Barron's

Gilding the Books for Main Street's Credit Unions

By JIM MCTAGUE | **MORE ARTICLES BY AUTHOR(S)** April 19. 2010

Why U.S. credit unions face billions of dollars in losses.

PICK A NUMBER, ANY NUMBER. THAT'S WHAT federal credit-union regulators have done to establish capital for some large, financially battered institutions. They are employing the same creative accounting endorsed by Congress in the 1980s to keep hopelessly insolvent savings and loans going. Some 27 corporate credit unions are pretending their capital cushions are as fat as they were back in November 2008, before their portfolios of mortgage-backed securities blew up. In reality, most are either broke or barely capitalized. The system is held together by rubber bands.

This gilding of the books allowed Debbie Matz, chairman of the National Credit Union Administration, to gush in an April 8 speech, "In a day and age when every other part of America's financial-services sector has seen its reputation tarnished, credit unions are still shining."

It is impossible to tell how big the losses are in the credit-union system, because the NCUA hasn't produced an audited annual report for 2008 or 2009. An injection of loans from the Treasury has complicated GAAP calculations, an NCUA spokesman explained. Congress hasn't noticed. The banking overlords on Capitol Hill have big Wall Street sharks to fillet, and have given Main Street's financial wizards a pass. We've heard estimates ranging from $6 billion to $18 billion.

The credit-union system resembles the U.S. banking system before the Federal Reserve Act of 1913, according to Keith Leggett, an economist with the American Bankers Association. Three-quarters of the 7,600 federally insured "natural person" credit unions -- the ones that serve 90 million retail customers -- own a stake in some 26 corporate credit unions, big cooperatives that provide members with liquidity, card and checking services, and investment products. The corporates, in turn, all owned a stake in the huge U.S. Central Credit Union, a banker's bank in Kansas that failed. The system created old-fashioned "interdependency risk," says Leggett.

The corporates competed with one another for credit-union business by trying to offer the lowest-cost services and the highest yields. They concentrated their investments in high-yielding mortgage-backed securities, using 25-to-1 leverage. This wasn't greed, exactly; credit unions offer no stock options. They needed high rates to subsidize their services and attract more customers.

Regulators seized U.S. Central in 2009 and placed it into conservatorship due to insolvency. WesCorp, a big California-based corporate, also failed. All 26 corporates, including WesCorp, lost 100% of their equity in U.S. Central, leaving most severely undercapitalized. The regulators had to guarantee all natural credit-union deposits in the corporates to avoid runs that would have necessitated a fire sale of mortgage-backed securities.

The NCUA is planning to remove MBS from the corporates and sell them with a face value of $50 billion. Best case: A $6 billion loss. Probable loss: $9 billion to $11 billion, says Bill Hampel, an economist for the Credit Union National Association. Deposit-insurance funds and a loan from the Treasury will cover the hole. The credit unions have seven years in which to pay back the money, which will likely cause loan and card rates to rise and savings rates to decline.

Capital levels will increase for corporates and investing will be restricted, reducing earnings. Mergers are a certainty.

Matz said in her speech that natural-person credit unions would have lost $30 billion in net worth -- that's a third of their equity -- if the corporate system had collapsed. This loss would have shattered customer confidence, she added. It still could happen, if the slowly recovering economy stumbles and credit-union losses rise.