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MARKETS

Credit Unions Ramp Up Risk

Lenders Loosen Lending Standards, Increase Exposure to Longer-Term Assets

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WASHINGTON—Credit unions in search of higher returns are loosening lending standards and piling into longer-term assets, exposing the firms to potentially significant losses if interest rates rise and worrying regulators in the process.

Such moves are raising concerns at the National Credit Union Administration, the sector's regulator, which said a rise in interest rates could make loans and investments unprofitable. Some analysts also said credit unions likely are unaware of the risk they are taking on because they largely avoided the housing downturn. That has raised worries that lax underwriting standards could fuel another bubble.

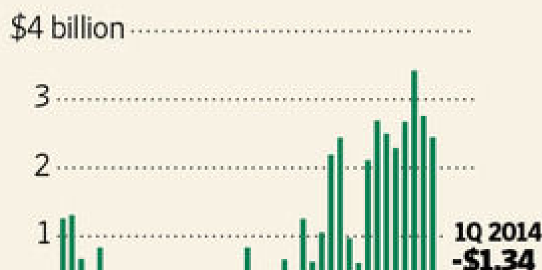
"I am concerned that the message [about rates] is either not getting through, or it's getting through and they are just choosing not to do anything about it," said Debbie Matz, chairman of the NCUA, who has long sounded the alarm about the industry's exposure to interest-rate risk.

Credit unions, which have been expanding steadily for years and now serve more than 97 million members nationwide, collectively held $1.098 trillion in assets at the end of the first quarter of 2014.

The Long View

Regulators say some credit union investments swung into the red when interest rates rose, suggesting potential losses if rates rise again.

Unrealized gains, losses on investments



30-year fixed mortgage rate

For the lenders, taking on more risk can help boost returns in a low-rate environment. A firm that offers a low-rate, long-term loan might win business over a competitor, and a credit union that invests in a mortgage bond with a relatively longer term can often demand a higher return.

But if interest rates rise, the money in those loans or investments will be locked in, generating relatively less revenue than a new loan or investment made in the higher-rate environment. Meanwhile, those banks and credit unions will have to pay depositors higher interest rates, otherwise those customers could move elsewhere.

"It's a double-edged sword," said Federal Deposit Insurance Corp. Chairman Martin Gruenberg at a news conference last week.

Credit unions' net holdings of long-term assets, a measure of exposure to rising interest rates, rose to an all-time high at the end of 2013 to 35.85% of total assets, according to the NCUA. The increase comes as some credit unions are adopting lax standards for mortgage and home-equity loans and lines of credit reminiscent of those leading up to the financial crisis, according to interviews. Credit unions also are extending the duration on investments like mortgage bonds, regulatory data show.

"In periods of declining mortgage volume, people start loosening underwriting to boost business," said Guy Cecala, chief executive at Inside Mortgage Finance, an industry newsletter. "They seem to be taking on a lot more risk than in the past."

Credit unions said they aren't concerned about the safety of these loans because borrowers still are required to have high credit scores and provide proof of income. The credit union administration said it is monitoring the issue but notes that credit unions as a whole "have had a relatively good credit quality record." The largest U.S. banks haven't followed the same trend in increasing long-term assets because they are increasing short-term investments, like reserves held at the Federal Reserve, the FDIC said.

Navy Federal Credit Union, the largest credit union in the U.S. with more than $58 billion in assets, began allowing members in January to borrow up to 100% of the value of their home using a home-equity loan. Pentagon Federal Credit Union, the third-largest credit union, said it is raising the maximum amount homeowners can borrow using a home-equity loan from 85% to 90% of a home's value.

Zero-down mortgages are picking up steam at credit unions. Navy Federal said it originated $388.8

million of mortgages for home buyers with no down payments, excluding government-backed mortgages, during the first five months of 2014, up 31% from the same period a year ago. The credit union is holding these loans on its books.

Down payments elsewhere are declining. Last month, Arlington Community Federal Credit Union, based in Arlington, Va., began accepting down payments of 3%, down from a minimum of 5% for loans of up to $417,000.

Some lenders are rolling out marketing campaigns similar to those of the last housing boom. "Just because the words home equity are there doesn't mean you have to use it for your home," said John Garner, vice president of lending at 3Rivers Federal Credit Union, which lends in northeast Indiana and northwest Ohio. The credit union said it recently began marketing home-equity lines of credit on regional radio and television programs that can be used to pay for a vacation, buy a car or pay off credit-card debt.

Last year's rise in long-term interest rates alarmed officials at the credit union administration, when unrealized losses increased to about $2.5 billion across the sector, versus the $2.5 billion unrealized gain in 2012.

Among those that felt the impact: APCO Employees Credit Union of Birmingham, Ala., a cooperative of employees of the Alabama Power Co., which had recently piled into more long-term investments, regulatory data show. After the rate increase, its unrealized losses were valued at 36% of its net worth, or capital, at the end of 2013, according to the data. In comparison, at the end of 2012, the credit union had an unrealized gain of 1%.

APCO President and Chief Executive V. Merrill Mann said the credit union is likely to hold its long-term investments, rather than sell them at a loss, in part because it has a significant amount of reserves on hand and doesn't expect to need cash if rates rise. "You can't avoid risk," he said. "We do try our best to mitigate risk in the best possible way."

A similar increase in long-term assets is playing out at the smaller banks the FDIC oversees. Community lenders, those with a focus on local markets, have boosted the share of long-term assets on their books as the economy recovers and demand for credit increases. The share of assets maturing in five years or more at community banks stood at more than 34% in the first quarter of 2014, compared with 19% in 2007, the FDIC said.

Pushing banks to stay on top of their exposure to higher rates, Mr. Gruenberg said, "in many ways [is] going to be the key supervisory challenge going forward." Still, the FDIC chairman said banks have been improving the quality of their assets since the crisis as regulators tighten restrictions on risk-taking.

Jay Johnson, executive vice president at Callahan & Associates, a firm that advises the sector, said credit unions also are prepared for a rise in interest rates because they have to hold capital against potential losses, and they also are holding short-term assets that could provide cash in a pinch, including more than 40% of investments in short-term holdings that mature in less than one year. "For the most part, I would say that [credit unions] are extremely ultraconservative," he said.

Regulators have begun to try to rein in risks, but those efforts face hurdles. The credit union

administration in January proposed a rule that could force credit unions to maintain loss-absorbing capital if they take on assets regulators judge to be risky. Credit unions said the rule is inappropriately strict, and many lobbied their congressman. Last month, almost three-quarters of the House of Representatives signed a letter urging the regulator to "consider the economic impact and consequences" of the proposal.

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