credit union must be able to demonstrate that it is planning and controlling any temporary decline in net income and net worth ratios. You will need to model the credit union's earnings and net worth for the coming few years, prepare revised high-level budgets, and justify that the ending net worth ratio is adequate. The Board of the credit union will need to thoroughly discuss and understand this, and document that fact in the minutes.

Summary

These will be very trying and unpleasant times for credit unions. We do not in any way intend to minimize the risks in the current environment. It's not going to be pretty. However, given an adequate level of capital going into this situation, credit unions should seriously consider allowing that built-up capital to absorb short-term variations in results rather than forcing net income to do the adjusting.