

2011 Credit Unions Failures and Trends

January 31, 2012

The purpose of this research paper is twofold – it will illustrate the differences in financial condition between the credit unions that failed and those that survived in 2011 as well as explain the financial trends of the credit unions still operating as of December 31, 2011.

Background

The Kroll Bond Rating Agency, Inc. (KBRA) Subscription Rating Service (SRS) recently concluded testing on a new statistical rating model and implemented a new methodology for assigning financial strength ratings to domestic non-corporate credit unions. The new rating methodology uses four key financial ratios, which are similar to the ratios used previously. One key difference is the replacement of the previously used *temporary investments minus volatile liabilities divided by total assets* with a new ratio, *total loans and leases divided by total assets*. Additionally, asset quality is measured by dividing nonperforming assets by total loans rather than by equity plus reserves. As is the case with KBRA's model for domestic banks and thrifts, the new credit union model measures the historical likelihood of failure associated with each key ratio value and maps the combined, estimated probability of failure to a letter rating on the existing "A" to "E" scale. KBRA feels that the new model is more predictive of failure and assigns more balanced ratings. The rating distribution for all credit unions as of December 31, 2011 is illustrated below.



Failures

Nineteen credit unions failed in 2011, as compared to ninety-two combined bank and thrift failures during the same timeframe, highlighting the differences in the two domestic retail banking sectors.¹ Equally striking is the fact that, according to the new model, no credit union currently faces a statistical possibility of failure greater than fifty percent during the next twelve months. This number contrasts with the forty-five banking institutions that have a greater than fifty percent likelihood of failing during the same time horizon. KBRA believes that credit unions will continue to fail in 2012; however, the number of failures will be significantly lower than commercial bank and thrift failures.

The analysis below is based on KBRA's ratings outstanding prior to the adoption of the new methodology. Based on our testing, we expect future rating performance to be significantly improved.

Ratings of Credit Unions Failing in 2011

Rating Distribution as of January 1, 2011

A+	0
A	3
A-	0
B+	1
B	0
B-	2
C+	1
C	0
C-	1
D	2
E	9
NR	0
Total	19

¹ KBRA defines the term "failed" as a credit union that has been taken into conservatorship and/or liquidated, but excludes those that were merged with the NCUA's assistance.

Rating History – January 1, 2011 to December 31, 2011

Name	3Q10	4Q10	1Q11	2Q11	3Q11
FAMILY FIRST	E	E	-	-	-
LAND OF ENCHANTMENT	E	E	-	-	-
WISCONSIN HEIGHTS	B-	E	-	-	-
OAKLAND MUNICIPAL	E	E	-	-	-
NYC OTB	C-	E	-	-	-
VALUED MEMBERS	C+	D	E	-	-
ST. JAMES A M E	E	E	E	-	-
MISSION SAN FRANCISCO	E	E	E	-	-
UTAH CENTRAL	E	E	E	-	-
HMONG AMERICAN	A	A	A	-	-
VENSURE	A	A	A	E	-
BORINQUEN	B-	C+	C	E	-
CHETCO	E	E	E	E	E
TEXANS	E	E	E	E	E
SAGUACHE COUNTY	E	E	E	E	E
GREENSBURG COMMUNITY	B+	B+	B	B	C
BIRMINGHAM FINANCIAL	D	D	E	E	NR
O.U.R.	D	E	E	E	NR
BCT	A	A	A	A	NR

As can be seen in the charts above, three of the failed credit unions, BCT, Hmong American, and Vensure, were rated “A” at the beginning of 2011. In all three cases, the credit unions’ 5300 call report data indicated that the institutions were all very well capitalized, profitable, and possessed few, if any, nonperforming assets. However, in the case of BCT and Vensure, the credit unions both reported significantly poorer earnings and capital metrics on their final call reports, which Kroll Bond Rating Agency did not have access to prior to the institutions failing.²

Hmong American appeared to be in sound financial condition. According to the credit union’s second quarter 2011 5300 call report (the most recent report available at the time of failure), the institution was profitable with a return on assets ratio of 1.88 percent, well capitalized with an equity to assets ratio of 15.99 percent, and possessed few nonperforming assets, with an NPAs to total loans ratio of 0.45 percent. As of this writing, there is nothing to suggest any financial shortcomings nor is there currently any evidence of fraud within the institution.

The analysis below draws, in part, on KBRA’s new model for rating credit unions. We highlight those factors shown to be statistically correlated with credit union failures.

² Note: as of the third quarter 2011 rating period, credit unions, which have already failed will be assigned an “NR” symbol regardless of the existence of call report data.

Summary financials

	Total assets	Total capital	Total loans	Net income	Net Worth Ratio ³
Average for failed credit unions	\$130,128,119	\$5,345,768	\$88,760,533	-\$1,876,622	10.34%
Average for non-failed credit unions	\$121,739,925	\$12,189,291	\$76,047,084	\$403,779	13.43%

Total loans and leases divided by total assets (%)

- 68.21 Average for failed credit unions
- 62.47 Average for non-failed credit unions

The discrepancy between the loans to assets ratio for failed and non-failed credit unions is relatively small; however, failed credit unions, on average, reported higher levels of total loans as a percentage of assets as of the beginning of 2011, suggesting that a higher concentration in loans may negatively impact the credit union's liquidity position and/or foreshadow weak or deteriorating asset quality. Additionally, 1st mortgage loans as a percentage of total loans amounted to 58.03 percent for failed credit unions versus 39.09 percent for non-failed institutions, indicating that loan concentrations in real estate loans may be a driver of financial soundness.

Nonperforming assets divided by total loans and leases (%)

- 13.94 Average for failed credit unions
- 2.04 Average for non-failed credit unions

As has been the long-held assumption of Kroll Bond Rating Agency, a concentration of impaired loans and/or repossessed assets (i.e. nonperforming assets) is a key indicator of financial weakness. As is illustrated by the above ratios, there is a stark contrast in asset quality between the credit unions that failed in 2011 and those that did not.

Total equity divided by total assets (%)

- 4.11 Average for failed credit unions
- 10.01 Average for non-failed credit unions

Capital levels, as measured as a percentage of total assets, closely track the net worth ratio used by regulators, with an average difference of two basis points, and are a powerful measure of financial soundness. In 2011, the difference in this measure of capital was quite large, indicating, unsurprisingly, that credit unions with low capital levels are susceptible to failure.

Return on assets (%)

- 1.15 Average for failed credit unions
- 0.44 Average for non-failed credit unions

Net losses are one of the hallmarks of a failing business; credit unions are no different in this regard. On average, the credit unions that failed in 2011, reported a net loss of \$1.88 million and a negative return on assets as compared to a positive net income of \$404,000 for the surviving credit unions.

Financial Trends – Third Quarter 2011

³ Average of reported ratios

As of September 30, 2011, 161 credit unions were less than adequately capitalized by regulatory standards, an 8.8 percent increase as compared to 148 credit unions that filed call reports in the prior quarter. On average, total equity increased by 1.5 percent on a linked-quarter basis and by 7.0 percent since the third quarter of 2010.

On a cumulative basis, reported net income increased by 54.3 percent as compared to September 30, 2010, largely due to a decrease in interest expenses, which declined by 21.4 percent, and due to 33.5 percent decrease in provisioning expenses as compared to the year-ago period. Conversely, interest income declined by 5.5 percent.

Asset quality improved as compared to the year-ago quarter with total nonperforming assets decreasing by 7.3 percent. On a linked-quarter basis, nonperformers increased by 0.7 percent, while the repossessed assets portion of the figure decreased by 2.1 percent over the quarter. On a cumulative basis, charge-offs decreased by 17.6 percent over the third quarter of 2010.

Total loans increased by 0.5 percent as compared to the second quarter of 2011, but decreased by 0.1 percent from a year ago. The only loan category to decrease during the third quarter of 2011 was other real estate loans, which fell by 1.4 percent. On an annual basis, other real estate loans declined by 7.6 percent, while all other unsecured loans declined by 1.4 percent. First mortgage loans increased the most, rising by \$7.7 million, or 3.4 percent over the third quarter of 2010 and by \$1.9 million over mid-year 2011. Additionally, Total assets, increased by 0.9 percent on a quarterly basis and by 34.7 percent on an annual basis.

While the commercial banking industry continues to struggle with legacy issues, non-corporate credit unions appear to be financially stable and less susceptible to failure than its bank and thrift cousins.

Third Quarter 2011 Regional Data								
	Total Assets	Total Equity	Net Income	Total Loans	1st Mortgage Loans	NPAs	Provisions	Charge-Offs
West								
Total (\$Mil)	253,933	24,708	1,209	149,131	62,446	3,651	1,149	1,661
% Change from previous quarter	2.49%	6.92%	115.26%	-4.05%	0.48%	-17.61%	-44.82%	-24.70%
Midwest								
Total (\$Mil)	190,953	20,049	826	115,004	46,985	1,997	594	712
% Change from previous quarter	5.50%	5.68%	45.45%	1.82%	4.78%	-6.67%	-21.60%	-8.69%
Northeast								
Total (\$Mil)	160,124	16,966	711	94,212	38,816	1,395	377	440
% Change from previous quarter	5.19%	6.48%	28.93%	2.70%	6.66%	3.18%	-29.38%	-12.59%
South								
Total (\$Mil)	357,365	36,532	1,887	215,550	84,337	4,011	1,448	1,756
% Change from previous quarter	5.71%	8.02%	42.72%	0.67%	3.44%	0.21%	-27.19%	-14.56%

Ben Stewart
Vice President
Senior Financial Analyst
bstewart@krollbondratings.com
(301) 662-1011

© Copyright 2012, Kroll Bond Rating Agency, Inc., and/or its licensors and affiliates (together, "KBRA"). All rights reserved. All information contained herein is protected by copyright law, and none of such information may be copied or otherwise reproduced, further transmitted, redistributed, or resold, in whole or in part, by any person, without KBRA's prior express written consent. The statements contained in this report are based solely upon the opinions of KBRA and the data and information available to the authors at the time of publication of this report. All information contained herein is obtained by KBRA from sources believed by it to be accurate and reliable. No warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability, or fitness for any particular purpose of any rating or other opinion or information is given or made by KBRA. Under no circumstances shall KBRA have any liability resulting from the use of any such information. The credit ratings, if any, and analysis constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities.