For release on delivery
2:30 p.m. EDT
April 20, 2004

STATEMENT

OF

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CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

"CONDITION OF THE CREDIT UNION INDUSTRY"

BEFORE THE

COMMITTEE
ON
BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

APRIL 20, 2004

Chairman Shelby, Ranking Member Sarbanes and Members of the Committee, thank you for the invitation to testify before you today on behalf of the National Credit Union Administration (NCUA) regarding the condition of the credit union industry in America and the National Credit Union Share Insurance Fund (NCUSIF) that insures the deposits of credit union members nationwide.

CONDITION OF THE CREDIT UNION INDUSTRY

I am pleased to report to the Committee that the state of the credit union industry remains strong and healthy with all indicators clearly portraying a safe and sound industry serving over 82 million Americans and well positioned for continued strength and vitality in our nation's financial marketplace, both now and in the future.

At this point I would like to provide a brief discussion of key ratios and trends compiled from call report data submitted to NCUA by all federally insured credit unions as of December 31, 2003.

- The average net worth-to-assets ratio of all federally insured credit unions remains extremely strong at 10.72 percent, even though there has been significant share growth of 15.27 percent in 2001, 10.77 percent in 2002 and 9.11 percent in 2003. Such a strong share deposit growth would normally bring about a significant decrease in the net worth ratio were not the credit unions managing these increased shares effectively and continuing to build net worth. For example, over the course of 2003, credit union net worth, which is built solely from the retained earnings of the credit union, has increased in total dollars by 9.57 percent. This growth in actual dollars of net worth results in the highest level in history of total industry net worth, currently at $65.4 billion as of December 31, 2003.
- Return on average assets (ROA) is 0.99 percent which, even with a historically high growth in shares during a low interest rate environment, compares favorably with recent historical trends (1.07 percent in 2002 and 0.94 percent in 2001).
- Asset growth was 9.52 percent and share growth was 9.11 percent in 2003.
- Loan growth was 9.75 percent in 2003. Over the course of 2003, share growth slowed and loan growth increased, resulting in a loan-to-share ratio of 71.2 percent, compared to 70.8 percent in 2002 and 79.5 percent in 2000. Total loans to credit union members totaled $376.1 billion, up $104.5 billion since yearend 1999.
- Credit unions' overall delinquency ratio remains steady at 0.77 percent and is slightly lower than the ratios recorded in the previous two years (0.80 percent in 2002 and 0.82 percent in 2001), thus demonstrating effective risk management in the loan portfolios during a period of economic downturn in many industries and communities.

- Savings grew to $528.3 billion in 2003, an increase of 9.11 percent. Despite the increases in lending indicated earlier, much of these increased savings are being placed in the conservative investment options available to credit unions under applicable federal and state laws and regulations. Investments in federal agency securities grew 18.6 percent in 2003. Funds deposited in corporate credit unions grew 9.4 percent during the same period, and investments in banks, savings and loans and savings banks expanded 12.3 percent.
- Total assets grew to an all-time high of $610.2 billion, an increase of 9.52 percent.
- Member business lending in credit unions increased by 32.9 percent to $8.87 billion. Although this category of credit union lending has increased over the past year, member business lending still represents only 2.36 percent of all loans in federally insured credit unions.
- First mortgage real estate loans grew 16.63 percent to $117.5 billion, thus continuing the growth of credit unions as a source of access to the American dream of home ownership for millions of their members.
- New auto lending increased 5.47 percent in 2003. Reflecting both economic trends and market considerations, used auto loans increased by 12.51 percent to $81.2 billion.

The ratios and trends presented above are not unexpected in the present economic and marketplace environment; however, taken as a whole, they are indeed indicative of a healthy and robust industry.

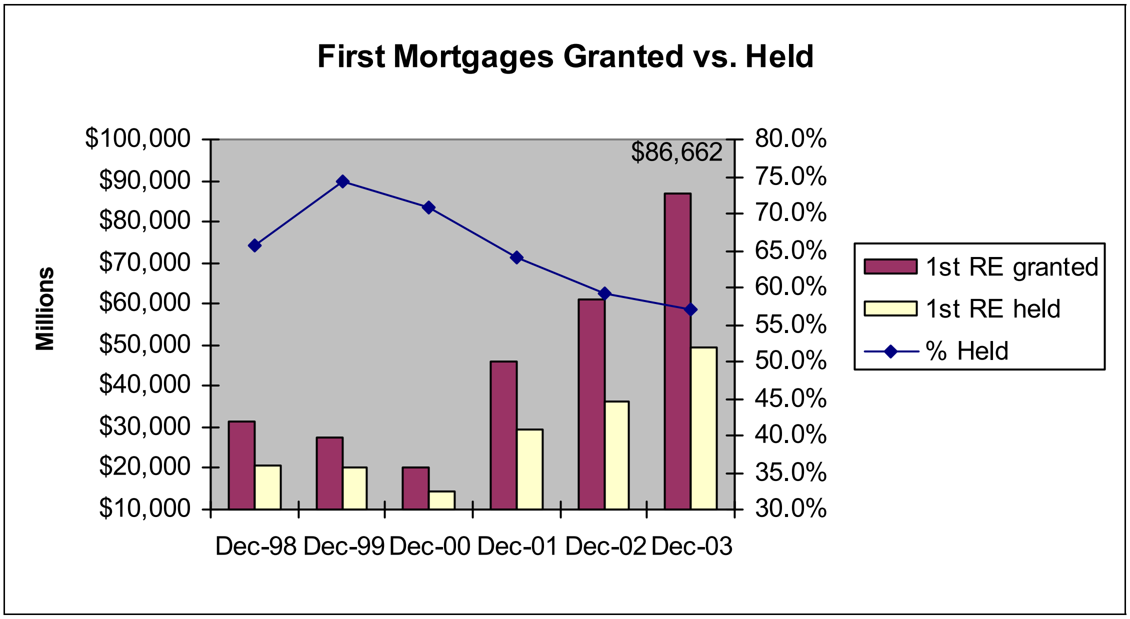
EMERGING RISKS AND CHALLENGES FOR THE INDUSTRY

NCUA is closely monitoring a number of key issues and trends specifically affecting the credit union industry, as well as those related to the overall financial marketplace. The following issues are among those we have been closely monitoring:

Interest Rate Risk and Net Margin Compression
Loan growth continues to be concentrated in fixed rate real estate loans being granted at the lowest rates in 40 years. In 2003, total real estate loans grew 13.9 percent and accounted for 44.6 percent of loans outstanding. At the same time, shares grew 9.11 percent, with growth concentrated in short-term, liquid accounts.

The combination of high growth in fixed rate real estate loans and volatile, non-maturity shares poses potential risk management challenges to credit unions, while also providing unique member service opportunities. If the economy continues to improve, equity market investing increases, consumer borrowing demand returns and interest rates rise, meaning potential interest rate risk, liquidity risk, credit risk and earnings risk may increase, as well.

While the volume of first mortgage loan originations has increased, so has the percentage of first mortgages sold, increasing from 29.2 percent in 2000 to 43.1 percent as of December 2003. Credit unions sold $37.4 billion in first mortgages in the secondary market in 2003, compared to $25 billion in 2002. This indicates that credit unions are appropriately managing, recognizing and responding to the potential interest rate risk posed by these assets.



To address the potential risks associated with high concentrations of fixed real estate loans held in portfolio, NCUA issued a *Letter to Credit Unions* in September 2003 to highlight these trends and to emphasize the need for prudent and diligent balance sheet management. In addition, NCUA continues to effectively utilize its regional capital market specialists to assist credit unions and examiners alike and to offer ongoing training and guidance to field examiners to address these risks from a safety and soundness perspective.

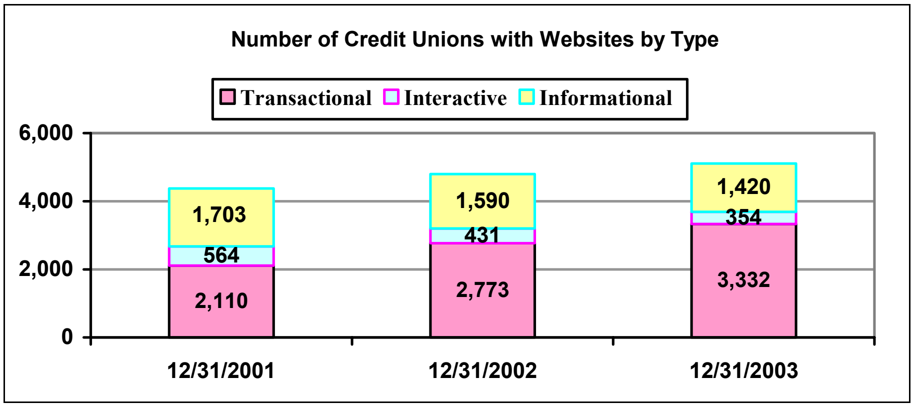
The low interest rate environment likewise has resulted in compressed net interest margins for credit unions. This provides an increased likelihood for credit unions to consider moving out further on the yield curve to maintain net income levels. Interest rate risk and net margin compression in credit unions remain an oversight priority at NCUA and will continue to be closely monitored.

Increased Competition for Consumer Lending
As mentioned earlier, the level of consumer borrowing has slowed somewhat in favor of real estate lending with credit unions continuing to search for new and innovative solutions to serve their members and retain market share. To remain competitive for consumer loans some credit unions rely on indirect or third party lending which could result in potential risks from third party transactions if not managed properly. In a November 2001 *Letter to Credit Unions,* NCUA provided

guidance on the level and degree of due diligence that should be exercised by credit unions when dealing with third party service providers.

Information Systems and Technology Risks

Today more than half of all federally insured credit unions (5,106, representing 54 percent of all federally insured credit unions) have websites with approximately 1,100 more credit unions planning to implement sites in the future. As of December 2003, 15.1 million credit union members conduct transactions via the Internet, up from 5.6 million as of December 2000.



While credit unions are implementing new websites, the number and type of electronic services provided has grown steadily with considerable potential for additional growth. Potential transaction risk continues to increase as more credit unions move to transactional websites and increasingly complex e-commerce services.

Service	2003 Number of FICUs Offering	2003 Percent of FICUs	2002 Percent of FICUs
Account Balance Inquiry	4,983	53.2%	49.4%
Share Account Transfers	4,817	51.4%	47.7%
Loan Payments	4,189	44.7%	40.6%
View Account History	4,086	43.6%	37.3%
Share Draft Orders	4,007	42.8%	37.2%
New Loan	2,840	30.3%	26.6%
Download Account History	3,233	34.5%	28.3%
Member Application	1,944	20.7%	18.3%
Bill Payment	2,253	24.0%	19.7%
Merchandise Purchase	581	6.2%	6.2%
New Share Account	1,037	11.1%	9.5%
Account Aggregation	328	3.5%	2.3%
Internet Access Service	912	9.7%	8.0%
Electronic Signature	68	0.7%	0.5%

NCUA is fully committed to ensuring credit unions are properly prepared to safely integrate financial services and emerging technology in order to meet the changing needs of their members. NCUA implemented its Information Systems & Technology Examination Program (ISTEP) in FY2000. ISTEP represents a multi-prong approach for identifying, measuring and mitigating risks associated with information systems and technology (IS&T). This approach includes credit union IS&T examinations, credit union vendor reviews and examinations (NCUA and FFIEC), specialized IS&T examiner training and credit union guidance. Ongoing and further IS&T initiatives are outlined in greater detail in NCUA's strategic plan.

CORPORATE CREDIT UNION TRENDS

There are currently 30 retail corporate credit unions and one wholesale corporate credit union. Assets for all corporate credit unions total $108.9 billion. Retained earnings equal $2.354 billion with a retained earnings ratio of 2.19 percent. The core capital ratio is 2.95 percent and the total capital ratio equals 6.46 percent. These numbers reflect activity through December 31, 2003.

Based upon the savings growth trends indicated earlier for natural person credit unions, corporate credit unions have found themselves flush with excess liquidity for the past three years. Since October 2000, when total assets were at a low of $53 billion, many corporate credit unions have seen their balance sheets double in size. The highest asset level was reported in May 2003, when total assets exceeded $126 billion. Total assets have been fluctuating, but have consistently remained over $95 billion since March 2002. The liquidity trend in corporate credit unions coincides with consumer confidence in the economy. The flight to safety among investors has resulted in increased deposits in natural person credit unions. Many of these credit unions, seeking a safe place for their excess liquidity, are passing the deposits on to the corporate credit unions.

The high levels of liquidity in the corporate system continue to have a significant impact on the various capital ratios. Even if liquidity should begin to flow out of the system, it will take time for the ratios to recover as they are based on 12-month moving daily average net assets (moving DANA) rather than month-end assets.

<u>Key Issues Facing Corporate Credit Unions</u>

Increased Competition: NCUA expects a continued competitive environment among corporate credit unions. Corporate credit unions that have increased expenses due to expanded authority infrastructure acquisitions or the purchase of expensive item processing/imaging equipment will find it necessary to increase service volume to remain profitable. The increased volume will most likely come through marketing their services to credit unions outside their traditional service areas. The corporate credit unions that lose members to their competitors will have to decide whether to enhance their operations so they can also offer more complex products and services, focus on a niche product or service they can offer at a reasonable price or consider a viable merger partner. Conversely, the impact of competition may be somewhat softened as a number of corporate credit unions are looking at strategic alliances and partnerships as a means of offering some products and services.

Net Worth/ALM: Corporate credit unions have found it increasingly challenging to remain profitable while maintaining a low-risk, highly liquid balance sheet. Economic and competitive factors will continue to put pressure on corporates to seek additional yield wherever possible. NCUA will continue to monitor corporate credit union modeling policies and procedures to ensure the information and reports produced provide reasonable information for decision makers of corporate credit unions.

CONDITION OF THE NATIONAL CREDIT UNION SHARE INSURANCE FUND

The NCUSIF provides federal share insurance coverage on credit union accounts generally up to $100,000 per member in a single federally insured credit union. As with FDIC coverage of deposits in banks and thrifts, depending upon the structure of the accounts, there is an opportunity to structure separate account coverage under the NCUSIF based on the number and nature of the accounts established.

As of December 31, 2003, there were $479 billion in insured funds covered by the $6.163 billion NCUSIF, with a 1.27 percent equity ratio. At the end of the first quarter of 2004, the equity ratio in the NCUSIF was 1.29 percent.

Under the Federal Credit Union Act (FCUA), the NCUA Board has the authority to determine the annual operating level of the fund between the statutorily prescribed parameters of 1.2 and 1.5 percent. This year, as in the last several years, the Board has set the operating level at 1.3 percent. If, at the end of the calendar year, the NCUSIF equity level is above 1.3 percent, the Board may declare a dividend. If it is below 1.3 percent, the Board may assess a premium. If the equity ratio falls below 1.2 percent, the FCUA requires a premium to be assessed. However, based upon the limited number of losses in federally insured credit unions, history has proven that in most years the fund level can be maintained without the assessment of a premium through the combination of the one percent of insured funds required deposit plus earnings on those deposits.

Since the NCUSIF was capitalized in 1985, only one insurance premium has been assessed. That single premium assessment took place in 1992 when the problems in New England area credit unions and in the real estate markets resulted in significant losses to the NCUSIF. Other than in that extraordinary situation, no premium assessments have been required. In fact, to the contrary, effective management of the NCUSIF and minimal credit union losses has resulted in the end-of-year equity ratio being above the required operating level in an amount sufficient to allow the NCUA Board to declare dividends to insured credit unions for six consecutive years beginning in 1995. Due to the high rate of share growth in 2001 and 2002 during a period of declining earnings on the investments of the NCUSIF, the fund ended the year just below the 1.3 percent operating level and dividends were not paid in those years. This was also the case for 2003.

There are two primary factors influencing the NCUSIF and its equity ratio at this time. First, the low interest rate environment of recent years has reduced the investment income to the NCUSIF. In December 2003 gross income was $10.6 million, while in December 2002 gross income was $16.2 million. Investment earnings have been significantly reduced since many of the fund's older investments which yielded over six percent have matured over the past several years. The funds are now being reinvested in Treasury Notes of similar maturities with yields less than two percent. During this same period, the yield of the NCUSIF has fallen over 300 basis points to 2.02 percent for December 31, 2003.

Second, in July 2002 the NCUA Board adopted a policy of building its reserves for losses to the NCUSIF by transferring $1.5 million a month to the reserve account for incurred losses not specifically identified, in addition to reserves for specific cases and a pool for CAMEL Code 4/5 credit unions. The final $1.5 million transfer was made as of December 31, 2003 to the reserve account for incurred losses not specifically identified.

Earnings on the fund principal have been sufficient to keep the NCUSIF appropriately funded into the future absent extraordinary losses, but dividends to insured credit unions that are allowable by statute when the fund equity level exceeds the established operating level are not likely to return until interest rates rise sufficiently to allow earnings to return to historical levels.

Losses are anticipated to remain low and extraordinary losses are not anticipated based upon the ongoing examination and supervision of the credit unions NCUA regulates and insures.

As of December 31, 2003, there were 217 problem credit unions coded CAMEL 4 or 5. Of the 217, only 10 are coded CAMEL 5. This number has remained quite constant over the last four years. For purposes of comparison, there were 338 problem credit unions in 1999 and, for a 10-year indication, there were 319 in 1994.

For 2003, NCUA was called upon to provide assistance to liquidate, merge or arrange a purchase and assumption for 13 federally insured credit unions. This number is trending lower than in the past 10 years when we averaged 27.8 such cases per year.

AGENCY INITIATIVES

Over the course of the last three years NCUA has taken several initiatives to help the agency address a rapidly changing and dynamic financial marketplace as well as bring more efficiency, accountability and productivity to agency operations. These initiatives have been influenced by several factors. The overall number of credit unions is declining while assets and credit union membership are continuing to grow at record pace. Credit unions are becoming more complex and sophisticated as technology and member demands change and emerge. Economies of scale and availability of resources are likewise impacting the level and types of services offered. In recognition of these and other factors, the agency has taken a number of specific measures to address this changing financial and regulatory environment.

In 2002, NCUA fully implemented a risk-focused examination program in conjunction with a system of risk-based scheduling of examinations. This change in examination emphasis and focus required an agency-wide effort to redesign and update the call report as well as other computer and informational system enhancements. In addition, NCUA embarked upon an aggressive and thoroughly enhanced training program for our field examiners, their supervisors, all regional office staff and central office personnel in an effort to maximize productivity and to ensure the overall safety and soundness of the program. As a result of the risk-focused examination program, agency resources are now geared more than ever toward institutions and areas of risk requiring the most attention. Likewise, this approach permits examiners to direct their attention to areas of institutional risk and allows them to spend less time on issues presenting minimal or no risk to the credit union and the insurance fund. Risk-based scheduling of examinations has also provided NCUA flexibility to direct more of its resources to those institutions requiring additional supervision according to their individual risk factors while at the same time maintaining integrity in our first and foremost mission of ensuring safety and soundness. Not only has the program allowed NCUA to focus on true areas of risk, it has resulted in more efficient use of agency resources with fewer employees than were employed by NCUA 10 years ago.

A key component of the risk-focused examination program was the NCUA Board's action to require the submission of quarterly call reports, known as 5300 reports, from all federally insured credit unions. Previously only credit unions over $50 million in assets were required to submit quarterly call reports. All other credit unions (79.8 percent of the 9,369 federally insured credit unions have less than $50 million in assets) were only required to submit call reports on a semi-annual basis. However, for the risk-focused examination program and risk-based scheduling to be effective and to properly monitor and identify areas of risk, NCUA felt it was necessary to require quarterly call reports from all federally insured credit unions so that the agency, and the state supervisory authority in the case of state-chartered federally insured credit unions, could have the most current financial information possible available for analysis and review. In an effort to prevent unnecessary regulatory burden, a short form 5300 report was devised for the smallest credit unions with less than $10 million in assets for the interim first and third quarter reports. Call report data is analyzed and a financial performance report (FPR) is produced for every federally insured credit union, serving as the basis for ongoing risk analysis.

Another component of the risk-focused examination program involves the designation of subject matter examiners. When areas with a greater opportunity for loss are identified, the risk-focused examination program relies upon staff to act as brokers for problem resolution. The increasing complexity of credit union operations and the advanced knowledge necessary to properly identify risk in some areas have made it increasingly difficult for a generalist examiner to resolve problems without more extensive knowledge and skills. Therefore, NCUA has developed an examiner structure where experienced examiners are designated and trained in a specific subject area of concentration such as IS&T and specialized lending. To further enhance the agency's examination program, NCUA is studying the creation of a large credit union examination specialty program based upon a pilot program now concluding. These programs are intended to ensure the necessary expertise is available to accomplish the more demanding examination skills required when examining more complex or larger institutions. By focusing staff development in certain areas, NCUA is able to accelerate the effective evaluations of technical subjects and maintain a current level of knowledge during periods of rapid industry development. This revised examiner structure will ensure that the sufficient skills and resources are available to timely identify and limit potential risk to NCUSIF.

Beginning in 2001, NCUA initiated an internal agency self-study, known as the Accountability In Management (AIM) study, whereby agency management personnel were tasked with identifying potential areas of NCUA's internal operations where cost savings and greater efficiency and productivity could be realized within the strategic goals of the agency without sacrificing the safety and soundness of the credit union industry. This in-depth process was finalized over a two-year period in two phases with the first portion focusing on the central office and the second phase focusing on the regional offices. The results of this process have been extremely positive both for agency effectiveness and efficiency. The overwhelming majority of the AIM recommendations have been implemented and others are presently in the process of implementation with a timetable of being fully implemented by the end of 2004.

One of the most significant recommendations stemming from the AIM study was the realignment and reduction of NCUA's regional offices from six to five. Realignment has been accomplished, and in January 2004 one of NCUA's six regional offices closed while another regional office moved to a lower-cost area. This consolidation, along with the restructuring of several offices in both central and regional offices, is expected to save the agency and its stakeholders $27 million over the next 10 years. Additionally, as part of this internal initiative, agency staffing levels have been reduced by 58 FTEs over the last two years without any adverse impact on the agency's safety and soundness responsibilities. All of the AIM staffing reductions were accomplished through attrition and without layoffs, forced retirements or costly buyouts.

The NCUA Board has successfully implemented a number of regulations and updates that are consistent with the spirit and requirements of the Federal Credit Union Act as amended by passage of the Credit Union Membership Access Act of 1998 and are resulting in stronger, safer and sounder credit unions. These updates in areas such as field of membership, investment options and member business lending, among others, have served to provide federal credit unions with much needed diversification options required to remain competitive and financially strong in a constantly changing and rapidly evolving financial marketplace.

Among the more notable initiatives undertaken by NCUA has been the successful Access Across America program which is designed to create economic empowerment for people from all walks of life, particularly those residing in underserved or unbanked neighborhoods and communities. This initiative has seen impressive results as 494 federal credit unions across the United States have voluntarily adopted over 1,021 CDFI-designated investment or underserved areas into their fields of membership since the beginning of 2000. As a result of their expanding into underserved areas, credit unions are required to be financially able to extend services to the entirety of the community, have an acceptable business and marketing plan to do so and establish a physical presence in the community. The result has been the extension of access to affordable financial services and products to over 64.7 million Americans residing in underserved communities who previously lacked access to a not-for-profit, member-owned credit union as a alternative source of lower cost financial services in their local neighborhoods – neighborhoods which have become the home of countless higher cost lenders such as pawn shops, rent-to-own centers, check cashing outlets and title loan companies.

NCUA call report data indicates that the 494 federal credit unions adding underserved areas to their field of membership since 2000 have grown their membership at an annual rate of 4.36 percent, which is 237 percent greater than the annual membership growth rate of 1.29 percent for federal credit unions overall during the same four year period. Lending growth increased at an annual rate of 12.5 percent in those federal credit unions adopting underserved areas, and savings growth has increased 13.5 percent annually. These loan and savings rates are 58 percent and 30 percent higher than the respective growth rates of these two categories in the federal credit union community as a whole.

RECOMMENDED REGULATORY REFORMS

In response to a request from Chairman Shelby, and on behalf of the Board of the National Credit Union Administration, I provided the Committee in June of 2003 with seven specific recommendations to address unnecessary regulatory burden, improve productivity and other needed regulatory reforms for federal credit unions. It is my understanding that each of my colleagues from federal financial regulatory agencies represented here today likewise made their own recommendations in response to your letter. We are pleased that these regulatory relief issues, among others, are being evaluated for possible inclusion in legislation this Congress.

The addendum to this testimony describes NCUA's proposals and the reasons for them. These proposals are consistent with the mission of credit unions and the principles of safety and soundness. They address statutory restrictions that now act to frustrate the delivery of financial services because of technological advances, current public policy priorities or market conditions.

I would encourage the Committee to give serious consideration to NCUA's regulatory relief recommendations. As always, NCUA stands ready to work as a resource to the Committee on these and other matters impacting the delivery of financial services through and the safety and soundness of America's credit unions.

CONCLUSION

Again, thank you, Mr. Chairman, for the opportunity to appear before you today on behalf of NCUA and my colleagues on the NCUA Board to discuss the state of the American credit union industry. I will be more than pleased to respond to any questions the Committee may have or to be a source of any additional information you may require.