

Report of the CUNA Corporate Credit Union Next Steps Working Group to the CUNA Governmental Affairs Committee

August 26, 2010

INTRODUCTION

In January of 2009, then CUNA Chair Tom Dorety appointed the CUNA Corporate Credit Union Task Force to recommend policy to the CUNA Board on how credit unions could deal with emerging problems in corporate credit unions. The first meeting of the Task Force in January happened to occur on the same day NCUA announced the first steps it was taking to stabilize the corporates, including a temporary guarantee of credit union shares in corporates, a \$1 billion capital injection into US Central, and an Advance Notice of Proposed Rulemaking (ANPR) on restructuring the corporate credit union system. The Task Force guided CUNA's response to the ANPR, and made recommendations to the CUNA Board on policy dealing with the corporates. The Task Force then oversaw CUNA's comment letter on the proposal that followed the ANPR. Its work culminated with a report to the Board in February of 2010 which is available from the "New Initiatives" section of CUNA's home page www.cuna.org. The report recommended a sharply revised corporate business model, which is described later in this report.

Taking up where CUNA's previous Corporate Credit Union Task Force left off in February, CUNA's Corporate Credit Union Next Steps Working Group has had the mission of ensuring that credit unions continue to have access to the services they have in the past relied on corporate credit unions to provide. The Working Group reviewed a great deal of information, and held a number of conversations with corporate credit union representatives and other providers of financial services. Based on what it has learned, the Working Group is of the view that a system that might evolve from the current corporate credit union network could well become the best provider of financial services to credit unions in the future. This is because credit unions have invested a substantial amount in the infrastructure of the corporate network, and the Working Group believes that a system that is owned and controlled by credit unions is likely to be best for credit unions in the long run.

However, this outcome is by no means assured. The future of corporate credit unions depends in part on the final corporate rule to be issued by NCUA, on the Agency's legacy asset plan, but most profoundly on whether or not corporates are willing and able to make the deep and far reaching changes necessary to succeed in the future. In other words, the future of corporate credit unions is uncertain. If the necessary changes do not occur, credit unions will have a variety of options other than corporates to meet their needs, although many credit unions will find these alternatives more costly and less service driven than they have experienced with corporates in the past. These fundamental changes in corporate credit unions, if they occur, will need to be driven by the members, boards, and management of corporate credit unions.

The remainder of this report:

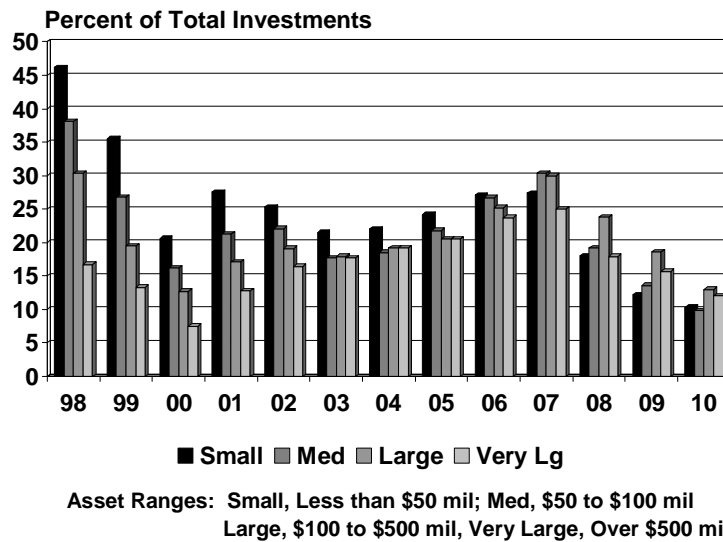
- Describes the types of services credit unions have in the past secured from corporate credit unions.
- Lists some of the alternate providers of these services that credit unions may use in the future.
- Discusses the selection and due diligence process that credit unions will need to use to determine their financial service providers.
- Outlines the current condition of corporate credit unions.
- Comments on the types of changes that corporates will need to make in order to remain important service providers to credit unions.

SERVICES HISTORICALLY PROVIDED BY CORPORATES

In the past, natural person credit unions have secured three types of services from corporate credit unions:

- **Investments.** Investments have ranged from overnight to term. Credit unions have for the last several years held about 60% of their cash and equivalents in corporates. This ratio has not changed much recently, nor does it vary much by asset size. For non-cash investments, historically smaller credit unions were much heavier users of corporates than were larger credit unions, although this has changed in the last decade, as is shown in the chart below.¹

Investments in Corporates as % of Total by CU Size



¹ Typically, non-cash investments are much greater than cash and cash equivalents. For the past several years, non-cash investments have averaged about three times cash and cash equivalents. The chart refers only to non-cash investments.

At the end of 1998, smaller credit unions—those with less than \$50 million in assets—held almost half (46%) of their non-cash investments in corporates. In sharp contrast, larger credit unions—those with assets over \$500 million—held barely a sixth (17%) of their non-cash investments in corporates. Over the following five years, smaller credit unions invested less in corporates, while larger credit unions invested more. By 2003, there was not much variation in the proportion of investments in corporates by asset size. Following that, from 2003 to 2007, credit unions of all sizes increased the proportion of their investments in corporates, and again there was little difference by asset size. Since then, as all credit unions have reduced investments in corporates, larger credit unions have tended to hold a greater proportion of their investments in corporates than smaller credit unions.

Finally, although the vast bulk of credit union deposits in corporates have been very short term, they have often been invested by corporates in longer maturity assets. In other words, corporates have historically engaged in maturity mismatching. This, along with significant concentrations in private label mortgage-backed and other asset-backed securities, contributed to high dividend rates paid by corporates, which no doubt attracted additional credit union funds from 2003 to 2007. Such maturity mismatching is unlikely to be permitted under the forthcoming corporate regulation.

- **Credit Services.** “Credit services” include both “liquidity services”-- lines of credit and short-term loans, and “term credit services”-- longer-term lending. Credit services include both actual loans from corporates to credit unions, and also the provision of lines of credit for potential credit union borrowing needs. Most of the longer-term borrowing that credit unions secure appears to be from outside the corporate network, e.g. from Federal Home Loan Banks. As of December 2009, of credit unions’ total outstanding borrowing of \$38 billion; only \$2.1 billion was from corporates.

Perhaps the most valued of the liquidity services provided by corporates has been not so much actual loans, but potential liquidity in the form of lines of credit to cover short-term cash needs. The aggregate amount of lines of credit from corporates to credit unions is very substantial, around \$30 billion, even though very little of these lines are used at any one time. Because the use of credit lines was relatively small in the past, corporates did not have to price them in a manner to limit use. As a result, what credit unions have paid in the past to corporates for short-term lines of credit is likely to be much lower than they will have to pay for such credit from other sources, especially from commercial banks.

- **Settlement, Payment, and other Correspondent Services.** Corporates offer a variety of services related to payments. Chief among these is the maintenance of a credit union’s core settlement account, and the provision of settlement to that account of all in-coming and out-going transactions caused by members’ use of their accounts at their credit union. Other correspondent services typically offered by some of the corporates are: item processing, ACH services, wire transfers, foreign exchange, coin and currency, ATM services, etc. Some of these services are provided directly by corporates, others by third parties contracted by the corporate.

As we have seen, the corporate credit union system has grown to offer a wide variety of services to credit unions. Although smaller credit unions may be more dependent on corporates than are larger credit unions, the vast majority of credit unions use, or up until recently used, corporates for a least some services. Indeed, the high corporate share of cash holdings and anecdotal evidence suggest that corporates have been very significant providers of settlement and payment services to credit unions of all sizes. The Working Group believes that this high market share is the result of the member service focus of corporates as member-owned cooperatives, and the attractive pricing corporates have offered across the board. This attractive pricing on all services has been supported by significant net interest income, generated both by the size of the investment portfolio and nature of the investments themselves, as described above. The Working Group encourages credit unions to be aware that in the future, the costs of these services, either from a revamped corporate credit union or an alternate provider, are likely to be higher than credit unions have been accustomed to in the past.

ALTERNATE SOURCES OF SERVICES

Given the recent turmoil in and uncertain future of the corporate credit union system, credit unions are having to consider alternate providers of the services they have in the past secured from corporates. There are a number of options. Indeed, some credit unions have for some time acquired many of their payment, investment, and credit services from these other providers. It is also quite possible that in the future many credit unions will find it most advantageous to spread the sourcing of these services over a variety of vendors, rather than using the equivalent of a primary financial institution. We describe below the variety of options available to credit unions.

Going forward, the primary options for credit unions for **investments services** are likely to be:

- **Corporate credit unions.** As described below, because of forthcoming capital requirements the Working Group believes it is very unlikely that corporates will be able to provide from their own balance sheets significant investment services to all but the very smallest credit unions. Credit union investments will most likely be comprised of obligations of other financial institutions (e.g. CDs), or securities. In that context, there could be important roles for corporates in the provision of brokered CDs, investment advisory services, broker dealer services, investment management, and securities safekeeping. Some corporates already have expertise in these services.
- **Other third party providers** of brokered CDs, broker dealer services, investment advisory and management services, and securities safekeeping.
- Regardless of what firm or entity a credit union uses to acquire investments in the future, those investment risks that used to be housed on a corporate's balance sheet will now reside on the balance sheet of the investing credit union. For some smaller credit unions that have relied exclusively on corporates for investment services, this will be a significant change. However, as the chart on page 2 shows, even small credit unions already hold most of their investments in institutions other than corporates, chiefly in brokered CDs.

Going forward, the primary options for credit unions for **credit services** are likely to be:

- **Corporate credit unions.** With the much smaller corporate balance sheets envisioned by the Working Group, only very small amounts of overnight liquidity are likely to be available directly from corporates. However, corporates may be able to arrange peer-to-peer lending facilities among member credit unions, or to serve as agents for Fed Funds transactions among members. They may also be able to secure liquidity, both short- and long-term, collateralized by pools of securities held and pledged by member credit unions. This would be a significant departure from how corporates have offered these services in the past, and will require corporates to develop new processes and infrastructure.
- **Federal Home Loan Banks.** For longer-term liquidity, the FHLBs are likely to remain a significant source of term credit for credit unions, so long as the current Home Loan Bank charter survives in its current form. Borrowing from the FHLBs requires collateral, and is not without risk as it also requires capital purchases based on usage.
- **Commercial banks.** Commercial banks can also provide lines of credit to credit unions, but the fees are likely to be substantially higher than credit unions are accustomed to paying. As a result, credit unions may find it economical to maintain higher average balances in their settlement accounts than they have traditionally. In addition, the reliability of banks as providers of liquidity and lines of credit is open to some question as many small businesses have recently found. A sudden change of ownership can result in an equally sudden shift in the product offerings and policies of a bank.

Going forward, the main options available to credit unions for **settlement, payments, and other correspondent services** will be:

- Continued service from a **revised corporate credit union system.** Without net interest income from a significant balance sheet to fund a portion of a corporate's operations, greater efficiency or modified pricing (see below) will be required.
- **Correspondent banks, or bankers' banks.** Some credit unions already use correspondents for some services. Bankers' banks as a group have recently experienced problems similar to those of the corporates, and hence do not appear to be that attractive an option. In both cases, the problems derived not so much from the settlement, payments, and other correspondent services, but from the balance sheets managed by the institutions. In the case of corporates, the balance sheet difficulties arose from investments, largely private label mortgage-backed and other asset-backed securities. At bankers' banks, the problems came from commercial loan portfolios, often acquired from their customer banks. However, established commercial banks that offer correspondent services could well be viable alternatives for credit unions, although the pricing and service level may not match what credit unions are accustomed to receiving from corporates.
- **Credit unions, groups of credit unions or CUSOs.** Individual credit unions could serve as "correspondents" to other credit unions. There have been some attempts by groups of credit unions to replicate the entire set of corporate services, but the attempts do not seem to be taking off. There are, however, a number CUSOs that

- provide many of the payments-related services that corporates do, particularly those that don't require a financial institution charter.
- **In-house processing.** One avenue would be for credit unions to provide for their settlement services through direct access to the Federal Reserve (Fed) and other payments processors and networks. The Working Group met with representatives of the Fed who expressed a willingness to serve credit unions. However, the Working Group has heard conflicting reports from others on the ability or willingness of the Fed to deal directly with a large number of smaller credit unions. While the Fed offers a powerful service package, financial institutions that use their services need to have a certain amount of in-house expertise to be able to use them. This interface with the Fed is one of the services corporates have provided in the past. Therefore, credit unions using this option will need to have or develop that expertise in-house, and this may be a considerable task. For credit unions wishing to conduct in-house processing, there are a number of third party payments processing vendors that provide various support tools and services. In general, in-house processing is not likely to be a viable option for smaller credit unions.
 - **Some combination of the above.** For many credit unions, this is the most likely outcome. Rather than securing the totality of the services that they may have in the past used a corporate for, in the future many credit unions are likely to acquire those services from a variety of vendors.

EVALUATING OPTIONS

The Working Group fully appreciates the difficulty credit unions face in evaluating and selecting providers of investment services, credit services, and settlement, payments, and other correspondent services. Whatever decisions credit unions eventually make, they will require thorough due diligence, and new levels of risk management. The decisions will require an assessment of the future viability of a corporate credit union or other vendor, and a mechanism to evaluate and compare proposals or bids from a large number of different types of vendors. Regardless of whether credit unions use corporates, other vendors, or a combination, credit unions will need to regularly assess the current and future viability of service providers going forward. The rest of this paper addresses the future viability of corporate credit unions. To assist credit unions in evaluating their many options, the Working Group is developing a Request for Proposal (RFP) Toolkit that will help credit unions analyze the advantages and disadvantages of various potential vendors.

FUTURE CORPORATE CREDIT UNION BUSINESS MODEL

CUNA's Corporate Credit Union Task Force, which preceded this Working Group, suggested the general outlines of a future business model for corporate credit unions. The Task Forces' report is available at: www.cuna.org/initiatives/corp_report. The model envisages much smaller balance sheets than corporates have held in the past, with a focus on payments-related services provided on a fee basis, and investment and credit services largely provided on an agent basis. The Working Group believes this general approach still describes what is most likely to be successful for corporates and acceptable and attractive to credit unions. To succeed, the corporate credit union of the future must deal with the following realities:

- Although credit unions hold a wide variety of attitudes toward their own corporate, the corporate brand has been substantially tarnished over the past few years. In general, the largest, possibly most efficient, full service corporates are the ones that generated the greatest investment losses for their members, and many of those members are quite angry. The losses have spilled over to all credit unions through the National Credit Union Share Insurance Fund.

Smaller corporates that acted essentially as “pass-throughs” to US Central did not create the investment losses themselves, but they relied in part on the aggressive investment practices of US Central to offer attractive investment yields and attractive settlement, payments, and other correspondent service prices to their members. They also relied heavily on the wholesale provision of correspondent services by US Central, and many do not have the infrastructure to provide a full range of services without US Central. Because of the anticipated requirements of NCUA’s upcoming corporate rule, a two-tiered corporate system is unlikely to persist in the future. As a result, these smaller corporates will have to find alternatives to meet the needs of their members.

- Most corporate capital has been depleted (see table below). Of the 26 retail corporates, only five have retained-earnings-to-asset ratios in excess of 0.2% (20 basis points.) Three corporates have contributed capital of more than 2% of assets, although it is likely not in the form that would qualify under the forthcoming NCUA corporate rule. Therefore, new and/or converted capital will be required. The amount of required capital will depend on the asset size of the corporate, at least 4% of total (not risk-weighted) assets according to the proposed corporate rule.

**Corporate Credit Union Capital Ratios
Number of Corporate Credit Unions in each Cell
April 2010. Excluding US Central.**

Ratio to Total Assets	Retained Earnings (RUDE)*	Contributed Capital	Combined RUDE & Contributed Cap
Negative	3	0	3
Zero	1	21	1
0 to 50 bp	19**	1	17
50 to 100 bp	2	1	0
1% to 2%	0	0	1
2% to 3%	0	2	1
Over 3%	1	1	3
Total	26	26	26
Average of all 26 Corporates	-6.2%	0.20%	-6.0%
Average of Those Positive	0.23%	1.63%	0.67%

*RUDE is Reserves and Undivided Earnings.

**Of these 19 corporates, 17 had RUDE to Asset ratios of less than 20 bp.

Given the recent performance of the corporate network, many credit unions are unlikely to be willing to place substantial amounts of new capital at risk for a very, very long term in a corporate credit union. However, despite their recent experience with the corporate network, even the most skeptical credit union may be willing to capitalize a corporate in the required amount of four percent of the credit union's settlement account, if that capitalization provides access to a strong, low-risk source of attractive settlement, payments, and other correspondent services. This is why the Working Group believes that very much smaller balance sheets than in the past will be required of successful corporates in the future. In any event, it will be important that corporates be allowed sufficient time once the new regulation is finalized to both shrink their assets and acquire additional capital.

- Without a sizeable balance sheet to generate net interest income to subsidize other services, corporates will be required to provide correspondent services on a fully fee-funded basis. In recent history, only one or two corporates have generated sufficient fee income to cover their operating expenses, and then just barely. The Working Group has been advised that the bulk of operating expenses other than overhead are generated by the delivery of payments, settlement and other correspondent services, rather than by investments. As a result, reducing the balance sheet itself is unlikely to reduce operating expenses by much. Therefore, in the future, credit unions may have to pay higher fees for payments and other correspondent services, but there will also be a tremendous premium on efficiency in corporate credit unions. This need for efficiency will at a minimum require intense collaboration among corporates in back office services, and more likely very substantial consolidation.
- Credit unions have grown accustomed to the availability of lines of credit from corporates at very attractive rates. Corporates have been able to provide access to such lines in part because of their substantial holdings of securities that could be pledged as collateral, and also because natural person credit unions were unlikely to draw on these lines, especially not all at once. Corporates will need to find ways to provide access to liquidity without substantial securities holdings on their own balance sheets. Options include peer-to-peer arrangements for transferring liquidity among credit unions (for example, acting as an agent for Fed Funds transactions among members), or arranging for lines of credit collateralized by pools of securities pledged by member credit unions.

The Working Group has reviewed the current financial condition of the corporates using Call Report data, and makes the following general observations:

- As described above, most corporate capital has been depleted (see the table on the previous page). Additional capital will be required, and the generation of retained earnings will take considerable time. Therefore, corporates will soon require additional infusions of very long-term contributed capital from member credit unions.
- Corporates operate with varying levels of efficiency, but no corporate has yet operated for very long in such a way that fee income comfortably covers operating expenses. In the twelve months ending in April, fee income in retail corporates averaged about 60% of operating expenses. At only one corporate did fee income exceed operating expenses, and then just barely. At another four corporates, fee

- income accounted for between 80% and 90% of expenses. At the other extreme, at twelve corporates fee income was less than 50% of operating expenses. Thus, the need for dramatic expense reductions is clear.
- The very largest corporates tend to have the following characteristics:
 - They have experienced the greatest investment losses, and therefore have generated the greatest ill will among members.
 - They tend to have the more substantial infrastructure that will be necessary to provide correspondent services.
 - The very smallest corporates tend to have the following characteristics:
 - To the extent they experienced investment losses, it was from their US Central exposures. A few of them have some remaining capital.
 - They tend not to have the infrastructure in place to offer, on their own, a full palate of payments, settlement, and other correspondent services. They have relied on US Central and others to provide those services. Under the proposed NCUA corporate rule, the continued existence of a two tiered corporate system (US Central as one tier and the retail corporates as the other tier) is very unlikely.
 - There are some corporates in between the largest and smallest corporates whose balance sheets are not quite as battered as the larger corporates, and that also have some of the infrastructure in place to offer correspondent services.
 - The Working Group believes there are substantial redundancies in the corporate network. Working through these redundancies will be a very difficult task in the coming few months. Smaller corporates will need to arrange for the wide variety of services they previously offered in conjunction with US Central. This will require either: (1) contracting with some new third party; (2) combining with other smaller corporates to secure the infrastructure; or (3) merging into a larger corporate with the necessary infrastructure. Among larger corporates, the issue for credit unions will be to determine which has the best infrastructure to efficiently provide services. The responsibility for bringing about the necessary changes lies with three groups: the members of corporates, the boards of corporates and the management of corporates.

CONCLUSION.

When the previous Task Force released its report in March, there was substantial resistance from corporate credit unions to the general outline of the business model the Task Force suggested. In more recent conversations the Working Group has had with several corporates, there appears to be a much greater acceptance of the need for substantial change in the general direction of the model suggested by the Task Force in order to attract credit union capital and acceptance.

However, the actual implementation of that change will be very difficult. In the future, there are likely to be many fewer corporates, employing many fewer staff and management, providing less local service than was the case in the traditional corporate model. Despite how difficult it will be to bring about those sorts of changes, the Working Group is convinced that substantial change is required, and soon, for corporates to become the viable and valued providers of service to credit unions that the Working Group hopes will be the case.

The Working Group is aware that corporates are working, singly and in groups, on strategies to respond to the new realities. The Working Group also understands that any final implementation of new strategies on the part of corporates cannot be accomplished until NCUA has released its plan to deal with the legacy assets. CUNA has expressed its concerns to NCUA on several occasions that the legacy assets plan must minimize costs to the Corporate Stabilization Fund (and thus all federally insured credit unions) while allowing corporates the room to reorganize, recover and grow in the future. Although credit unions need to be informed about a workable plan very soon, there should be no rush to dispose of the legacy assets in such a way that the costs are not minimized. Once the plan is released, the corporates will need to act quickly and decisively to build a new future. Even then, it is conceivable that the details of the final plan will make it difficult for some of the corporates to reorganize into viable entities.

The Working Group believes that the core of a viable and productive engine to meet the needs of most credit unions exists today within the corporate credit union system. However, it is not certain that those resources will be trimmed down and rearranged adequately or quickly enough to meet the needs of credit unions. In the resolution of these issues, it is the interests of credit unions that are paramount, rather than the interests of the current corporate credit union structure.

Submitted by the Corporate Credit Union Next Steps Working Group.

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