Corporate Credit Union Restructure

Policy Task Force

REPORT AND RECOMMENDATIONS

Produced by a Joint Task Force appointed by CUNA and NAFCU to provide input to NCUA's deliberations in revising rules and regulations governing corporate credit unions.

September 3, 2009

INTRODUCTION

At the National Roundtable meeting in May of 2009, a number of credit unions raised the need to present NCUA with a unified credit union view on the future of the corporate credit union system to maximize the influence of credit unions on NCUA's rulemaking process on corporate credit unions. Following the Roundtable meeting, the chairs of CUNA and NAFCU appointed a joint Task Force to produce that view. The Task Force is comprised of members of the Corporate Credit Union Task Forces of NAFCU and CUNA, representatives of the National Credit Union Roundtable, representatives of smaller credit unions, and the Corporate Credit Union Stabilization Partnership. The Task Force is co-chaired by the chairs of NAFCU's and CUNA's Corporate Task Forces and is staffed by CUNA and NAFCU staff. The Task Force approached its mission beginning with the issues raised by NCUA's Advance Notice of Proposed Rulemaking issued in January, and the various organizations' comments in response to that Advance Notice, but also considered other issues that have risen since those comments were submitted.

PRINCIPLES

The Task Force set out with a set of principles that guided its deliberations. They are:

- In considering the future design of the corporate system, the interests of natural person credit unions (NPCUs), including those that choose to use a corporate and those which do not, are paramount.
- There is significant value to NPCUs in the corporate system, and it will be beneficial to preserve that value in the future. However, that value is only worth preserving if the system is so structured that the recent losses to NPCUs, both individually and systemically, will not reoccur.
- The goal for the future is a corporate system that credit unions will willingly capitalize and use. This will require two elements:
    - A business plan in which credit unions see sufficient value, and
    - A structure that credit unions perceive as sufficiently safe.

TASK FORCE CONCLUSIONS AND RECOMMENDATIONS.

The Task Force considered each of the major elements raised in the NCUA's Advance Notice of Proposed Rulemaking, and in the hundreds of comments submitted to NCUA, and reached a number of conclusions and recommendations concerning them. The Task Force's recommendations are purposefully strategic. We considered the major issues that must be resolved in a future corporate structure without being prescriptive about how specifically to implement the recommendations in a detailed way.

The Task Force stresses that the recommendations it presents are to be taken as an integrated set. Selecting the Task Force's suggested direction in some areas while not in others will likely not lead to a corporate design that will be acceptable to NPCUs.

Services.

The Task Force finds considerable value in the payments and settlement services provided by corporates. Concentrating the contact points for clearing and settling payments with other major financial institutions creates opportunities for credit unions. Although there are alternatives to some of these services from the Federal Reserve, Federal Home Loan Banks, and commercial banks, the Task Force believes there is significant value to credit unions in having these services provided by not-for-profit organizations controlled by credit unions. The long-run accessibility of these alternative sources is open to question. Because the risks inherent in these activities are much less than those found in investments, the capital requirements of these activities are relatively low.

Closely related to the settlement function is the maintenance of short-term deposit accounts and the provision of short-term credit to credit unions. Therefore, the Task Force believes that corporates of the future should also offer short-term investments and credit to credit unions. However, the Task Force concludes that longer term, on balance sheet investments should not be offered by corporates. This is the area that has historically and recently created the greatest risk in corporate credit unions. Purely for settlement purposes, a maximum maturity of three months would be sufficient. However, the Task Force believes that on-balance sheet deposit taking and investing in instruments of up to one year could be consistent with an acceptable level of risk. Even within this short maturity limit, care should be taken that interest rate risk is appropriately managed.

To meet the longer-term investment needs of NPCUs, the Task Force believes that it would be appropriate for CCUs to own credit union service organizations (CUSOs) that provide investment advisory and broker/dealer services to NPCUs. These CUSOs would assist credit unions in selecting, purchasing and managing longer-term investments to be held on the balance sheets of the NPCUs. Such CUSOs should only own longer-term investments on a temporary basis as may be necessary to provide services to NPCUs.

The Task Force is aware that its suggestions relating to services represent a substantial reduction in flexibility to corporate credit unions compared to current rules. The recommendations are intended to represent a level of risk that the Task Force believes credit unions would be willing to accept.

Recommendations:

- Services by corporate credit unions should be restricted to:
    - Payments
    - Settlement
    - Other correspondent services such as coin and currency, foreign exchange, etc.
    - Short-term investing
    - Short-term credit.

- Deposits in and on-balance sheet investments or loans held by corporate credit unions should be subject to a maximum maturity of 12 months.
- Corporates should be permitted to offer broker/dealer and investment advisory services through CUSOs to meet the longer term investment needs of credit unions without involving the balance sheet of the corporate.
- Capital requirements for credit unions investing in corporates for "longer" maturities (three months to a year) should be greater than for the other services provided by the corporate.
- Permissible investments for corporates should include all investment authorities for federally chartered natural person credit unions plus other limited investment types approved by NCUA for investment by corporates. NCUA should review the approved list of investment types annually. In addition, there should be significant concentration and credit restrictions on corporate investments.
- The new investment requirements and limits will have to be phased in as current corporate portfolios are allowed to amortize or mature.

Capital.

A crucial element to protect the interests of NPCUs in their corporates in the future will be the sufficiency of capital. It is also the case that most of the capital of a future corporate system will need to be supplied by NPCUs, at least initially. The Task Force concludes that in the future corporates should be subject to both a basic leverage (capital divided by total assets, measured as daily average net assets) and a risk-based capital requirement. These required capital ratios should have both Tier 1 (reserves, undivided earnings, and perpetual or very long-term contributed capital) and Tier 2 (medium-term contributed capital) components. Contributed capital should be required for membership and service use. In order to attract sufficient capital, the corporate of the future will have to present a sufficiently compelling business case covering both the value of services provided and strong risk control.

Recommendations:

- Contributed capital must be required of member credit unions. In the event a corporate is more than well capitalized, it should be permitted to return a portion of contributed capital on a pro-rata basis so long as the corporate remains more than well capitalized.
- NPCUs should be required to acquire a certain amount of Tier 1 capital based on the NPCU's asset size in order to belong to a corporate. The size-based capital requirement should be subject to a dollar cap, which could be indexed for inflation. Additional contributed capital should be required based on the amounts and types of business a NPCU does with a corporate, with the capitalization requirements depending on the risks to the CCU of offering the service. This additional service-based capital could be either Tier 1 or Tier 2, depending on the service, and should not be subject to a cap. The capital requirements by size or services should be prescribed by regulation, and should be the same across all corporates. NPCUs

discontinuing service usage or membership in a corporate should not be eligible for early capital refunding, except as provided to all member credit unions. In the event of a merger of corporates, NCPC contributed capital should continue under the same maturity and conditions in the merged corporate.

- There should be some form of mandatory, corporate specific PCA, specifying what actions NCUA must take for any corporate credit union that is less than adequately capitalized.

Structure.

The Task Force concludes that efficiency will require a reduced number of corporates in the future. A major concern over the next few years is how the system will consolidate. The cooperative structure is not terribly effective in encouraging voluntary mergers. Too often a merger is the result of a failure of a credit union or corporate rather than of the successful culmination of a business plan to grow and be acquired. Many of the components of the Task Force's recommendations, taken together, will increase the pressures to consolidate. These features are: a single tier and continued national fields of membership (see below), common capital requirements, corporate PCA, and significant limits on risk taking. The limits on risk-taking will mean that competition among corporates in the future will be driven by efficiency. This will place a premium on economies of scale, creating substantial pressures for consolidation. PCA will require NCUA to facilitate mergers in cases where corporates are not adequately capitalized. Nevertheless, the Task Force believes that the ultimate decisions of how many and which corporates survive in the future should be decided by credit unions and the play of these forces, not by NCUA.

Recommendations:

- Corporates should continue to serve national fields of membership. Potential, strategic competition will continue to exist among corporates, but the requirement to separately capitalize any CCU a NPCU belongs to will limit the virulence of that competition in the short run.
- There should be only one tier in the corporate system. However it will be important to retain the national data switch and other payments and settlement functions currently at US Central, perhaps as a CUSO or housed in one or more corporates.
- The Task Force calls on all credit unions to look for opportunities to advance the consolidation of corporates. Board members of corporates have the responsibility to look for effective combinations for the benefit of members. In managing the transition to a new corporate system, the NCUA should facilitate as opposed to deter mergers of corporates, without specifically picking winners and losers.

Insurance of Shares and Deposits in Corporates

The Task Force concludes that, upon termination of the existing temporary corporate deposit guarantee program, insurance coverage for NPCU shares and deposits in CCUs must be limited to the maximum coverage for personal deposits in NPCUs. This means that the vast majority of deposits in corporates will be uninsured. The Task Force strongly holds this view for two reasons. First, never again should the share insurance fund protecting members of NPCUs be burdened with significant losses arising from CCUs. The extension of coverage beyond the regular insurance limit, which was regrettably necessary recently, should never again be contemplated. Second, the absence of deposit insurance will induce NPCUs to more closely monitor the risk positions of the CCU(s) they belong to. Deposit insurance is designed to protect uninformed consumers who lack the resources and information to properly assess the riskiness of the depository institutions in which they place funds. In sharp contrast, credit unions are institutional investors in corporates. They are perfectly capable of assessing the policies, practices and balance sheet positions that define the risk of a corporate credit union. Their investments being at risk will create the right kinds of incentives for them to monitor and hold accountable their CCUs. In other words, moral hazard will be minimized. For similar reasons, corporate credit unions should not be permitted to cross guarantee each others deposits.

Recommendations:

- NCUSIF insurance of corporate accounts should be strictly limited to whatever the maximum per account coverage is for members of natural person credit unions.
- Corporate credit unions should not be permitted to create cross guarantees of deposits.

NCUA Oversight of Corporate Credit Unions

The recent failure[1] of the corporate credit union system had a number of causes, many of which have been brought into sharp focus with 20-20 hindsight. Corporates did not hold sufficient capital to be able to liquidate positions when they first began to deteriorate, investment authorities allowed too much concentration of corporate investments, corporate management took on too much risk in the attempt to boost returns to meet competitive demands and grow, credit unions, enjoying the high returns, did not do sufficient due diligence of their investments in their corporates, corporate boards allowed excessive risk taking. All of these elements contributed to the large losses credit unions will incur over the next several years. There is plenty of blame to go around. The recommendations the Task Force is presenting are designed, as a group, to create a

[1] The Task Force recognizes that almost all of CCUs have not "failed." But, although only two corporate credit unions have been placed in conservatorship, the huge losses imposed on NPCUs as a result of the operation of corporates, one of which served all the other corporates, means that the system itself has failed.

structure and set of incentives that will substantially reduce the likelihood of such a catastrophe again. However, another cause of the losses was the less than adequate supervision of corporates by NCUA.

- NCUA's oversight of corporates in the future must be improved, with adequate qualified staff with special knowledge of the complex operations of corporate credit unions.

Corporate Governance

Corporate boards of directors are also not without fault in the recent problems faced by the system. In the future, the system will need to ensure that CCU board members have sufficient expertise to govern their corporate, consistent with the powers available to a CCU.

CONCLUSION

The Task Force's presents its recommendations as a comprehensive whole. The interplay among its suggestions on services, capital, structure and other issues is part of the design to create a robust system in the future. Substantial deviation from the basic principles of any of the major components of the proposed system will likely render the rest of the recommendations less effective. For example, permitting longer term investments would require substantially more capital. Also, maintaining a two-tiered system would not produce the sort of consolidation that the Task Force believes is necessary. Therefore, the Task Force strongly encourages the NCUA not to pick and choose among the interrelated components of its recommendations.

The Task Force is keenly aware that the suggestions it is making represent a substantial departure from the status quo of the current corporate system. Its recommendations represent a level of risk that it believes credit unions would find acceptable, and hence represent a system that the Task Force expects that credit unions would be willing to capitalize. The recommendations would substantially limit the range of activities and investments that corporates would be able to pursue. The Task Force recognizes that these more binding constraints would likely require substantial changes in corporate business models in order to operate. Whether or not viable corporates can operate under the provisions the Task Force believes are necessary will be up to the corporates to figure out. However, in light of the recent costs to NPCUs of the corporate stabilization, the Task Force believes a proposed corporate system that imposes more risk than that represented by its proposal would be very unlikely to generate sufficient support and capital from credit unions.

Finally, the proposed system implied by the Task Force's suggestions represents a future corporate system that the Task Force believes that natural person credit unions would support and use. Not covered in this report are the crucial questions of the transition from the current system to the new one. That transition will need to be handled in manner that both preserves the valuable payments and data switch abilities of the current

system and manages the wind-down of the troubled investment portfolios of some corporate credit unions in a way that minimizes future costs to credit unions.

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