

## Report of the CUNA Corporate Credit Union Task Force

The mission of the CUNA Corporate Credit Union Task Force, in light of the current problems and issues in the corporate credit union system, has been to consider how natural person credit unions can continue to have access to key services such as settlement and payment services as well as liquidity and investment options, and to develop recommendations to the CUNA Governmental Affairs Committee and Board regarding CUNA's comment letter to the National Credit Union Administration on its proposed corporate credit union regulation.

Task Force has approached its mission with the following premises and guiding principles:

- In the resolution of the corporate credit union issues, the interests of natural person credit unions (credit unions) are above all others.
- Credit unions have made it clear that they are unwilling to invest significant amounts of capital in corporate credit unions (corporates) operating under the current corporate business model.
- Credit unions require access to settlement, payments, liquidity, investments and other correspondent services. It is preferable that the source of these services be entities owned and controlled by credit unions. It is not necessary that all of these services be provided by a single entity for each credit union.
- Credit unions will not accept entities to meet their financial services needs that impose significant risks to them, either in the form of exposure of the capital invested by credit unions in these entities, or through the share insurance fund. Credit unions want NCUA to help prevent another systemic crisis such as the one just experienced.
- Whatever entities emerge to serve the financial services needs of credit unions, they will require some level of capital from credit unions. The entities that succeed will be those that require less capital by assuming less risk, and that offer key services that are effective and of low cost to credit unions.

Based on these principles, the Task Force has concluded that the existing corporate business model no longer serves natural person credit unions well and is no longer viable. Several groups of credit unions are already developing cooperative models to replace it. After considerable input from credit unions, corporates, outside experts, NCUA, and others, the Task Force has developed a vision of the broad outlines of a new model that will be addressed in our comment letter, and it is described below.

The Task Force is aware that some corporates have concluded that they cannot operate under the proposed regulation. The Task Force concurs that without radical changes in the corporates' business model, their viable operation under the proposed regulation likely is impossible. However, credit unions are calling for a new business model that will require substantial improvements in operational efficiencies. Multiple operating systems of today cannot be supported in the future. If the corporate credit unions are to continue to play a role in serving credit unions, there will need to be significant changes in both their operations and functions, and substantial revisions in their business models.

The Task Force has concluded that with sufficient changes in the business model, broadly consistent with the model outlined below, corporates would be able to operate successfully under the proposal and serve natural person credit unions' interests well.

## A New Model for Credit Union Financial Services Entities

The Task Force has concluded that the business entities that meet the financial services needs of natural person credit unions in the future must operate according to a model that is quite different from the current corporate credit union model, in order to provide effective services and to minimize risks to the credit union system. It is possible that one or more of the current corporates could evolve into one of these entities.

There is a great deal of implementation detail that would be required to execute such a model, and a variety of options, that are beyond the purview of the Task Force. The Task Force is, however, convinced that future entities serving the financial needs of credit unions will have to adopt something along the lines of this model, and that such entities would be viable institutions serving the needs of all credit unions.

In general, the new model should have the following basic characteristics:

- Small balance sheets, comprised mostly of the settlement balances of credit unions.
- Provide payments and settlement services. Ideally, there would be a single national aggregation point for all such entities to concentrate daily settlement. This would protect credit union influence on the financial system and provide opportunities for economies of scale. Payments and settlement would not necessarily be provided by the same entity.
- Meet the short and medium term liquidity needs of credit unions by using, for example, one or more of the following mechanisms:
  - Acting as an agent or clearing house for credit unions to buy Federal Funds from other credit unions or financial institutions.

- Acting as an agent to facilitate inter-lending among credit unions for longer terms, using peer-to-peer lending systems or other systems.
- Securing lines of credit or term loans for credit unions based on pools of pledged collateral owned by credit unions.
- Meet investment needs of credit unions by using, for example, one or more of the following mechanisms:
  - Acting as an agent or clearing house for credit unions to sell Federal Funds to other credit unions or financial institutions.
  - o Operating or providing access to a money market mutual fund.
  - Operating or providing access to a family of other investment mutual funds.
  - Providing broker services.
  - Providing investment advisory or investment management services on a fee basis.
- The entity could provide the full range of other correspondent services on a fee basis.
- All services could be provided through the entity or through subsidiaries or vendors.

In short, the new model envisions institutions with much smaller balance sheets than existing corporates, acting more as agents than as principals, with investment risks remaining on natural person credit union balance sheets rather than being concentrated in a number of thinly capitalized wholesale institutions.

Although NCUA's proposed regulation does not explicitly require such a model, this approach would be very consistent with the proposed regulation. This is because the capital requirements, investment concentration limitations and ALM components of the regulation militate against large balance sheets at corporate credit unions.

In recognition of the need to address inadequacies in the current corporate credit union model, the Task Force has concluded that the main elements of NCUA's proposed regulation would help achieve the desired result of minimizing risks to natural person credit unions, and it is consistent with credit unions' need to avoid significant future losses. However, the Task Force has found that the proposed regulation overreaches in some areas, and has a number of suggestions for improvements.

The Task Force recognizes that there will be transitional difficulties in moving from the current system to a new model. It is not clear if some of the existing corporates will evolve to operate according to a new model, or if completely new entities will be formed. During the transition, it is imperative that NCUA, CUNA, Leagues, corporates and credit unions work together to minimize disruptions, such as loss of service or loss of capital. The continued availability of reliable and affordable payments and settlement services, liquidity and investment options, particularly to smaller credit unions, is vital.

Of singular importance is the treatment of the troubled legacy assets of the current corporates. Despite a number of communications from CUNA and others to NCUA, the Task Force remains concerned that NCUA has not provided sufficient transparency and accountability to credit unions on how it is planning to address the legacy assets to shield future providers of capital from having to absorb possible future losses from current corporate credit union assets. Further, NCUA's solution for addressing these assets should be disclosed to credit unions at least by the time the final corporate credit union regulation is adopted. These issues will be addressed again in a separate letter that CUNA will submit to NCUA.

The new model envisions the investments of credit unions being held directly on their balance sheets, rather than also being held on the balance sheets of corporates. Any risks inherent in these investments will therefore be born directly by natural person credit unions, which must maintain or develop the tools and resources to manage those risks as opposed to relying on corporates to handle them.

Under existing regulations, NCUA already has sufficient authority to regulate investment activity at the natural person credit union level. In fact, the Task Force recommends CUNA oppose any revisions to NCUA regulations concerning credit union investments (Part 703) based on the proposed changes to the corporate rules (Part 704), as unnecessary. In particular, many of the investment restrictions that might be appropriate for a corporate credit union are wholly inappropriate for a natural person credit union. This is because of the greater significance of member loans on natural person credit union balance sheets, their higher capital requirements, and the heavier restrictions on their investment options.

Credit unions will ultimately have to capitalize the financial services entities that will meet their correspondent services needs into the future. In formulating the outline of the model described above, the Task Force was ever mindful of the need to minimize both the amount of capital required, and the risks to that capital. This is primarily why the Task Force has concluded that a successful business model must maintain a relatively small balance sheet. Natural person credit unions must perform a similar analysis when deciding what entity or entities to capitalize in the future. In the view of the Task Force, entities that propose to operate under a business plan consistent with the one outlined above will be the most likely to succeed.

The Task Force is also concerned that in the context of these issues, there appears to be a widespread lack of knowledge and information about future risks to natural person credit unions. The Task Force has concluded that it is essential that NCUA, CUNA, the Leagues, and credit unions work together to provide more

information and education to credit union officials regarding the risks they are facing and how such risks could be minimized.

While the Task Force agrees with NCUA's overall objectives and the approach of the proposed corporate credit union regulation, it nonetheless concluded that substantial changes are necessary to ensure future entities will be able to operate in the best interests of natural person credit unions. Based on this view, the following are the key areas the Task Force recommends should be addressed in the final rule.

- The Task Force is particularly concerned about the transition period from the current system to a new model. The Supplementary Information to the proposal provides, "NCUA has the authority in appropriate cases and within the context of a carefully crafted investment action plan, to permit individual corporates to operate outside" certain limits of the proposal. Also, the proposal has provided a phase-in of key components of the regulation, such as the capital requirements. Nonetheless, the proposal does not sufficiently describe how a transition period could work. In light of this, substantive issues associated with the transition must be addressed in the final rule. This should include NCUA's role in helping to ensure the transition is orderly and successful. For example, NCUA should consider changes to the characteristics of contributed capital accounts that would facilitate a transition. Most important, the Task Force recommends that elements of the share guarantee program be extended while the corporate's legacy assets remain an issue.
- The proposal delineates required capital levels, which appear to be reasonable. However, the agency would reserve broad authority for itself in several areas, such as requiring additional capital of individual corporate credit unions as well as redesigning the risk-weighting of assets, as it deems appropriate under the provisions of the proposal. One of the reasons for a regulation is to provide certainty as to its requirements to stakeholders. This objective is undermined by such broad and potentially arbitrary authority, which would allow the agency to impose much more stringent requirements.
- In general, the Task Force concludes that the corporate governance requirements are too prescriptive and some of them are unnecessary. For example, the prohibition on indemnification of officials and the cumbersome requirements for disclosure of executive compensation should be addressed. While the Task Force agrees that executive compensation information should be available for review by members, it recommends that executive compensation disclosures follow standard formatting and guidelines used by other entities for the disclosure of such information.

- The Task Force concludes that there could be real benefits to corporate entities of having directors with specific expertise and recommends that NCUA permit up to 20% of the directors of a corporate entity be "outside" directors.
- Provisions in the proposal regarding derivatives are too limited and corporate entities should be able to offer derivatives to help natural person credit unions hedge their risks.
- Credit Union Service Organization models could be useful in the delivery
  of certain key services to natural person credit unions. The process for
  allowing CUSOs to develop new services that are not already approved is
  too burdensome and should be improved to facilitate the use of CUSOs.
- NCUA is engaging a third party to review its analysis and modeling under the proposal. NCUA should direct the third party to independently develop assumptions, particularly in the areas of ALM and testing, and provide a full accounting to credit unions of the third party's scope of review and findings.
- As stated above, NCUA must address the issues presented by the legacy assets by the time the final corporate credit union rule is approved.
- NCUA should not regulate natural person investments at this time or in the future by importing provisions into rules for natural person credit unions that are only appropriate for the regulation of corporate entities.

Because the costs natural person credit unions must bear now and into the future as a result of the risk-taking by corporates that was not offset by sufficient capital, few issues are more important to the credit union system than ensuring future risks associated with delivery of settlement, payment and liquidity services will be well-managed and thus, minimized.

In light of the magnitude of these issues, the Task Force urges the CUNA GAC and Board to support its recommendations detailed above that:

- call for a new business model for the delivery of key services to natural person credit unions;
- support NCUA's basic regulatory framework as contained in its corporate credit union proposal, while urging significant changes;
- request NCUA to address the transition period from the current corporate system to a new business model;
- request NCUA be more accountable to credit unions on the handling of the corporates' legacy assets; and
- encourage the entire credit union system to become better informed about the significance of these issues.

## Submitted February 2010

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