Credit Union Economics Group
Regional Report
Spring 2004

April 5, 2004

Credit Union Economics Group
www.cueg.org

Credit Union Economics Group

	<u>Bruce Beaudette:</u> Bruce Beaudette has been the President/CEO of Sunmark FCU in Schenectady, NY for the past seventeen years. He has also been a board member of Empire Corporate FCU for twelve years and is currently their Chairman of the Board. Mr. Beaudette additionally is the President of Sunmark Financial Services, LLC and sits on the Board of Member Trade Financial Group, LLC and Member Trade Advisory Services, LLC. He is the former Senior Accountant for First Maryland Bancorp and has a Bachelor's degree in Accounting from Siena College.
Not Available	<u>Elle Burkett:</u> Elle Burkett is the Economist for the California Credit Union League (CCUL) in Rancho Cucamonga, CA. Before joining the CCUL in 2001, Ms. Burkett held research positions at the Federal Reserve and also has economic consulting experience from two top Big Four accounting/consulting firms. Ms. Burkett holds a Bachelor's degree from the University of California, Santa Cruz in Economics, a Masters degree from the University of Michigan in Applied Economics, and is a M.B.A candidate in Econometrics & Statistics at the University of Chicago.
	<u>Bob Burrell:</u> Bob Burrell is the Executive Vice President and Chief Investment Officer of Western Corporate Federal Credit Union (WesCorp) in San Dimas, California. Prior to joining WesCorp in 1997, Mr. Burrell was Senior Vice President and group manager of capital markets and portfolio management at Boatmen's Bancshares, Inc., in St. Louis. He also serves on the board of Corporate Exchange, LLC. Mr. Burrell was educated in England where he attended the University of Leeds and earned a Bachelor's degree in Electrical Engineering.
	<u>David Colby:</u> Dave Colby is the Assistant Vice President & Corporate Economist for the CUNA Mutual Group in Madison, Wisconsin. Mr. Colby joined CUNA Mutual in 1977 as a Corporate Research Specialist and has progressed through the organization holding various corporate, operational and financial planning positions. Mr. Colby is a graduate of the University of Wisconsin - LaCrosse where he received his Bachelor of Science degree in Economics. He holds the designation of Fellow, Life Office Management Institute.
	<u>David Dickens:</u> David Dickens joined U.S. Central Credit Union in Lenexa, Kansas as Senior Vice President, Asset/Liability Management in December 1997. Prior to joining U.S. Central, Mr. Dickens served in the same role at Corporate One Federal Credit Union in Columbus, Ohio. Mr. Dickens, a Chartered Financial Analyst (CFA), also previously served as Senior Vice President of Corporate Network Brokerage Services, Inc. (CNBS). He earned a Bachelor's degree in business administration from the University of Missouri.
	<u>Bruce Fox:</u> Bruce M. Fox is the Senior Vice President and Chief Investment Officer of Southwest Corporate Federal Credit Union. Mr. Fox joined Southwest in January 1991 as an investment adviser. Mr. Fox is a member of Southwest's asset-liability committee and chairman of the loan committee. Prior to that, he was an investment portfolio manager at the Members Insurance Companies of the Texas Credit Union League. Mr. Fox has Bachelor's and Master's degrees in Finance from East Texas State University.
	<u>Scott Mainwaring:</u> Scott R. Mainwaring joined VyStar Credit Union in Jacksonville, Florida as the Executive Vice President & Chief Financial Officer in 1991. In addition, Mr. Mainwaring is the President of VyStar Financial Group, LLC, a wholly owned subsidiary of VyStar Credit Union, and is also a CPA. He worked for the public accounting firm of Coopers & Lybrand for five years before joining Vystar. Mr. Mainwaring graduated with a Bachelor's degree in Accounting from Furman University in Greenville, South Carolina.
	<u>Brian McVeigh:</u> Brian McVeigh is the Senior Vice President and Chief Financial Officer for State Employees Credit Union (SECU) in Lansing, Michigan and has been there since 1995. Prior to joining SECU, Mr. McVeigh spent eight years with First of America Corporation and three years with Michigan National Corporation. Mr. McVeigh has spent the majority of his nineteen year career specializing in asset and liability management, investments, and accounting after earning a Bachelor's degree in Accounting from Michigan State University.
	<u>Jeff Taylor:</u> Jeff Taylor joined NAFCU in 2000 as the Senior Staff Economist in the Research and Analysis Division. Prior to joining NAFCU, Mr. Taylor worked as a financial consultant and Senior Economist and Investment Strategist at Bear Stearns and NatWest Securities, and as a Senior Country Risk Analyst at the U.S. Export Import Bank. Mr. Taylor received a Masters degree in International Economics from George Washington University and Bachelor's degrees in Latin American political economy and Spanish from Denison University.
	<u>Tun Wai:</u> Dr. Tun A. Wai is in his seventeenth year as NAFCU's Director of Research and Chief Economist in Arlington, Virginia. Prior to joining NAFCU, Dr. Wai held research positions with the World Bank, the Federal Reserve Board of Governors, and the Brookings Institution, an independent research group. Dr. Wai has a Bachelor of Science in Business Administration in Management and a Ph.D. in Economics from Georgetown University, as well as an M.B.A. in finance from New York University.

Executive Summary

- Loan growth for all federally insured credit unions (FICUs) in 2003 was approximately 9.7 percent, the majority of the growth being in first mortgage loans at 16.6 percent, followed by used auto lending at 12.5 percent. Overall lending within five of the six regions grew at rates higher than the national average.
- Most credit unions have expectations of elevated new and used auto lending and unsecured lending for all of 2004. Several regions seem to be less optimistic about real estate lending, though, given the expectation that mortgage refinancing activity will slow dramatically this calendar year.
- Credit unions as a whole are mixed about whether growth in shares will decrease or remain roughly the same throughout 2004. Institutions in Region 5 seem to feel strongest about a possible up-tick in share growth in 2004, citing uncertainty related to the economy and the job market.
- Share growth for all FICUs was 9.1 percent last year, with growth in every region being concentrated in non-share certificates, particularly share drafts, regular and money market shares (each with double-digit growth year-over-year).
- The average return on average assets (ROA) for all FICUs in 2003 was roughly 0.99 percent. Most credit union management teams seem to believe that the prospects for earnings this year remain about the same or slightly lower.
- General economic conditions in each of the NCUA regions tend to mirror the national picture, as the primary issues remain the fallout from unemployment and the financially distressed state and local governments. Continued weak labor markets (especially in the Midwest) are likely to dominate the economic radar screen throughout 2004, despite significant evidence of improvement in certain areas of the United States (i.e. Region 6).
- What appears to be most on the minds of credit union leadership throughout the country were concerns about the low interest rate environment and the resulting margin pressure institutions have felt throughout the last year. Although general economic indicators have shown moderate signs of improvement, loan and asset quality issues related to current and near-term economic conditions remain major concerns to most credit unions.

NCUA Region One

NCUA's Region 1 (Northeast) consists of seven states.[1] At year end 2003, there were 1,201 credit unions in the region, with total assets of $71.4 billion and a total membership of 8.7 million.

Lending

Region 1's loan growth last year was 10.4 percent, compared to 9.7 percent for all federally insured credit unions (FICUs). Loan growth in 2003 was concentrated in real estate products, and to a lesser extent, used auto products. The mortgage "refi" wave that swept the nation yet again in 2003 was very evident in Region 1. First mortgage lending expanded by 13.0 percent, while home equity loan demand grew at a brisk pace as well (12.5 percent). Last year, new auto lending continued to be constrained by the dealer and finance company incentives, but indirect lending programs and Internet sales allowed for an 8.2 percent increase. Used auto loan demand rose by over 11.3 percent in 2003. Credit card and unsecured lending reversed the declines of the previous year, yet still only grew by 2.0 percent and 2.2 percent respectively. Finally, the region's credit unions experienced an elevated demand for member business loans, with lending expanding at 15.3 percent. Expectations for loan demand in 2004 are quite mixed. The weak condition of the labor market, coupled with an expected decline in real estate loan demand, have many credit unions in a cautionary mode. While 35.7 percent of the surveyed credit unions believe that loan growth in 2004 will be higher than last year, 42.9 percent of credit unions believe that loan growth will be slower than in 2003. Expectations for 2004 real estate loan demand were largely negative, with most of the region's credit unions envisioning greater demand for only home equity loans. Many of the survey respondents believe that both new (50.0 percent) and used (61.5 percent) light auto loan demand will strengthen. Approximately seventy-one percent of the region's credit unions believe that unsecured loan demand will be about the same as during 2003, yet 21.4 percent expect a modest up-tick in unsecured lending this year.

Member Shares

Region 1's share growth was 9.9 percent in 2003, compared to 9.1 for all FICUs. As with many FICUs, the region's share growth last year was concentrated in money market shares, share drafts and regular shares which rose by 17.1 percent, 13.0 percent, and 12.7 percent respectively. Last year IRA/KEOGH accounts grew by 9.0 percent, while there was a net outflow from share certificates of 0.4 percent as members chose to keep their assets as liquid as possible. In 2004, many of Region 1's credit unions expect share growth to decline significantly. Fifty percent of the surveyed credit unions believe that share growth will slow in 2004, while 21.4 percent feel that share growth will accelerate this year. Many of the Region's credit unions expect a shifting pattern of share growth as they feel members will try to gain yield at the expense of liquidity. For example, 42.9 percent believe that share drafts will be higher this year, while 35.7 percent expect an increase in IRA/KEOGH accounts. In 2004, only 21.4 percent of

[1] The seven states are Connecticut, Maine, Massachusetts, New Hampshire, New York, Rhode Island and Vermont.

surveyed credit unions believe that regular share growth will be higher, while 28.6 percent expect an increase in money market share growth. Half of the Region's credit unions expect an increase in share certificate balances this year. Regarding liquidity, 35.7 percent of the region's credit unions expect that their deposit structure liquidity will be more liquid in 2004 than during 2003, with only 14.3 percent expecting a less liquid deposit structure this year.

Return on Average Assets, Spreads and Asset Quality

Last year, the credit unions in Region 1 had a ROA of 0.96 percent compared to a ROA of 0.99 percent for all FICUs. A lower cost of funds, limiting expenses, and higher fee income helped offset a lower net interest margin. In 2004, the prospects for earnings remain positive for some credit unions, with 58.6 percent expecting an ROA in line with or better than that of 2003. However, due to the weak labor markets and the uncertainty surrounding the timing and magnitude of interest rates increases later this year, 42.9 percent of the responding credit unions believe that their ROA will contract in 2004. The majority (61.5 percent) envision lower gross spreads this year, while 30.8 percent expect similar spreads in 2004. The asset quality of Region 1 credit unions was much better than the asset quality of all FICUs. The delinquent loans-to-total loans ratio in the region was 0.62 percent in 2003 compared to 0.77 percent for all FICUs. Last year's net charge-off rate in Region 1 of 0.37 percent was much lower than the overall FICU charge-off rate of 0.56 percent. While Region 1 experienced a large number of bankruptcies in 2003, the number of cases and its effects on the credit unions was less significant than on many FICUs. Last year, Region 1 had the fewest bankruptcies of any of the six NCUA regions, and its bankrupt loans-to-total loans ratio of 0.24 percent was half of the FICU ratio of 0.50 percent. As a result, none of the credit unions indicated that bankruptcy is their principal concern for 2004.

Competition and Credit Union Operational Concerns for 2004

Thirty-two percent of the Region's credit unions feel that banks are their primary source of competition for loans, followed by other credit unions and auto dealerships (24 percent and 22 percent respectively), and internet lending (eight percent). For shares, 46 percent of the region's credit unions believe that banks are the primary competition, with 29 percent viewing other credit unions and 25 percent believing that mutual funds and corporate equity are the primary source of competition. In Region 1, 30 percent of the credit unions feel that loan growth is the principal concern for 2004. Twenty percent believe that earnings are the main concern, followed by interest rate risk, and share growth (10 percent each). The remaining 30 percent cited various concerns with the most common concerns being shrinking margins, asset quality, and whether or not new products and services will have the desired impact.

Member Concerns and Economic Conditions in 2004

When asked to assess their member's confidence/sentiment, 61.5 percent of the credit unions feel that their member's outlook for this year is better than it was last year, with the remaining 38.5 percent believing that member sentiment is about the same as in

2003. Half of the region's credit unions indicated that their members are most concerned about interest rate uncertainty, while 33 percent cited share rates. Seventy-nine percent of the region's credit unions characterize their local economic conditions as fiscally weak, while over one third described poor labor market conditions. Nevertheless, certain parts of the region appear to be recovering, as 36 percent responded that unemployment was low and retail sales were robust.

The economic and financial conditions throughout Region 1 were very disparate last year. During 2003, the economies in Rhode Island and Maine performed relatively well, while non-farm employment declined significantly in Connecticut, Massachusetts and Vermont. In New Hampshire and New York, conditions were mixed, varying greatly in different parts of the state. The region's economy began decelerating in 2001, and as a result, the unemployment rate and much of the region's overcapacity has stabilized. However, the slow recovery of the information technology, manufacturing, securities, and to a lesser extent, tourism industries, continued to constrain the economy's ability to gain significant momentum. Further weighing on the region's economies are the weak fiscal positions of most of the state and local governments. The housing market, while providing significant support to the region's economy, is at risk of suffering some "investment bubble" effects. The Boston, Manchester, N.H. and New York City areas are at greatest risk to experience a moderate depreciation in home values during 2004.

NCUA Region Two

NCUA Region 2 (Mid-Atlantic) consists of five states[2] plus the District of Columbia. The region's credit unions (CUs)[3] have about 14.7 percent of the total assets of the nation, up 11.2 percent for the year. There are roughly 11.9 million members in this region, up 221,000 (1.9 percent) over the past year. These percentages mirror the regional economy where the gross state product is about 13 percent of the U.S. gross domestic product. The regional production is concentrated more in government, services, finances, insurance, and real estate industries than the national average.

Lending

Region 2 CUs generated an annual loan growth of 10.7 percent, well above the national average of 9.7 percent. Over the course of 2003, first mortgages supplied 55.3 percent of loan portfolio growth, followed by used auto loans at 21.0 percent. Combined real estate secured lending (first mortgages and HELOCs) accounted for 74.7 percent of the gain.

Going forward into 2004, Region 2 CUs anticipate higher loan growth for new auto loans. Conversely, Region 2 CUs expect real estate loans to decline significantly over the next 12-months period. These loan expectations are similar to those among all CUs, except for used autos where a less positive outlook is indicated nationwide.

Total auto loans in Region 2 advanced by 8.5 percent in 2003 versus 9.3 percent for all CUs. Region 2 used auto loans led the way, up 14.5 percent for the year while the new auto loan portfolio increased 2.6 percent.

Unsecured loans (excluding credit cards) represent 9.0 percent of all CU loans in the region. This portfolio segment increased 0.1 percent in 2003. One factor may be that the average unsecured loan rate nationwide was 11.7 percent, down just 50 basis points from 2002. Credit card loans grew 5.6 percent in 2003 and also represent 9.3 percent of all CU loans in the region. CU leadership in the region does not see unsecured loans as a source of loan growth in 2004.

Member Shares

Member share deposits reached $77.2 billion in 2003, up $7.5 billion (10.7 percent) during the year. Regular shares contributed 43.1 percent of the increase last year, followed by money market accounts at 21.8 percent. Add in share drafts at 17.3 percent and that totals 82.2 percent of 2003's increase from highly liquid deposit accounts. Bucking the trend were share certificates, up 3.8 percent for the year, reflecting members concerns for low interest rates.

For 2004, Region 2 CUs see a similar share growth. In contrast, the nationwide expectation on share is a slightly slower growth rate for 2004.

[2] The five states are Delaware, Maryland, New Jersey, Pennsylvania, and Virginia.
[3] Credit unions (CUs) are federally insured credit unions.

Region 2 CUs share drafts (12.6 percent of Region 2 CU shares) increased at a higher rate (15.3 percent) than during last year (the 2002 regional average was 9.8 percent growth). Regular shares (40.0 percent of Region 2 CU shares) grew an exceptional 11.6 percent in 2003. Money market accounts (15.9 percent of CU shares) reached $12.3 billion in 2003, up 15.3 percent. CU share certificates (21.0 percent of CU shares) experienced a 3.8 percent increase in 2003.

IRA accounts (9.5 percent of CU shares) were a safe haven for members' precious retirement funds in 2003. This deposit segment advanced 9.5 percent for the year compared to a national average of 7.1 percent.

Return on Average Assets (ROA), Spreads and Asset Quality

With deposits re-pricing faster than loans in 2003, credit unions experienced a healthy improvement in Region 2's consolidated ROA. At 1.16 percent (average ROA for all CUs was 0.99 percent), this profitability measure increased 9 basis points over 2002 for the region's credit unions. Some CU management teams expect a slight decrease on ROA as a result of the reduction in interchange income from debit card transactions.

Gross spreads declined by 16 basis points from 3.49 percent in 2002 to 3.33 percent this year. The strong ROA among region 2 CUs was partly due to the 17 basis point decline in operating expenses while maintaining constant net charge-offs at 33 basis points.

Loan Loss Trends in 2003

Several Region 2 CUs indicated that their delinquency rate has risen, especially in the area of credit card loans. In 2003 Region 2 CUs have a slightly lower delinquency ratio than credit unions nationwide but a similar charge-off ratio. The trend in bankruptcy is still increasing among Region 2 CUs. In 2003 the bankruptcies-to-total loans ratio increased by 1 basis point while nationwide there was a 7 basis point rise.

The primary operational concerns for 2003, cited by our regional credit unions, were loan growth, interest rate risk, share growth, and capital ratios. Low delinquencies, and not material concern about bankruptcies were mentioned as examples of positive future performance.

Member Concerns and Region 2 Economic Conditions in 2003

Credit union leadership in Region 2 viewed the financially distressed state governments as a primary economic concern in their states. Low corporate profits were also cited in their assessments of economic conditions in the region. On the positive side low unemployment and a strong retail sector were also cited. Mutual fund/stocks were viewed as primary competition for savings while banks and auto dealerships were viewed as primary competitors on loans, a similarly held view nationally.

NCUA Region Three

At year-end 2003, there were 1,665 credit unions in NCUA's Region 3 (Southeast) consisting of 10 states and two territories[4]. The year-end count represents a decline of 53 CUs in 2003. Total CU assets in Region 3 increased 10.0 percent during the year to $103 billion. Membership increased by roughly 351,000 in 2003, raising total CU membership to just over 15.4 million. The 25 largest CUs in Region 3 hold 42 percent of all assets and 30 percent of the membership. Overall, asset quality in Region 3 CUs was very good in 2003. Eighty-four percent of CUs in our survey see asset quality at or above current levels by the end of 2004.

Lending

The CUs in Region 3 generated total loan growth of 9.8 percent last year, just above the national average. Over the course of 2003, first mortgages supplied 45 percent of all loan growth, followed closely by new and used auto loans at 44 percent. Combined, real estate secured loans (first mortgages and HELOCs) accounted for 55 percent of 2003's loan growth in Region 3.

A few key facts to note: annualized fourth quarter 2003 loan growth improved to 10.8 percent, the dollar volume of first mortgage originations was up 49 percent in 2003 and first mortgage loan sales were up 56 percent.

Looking forward through 2004, just over 84 percent of CUs believe total loan growth results will be equal to or better than 2003. A full 58 percent see their loan-to-share (L/S) ratio improving due to a combination of solid loan growth and slower share (deposit) inflows. During the fourth quarter of 2003, share growth slowed for many CUs as some member assets moved back into mutual funds, stocks and other investments. However, during early 2004, growth has rebounded primarily as a result of tax refunds being deposited at CUs and other seasonal factors. Just 16 percent of Region 3 CUs anticipate erosion in their L/S ratio over the course of 2004.

Fifty-three percent of CUs see purchase money mortgage originations growing at or above the 2003 pace, but 84 percent believe refinance originations will be lower. No CUs in the survey sample anticipate refinance activity will top 2003 results. Overall, respondents believe it will be difficult to improve upon the 14 percent first mortgage loan portfolio growth seen last year.

The "Other Real Estate" (HELOCs and second mortgages) loan portfolio expanded by 9.9 percent in 2003. This portfolio segment represents 9 percent of all loans. The HELOC component grew by almost 19 percent in 2003 with new credit extensions up 24 percent. Expectations for Other Real Estate loan growth are that 74 percent of CUs see gains at or above 2003's level.

After a portfolio decline in 2002, new auto loan growth improved to 5.7 percent last year. Used auto loans were up 14.8 percent, beating 2002 growth by 6.6 percentage

[4] The ten states include Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, Mississippi, North Carolina, South Carolina, and Tennessee, and the territories of Puerto Rico and the U.S. Virgin Islands.

points. Combined, total auto loans (41 percent of all loans) were up 10.5 percent last year versus 4.1 percent in 2002. The auto lending market remains very competitive as automakers continue to offer 0.0 percent financing deals and other attractive incentives. However, the growth posted by CUs in both the new and used auto financing areas was solid. Credit unions were successful at achieving these results by lowering their rates considerably throughout the year. A lower level of early payoffs during the latter part of 2003 contributed to these results as well. Just 6 percent of survey respondents foresee slower new auto loan growth in 2004 and 44 percent indicate that they expect an improvement. Surprisingly, 68 percent of surveyed CUs see used auto loan portfolio growth better in 2004, while 11 percent anticipate slower growth.

Unsecured loans (excluding credit cards) represent 6.6 percent of all CU loans, down from almost 10 percent in 1999. This loan portfolio segment has contracted in each of the past three years. It is a victim of debt consolidation/refinancing, high rates (average 12.6 percent) and the greater availability of higher risk unsecured credit in the marketplace. Eighty-three percent of our surveyed CUs see this portfolio's growth performance at or better than the 2.8 percent decline in 2003. It is unlikely that unsecured lending will be a source of loan growth anytime in the near future for most Region 3 CUs.

Member Shares

Region 3's members increased their share deposits by 10.1 percent in 2003 to 89.9 billion. Growth was much stronger through the first half of the year, but as the economic and equity market outlooks improved, deposit inflows slowed to a trickle. This is evidenced by fourth quarter growth of just 0.7 percent.

Share growth in 2003 was concentrated in liquid deposits. Regular shares accounted for 48 percent of the annual gain, money market accounts 26 percent and share drafts 16 percent. CDs were up fractionally, but contributed to less than one percent of the gain. When this highly liquid deposit structure was combined with a lower interest rate environment, we saw the cost of funds to average assets fell from 2.35 percent in 2002 to 1.75 percent last year. This ratio is down from 3.46 percent in 2001.

Seventy-eight percent of Region 3 respondents see 2004 share growth at or below the 10.1 percent rate achieved last year. Forty percent of respondents believe their CU's overall deposit liquidity structure will become less liquid in the coming year versus just 5 percent who anticipate more liquidity. As mentioned above, share flows have recovered in early 2004 and these funds are moving primarily into liquid accounts.

Fifty-eight percent of CUs see share drafts (12 percent of total shares) increasing at the same rate as they did last year (region average growth was 13.7 percent) and 26 percent are forecasting better results. Regular shares (38 percent of total shares) advanced 13.3 percent in 2003. Seventy-five percent of CUs believe 2004 results will be the same or lower. Money market accounts (17 percent of total shares) were up 16.5 percent last year. Almost 69 percent of respondents believe they will duplicate or improve upon this performance in 2004. CU share certificates of deposit increased just

0.03 percent last year. Forty percent of CUs see 2004 growth at about the same level as last year. The other 60 percent are split evenly between higher and lower growth.

Over the past few years, insured deposit IRA accounts (9 percent of total shares) were a safe haven for member retirement savings in light of equity market performance. Annual growth in 2003 slipped to 8.4 percent. Seventy percent of our survey respondents anticipate 2004 growth at about the same level, but 20 percent see the gains improving.

On a consolidated basis, Region 3 CUs finished 2003 with a return on average assets (ROA) of 0.98 percent. This reflects an erosion of 11 basis points from 2002 results. Reduced earnings on loans and investments coupled with the reduction in interchange revenues could not be offset by the lower cost of funds. In Region 3, 976 CUs (59 percent) experienced a decline in their ROAs. These CUs held 70 percent of the region's assets. Looking forward, 40 percent of the CUs believe they can improve on 2003 results, but 25 percent anticipate further declines in this key earnings indicator primarily because of the continued pressure on the net interest margin (or gross spread ratios) caused by the current interest rate environment.

Competitive and other market pressures pushed CUs' gross spreads down to 362 basis points. This is a 26 basis point decline from 2002 results. Forty-five percent of the CUs in the survey believe they can achieve similar results in 2004. Surprisingly, 30 percent are planning on improvements over last year. Current interest rate forecasts would indicate further pressure on spreads and interest margins as interest rates rise later in the year.

Credit Union Issues and Economic Factors Impacting Credit Unions

Auto dealerships are viewed as the principal competition for loans in 2004. They are followed by banks and other CUs. Only 5 percent of our respondents view the Internet as a primary competitive threat. It is interesting to note that retailers (excluding auto dealers) fell off the radar screen.

On the share side, 37 percent believe other CUs are the primary competition. Mutual funds/stocks came in second with 33 percent seeing these investment autos as the primary competition. This is a dramatic increase from last year when just 20 percent of CUs viewed mutual funds/stock as a major competitive threat. Thirty percent still see banks as the principal competition for members' savings dollars.

At an operational level, CUs are evenly split between generating loan growth, improving earnings and successfully managing interest rate risks. This is in sharp contrast to last year when bankruptcies and charge-offs were the top operational concern.

Credit union leaders were also asked to assess their memberships' general confidence/sentiment levels now versus a year ago. Fifty-eight percent thought it had improved, forty-two percent detected little or no change and none thought it was worse than last year.

When asked about their members' principal concerns, 70 percent reported that low share yields were the complaint they heard most often. Only 10 percent responded that it was the economy/jobs.

NCUA Region Four

NCUA Region 4 (North Central) consists of seven states.[5] The regional credit unions have about 16.0 percent of total credit union assets, up 7.8 percent for the last twelve months. There are roughly 14.7 million members in this region, up 62,114 (0.42 percent) over the past year. These percentages mirror the regional economy where the regional gross state product is concentrated more in manufacturing than the national average.

Lending

For the second half of 2003, loans grew by roughly 5.7 percent with total loans for Region 4 ending the period at $61 billion. Every loan category experienced positive growth for the last six months. The largest gains were in first mortgage (up 8.9 percent from June) and other real estate loans (up 7.3 percent). Despite heavy competition, credit unions were able to grow auto loans by nearly 3.0 percent during the second half of the year. The percentage of loans to assets was unchanged from the prior year at 63 percent.

Mortgage lending is expected to decline sharply in 2004 as the refinancing boom is not expected to repeat itself. The purchase mortgage business is expected to be above average but will pale in comparison to the robust refinancing of 2003. There is growing optimism for home equity lending in 2004 as households continue to restructure their balance sheets in the face of 45-year lows in interest rates. Auto lending is expected to be at close to the same performance level as last year.

Loan Quality

Region 4 credit unions continue to do a good job managing credit risk in the face of stressful economic times. Delinquency rates were up just 4 basis points from June, to 0.92 percent, as of December 31, 2003. The net charge off ratio was steady at 0.50 percent of total loans for the full year.

Bankruptcy filings continue to dominate the charge-off scene. The number of members filing for bankruptcy in the region increased 8.6 percent from the previous year. Unfortunately, that increase produced a 17.9 percent increase in the dollars charged-off as a result of bankruptcies. The percentage of total charge-offs caused by bankruptcy increased from 75.9 percent in 2002 to 81.1 percent in 2003.

Member Shares

Shares and deposits decreased by just 0.2 percent during the second half of 2003. Total shares and deposits stood at $84.4 billion on December 31, 2003. Despite the flat growth performance, significant shifting occurred between categories. Certificates of deposit declined by $444 million, or 2.4 percent, as money market savings accounts grew by $572 million, or 3.6 percent. Other less significant shifts occurred between share draft accounts (down 1.8 percent), regular shares (down 0.2 percent) and IRAs (up 0.6 percent).

[5] The seven states are Illinois, Indiana, Michigan, Missouri, Ohio, West Virginia, and Wisconsin.

Share and deposit growth for the first half of 2004 will be dependent on income tax refunds and a possible flight to the stock market. For the time being, job and income growth will not likely add much to the credit union share base in Region 4. Gaining market share from competitors will likely be a defining factor in 2004 share and deposit growth success stories.

Investments

With loan growth outpacing share growth, investments declined by $2.8 billion during the last six months of 2003. Region 4 credit unions ended the year with $32.8 billion in total investments, and $8.2 billion of the total in cash and cash equivalent instruments. Clearly, there is ample liquidity for now.

Earnings

The average return on assets in 2003 improved to 0.99 percent from 0.95 percent in 2002. Regional credit unions lowered their cost of funds from 2.28 percent to 1.68 percent during the same timeframe. These factors brought the net interest margin down from 3.68 percent to 3.44 percent. This margin compression was countered with an increase in non-interest income and a reduction in operating expenses as a percentage of assets. As interest rates continue to hover at 45 year lows, margin compression remains a key earnings concern.

Credit unions in Region 4 added $900 million to net worth in 2003 while average assets grew by $7.1 billion. This raised the average net worth ratio by 4 basis points to 11.11 percent.

General Economic Conditions

Economic conditions in the Midwest appear to be less favorable than in the nation as a whole. Heavier reliance on the manufacturing sector has produced greater job losses and a tougher recovery. Based on employment and industrial production, it can be said that Michigan and Ohio are still in a recession. State and local governments have been busy cutting budgets just to keep deficits from reaching the alarming levels seen in California.

On a positive note, the region has endured much worse during previous recessions. While manufacturing is still a key economic component, other sectors such as finance, healthcare, and technology have grown in importance and impact. Several of these sectors are starting to show signs of recovery. We have probably seen the worst of this recent recession, but the Midwest will likely lag the nation in posting the positive statistics showing we are back on track.

NCUA Region Five

NCUA Region 5 (Central) consists of eleven states[6] and 1,698 credit unions as of December 31, 2003. The credit unions in this region represent approximately 16.6 percent of the total assets of all federally insured credit unions, up 9.5 percent since December 2002. There are an estimated 15 million members in this region, up 304,000 (2.1 percent) over the past 12 months. These percentages mirror the regional economy where the regional gross state product is about 16.7 percent of the U.S. gross domestic product. The regional production is concentrated more in transportation, public utilities, farms, forestry, fisheries, construction and retail and wholesale trade than the national average.

Lending

Region 5 credit unions (CUs) generated annual loan growth of 10.0 percent, which was slightly above the national average of 9.7 percent for all FICUs. Loan growth during the twelve-month period ending December 2003 was concentrated in new and used automobile loans and first mortgage real estate lending. During the period, used auto loans accounted for 40 percent of loan growth, followed by first mortgages at 34 percent. New automobile lending accounted for only 19 percent as volumes continued to be constrained by dealer finance company incentives. Combined new and used auto loans accounted for 59 percent of the gain. The loan-to-share ratio in Region 5 was 74.7 percent as of December 2003.

Going forward into 2004, 75 percent of Region 5 CUs anticipate higher or equal overall loan growth when compared to their 2003 results. About 33 percent believe they will see their loan-to share ratio improve, and 25 percent expect a lower result for this key measure.

Credit unions seem to be generally optimistic regarding new and used automobile lending activity in 2004. Only 16 percent of our survey respondents believe new and used automobile loan growth in 2004 will be lower than during 2003. A full 84 percent anticipate better or equal results.

Looking forward, credit unions generally view the prospects for real estate lending as remaining somewhat positive; although there is an overwhelming expectation that mortgage refinancing activity will slow dramatically in 2004. Fifty-seven percent of CUs expect first lien mortgage loan growth to be stronger in 2004. However, only 17 percent of CUs believe first lien mortgage lending will be the loan product in most demand in 2004. Survey results also show that 89 percent of Region 5 CUs are counting on lower mortgage refinancing activity in 2004.

Unsecured loans represent 9.4 percent of all credit union loans in Region 5. This portfolio segment declined approximately 1 percent since December 2002. Almost none of the credit union leadership in the region sees this portfolio segment as a source of

[6] The eleven states are Arizona, Colorado, Iowa, Kansas, Minnesota, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, and Texas.

growth in 2004. In fact, about 92 percent of credit union managers expect unsecured loan growth to be about the same this year as in 2003.

Credit unions in Region 5 continue to do a good job in managing credit risk and the outlook for 2004 remains very positive. The region's average delinquency rate was .9 percent, slightly higher than the national average of .8 percent. Seventy-five percent of credit unions surveyed in the region expect loan quality to be the same or better in 2004.

Member Shares

Member share deposits reached $87.6 billion as of year-end 2003, up $5.7 billion (6.9 percent) during the past twelve months. Regular shares contributed 40.7 percent of the increase since December 2002, followed by money market accounts at 29.6 percent. Additionally, if we consider the 16.9 percent growth in share drafts, then 87.2 percent of the total increase is in highly liquid share accounts. IRA deposits were also up 6 percent for the survey period, suggesting that some members are still concerned about safety of principal. Share certificate accounts showed a slight increase in overall balances. Share certificate deposits increased only 1.3 percent, as consumers remained cautious about extending their deposit maturities in the current low interest rate environment.

Uncertainty related to the economy and the job market is the primary reason credit unions expect share growth to remain relatively strong in 2004. For 2004, 33 percent of Region 5 respondents expect a higher share growth while 42 percent anticipate a decline. About 67 percent believe their deposit liquidity structure will be "about the same" or "more liquid" in 2004. The other 33 percent indicated they expect their deposit maturity to increase as members purchase more term certificates of deposit. Most of the growth is expected to come in regular share and money market accounts.

Investments

Total investments grew 8.7 percent for the twelve-month period ending December 2003. Credit unions continued to keep the majority of their investment maturities short-term. Approximately 86 percent of all investments and cash will mature or reprice within three years and over 52 percent will mature or reprice within 12 months. Seventy-five percent of the credit unions that responded to the survey indicated that the maturity structure of the investment portfolio is not expected to change in 2004. Investment categories that experienced the most growth in 2003 were corporate share certificates (13.2 percent), bank and S&L certificates (11.7 percent) and federal agency securities (11.2 percent).

Liabilities

Borrowing increased nearly 53 percent in 2004, as credit unions took advantage of the current low interest rate environment to lock in longer-term fixed rate funding.

Earnings

Return on average assets (ROA) in Region 5 declined from 1.04 percent to 0.94 percent during the twelve-month period ending December 2003. This compares to an ROA of 0.99 percent for all FICUs. In 2004, the prospect for earnings remains a concern for most credit unions, with only 33 percent of those surveyed expecting an improvement in this key performance measurement.

CU Operational Concerns

When credit unions were asked to identify the principal concern for 2004, about 58 percent cited loan growth and asset growth. The second most common concern was pressure on net interest margins. These credit union managers are concerned about gross margin pressure resulting from soft loan demand and the impact of the current low interest rate environment. Other issues mentioned in our survey included membership growth concerns, interest rate risk associated with rising interest rates, managing operating expenses, and responding to membership needs.

Region 5 credit unions view their principal competition for lending as banks, followed by other credit unions. Only a small percentage viewed finance companies as competitive concerns in 2004.

Member Concerns

Credit union members are primarily concerned with the low interest rates currently available on their share accounts. Members cited low interest rates 67 percent of the time when asked about their primary concern for 2004. The overall economy, employment, paying down accumulative debt, and service quality were mentioned as well, but far less often than concerns about low rates.

Region 6 (Western) is comprised of ten states and two territories[7]. As of December 31, 2003, the region's 1,226 federally insured credit unions comprised 13.1 percent of all FICUs and held some $146.7 billion in total assets, 24.0 percent of the nation's total credit union assets. Region 6 saw membership increase by 382,000 in 2003, ending the year with a total of 16.5 million members. In 2003, total assets grew by 10.3 percent and reserves and undivided earnings increased 9.3 percent to a total of $14.9 billion. Shares grew $11.7 billion (10.1 percent) in 2003 while loans increased $8.2 billion, or 9.9 percent. At December 31st, 2003 share balances totaled $128.3 billion while outstanding loans came in at $90.5 billion. The loan-to-share ratio decreased from the year-end of 2002, when the ratio was at 70.65 percent, to year-end 2003 when the ratio was at 70.55 percent.

Lending

Loan growth in Region 6 for 2003 was 9.9 percent, with the fourth quarter showing particular strength. Total loans for Region 6 ended the year at $90.5 billion – making up 61.7 percent of total assets. Loans comprised 62.0 percent of assets in 2002 and 64.8 percent in 2001. The only areas of significant strength were in residential first mortgage loans (33.1 percent) and automobile loans (40.7 percent).

Real estate loans grew at a pace of 13.2 percent. In line with the low-rate environment, fixed–rate loans showed the highest growth, increasing by 17.6 percent to $20.4 billion. For the region as a whole, real estate loans made up 45.0 percent of total loans. Surprisingly, ARM's grew 12.2 percent, however, most of these loans are hybrids with fairly long fixed rate periods (3-10 years) up front.

Auto loans grew 9.8 percent in 2003, but new car lending effectively stalled due to competition from automakers, so all of the growth was from lending for previously owned vehicles. Increasing activity in indirect lending has also helped maintain portfolio balances. Origination of indirect auto loans in Region 6 totaled $8.6 billion in 2003 compared to $6.1 billion in 2002. More than 70 credit unions in the Region entered the indirect market in 2003. Credit unions are generally optimistic about future prospects, particularly in the used car market. Opportunities in new car financing will depend on what happens to automaker subsidized financing in 2004, however, the launch of an unprecedented number of new models in 2004 suggests that the automakers might have to remain fairly aggressive in this area.

Member business lending activity continues to grow as credit unions start to assist members in this area. Originations increased nearly 38 percent in 2003 to a total of $3.6 billion. Over 21 percent of the credit unions in the Region originated at least one member business loan in 2003.

Elsewhere, loan prospects are not so bright. In fact, home equity lines of credit fell during the period as homeowners took advantage of low mortgage rate to refinance into

[7] The ten states include Alaska, California, Hawaii, Idaho, Montana, Nevada, Oregon, Utah, Washington, Wyoming, and the territories are Guam and American Samoa.

first mortgages. There is little expectation for any major strength in unsecured lending, which remains in a cyclical decline.

Credit unions have mixed views on the outlook for loan growth depending on their competitive position in various lending sectors. Refinancing activity will no doubt decline from the heady levels seen in 2003. However, low interest rates should help support purchase activity for credit unions with competitive mortgage lending programs. There was some mild optimism on new car financing in the first quarter of 2004, while the outlook for new auto lending remained weak. We expect to see continued growth in indirect auto lending as existing players increase their activity and new credit unions enter the market. Member business lending is another bright spot. The outlook for unsecured lending in the first quarter of 2004 remains very weak.

Credit unions continue to do a good job in managing credit risk and generally remain very positive about the outlook for 2004. The delinquency ratio was at 0.62 percent by year-end 2003 with a total of $521 million in net charge-offs. Results for Region 6 mirror results nationally.

Bankruptcy filings by members did show increases for the period. Region 6 credit unions are on pace to charge off $434.1 million in loans subject to bankruptcy this year compared to $395.9 million last year. Loans subject to bankruptcy accounted for 76.2 percent of total delinquent loans in the region.

Member Shares

In 2003, shares grew at a 10.0 percent growth rate to $143.2 billion. However, the pace in the fourth quarter slowed to an annualized rate slightly above 2 percent and many credit unions actually experienced net outflows of deposits during the quarter. The growth shares in 2003 were largely concentrated in regular share accounts (43.8 percent) and money market shares (34.2 percent). However, transaction accounts also grew substantially (18.5 percent). Share certificate balances experienced negligible growth in the year. As of December 31, 2003 regular share accounts (33.3 percent), share certificates (23.3 percent) and money market shares (21.6 percent) made up the major portion of share accounts. The current low rate environment makes it very difficult for credit unions to interest members in long-term share certificates. We are hearing some concern from credit unions about the need to match fund some of their fixed-rate residential mortgage loans. Consequently, we expect to see some growth in long-term fixed rate borrowings in the coming months, even though liquidity is clearly not an issue for the majority of credit unions. Borrowings increased $737 million (26.9 percent) in 2003 to end the year at a still modest $3.5 billion. Several credit unions are looking to the derivatives market to hedge the cost of share balances and short-term share certificate issuance. Region 6 credit unions expect share growth to be weak in the first quarter of 2004.

Investments

By year-end 2003, investments grew at a rate of 15.1 percent and ended the period at $40.8 billion or 27.8 percent of total assets. This represents an increase from last year's ending balances of $35.5 billion. Credit unions continue to keep the majority of their investments short-term. The yield on average investments was 2.8 percent. Credit unions continue to hold ample liquidity in case funds start to flow out of the system.

Earnings

Average return on assets in 2003 was 1.04 percent mostly due to compression in net interest margins. Return on equity was at 9.71 percent in 2003 from 10.66 percent in 2002. This represented a decline of 95 basis points from 2002 and most credit unions say they are expecting further spread compression in 2004. The average yield on loans declined from 7.5 percent in 2002 to 6.7 percent in 2003 and yield on investments declined from 3.5 percent in 2002 to 2.8 percent in 2003. On the other side of the balance sheet, credit unions were only able to reduce their cost of funds from 2.22 percent to 1.59 percent and liability costs seem to have hit a floor. Consequently, the net margin declined from 4.69 percent in 2002 to 4.59 percent in 2003. Operating expenses over income was at 52.3 percent while fee income comprised 11.6 percent of the total gross income.

General Economic Conditions

Economic conditions in the Western States improved by the end of 2003. Recent data shows improvements in the labor market, consumer spending, commercial real estate, information technology, service, and manufacturing industries. Alaska, California, Oregon, and Washington continue to face the greatest challenges with unemployment levels rising well above the national average. These states lost jobs earlier in the year, but have been adding jobs since August. In addition, Hawaii, Idaho, Nevada, and Utah have been adding jobs throughout the year of 2003.

Although the pace of home sales is expected to slow down in 2004, the housing market in California is still likely to be the third strongest housing market in history. Agriculture, international trade, and tourism should also boost the economy. Strong economic activity and employment have been present in San Diego, San Bernardino, and Riverside while the Bay Area economy has faced more challenges. Economic problems include the budget deficit schedule to be remedied by Governor Schwarzenegger via borrowing and cuts, the compensation insurance crisis, painfully slow job growth, and high unemployment insurance claims.

Hawaii's economy is starting to do a little better and currently enjoys the highest job growth rate in the nation and one of the lowest unemployment rates. Hawaii is also currently among the leading states in personal income growth. The state is highly dependent upon tourism and developments in Asia will remain a key issue. Travel to Hawaii is currently running a bit below last year's level, though domestic travel activity was particularly strong during the summer months. New construction is especially strong in the state and is expected to remain a major source of growth. The U.S. government is also beginning a major construction effort for housing on the bases in Hawaii. In addition, Honolulu's CPI is projected to remain low.

In the 33-months following the first Federal Reserve Board interest rate cut in January 2001, credit union liquidity had steadily increased as share growth dramatically outpaced loan growth. That trend finally reversed in the fourth quarter of 2003 as reserves and shares increased by only $1.1 billion while loans grew 2.6 billion. The outlook for 2004 would suggest that share growth would remain subdued while loan growth should continue to be fairly strong and outpace the growth in liabilities. However, we expect the decline in excess liquidity to be fairly modest. We also saw a steady decline in net interest margins over the course of 2003 as the yield on assets declined faster than the cost of funds. This trend is also likely to stay in place in 2004.

The Federal Reserve Bank of San Francisco reported improvement in overall employment activity in the last few months and stated that job additions were broad-based in several major sectors. Gains in construction, trade, transportation & utilities, and professional and business services were strong while new home construction boosted construction payrolls. Added demand for temporary support services, advertising, marketing, and IT support caused professional and business services to rise. The manufacturing sector added jobs in recent months, after two years of reductions while government employment continues to decrease.

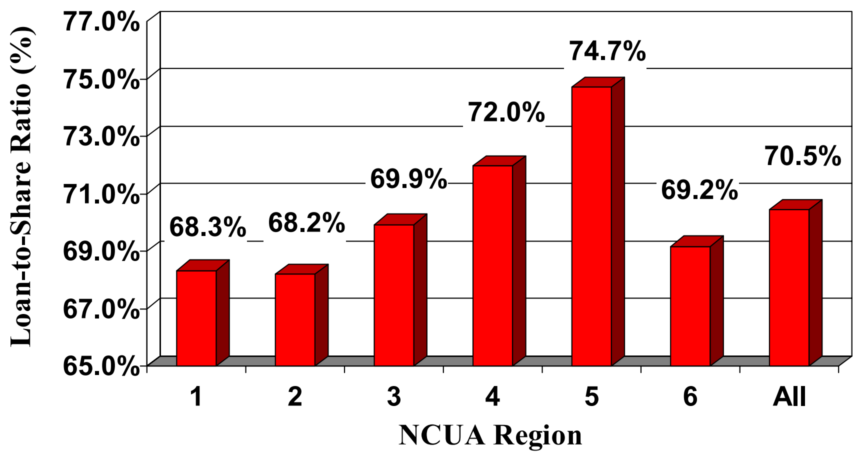
Reports from District retailers reported that nominal sales gains in the West generally followed the U.S. pattern. As in the nation, the best-selling items among District retailers reportedly were DVD players, DVDs, CDs, and toys. Apparel also sold relatively well, as did home furnishings and home decorations. Consumers have also been spending on travel and the early start to the ski season in many states has helped this trend.

Overall District manufacturing activity picked up due to the weaker dollar and stronger domestic business investment that boosted orders for manufactured goods. Lumber and wood product makers experienced a pickup in orders associated with home building and improved export demand. Machine tool makers reported stronger growth due to several state and federal government infrastructure projects. In California, the IT sector showed an increase in hours worked in the computer and peripherals, semiconductors, and electronics sectors. Demand for semiconductors improved and shipments for goods within this sector have picked up. In addition, the biotech sector is becoming a more important part of R&D spending.

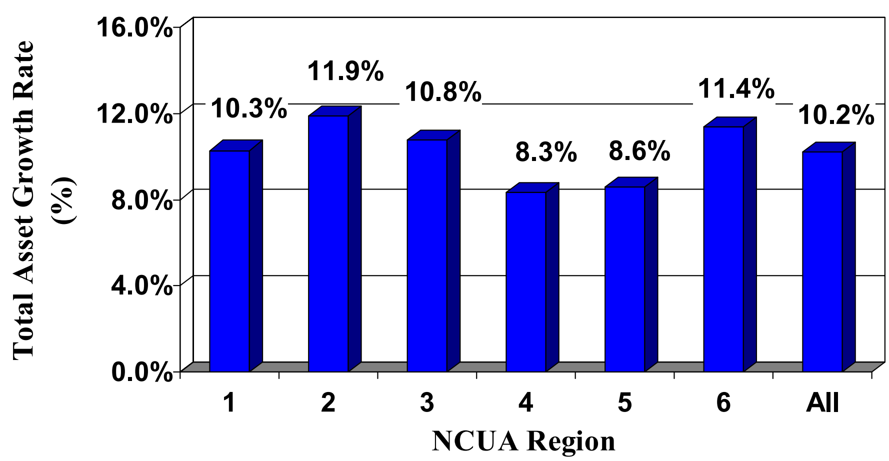
Housing demand remained a bright spot in the District's economy. There has been a surge in home sales to take advantage of low interest rates before they begin to rise. Nominal house price appreciation remains relatively robust in most areas. Growth in construction and permits continues to attempt to accommodate strong housing demand.

On the commercial side of real estate, vacancies and lease rates have leveled off and businesses have begun to renew leases on existing spaces. Although vacancies remain high in many areas, they appear to be coming down in areas most impacted by this trend.

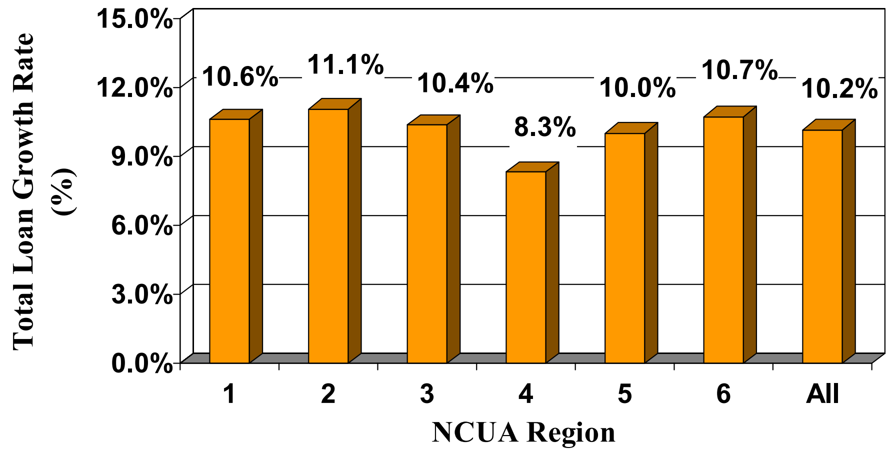
Loan-to-Share Ratio
Federally Insured Credit Unions
by NCUA Region
December 2003



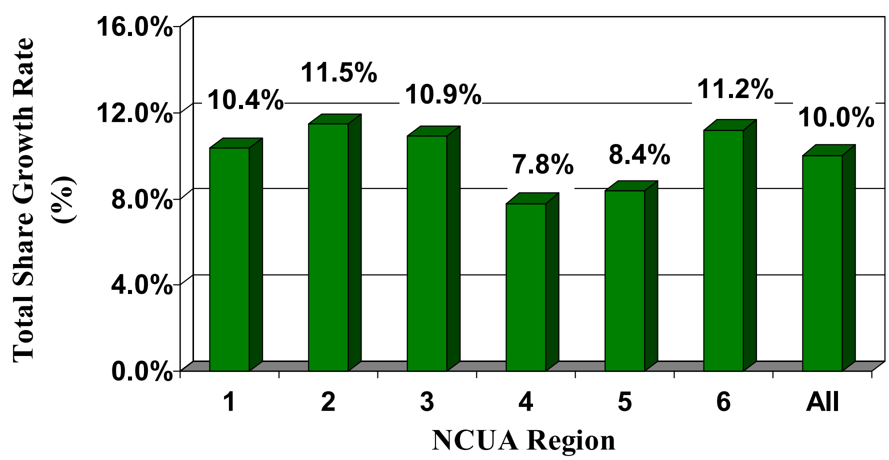
Total Asset Growth
Federally Insured Credit Unions
by NCUA Region
December 2003



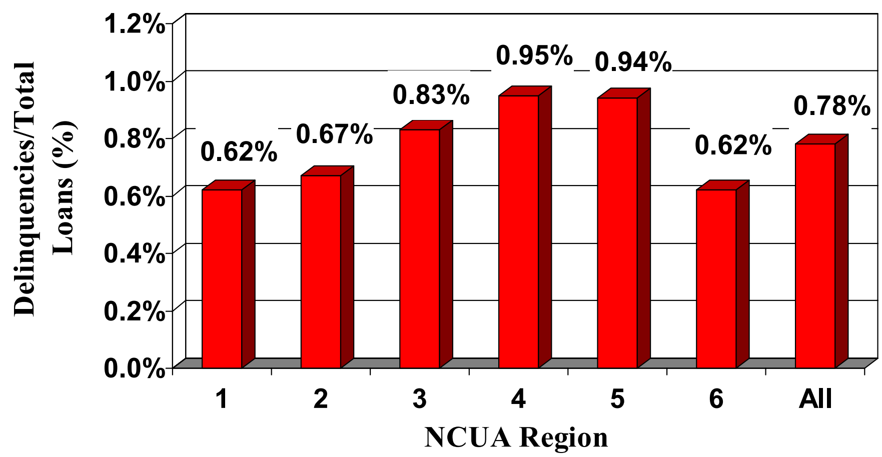
Total Loan Growth
Federally Insured Credit Unions
by NCUA Region
December 2003



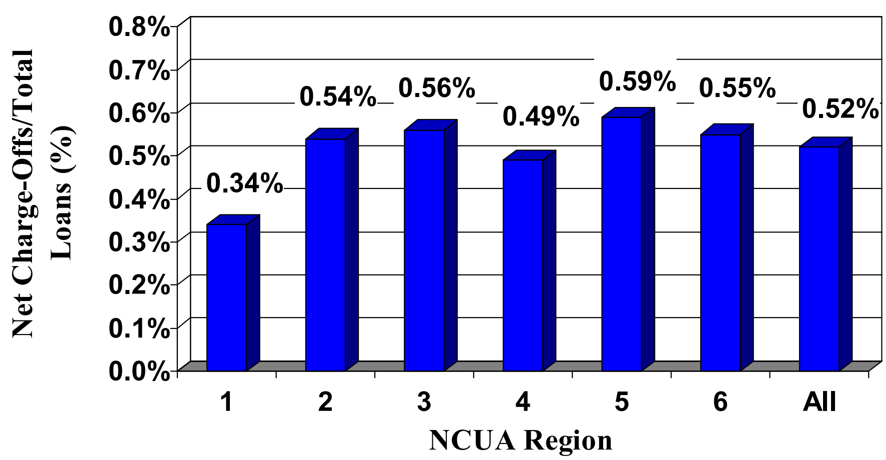
Total Share Growth
Federally Insured Credit Unions
by NCUA Region
December 2003



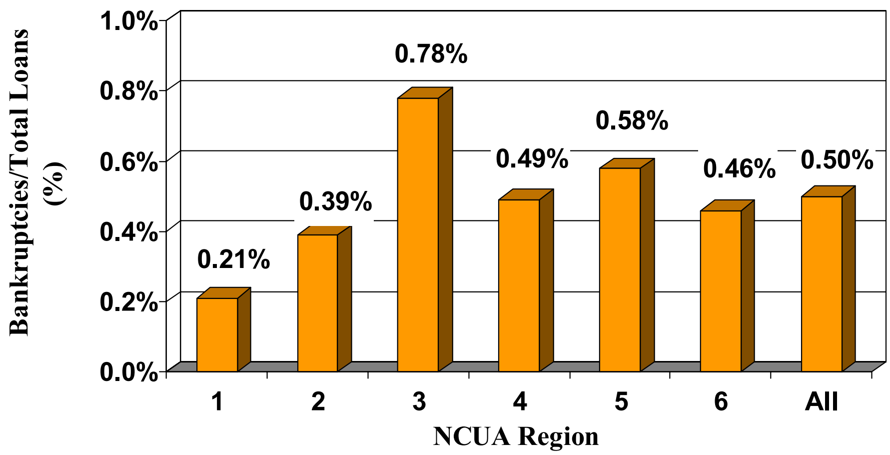
Delinquency Ratio
Federally Insured Credit Unions
by NCUA Region
December 2003



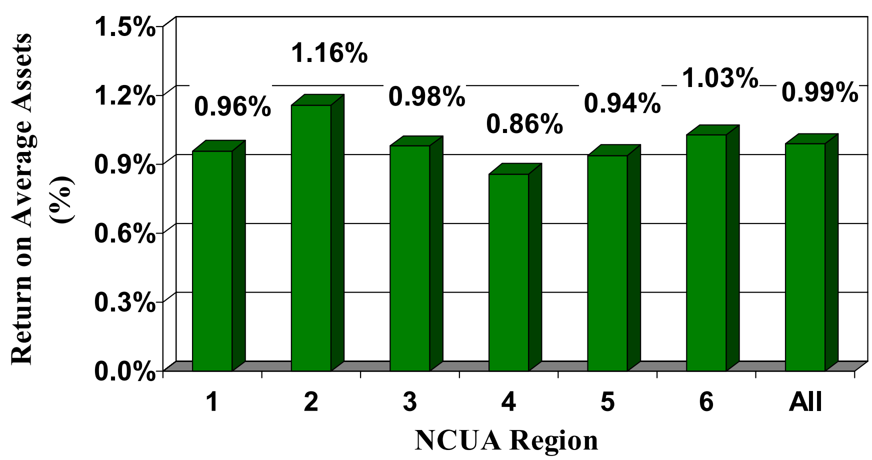
Net Charge-Offs/Total Loans
Federally Insured Credit Unions
by NCUA Region
December 2003



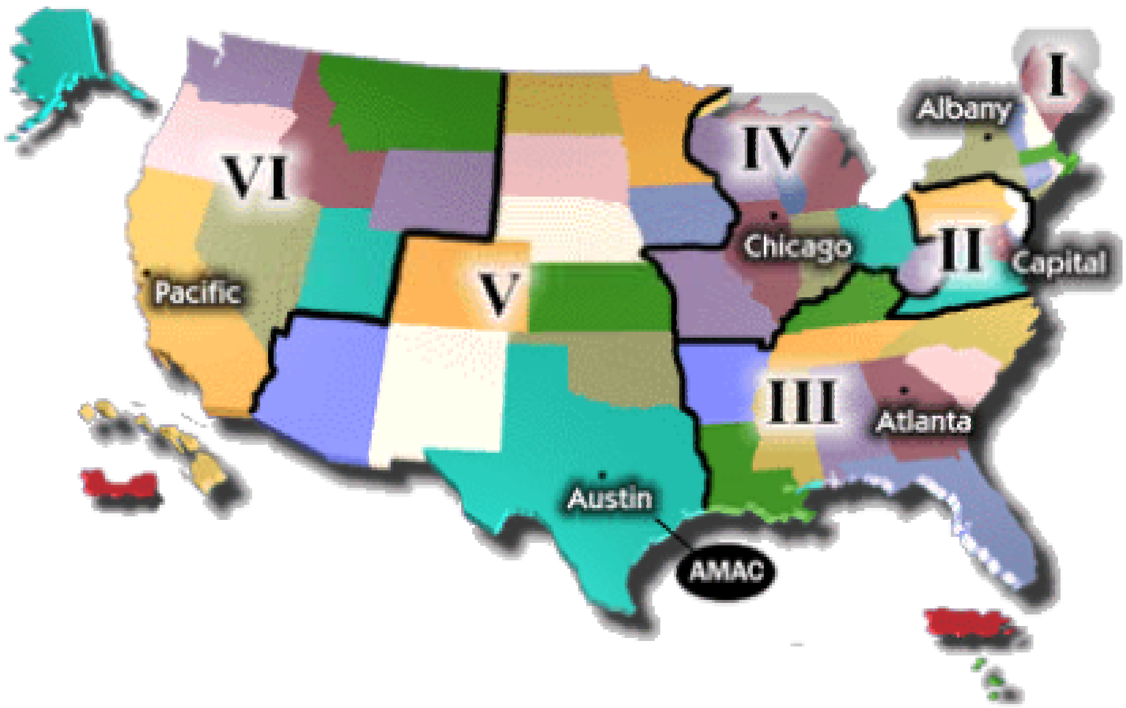
Bankruptcies/Total Loans Federally Insured Credit Unions by NCUA Region December 2003



Return on Average Assets (ROA) Federally Insured Credit Unions by NCUA Region December 2003



NCUA REGIONAL BREAKDOWN



Source: NCUA Web site - http://www.ncua.gov/org/regionalmap.html