

# **U.S. Central 2008 Audited Financial Statements**

## **Questions and Answers**

Sept. 9, 2009

### **1. Why has issuance of U.S. Central's 2008 annual report been delayed?**

U.S. Central appointed Deloitte & Touche (D&T) as its independent auditor in October 2008, and some of D&T's work occurred prior to U.S. Central's March 20 conservatorship. U.S. Central's significant exposure to residential mortgage-backed securities (RMBS) resulted in extensive testing of valuation and impairment. In addition, after the National Credit Union Administration (NCUA) placed U.S. Central in conservatorship, the engagement began anew in some aspects, given the change in U.S. Central's management and board. The engagement was then subject to numerous national office reviews and additional requirements that extended the time frame of the 2008 audit.

### **2. Why did D&T issue a "qualified" instead of "unqualified" opinion regarding U.S. Central's 2008 financial audit?**

U.S. Central has always obtained a qualified opinion for the presentation of members' share and certificate accounts and Membership Capital Shares (MCS) on U.S. Central's balance sheet as equity (instead of liabilities). This presentation adheres to credit union law, rather than Generally Accepted Accounting Principles (GAAP). An explanation of the difference between the two methods of reporting appears in the opinion.

### **3. Why do "extra paragraphs" appear in D&T's audit opinion?**

The last three paragraphs emphasize significant events and accounting matters. One paragraph highlights the conservatorship and refers the reader to additional information contained in Note 1. The other two paragraphs alert the reader to new accounting guidance implemented during the year (SFAS No. 157 and 159) and the fact that, for one-third of U.S. Central's total assets, management estimated fair values (i.e. "Level 3") in the absence of readily determinable fair values, which is not uncommon for holders of RMBS.

**4. Does U.S. Central remain a viable credit union, and can it continue its traditional support of the credit union system?**

Yes.

The NCUA has pledged its continued financial support for U.S. Central in a variety of forms. These include guaranteed deposits, guaranteed debt of up to \$10 billion, a \$10 billion line of credit and a guaranteed retained earnings deficit of up to \$3 billion (if needed), in addition to the \$1 billion capital note provided in January.

The NCUA has made it clear that U.S. Central is to continue offering its products and services for the foreseeable future. U.S. Central's goal is to minimize losses to the National Credit Union Share Insurance Fund (NCUSIF). Under current market conditions, the board and management generally believe that losses will be minimized by continuing to hold the impaired assets and collecting principal and interest payments.

**5. What are the effects of the NCUA's conservatorship of U.S. Central?**

The NCUA placed U.S. Central into conservatorship with the intent of providing a financial backstop that would ensure U.S. Central's viability. This action has allowed the institution to continue providing the products and services necessary to maintain a properly functioning U.S. credit union system.

Upon conservatorship, the NCUA instructed U.S. Central staff to operate "business as usual," and that remains the institution's approach. U.S. Central continues offering the same products and services – APEX/ACH services, international wires, Corporate Network eCom services – as it did prior to conservatorship. In addition, conservatorship has not halted plans for new products and services, evidenced by eCom's recent introduction of MobileMember™, a service allowing credit union members to pay bills and view account information via their cell phones.

At the same time, conservatorship has afforded U.S. Central the opportunity to review and streamline its operations, and management has reduced expenses and improved efficiency throughout the institution, and will continue to do so.

**6. In January, the estimate for other-than temporary impairment (OTTI) charges on U.S. Central's 2008 income statement was \$1.2 billion. Why did that amount quadruple on the final 2008 financial statements?**

Upon conservatorship, U.S. Central's new board and management adopted a more conservative approach to estimating OTTI in the portfolio.

In addition, more securities were subsequently determined to have OTTI as of Dec. 31, 2008, as more information became available. Specifically, subsequent to January, the claims-paying ability of Financial Guaranty Insurance Company (FGIC) was deemed insufficient for covering its estimated losses. Accordingly, U.S. Central recorded

additional OTTI charges for securities insured by FGIC if, without the support of insurance, losses of principal or interest were projected as of Dec. 31, 2008. The FGIC adjustment represented a timing difference in recording OTTI as U.S. Central had recognized the impairment for first quarter 2009. Recognition of OTTI on two other bonds was likewise moved back from 2009 to 2008.

And finally, OTTI of \$9 million, representing impairment on one bond, was added to the Dec. 31, 2008, total after additional stress testing was performed.

**7. The Financial Accounting Standards Board (FASB) recently introduced new accounting rules for the recognition and presentation of OTTI. How does the OTTI on U.S. Central's financial statements reflect these new rules?**

FSP 115-2, issued by FASB in April, changes the calculation of OTTI charges by requiring "credit losses" to be recorded in earnings, with all other declines in fair value recorded in other comprehensive income/loss. As a result of adopting FSP 115-2 effective Jan. 1, 2009, U.S. Central reclassified \$3.7 billion of non-credit losses included in the \$4.9 billion of 2008 OTTI charges from retained earnings to accumulated other comprehensive loss (AOCL), a component of equity.

**8. What is the accumulated deficit shown in members' equity on U.S. Central's balance sheet?**

The accumulated deficit represents negative retained earnings.

As of Dec. 31, 2008, U.S. Central had an accumulated deficit that was greater than the combined total of Paid-in Capital (PIC) and Membership Capital Shares (MCS). Under the definitions of membership capital and PIC in Part 704.2 of Rules and Regulations of the NCUA, capital is available to cover losses that exceed retained earnings. However, the NCUA did not require U.S. Central to fully deplete all PIC and MCS accounts as of Dec. 31, 2008, because of the issuance of FSP 115-2 (see previous answer). The NCUA opined that the Dec. 31, 2008, depletion of PIC and MCS should be determined as if the Jan. 1, 2009, reversal of non-credit losses had occurred one day earlier.

The effect of the NCUA action was to preserve \$3.7 billion of member capital, rather than to restore U.S. Central's retained earnings, by the reversal of the non-credit losses.

**9. Why did the AOCL increase to nearly \$8 billion as of Dec. 31, 2008, from \$1.5 billion as of Dec. 31, 2007?**

AOCL represents the unrealized, mark-to-market losses on U.S. Central's security portfolio. Market conditions continued to deteriorate throughout 2008, resulting in

numerous downgrades and reduced availability of funding, both of which contributed to steep declines in fair values.

**10. What will be the effect on U.S. Central's OTTI and AOCL if market conditions improve the prices for investments in the institution's portfolio?**

OTTI charges are not reversed for future recoveries in fair value. If fair values increase in future periods, unrealized losses in U.S. Central's AOCL will decrease. If such increases in fair value are the result of a favorable change in projected cash flows (i.e., lower principal losses or higher projected interest) and not simply the result of a more liquid market, U.S. Central will record this effect as an increase in yield through the income statement on the affected securities in future periods.

**11. Considering the audited OTTI 2008 losses and projected 2009 losses, what changes has U.S. Central made in managing its investment portfolio?**

U.S. Central ceased purchasing securities in mid-2008. Since that time, all principal and interest payments received have been used to pay down borrowings and subsequently invested in short-term, low-risk money market accounts or left in U.S. Central's account with the Federal Reserve Bank of Kansas City.

**12. What actions has U.S. Central taken to shore up its ongoing operating finances?**

U.S. Central has achieved lower costs through an 18 percent reduction of staff in 2009, elimination of merit increases and incentive pay, revised cost-sharing with employees for health insurance, elimination of other employee benefits, and cancellation of travel, conferences and meetings. Based on 2009 budget projections, the institution has reduced its expenses by 25 percent compared with 2008. Management will continue searching for ways to improve U.S. Central's operating efficiency.

**13. Based on U.S. Central's weakened financial condition, how will the institution adjust its business plan going forward?**

As directed by the NCUA upon conserving U.S. Central, management has remained committed to providing products and services without interruption. As the NCUA continues the process of reforming the regulations that apply to corporate credit unions, U.S. Central management is evaluating various alternative future business models. In addition, by improving operating efficiency, management is preparing the institution to adapt as the future operating environment takes shape.