United States Government Accountability Office

GAO

Report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

September 2004

CORPORATE CREDIT UNIONS

Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA Oversight

GAO

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GAO-04-977

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Highlights

Highlights of GAO-04-977, a report to the Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

Thousands of credit unions have placed about $55 billion of their excess funds in corporate credit unions (corporates). In a three-tiered system, corporates provide lending, investment, and processing services for their member credit unions. Problems with investments in the past prompted regulatory changes that required higher capitalization and stricter risk management, but allowed for expanded investment authorities. GAO assessed (1) the changes in financial condition of the corporate network and (2) the oversight of corporates by the National Credit Union Administration (NCUA), the federal regulator of credit unions.

What GAO Recommends

To improve oversight of corporates, GAO recommends that the Chairman of NCUA (1) establish a process and structure to systematically involve specialists in identifying and addressing problems, (2) track and analyze examination deficiencies to address complex and emerging issues, (3) pay increased attention to oversight of corporates' risk management functions, (4) provide improved guidance to corporates and examiners for preparing and reviewing merger packages, and (5) require internal control reporting consistent with other financial institutions. NCUA agreed to implement all of these recommendations, except for providing improved guidance to examiners reviewing mergers.

www.gao.gov/cgi-bin/getrpt?GAO-04-977.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Richard J. Hillman at (202) 512-9073 or hilmanr@gao.gov.

September 2004

CORPORATE CREDIT UNIONS

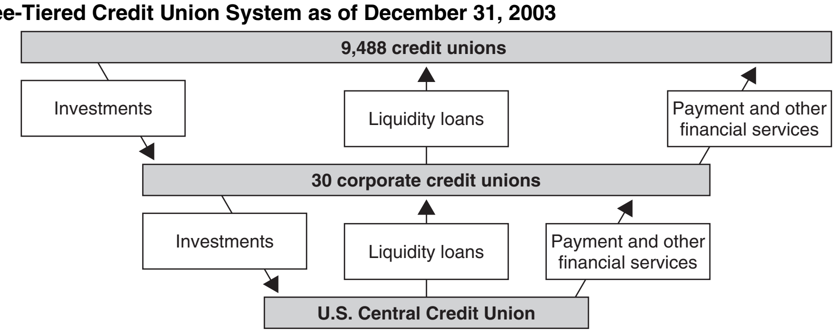
Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA Oversight

What GAO Found

Corporates face an increasingly challenging business environment that potentially could stress their overall financial condition. In response to the competitive environment, corporates are offering new and more sophisticated products and services, expanding their use of technology, and seeking opportunities to merge or collaborate with other corporates. The corporates' financial condition as measured by profitability and capital ratios remained close to a range that has prevailed since the mid-1990s. However, since 2000, a large influx of deposits, coupled with low returns on traditional corporate investments, has constrained earnings and caused a downward trend in corporates' overall profitability. To generate earnings, corporates increasingly have targeted more sophisticated and potentially riskier investments, but appear to be managing risk by shifting toward more variable-rate and shorter-term investments, providing a potentially better match for the relatively short-term nature of their members' deposits. However, the corporates' changing business environment and utilization of more sophisticated and riskier investments increases the importance of NCUA regularly assessing its oversight processes to ensure that corporates are properly managing these risks.

NCUA has strengthened its oversight of corporates by creating a centralized office for oversight, revising regulations, implementing risk-focused supervision, and hiring specialists. However, NCUA faces challenges in identifying networkwide problems on a consistent basis, using specialists effectively, providing relevant guidance on mergers, and assuring the quality of corporates' internal controls. Although NCUA identified deficiencies during its examinations, it has not systematically tracked their resolution or evaluated trends in examination data, which could help anticipate emerging issues facing corporates. NCUA also did not fully consider all risks when allocating resources or assigning specialists to examinations, leading to NCUA overlooking some information system deficiencies. Although corporates continue to consider mergers to remain competitive, NCUA had not developed adequate guidance for submitting and reviewing merger proposals. Finally, NCUA has not ensured that corporates' internal controls have remained consistent with those of similarly sized financial institutions.

Three-Tiered Credit Union System as of December 31, 2003



Sources: Call report data and U.S. Central.

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Abbreviations

ACCU	Association of Corporate Credit Unions
ACH	automated clearing house
ALM	asset/liability management
CLF	Central Liquidity Facility
CMO	collaterized mortgage obligation
corporates	corporate credit unions
CRIS	Corporate Risk Information System
CUGR	U.S. Central Grantor Trusts
CUSO	Credit Union Service Organization
DANA	daily average net assets
DCI	data collection instrument
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FFIEC	Federal Financial Institutions Examination Council
FRAP	floating rate asset program
NCUA	National Credit Union Administration
NCUSIF	National Credit Union Share Insurance Fund
NEV	net economic value
OCC	Office of the Comptroller of the Currency
OCCU	Office of Corporate Credit Unions
OSPSP	Office of Strategic Program Support and Planning
OTS	Office of Thrift Supervision
REMIC	real estate mortgage investment conduit
RUDE	reserves and undivided earnings
U.S. Central	U.S. Central Credit Union

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, D.C. 20548

September 10, 2004

The Honorable Paul S. Sarbanes
Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

Dear Senator Sarbanes:

Thousands of credit unions have placed about $55 billion of their excess funds in corporate credit unions for investment purposes. Under a three-tiered system, corporate credit unions (corporates) are member-owned financial cooperatives whose members are credit unions, not individuals. As the "credit union for credit unions," corporates provide deposit, liquidity, investment, and processing services for their members. In turn, the member credit unions have about 82 million members, to whom they provide deposit, loan, and some investment services. U.S. Central Credit Union (U.S. Central), a nonprofit cooperative, is owned by corporates (serves as the "corporate for the corporates") and it serves its members much like corporates serve their credit union members—which the federal regulator for credit unions, National Credit Union Administration (NCUA), and the corporate network refer to as natural person credit unions.[1]

We last conducted a comprehensive review of corporates and their oversight by NCUA in 1991.[2] In addition, we conducted more targeted reviews of corporates in 1994 and 1995 in response to the failure of a large corporate in the mid-1990s.[3] Since that time, assets placed in corporates have grown, corporate credit union business strategies have changed, and

[1]NCUA's authority over corporate credit unions exists in NCUA's general regulatory powers under section 120(a) of the Federal Credit Union Act. See 12 U.S.C. § 1766(a) (2000); see also, 12 C.F.R. § 704.1 (2004).

[2]GAO, *Credit Unions: Reforms for Ensuring Future Soundness*, GAO/GGD-91-85 (Washington, D.C.: July 10, 1991).

[3]See GAO, *Corporate Credit Unions: Conditions, Issues, and Concerns*, GAO/T-GGD-95-15 (Washington, D.C.: Oct. 6, 1994). In addition, see *Credit Unions: The Failure of Capital Corporate Federal Credit Union*, GAO/T-GGD-95-107 (Washington, D.C.: Feb. 28, 1995) and *Credit Unions: Proposed Reforms for Corporate Credit Union Regulation*, GAO/T-GGD-95-115 (Washington, D.C.: Mar. 8, 1995). These testimonies described the reasons for the failure and provided recommendations to Congress and NCUA to improve the safety and soundness of corporates.

NCUA has significantly changed its approach to oversight. In light of the evolution of corporate credit union operations and the change in NCUA's supervisory approach, and as part of our overall review of the credit union industry, you asked us to review a number of issues involving corporates and NCUA.[4] Based on discussions with your staff, we assessed (1) the changes in financial condition of corporate credit unions since 1992 and (2) NCUA's supervision and oversight of corporates, particularly with regard to how it identifies and addresses safety and soundness issues.

To assess the changes in the financial condition of corporates, we analyzed corporate credit union call report data from December 1992 to December 2003, and reviewed internal corporate credit union analyses and independent studies of the industry from rating agencies.[5] We also conducted a legislative and regulatory review to determine the key legislative and regulatory changes affecting corporates since 1992. To depict the business environment that can affect the financial condition of corporates, we administered a questionnaire to all 31 currently operating corporates, and interviewed NCUA and credit union trade organization officials. To assess how NCUA's supervision of corporates identified and addressed safety and soundness issues, we reviewed NCUA documentation on its risk-focused examination program and reviewed examinations and NCUA management reports for all corporates from 2001 through 2003. We also conducted a detailed review of NCUA workpapers for 10 corporates and interviewed the examiners who were responsible for supervising these corporates. In addition, we conducted site visits to seven corporates, selected based on their size, geographic location, and whether they were state or federally chartered, or were granted expanded investment authorities.[6] Appendix I provides additional details on our scope and

[4]See GAO, *Credit Unions: Financial Condition Has Improved, but Opportunities Exist to Enhance Oversight and Share Insurance Management*, GAO-04-91 (Washington, D.C.: Oct. 27, 2003).

[5]A call report is a periodic (for example, monthly or quarterly) statement detailing income and certain financial condition information, which is filed by an institution with its regulator. Corporate credit unions currently file the Form 5310 monthly with NCUA. See appendix I for more information.

[6]As part of NCUA's revision of Part 704 of its rules and regulations, corporate credit unions that meet applicable requirements of this rule and fulfill additional management and infrastructure requirements are allowed to invest in a broader array of products, such as lower-rated investments and certain foreign investments, and engage in derivative transactions. See 12 C.F.R. Part 704, App. B (2004); see also, 67 Fed. Reg. 65640, 65658 (Oct. 25, 2002).

methodology. Appendix II provides a list of all 31 corporates that were active as of December 31, 2003, and appendix III contains a copy of the structured questionnaire. We conducted our work in Alexandria, Virginia, Washington, D.C., and other U.S. cities from December 2003 to September 2004 in accordance with generally accepted government auditing standards.

Background

Corporate credit unions occupy a unique niche among financial institutions.[7] They are nonprofit financial cooperatives that are owned by natural person credit unions (that is, credit unions whose members are individuals), and provide lending, investment, and other financial services to these credit unions. For example, corporates offer loans to member credit unions, which in turn use these loans to meet the loan demands of their individual members. However, corporates are not the only financial institutions that provide products and services to credit unions. For example, some credit unions may also obtain loans from Federal Reserve Banks or Federal Home Loan Banks.[8] Additionally, corporates offer credit unions investment products and investment advice, but credit unions can also obtain these services from broker-dealers or investment firms. Finally, corporates also offer automated settlement, securities safekeeping, data processing, accounting, and electronic payment services, which are similar to the correspondent services that large commercial banks have traditionally provided to smaller banks. With an emphasis on safety and liquidity, corporates seek to provide their members with higher returns on their deposits and lower costs on products and services than can be obtained individually elsewhere. However, corporates' limited ability to generate profits—as nonprofit institutions, owned and controlled by their primary customers—constrains their ability to build a financial cushion against adverse financial conditions or unexpected losses.

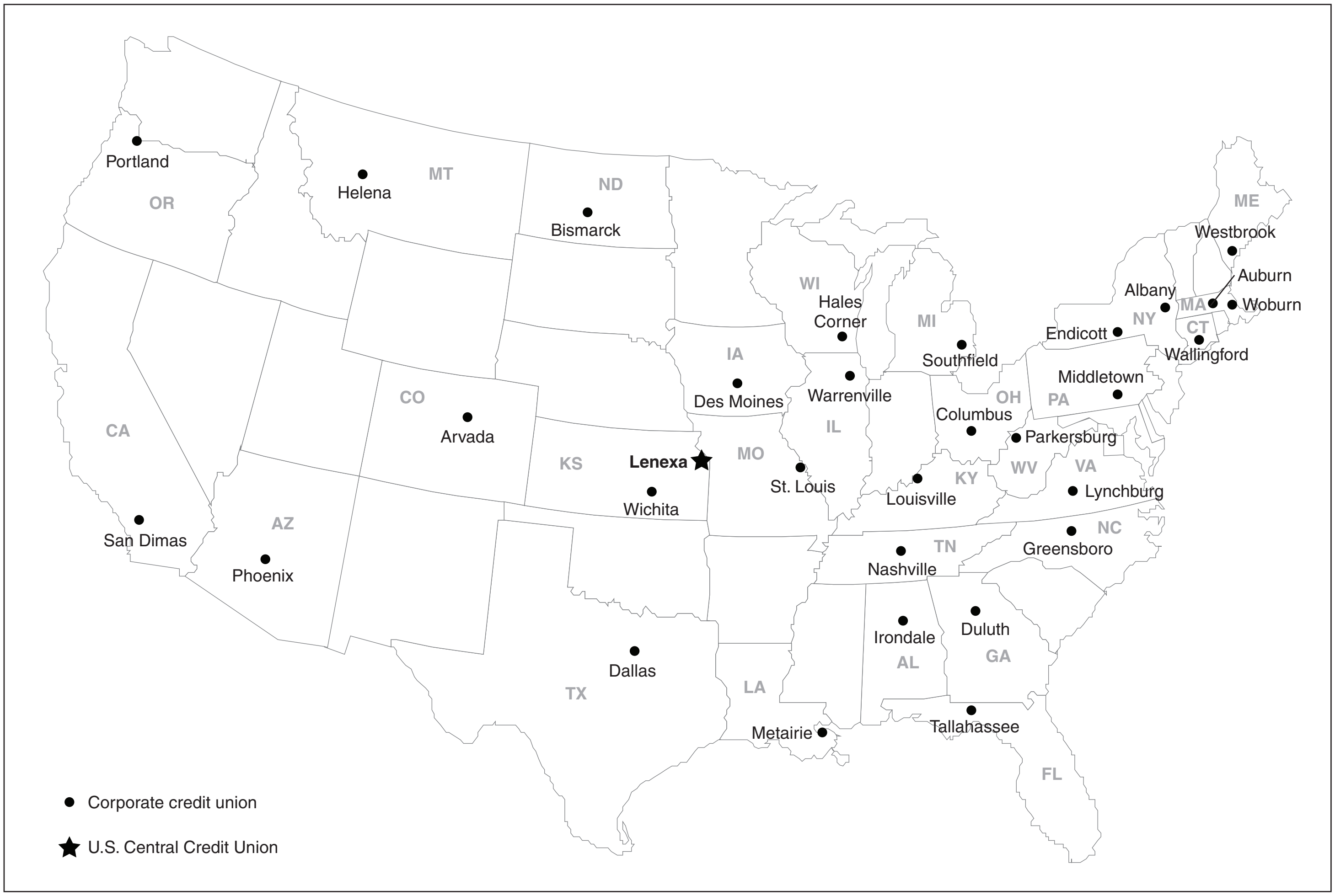
[7]In this report, we refer to the retail corporate credit unions as "corporates," emphasizing the distinction between these institutions and U.S. Central, which is a wholesale corporate credit union. We refer to corporates and U.S. Central as the "corporate network."

[8]In addition, the Central Liquidity Facility (CLF) is a source of funds for credit unions. Congress created CLF, which is managed by NCUA, in 1978 to improve the financial stability of credit unions by serving as a lender to credit unions experiencing unusual or unexpected shortfalls in funds. Most credit unions join CLF through their corporate, which acts as an agent for its members.

Since 2000, corporates have experienced deposit inflows from natural person credit unions that increased corporates' assets and shares. Corporates act as a "liquidity sponge" for the underlying natural person credit union system, and the cyclical rise and fall of corporates' assets and shares (deposits) are rooted in the deposit flows of the natural person credit unions. Thus, these inflows and outflows of deposits, which are beyond corporates' control, affect their measures of financial strength—such as profitability and capital ratios. As we discuss later in the report, this has exacerbated the stress on their financial condition.

Since 1992, the number of corporates in the corporate network has decreased, with assets more concentrated in larger institutions. (See fig. 1 for an illustration of the network's geographic distribution.) Mainly as a result of mergers, corporates have decreased in number from 44, at the end of 1992, to 30 as of December 31, 2003, excluding U.S. Central. On average, corporates also have become larger, with the median asset size (excluding U.S. Central) increasing from $450.6 million in 1992 to $1.2 billion at the end of 2003. However, the corporate network still encompasses small and large institutions, ranging in size from $7.3 million in assets to $25 billion, as of December 31, 2003. In addition, asset concentration in the network has become more pronounced since 1992. Excluding U.S. Central, at the end of 1992 the three largest corporates accounted for approximately 42 percent of the corporates' total assets. By the end of 2003, these corporates accounted for roughly half of corporates' total assets and the largest corporate accounted for about one-third.

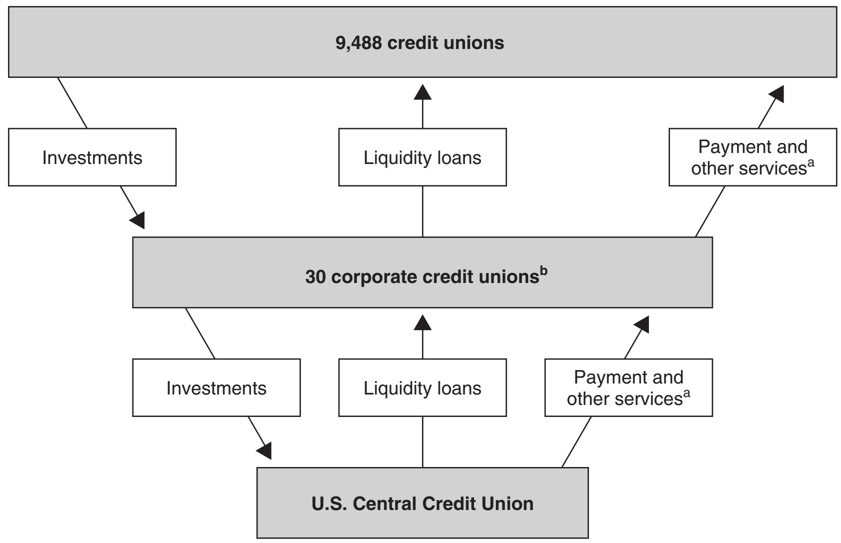
Figure 1: Location of Corporate Credit Unions, as of December 2003



Source: NCUA 2003 Annual Report.

As shown in figure 2, the credit union industry is organized into three closely connected groupings. At the “top” or retail level, as of December 31, 2003, there were the 9,488 credit unions that served roughly 82 million individual customers. In the middle are the 30 corporates, which serve credit unions by investing the cash they have not lent out and by providing loans and other financial services to the credit unions. Finally, on the “bottom” or wholesale level is U.S. Central, which provides corporates a range of products and services, similar to those that corporates provide to credit unions.

Figure 2: Services Provided to Natural Person Credit Unions by Corporate Credit Unions and U.S. Central Credit Union, as of December 31, 2003



Sources: Call report data and U.S. Central.

[a]Includes cash management products and services, risk management, settlement, and funds transfer.

[b]Twenty-nine corporates are members of U.S. Central Credit Union. LICU Corporate Federal Credit Union is not a member of U.S. Central. LICU Corporate was originally established as a corporate credit union to facilitate payment and payroll processing for a league of IBM credit unions. While LICU Corporate and U.S. Central have discussed the possibility of LICU Corporate joining U.S. Central, LICU has not applied for membership.

Since their inception, corporates' primary functions have been to accept deposits and make loans to their members. In addition, today, they also provide investments and other financial services to credit unions, and corporates over time have broadened the types of products and services they offer. Most corporates offer

- investment services;
- electronic services, such as the Automated Clearing House (ACH) and wire transfers;
- correspondent services, such as settlements with the Federal Reserve and other financial institutions;
- check services, including collection and settlement of money orders and traveler's checks;

- credit card settlement; and
- education and training.

However, corporates now offer or plan to introduce new products and services such as online training, electronic bill payment, Internet banking, asset/liability management (ALM), and brokerage services.[9] For more detailed information on the products and services corporates offered or planned to offer, see appendix IV.

While the first credit union in the United States started in 1909, the first corporate did not start operations until 1968.[10] Many corporates grew out of the various state credit union leagues and initially served only single states or regions. Over time, corporates were granted national fields of membership that allowed them to expand the number of credit unions they served. While corporate credit union membership can be national, corporates can have either a state or federal charter. As of December 31, 2003, 18 of the 31 corporates, including U.S. Central, were state-chartered. In terms of oversight, NCUA has authority for supervision and examination of federally chartered corporates. Under the dual-chartering system, the supervisory authorities for those states that have state-chartered corporates are primarily responsible for supervision of these institutions. However, since all corporates provide deposit, liquidity, and correspondent services to federally insured credit unions, NCUA also has regulatory authority over state-chartered corporates and assesses the risks federally insured, state-chartered corporates and noninsured, state-chartered corporates present to the National Credit Union Share Insurance Fund (NCUSIF).[11] This assessment, which is essentially an examination of the

[9]Asset/liability management is the process of evaluating interest-rate and liquidity risk and making decisions about the mix of assets and liabilities to hold, which enable a credit union to remain financially viable as economic conditions change. Interest-rate risk is the potential for lower earnings and capital resulting from interest-rate changes. Liquidity risk is the risk that a sudden withdrawal of deposits by natural person credit unions will force the corporate to sell assets quickly to cover the withdrawals.

[10]U.S. Central started operations in 1974.

[11]NCUSIF provides primary deposit insurance up to $100,000 per member per qualifying account. In the case of corporates, the members are natural person credit unions. Since the insurance coverage is very small compared with the deposits natural person credit unions have in corporates, most of these deposits are not federally insured. One state-chartered corporate does not have insurance coverage by NCUSIF. NCUA administers NCUSIF, which is funded by credit unions that deposit 1 percent of their insured shares into NCUSIF.

corporates' operations, is performed jointly with state supervisory authorities during their examinations of state-chartered corporates.

Part 704 of NCUA's regulations, together with the relevant provisions of the Federal Credit Union Act of 1934, constitutes the primary federal regulatory framework for both state- and federally chartered corporates.[12] NCUA first issued Part 704 in 1982. Since our previous report on corporates in 1991, NCUA made significant revisions to Part 704 in 1998 and 2002 relating to risks, capital, investments, and other areas covered by this report.

Results in Brief

Corporates face an increasingly challenging business environment that has created potential stresses on their financial condition. Like other financial institutions, corporates operate in an environment characterized by increasing competition, changing product and service offerings, and the continuous introduction of new technology—thus increasing the complexity of their operations, which in turn can impact their financial condition. The corporates' financial condition, as measured by profitability (the ratio of net income to average assets) and capital ratios, remained close to a range that has prevailed since the mid-1990s. However, since 2000, a large influx of deposits coupled with low returns on traditional corporate investments has caused a downward trend in corporates' overall profitability because deposits/assets have grown more quickly than income. More recently, the relatively slower growth in retained earnings (a component of income) has also put pressure on capital ratios, which raises some concern since capital ratios are an important indicator of financial strength. To generate earnings, corporates increasingly have targeted more sophisticated and potentially riskier investments. However, corporates appear to be managing risk by shifting toward more variable-rate and shorter-term investments, providing a potentially better match for the relatively short-term nature of their members' deposits and managing its other risks. Further, NCUA recently permitted the three largest corporates to invest in lower-rated securities, potentially increasing their credit risk (that is, there is a higher risk of nonpayment on assets held by the corporate), but their use of this expanded authority has been negligible to date. The corporates' changing business environment and their use of more sophisticated and potentially riskier investments increases the importance

[12] 12 C.F.R. Part 704 (2004).

of NCUA regularly assessing its oversight processes to ensure that corporates are properly managing these risks.

NCUA has strengthened its oversight of corporates, which has allowed it to better address safety and soundness issues; however, NCUA faces challenges in identifying networkwide problems on a consistent basis, using specialists effectively, providing relevant guidance on mergers, and assuring the quality of corporates' internal controls. Since 1991, NCUA has created an office dedicated to the oversight of corporates—the Office of Corporate Credit Unions (OCCU)—significantly revised regulations specific to corporates, implemented risk-focused supervision and examinations, and hired specialists in areas such as capital markets and information systems. Based on our review of NCUA examinations for 2001 through 2003, NCUA examiners generally have identified safety and soundness issues and mandated corrective actions to address them. However, NCUA has not tracked or systematically evaluated trends in examination findings and their resolution to help its examiners anticipate emerging issues within the corporate network. Further, NCUA has not systematically considered certain operational risks, such as weak information system controls, when assigning specialists to examinations. This may have led to NCUA overlooking certain problems or not ensuring that problems were corrected in a timely manner. In addition, although it has responsibilities to approve proposed mergers, we found that NCUA had not developed specific guidance for corporates submitting merger proposals or ensured that the guidance examiners used to assess these proposals was comprehensive and clearly applicable to corporates. For example, NCUA has referred corporates to guidance issued for natural person credit unions that provides step-by-step instructions for completing the merger process, but the capital ratios were not relevant for evaluating corporates' proposals. During our review of five recent mergers, we found that NCUA did not conduct their reviews in a consistent manner; additionally, we could not always determine why NCUA reached certain decisions concerning these mergers. In an increasingly competitive environment in which corporates are considering mergers to remain competitive, nonspecific guidance and inconsistent reviews of merger proposals might lead to mergers that would not be in the best interest of members and would present undue risks to the network's safety and soundness. Finally, as corporates introduce new technologies and offer their members more sophisticated products and services, NCUA's oversight of corporates' internal controls has become more important. However, corporates are not subject to the internal control reporting requirements imposed on other financial institutions of similar size that help to ensure safety and soundness, as defined under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This raises a question about whether NCUA has the necessary information to assess corporates' internal controls.

This report contains recommendations to NCUA that, if implemented, would provide a more systematic and consistent approach to NCUA's oversight of corporates to help achieve its goal of promoting a network of financially healthy, well-managed federally insured corporates.

We requested comments on a draft of this report from the Chairman of the National Credit Union Administration. We received written comments from NCUA that are reprinted in appendix VIII. NCUA concurred with most of our assessments and conclusions and agreed to take action to implement all but part of one of our report's recommendations. NCUA's comments and our response are discussed at the end of this report.

Corporate Network Faces an Increasingly Challenging Business Environment, Creating Potential Stress on Its Financial Condition

Like other financial institutions, corporates face a challenging business environment that affects their financial condition and is characterized by increasing competition, changing product and service offerings, and rapid technological advances.[13] Moreover, recent pressure from a low-interest-rate environment and rapid growth in assets has put additional stress on the corporate network's profitability and capital ratios.[14] While net income levels have grown since 2000, corporates' profitability was lower in 2003 than in 1993. As rapid asset growth negatively impacts profitability, it affects corporates' ability to generate sufficient retained

[13]We assessed the financial condition of the corporate network by the overall profitability, capital ratios, and assets of the corporates and U.S. Central. Assets include cash, investments, and loans, among other things. Profitability is the ratio of net income to average assets. Capital, which represents the long-term funding of a financial institution, enables a corporate to continue to fund operations, generate earnings, and grow, and it also provides a cushion to absorb unexpected losses. A capital ratio is the ratio of capital to average assets, which takes into account the size of an institution.

[14]Our quantitative analysis is based on publicly available balance sheet and income statement information from call reports and annual reports, unless otherwise noted. We generally separated U.S. Central from the corporates to control for the interrelationship that exists between the corporates and U.S. Central, in which a substantial portion of corporates' assets is held by U.S. Central and contributes to its capital. U.S. Central's overall financial holdings and investments tend to parallel those made by other large corporates. For more information on the financial condition of U.S. Central, see appendix VI.

earnings—the primary component of their capital.[15] As overall capital levels have been rising, corporates have been relying more on less permanent (relatively weaker) forms of capital. Additionally, rapid asset growth and the relatively slower growth in retained earnings has put pressure on corporates' capital ratios, which could be a cause for concern since capital ratios are an important indicator of financial strength. Growth and changes in corporate investments, such as recent shifts of more of the corporates' investment portfolios into potentially higher yielding and more volatile securities, may increase interest-rate risk if the investments are not managed properly. In particular, the percentage of corporate investments in obligations of U.S. Central has declined while the percentages of corporates' investments in privately issued mortgage-related and asset-backed securities have increased.[16] Corporates appear to be managing risk by shifting toward more variable-rate and shorter-term securities, providing a potentially better match for the relatively short-term nature of their members' deposits. However, a regulatory change effective in 2003 allowed certain corporates to purchase securities with lower credit quality (more credit risk), raising implications for NCUA oversight since this activity may lead to increased risk if it is not managed properly.

The Challenging Business Environment in Which Corporates Operate May Impact Their Financial Condition

Corporate credit unions are operating in a challenging business environment characterized by increased competition, pressure to increase returns on their investments in a low-interest-rate environment, and the need to invest in technology and personnel to meet the demands of their credit union members for new and more sophisticated products and services. To obtain the corporates' views on their business environment, we distributed a questionnaire to the entire network and achieved a 100 percent response rate. The corporates reported that they faced competition from outside the corporate network from entities such as banks, broker-dealers, the Federal Reserve System, and Federal Home Loan Banks. About 87 percent of the corporates reported that they also faced competition from other corporates despite the cooperative nature of the network. In addition, in recent years (since 2000), corporates have received a large inflow of deposits from their natural person credit union members,

[15]A corporate's retained earnings are the key component of its capital, as they represent the corporate's net income not distributed to members and, as they are generated internally, are the most permanent form of capital.

[16]These include investments usually secured by mortgages, automobile loans, or credit cards.

which had increasing amounts of unloaned funds because of the "flight to safety" that occurred in the wake of the stock market downturn.[17] These inflows increased corporates' assets, pressuring them to ensure that they received sufficient returns when investing these funds to maintain adequate capital levels and fund operations. However, over the last several years, low interest rates have reduced the returns that corporates could obtain on their investments, which has put stress on their overall profitability. Finally, the corporates stated that they faced a rapidly changing marketplace, particularly related to the increased demands from credit unions for more sophisticated products and services such as electronic banking.

The strategies corporates have employed to respond to their challenging business environment can have positive or negative impacts on their overall financial condition. For example, over time, corporates have increasingly invested in securities such as privately issued mortgage-related and asset-backed securities and less so in obligations of U.S.Central, suggesting that they are seeking to enhance the yields on their investments. As corporates shift their investments into potentially higher-yielding securities, the network could face increased risks if individual corporates do not have adequate infrastructure in place to manage risks associated with their investments.[18]

Increasing competitive pressures may have encouraged consolidation, through mergers within the network, as corporates sought to achieve economies of scale. Consolidation is likely to continue as 7 of the 30 corporates responding to our questionnaire stated that they were likely or would consider merging in the next 2 years. Industry observers have noted that mergers are an effective strategy to attain economies of scale necessary to afford investments in technology and skilled personnel; however, if poorly implemented, mergers have the potential to impact operating performance. The recent and expected consolidation activities

[17]As investors sought high-quality (that is, safe) investments due to weak performance by the stock and other investment markets in the early 2000s, credit unions experienced significant growth in member share deposits. See GAO, *Credit Unions: Available Information Indicated No Compelling Need for Secondary Capital*, GAO-04-849 (Washington, D.C.: Aug. 6, 2004).

[18]Risks include interest-rate, liquidity, and credit risks. Credit risk is the risk that the promised cash flows due from an investment will not be fully paid, exposing investors to potential decreases in its capital.

within the network could impact the financial condition of the acquiring corporate, as well as the corporate network.

Finally, based on the responses to our questionnaire, corporates reported that they have been forming strategic alliances with other corporates to provide member credit unions with sophisticated products and services such as online banking and business lending services. Industry observers have viewed these alliances as an effective approach to meet the demands of members while distributing the costs among several corporates. However, as corporates move into new areas to meet the demands of their members, corporates need to maintain sufficient retained earnings and capital levels.

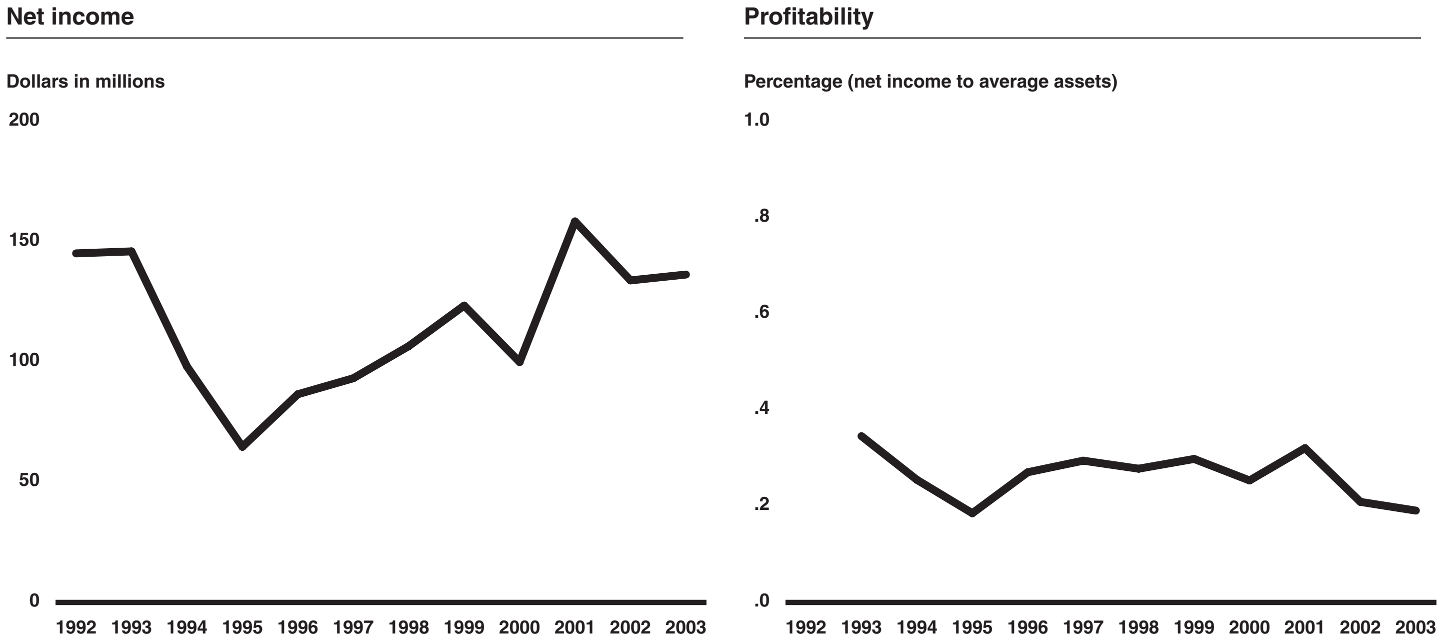
Despite General Growth in Net Income, Corporate Profitability Has Trended Lower Recently

Despite generally rising net income levels since 1995, the profitability of corporates has declined recently due to the low-interest-rate environment and large inflows of deposits from natural person credit unions.[19] More specifically, as shown in figure 3, while net income of corporates generally fluctuated since 1992, it grew overall since 1995. While profitability generally remained within ranges prevalent in the industry since the mid-1990s, it was lower at the end of 2003 than at the end of 1993.[20]

[19]Profitability in a given year is measured by the ratio of that year's net income to the average of that year's total assets and the prior year's total assets. We used this measure of average assets to create consistency in 1993-2003 data.

[20]U.S. Central did not experience the same rapid increase in its assets and, thus, has not suffered recent declines in its profitability. In fact, U.S. Central's profitability has generally been increasing. See appendix VI for more information.

Figure 3: Net Income Has Generally Risen, but Profitability Has Declined Recently



Source: Call report data.

Note: In this figure, profitability in a given year is measured by the ratio of that year's net income to the average of that year's total assets and the prior year's total assets. This figure excludes data on U.S. Central.

Also, as shown in figure 3, profitability—the net income corporates realize on their assets—was relatively stable in the mid-1990s, but has been trending downward since 2001. Effectively, the recent lower-interest-rate environment has narrowed the difference between what corporates were earning on their investments and what they were paying to their members. (Appendix V provides more details on corporates' income and operating expenses.) Profitability is an important indicator of financial condition, as it is a key determinant of the sufficiency of a corporate's retained earnings. Retained earnings are the primary component of a corporate's capital, representing that corporate's financial strength and its ability to withstand adverse financial events. The recent trend downward in corporates' profitability has slowed growth in their retained earnings and capital compared with their assets.

Despite Increases in Overall Capital Levels, Corporates' Capital Ratios Have Trended Lower Recently

The overall level of capital at corporates has steadily increased since 1998, in part due to regulatory changes that allowed corporates to use other, less permanent (or relatively weaker) forms of capital in addition to retained earnings.[21] Corporates have been increasingly relying on these relatively weaker forms of capital. However, since 2000 capital ratios have declined as growth in assets outpaced growth in capital.[22] The increasing reliance on less permanent forms of capital and corporates' generally constrained ability to build capital in periods of stress raises a potential concern about the financial strength of the corporate network.

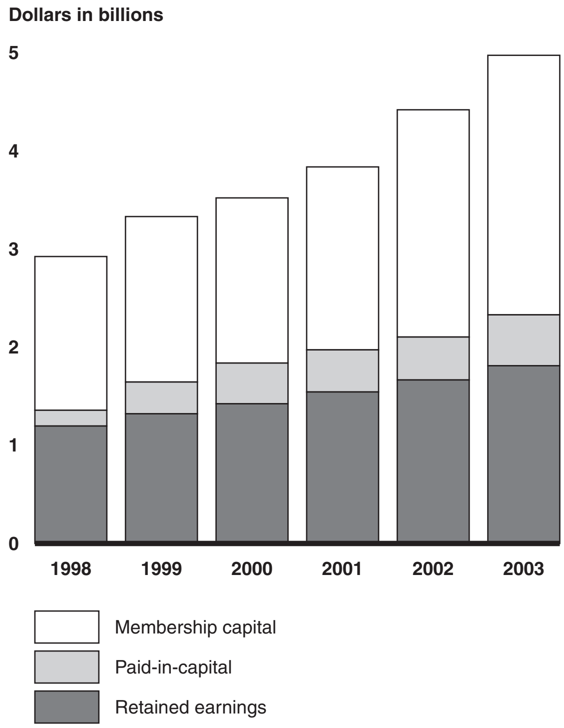
Capital Levels Have Generally Risen, but Corporates Increasingly Have Relied on Less Permanent Forms of Capital

As shown in figure 4, the overall level of capital at corporates has steadily increased since 1998. This is due in part to regulatory changes that allowed corporates to use other, less permanent (or relatively weaker) forms of capital in addition to retained earnings.

[21]Because changes in the regulatory definition of capital preclude meaningful comparisons between the pre- and post-1998 periods, we focused our discussion on 1998-2003.

[22]In general, an institution's capital ratio reflects the extent to which it has a cushion against losses—the higher the ratio, the more severe an adverse financial shock it can endure. The relative cushion offered by a particular type of capital also depends on the relative permanence of the capital. To calculate the capital ratio, we divided capital by the moving daily average of net assets (DANA), which is the average of a corporate's daily average net assets for the month being measured and the previous 11 months. Effective 1998, Part 704 prescribed moving DANA as the denominator for capital ratios.

Figure 4: Capital Levels Have Risen, but Corporates Have Increasingly Relied on Less Permanent Forms of Capital



Source: Call report data.

Note: Retained earnings represent the most permanent form of capital, while membership capital represents the least permanent. This figure excludes data on U.S. Central.

Beginning in 1998, Part 704 of NCUA regulations expanded the definition of regulatory capital by defining capital as the sum of reserves and undivided earnings (that is, retained earnings) and permitted corporates to include two other, less permanent forms—paid-in capital and membership capital. More specifically, reserves and undivided earnings include all forms of retained earnings, including regular or statutory reserves and any other appropriations designated by management or regulatory authorities. NCUA currently defines "core capital" for corporates in Part 704 as retained earnings plus paid-in capital. Retained earnings, which are internally generated, are the most permanent form and the primary component of corporates' capital. Both paid-in capital and membership capital, which are from external sources, are less permanent forms of capital, suggesting they provide a relatively weaker cushion against adverse financial events. Prior to July 1, 2003, paid-in capital was defined as a member deposit account with an initial maturity of at least 20 years. However, NCUA now requires paid-in capital to be a more permanent form of capital (a perpetual dividend account), available to cover losses that exceed reserves and undivided earnings. NCUA had noted that, due to its high cost, paid-in capital would be used by corporates as a bridge during short periods of stress, such as rapid growth, and should not be used for long periods. While NCUA's redefinition of paid-in capital has increased the relative permanence of this form of capital, membership capital represents funds contributed by members that have either an adjustable balance with a required notice of withdrawal of at least 3 years or are term certificates with a minimum term of 3 years.[23] As such, membership capital is probably best thought of as a form of subordinated debt, which can protect the insurance fund in the event of a corporate failure.

As shown in figure 4, corporate capital rose from $2.9 billion in 1998 to $5 billion at the end of 2003. Retained earnings accounted for 41 percent of total capital in 1998 but declined to around 36 percent of total capital at the end of 2003. Paid-in capital increased from around 6 percent of total capital in 1998 to around 10 percent in 2003. Membership capital shares have consistently represented the largest percentage of capital, typically around 50 percent, and have been steadily accounting for a greater percentage of capital since 2000. Thus, while the capital of corporates continues to rise, corporates have increasingly relied on less permanent (that is, relatively weaker) forms of capital. While this is a method corporates can use to increase capital during periods of rapid growth in assets, it does lead to concerns about the ability of the network to withstand financial shocks, especially in light of the increasingly challenging business environment they face.

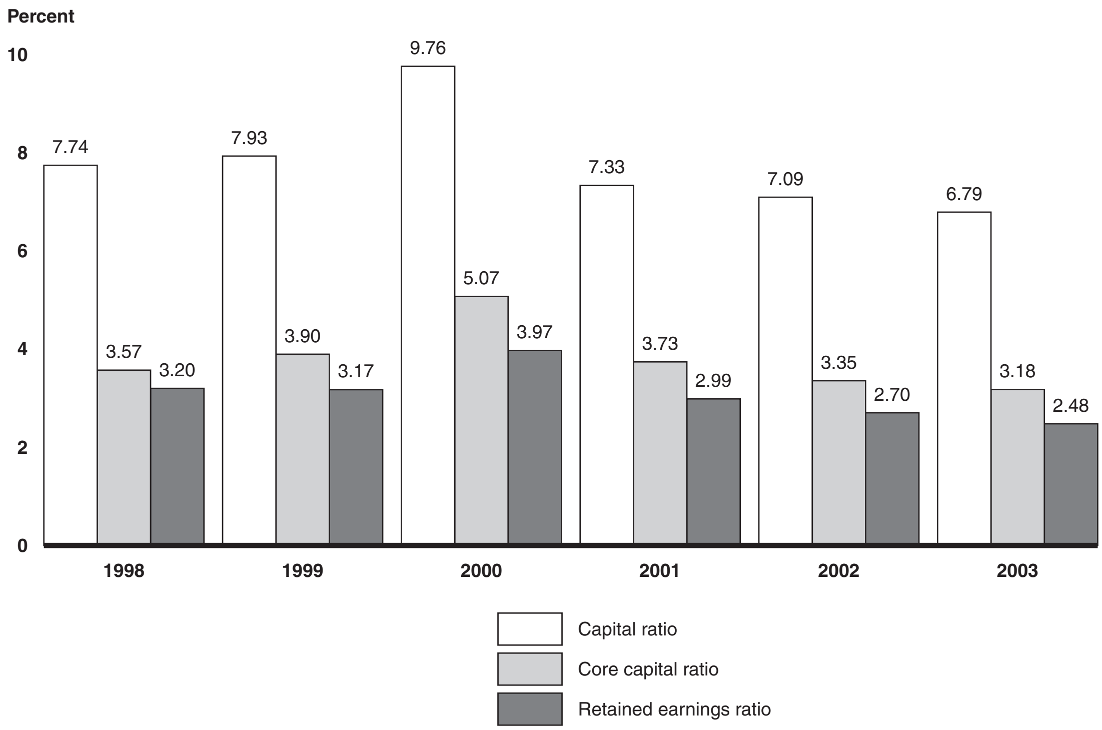
Capital Ratios Have Declined Recently but Remain above Current Regulatory Requirements

While the total capital of corporates has steadily increased since the late-1990s, since 2000 capital ratios have declined as growth in assets outpaced growth in capital. NCUA currently specifies three capital ratios: the capital ratio, which includes all forms of capital relative to moving daily average net assets (DANA); the core capital ratio, which includes core capital (retained earnings plus paid-in capital) relative to moving DANA; and the retained earnings ratio, which includes reserves plus undivided

[23]Neither paid-in nor membership capital is insured by NCUSIF or other share or deposit insurers and cannot be pledged against borrowings.

earnings relative to moving DANA.[24] As depicted in figure 5, these capital ratios were lower in 2003 than in 1998 despite generally rising capital levels.

Figure 5: Capital Ratios Have Declined Recently (1998-2003)



Source: Call report data.

Note: In this figure, capital ratios are calculated by dividing capital by the moving daily average of net assets (DANA), which is a measure of average assets as set forth in Part 704 in 1998. This figure excludes data on U.S. Central.

As assets have increased, corporates have been unable to generate sufficient capital to maintain capital ratios. In particular, after peaking in 2000, capital ratios declined, as the corporates' asset base—which inversely affects the capital ratio—increased by over 80 percent over the same period. Despite recent declines, at the end of 2003 the capital and

[24]Prior to 2003, NCUA defined the ratio of retained earnings and paid-in capital to moving DANA as the reserve ratio, and it defined the ratio of retained earnings to moving DANA as the reserves and undivided earnings, or RUDE, ratio.

retained earnings ratios remained in excess of their current respective regulatory requirements of 4 percent and 2 percent.[25] Due to corporates' role in serving their members, their generally low earnings continue to present a challenge and a potential weakness—as corporates generally rely on building permanent capital from retained earnings—and could put a strain on the profitability of the corporate network in the future. As a result, corporates' capital ratios, although above current regulatory requirements for safety and soundness purposes, are vulnerable to erosion from factors such as rapid inflows of deposits that corporates may not be able to control.

Growth and Changes in Corporates' Investments May Increase Risks If Not Monitored or Managed Properly

Although assets have grown through the recent influx of deposits, corporates have continued to allocate them almost exclusively to investments (rather than other assets that include cash, loans, or fixed assets). With this growth, the percentage of corporates' investments in obligations of U.S. Central has declined somewhat, particularly for the largest corporates. In response to the low-interest-rate environment, corporates have moved relatively more of their investments into potentially higher yielding—and more volatile—securities. The largest corporates also appear to be managing interest-rate risk by shifting toward more variable-rate and shorter-term securities, providing a potentially better match for the relatively short-term nature of their members' deposits. However, a regulatory change effective in 2003 allowed certain corporates to purchase securities with lower credit quality, but few have used this investment authority. It is not clear, however, to what extent corporates might use this investment flexibility in the future, raising implications for NCUA oversight since this activity may lead to increased credit risk if it is not managed properly.

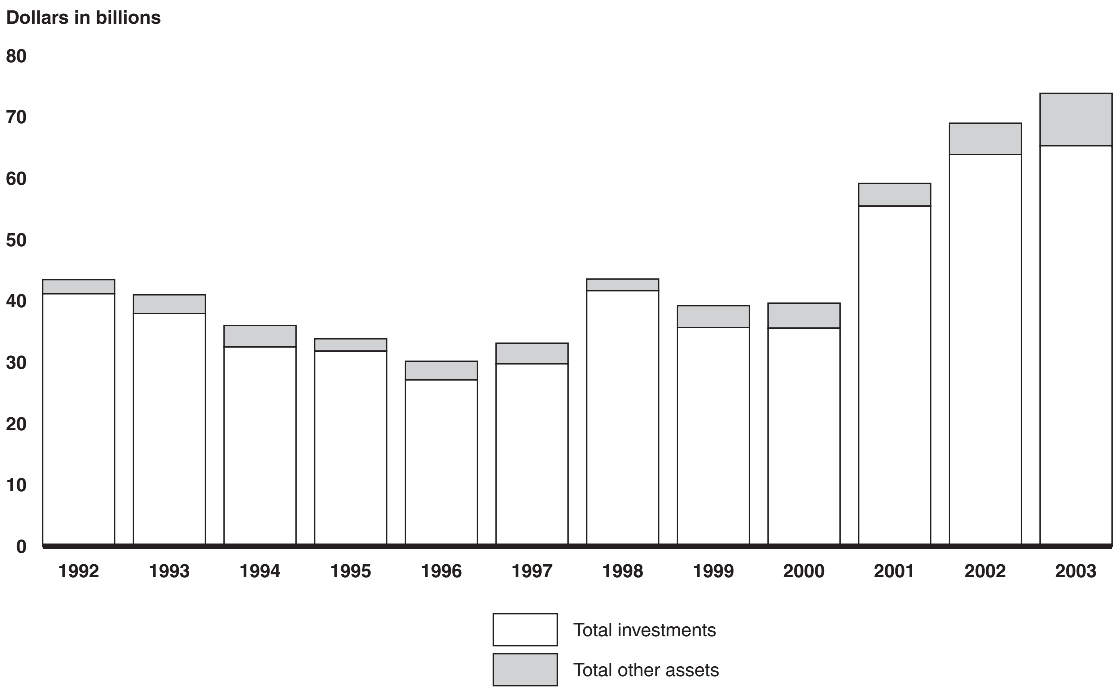
While Corporate Investment Portfolios Have Grown, Larger Corporates Invested Less in U.S. Central

Corporates' investments have grown with the recent inflows of deposits from natural person credit unions. Investments, which include asset-backed securities, commercial debt obligations, mortgage-related issues, and U.S. government obligations, represent the vast majority of corporates' assets—usually 90 percent or more (see fig. 6). At the end of

[25]The regulatory requirements (Part 704) for capital and retained earnings ratios represent the basic level of capital regulation for credit unions. In general, regulatory capital requirements for corporates can vary, depending on such factors as corporate type (that is, retail or wholesale), the corporate's eligibility for expanded investment authorities, and limits on monthly changes in risk.

1992, total investments of corporates stood at $41.1 billion; at the end of 2003, they were reported at $65.3 billion. Since 2000, total investments of corporates have grown by 84 percent.

Figure 6: Corporates' Investments Have Grown and Consistently Represent Most of Corporates' Assets

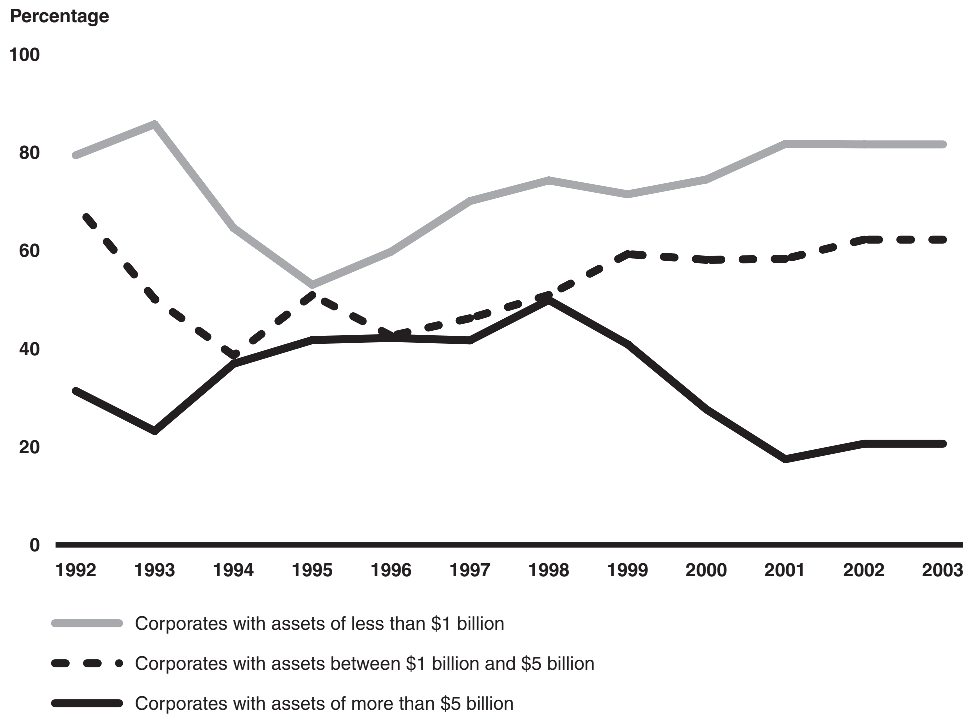


Source: Call report data.

Note: Other assets include cash, loans, and fixed assets. This figure excludes data on U.S. Central.

Since 1992, corporates' investments in U.S. Central obligations have typically accounted for approximately one-half of their total investments, the largest single investment category. The generally high proportion of investments in U.S. Central obligations reflects the "pass-through" nature of many corporates. Historically, U.S. Central has functioned as a conduit between corporates and the capital markets. Despite growth in the overall amount of corporates' investments in U.S. Central obligations, they declined as a percentage of corporates' total investments from 1997 to 2003. For example, they went from $15.6 billion (53 percent) at the end of 1997 to $29.2 billion (45 percent) at the end of 2003. This decline indicates that the largest corporates are investing their funds directly, rather than through U.S. Central. As shown in figure 7, in general, the largest corporates have held smaller percentages of their investments in U.S. Central obligations than smaller corporates.

Figure 7: Largest Corporates Have Invested Relatively Less in U.S. Central Obligations Than Smaller Corporates



Source: Call report data.

Notes: In this figure, which separates corporates into three categories according to their year-end assets, corporates' investments in U.S. Central obligations are shown relative to corporates' total investments. Prior to 1997, NCUA call reports did not disaggregate investments in U.S. Central obligations from investments in corporate credit unions, and thus a proxy measure—investments in corporates relative to corporates' total investments—is depicted for 1992-1996. To the extent that corporates invested in other corporates during 1992-1996, the call report data reflect an upper bound on investments in U.S. Central obligations. This figure does not follow the same institutions each year; rather, it reflects the investments of those corporates in a given size category in a given year. This figure excludes data on U.S. Central.

As investment management has increased in complexity, smaller corporates may not have had the resources necessary to develop and maintain investment capabilities internally, and U.S. Central thus was able to provide smaller corporates with these services by leveraging the efficiencies gained through its economies of scale. Despite the recent decline in the percentage of corporates' investments in U.S. Central obligations, U.S. Central still provides substantial investment services—suggesting that the health of U.S. Central remains critically important for its members and their associated natural person credit unions.

Investments Have Shifted Toward Potentially Higher Yielding and More Volatile Securities, but Largest Corporates Appear to Be Managing Interest-Rate Risk

In response to the low-interest-rate environment, corporates have moved relatively more of their investments into potentially higher yielding—and more volatile—securities. In particular, corporates have increased their relative holdings of privately issued mortgage-related and asset-backed securities, which may offer higher yields for corporates relative to other investments such as government-guaranteed obligations. As illustrated in table 1, the percentage of investments in privately issued mortgage-related securities increased from 0.9 percent of total investments in 1997 to 14.1 percent in 2003. Asset-backed securities also increased relative to total investments (from 19.5 percent in 1997 to 24.7 percent in 2003).[26] With the potentially higher yields, the corporates are also potentially increasing risk—notably interest-rate risk. This shift highlights the importance of risk monitoring and management by the corporates and NCUA.

Table 1: Corporates' Investments Shifted toward Potentially Higher Yielding and More Volatile Securities

Investments relative to total investments (percent)	1997	1998	1999	2000	2001	2002	2003
U.S. Central obligations held by corporates	53%	56%	57%	53%	45%	42%	45%
Asset-backed securities	19	18	24	23	23	23	25
Privately issued mortgage-related securities	1	2	3	4	6	9	14
Government and agency mortgage-related securities	13	9	9	8	8	7	6
Other	14	14	7	11	18	18	11
Total investments (in millions)	**$29,727**	**$41,645**	**$35,642**	**$35,553**	**$55,449**	**$63,859**	**$65,280**

Source: Call report data.

Notes: Totals may not add due to rounding. "Other" includes U.S. government obligations, U.S. government-guaranteed obligations, obligations of U.S. government-sponsored enterprises, and commercial debt obligations. This table excludes data on U.S. Central.

However, corporates also have shifted the composition of their investment portfolios toward more variable-rate and shorter-term securities, a strategy that tends to reduce adverse exposure to changing interest rates and thus

[26]Asset-backed securities include securities backed by fixed- and variable-rate credit card, auto, and home equity loans.

reduces interest-rate risk. While 41.7 percent of corporates' asset-backed securities were classified as fixed-rate at the end of 1997, 18 percent were so classified at the end of 2003. Since corporates' call reports do not include weighted-average life data—the expected time that the principal portion of a security will remain outstanding—we reviewed materials from the three largest corporate credit unions that showed these institutions tended to hold securities with relatively short weighted-average lives, with most being less than 3 years.[27] As a result, while corporates have moved to securities that may entail additional investment risk, the largest corporates in the network appear to be managing interest-rate risk by shifting toward more variable-rate and shorter-term securities, providing a potentially better match for the relatively short-term nature of their members' deposits.[28]

Expanded Authority to Invest in BBB Rated Securities May Lead to Increased Credit Risk If Not Managed Properly

Due to the revision of Part 704, some corporates have been allowed to invest in lower-rated securities (down to BBB rated), which might lead to increased credit risk if these investments were not managed properly.[29] Investments with lower credit quality tend to provide higher yields but can also expose investors to the increased likelihood that promised cash flows will not be paid. While "moving down the credit curve" (that is, investing in lower credit quality securities) potentially exposes a corporate to increased credit risk, such a strategy might not increase the overall risk for a corporate making such investments provided the additional risk was managed appropriately. According to NCUA, this regulatory change gave corporates added flexibility with which to diversify their portfolios and

[27]We chose the largest corporates because they had been granted the broadest investment authorities.

[28]Because members' deposits tend to be short-term in nature, a corporate's asset mix tends to be short-term, too. In general, corporates need to maintain a high level of liquidity given their role as a liquidity provider to credit unions.

[29]Investment ratings are a measure of credit risk, ranging from AAA to D (a total of 10 ratings). Investment grade (that is, highest quality to medium grade) investments carry the top four ratings—AAA, AA, A, or BBB. A BBB rated investment is considered to be of medium investment grade.

reduce investment concentration.[30] In particular, these securities could be used in an attempt to limit credit risk by lowering concentrations in certain industries or geographical areas and creating a more diversified portfolio. Also, lower-rated securities could be purchased because they carried a particularly attractive return for their credit rating or provided a good mix of credit risk and interest-rate risk given the other holdings of a corporate.[31] According to NCUA and corporate officials, the ability to hold such lower-rated securities in their portfolios (as opposed to having to sell a security immediately if it were downgraded) might provide these institutions more flexibility in disposing of an investment that suffered a rating downgrade. Corporates would be able to hold the investment in an effort to limit realized losses rather than being forced to promptly liquidate it. Based on our review of information provided by the three corporates that have the authority to invest in these securities, as well as discussions with their officials and risk management staff, corporates either have made few such investments or none. Further, officials at the three institutions indicated that they did not plan to use their authority to purchase BBB rated securities.

However, it is not clear to what extent corporates will take advantage of this investment flexibility in the future, which has implications for NCUA oversight that we discuss later in this report. If corporates were to hold or invest in BBB rated securities to a greater extent, these investments might create additional risks to the corporate network if not managed properly. In general, like other financial institutions, a corporate's vulnerability to risk depends on its overall portfolio and the amount of capital that is backing it. Some have suggested that corporates tend to be relatively thinly capitalized compared with other financial institutions, which may raise concerns over

[30]The 1998 revisions to Part 704 also allowed corporates, with prior NCUA approval, to seek expanded investment authorities and greater flexibility to manage their risks and earnings. For example, under this additional authority, a corporate that fulfilled additional capital, management, infrastructure, and asset and liability requirements, and received NCUA's written approval, was allowed greater flexibility in managing its net economic value, given more relaxed concentration limits on investments, and given the ability to invest in lower-rated securities. NCUA subsequently revised Part 704 in 2002 and allowed corporates with certain types of expanded authorities to invest in BBB rated securities. Prior to the 2002 revisions, some corporates had been allowed to invest in securities rated as low as A-.

[31]Interactions among the risks to which a corporate is exposed, such as interest-rate and credit risk, can be complex and need to be considered in the context of the institution's overall portfolio of assets and liabilities. The addition of a particular investment to a corporate's investment portfolio can impact risks in differing ways, potentially increasing some risks while lessening others.

potential additional exposure to risk. For example, the Department of the Treasury has raised concerns that allowing corporates to invest in BBB rated securities could weaken the safety and soundness of the corporate network because the amount of capital held in the corporatesmight not be commensurate with the risks associated with these lower credit quality investments.[32]

NCUA Strengthened Its Oversight of Corporates, but Could Do More to Anticipate and Address Emerging Network Issues

NCUA has made numerous changes over the last several years to strengthen its oversight of corporates but faces challenges in such areas as networkwide assessments, obtaining and utilizing technical staff resources, developing merger guidance for corporates, and assuring the quality of corporates' internal control structures. Specifically, NCUA established a separate office dedicated to the oversight of corporates, and revised its corporate regulation (Part 704) to improve corporates' management of credit, interest-rate, and liquidity risks. NCUA also adopted a risk-focused supervision and examination approach, and trained or hired a limited number of specialists to help oversee increasingly complex operations at corporates. However, NCUA has not put in place a system to track the resolution of deficiencies or evaluate trends in examination data and therefore may not be able to anticipate emerging issues within the network. Further, NCUA has not systematically considered certain operational risks, such as weak information system controls, when assigning specialists to examinations, which may have led to NCUA overlooking certain problems or not ensuring that problems were corrected in a timely manner. While continued consolidation of the corporate network appears likely, NCUA has not developed merger guidance specific to corporates, and its examiner guidance has not ensured that merger proposals were assessed consistently. Thus, NCUA's inadequate guidance has increased the risk that resulting decisions may not be in the best interests of corporates or their members, or may negatively affect the safety and soundness of corporates. Also, as corporates have invested in more complex technologies and added more sophisticated products and services, the importance of NCUA's oversight of corporates' internal controls has increased. However, corporates are not subject to the internal control reporting requirements imposed on other financial institutions of similar size that help to ensure safety and soundness, as defined under the Federal Deposit Insurance

[32]Department of the Treasury comment letter concerning NCUA's proposed rule on corporate credit unions, amending Part 704, dated October 15, 2002. Treasury has not modified its position since then.

Corporation Improvement Act of 1991 (FDICIA). This raises a question about whether NCUA has the necessary information to assess corporates' internal controls.

NCUA Made Several Major Improvements in Oversight Since 1991

Since 1991, NCUA has strengthened its oversight of corporates by reorganizing staff, revising regulations, and changing examination and supervisory focus. NCUA established the Office of Corporate Credit Unions (OCCU) in 1994, partly in response to problems with selected investments at U.S. Central.[33] Within this new office, NCUA centralized its supervision of corporates and increased the number of examiners dedicated to supervision and examination of corporates. According to NCUA officials, prior to this change, NCUA examiners lacked adequate training and expertise to examine activities undertaken by corporates, since they spent most of their time examining natural person credit unions, whose operations generally are less complex than those of corporates. Further, in 1992, NCUA had 12 examiners dedicated to the oversight of 44 corporates and U.S. Central. As of June 2004, NCUA had 22 examiners plus three information systems specialists and one payments system specialist hired to help oversee the 30 corporates and U.S. Central.

NCUA also revised its corporate regulation (Part 704) in 1998 to increase measurement and monitoring of interest-rate, liquidity, and credit risk within the corporate network.[34] The revisions to Part 704 were in response to the failure of Capital Corporate Federal Credit Union in January 1995 and GAO and other recommendations for NCUA to improve its oversight of corporates.[35] The 1998 revisions required corporates to measure and report on the impact of interest-rate and liquidity changes on their net economic

[33]In mid-1993, U.S. Central made a series of investments in Banco Español de Credito (Banesto). On December 28, 1993, the Spanish Central Bank took over Banesto because of problems in its commercial loan portfolio, which placed some of U.S. Central's remaining investments in potential jeopardy (at that time $255 million). Although U.S. Central did not incur any loss as a result of the Banesto investment, NCUA and Congress raised questions about these investments.

[34]62 Fed. Reg. 12929 (Mar. 19, 1997, effective Jan. 1, 1998).

[35]See GAO/T-GGD-95-107 (Feb. 28, 1995) and GAO/T-GGD-95-115 (Mar. 8, 1995). These two testimonies provided recommendations for NCUA to improve oversight of corporate credit unions in the wake of the failure of Capital Corporate Federal Credit Union. See NCUA-commissioned study by Harold Black, Albert DePrince, William Ford, James Kudlinski, and Robert Schweitzer, *Corporate Credit Union Network Investments: Risks and Risk Management* (Alexandria, Virginia, 1994).

value.[36] Corporates also were required to change the methods used to calculate their investment concentration limits—moving from a calculation that used an asset base to one that consisted of core capital (reserves and undivided earnings and paid-in-capital). Corporates could use this method to improve their management of credit risk by matching the risks associated with investment concentrations with capital, which protects corporates if investment risks lead to losses.

NCUA also implemented a risk-focused supervision and examination approach in 1999 to concentrate its resources on the high-risk areas within corporate operations. Similar to the examination approach taken by other financial institution regulators, the risk-focused approach is intended, in part, to better employ examiner resources and improve examination results by emphasizing the areas of greatest risk. Under this approach, examiners have greater discretion to identify areas that require their attention and allocate their time accordingly. Further, examiners can determine when and where to employ the assistance of specialists with skills tailored to the activities of the institution, as its operations become more complex. According to NCUA officials, OCCU also began to promote examiners who had experience in investments and asset/liability management to the position of capital market specialist. As of August 2004, OCCU had five capital market specialists. Additionally, NCUA's Office of Strategic Program Support and Planning (OSPSP) had three investment specialists with private-sector financial market experience that could assist OCCU's capital markets specialists.[37] For example, OSPSP investment specialists participate in selected examinations of corporates that have expanded investment authorities.

[36]Net economic value is defined as the fair or economic value of assets minus the fair value of liabilities. Specifically, corporates must limit their risk exposure to levels that did not result in a decline in the net economic value of more than 18 percent.

[37]OSPSP develops agency policies and procedures related to credit union investments and asset/liability management, and the office assists examiners in evaluating investment issues in credit unions.

NCUA Identified Deficiencies but Did Not Systematically Track Their Resolution or Evaluate Trends in Examination Data

NCUA's risk-focused approach has helped it identify weaknesses in corporates' operations and require corrective actions at corporates; however, we found that NCUA did not methodically aggregate and track the resolution of deficiencies or systematically conduct trend analyses to identify recurrent or networkwide issues. We have reported that sound risk-focused examination practices rely on the regulator's ability to maintain an awareness of industrywide risk.[38] Other depository institution regulators, such as the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision reported that they have mechanisms in place to conduct some degree of industrywide assessments of their depository institutions. Further, the Federal Deposit Insurance Corporation (FDIC) tracks and analyzes trends in examination findings and their resolution in several ways. For example, after each examination, FDIC reviews, analyzes, and enters findings and their resolution into various databases. In addition, FDIC gathers information on its institutions' internal controls to report on local, regional, and national trends in bank performance and identify activities, products, and risks that affect banks and the banking industry.

Based on our review of about 100 risk-focused examinations for all corporates and U.S. Central from January 2001 through December 2003, NCUA examiners had identified deficiencies—most frequently in the areas of asset/liability management, investments, management, funds transfer, and information systems—but we could not always determine if corporates had resolved these deficiencies. NCUA also had established time frames for correcting deficiencies and procedures for corporates to take actions to address the deficiencies. According to NCUA, corporates must prepare plans that specify the action needed and identify the corporate official responsible for implementing the plan. Further, NCUA reported that examiners typically verify the resolution of deficiencies during an examination or on-site supervision, actions that examiners were expected to document in the examination workpapers. Examiners assigned to subsequent examinations also were to review the deficiencies from the last examination report to see what corrective action had been implemented. NCUA reported that based on the severity of the deficiency, as a matter of practice, resolutions might be noted in the examination report or in the workpapers.

[38]GAO, *Risk-Focused Bank Examinations: Regulators of Large Banking Organizations Face Challenges*, GAO/GGD-00-48 (Washington, D.C.: Jan. 24, 2000).

However, after reviewing these examination reports and other NCUA oversight documents, we were unable to consistently determine whether the deficiencies NCUA had identified for individual corporates had been resolved. The executive summaries included in some examination reports noted that deficiencies from the previous year had been addressed, but this practice was not standard for all of the exam reports we reviewed. For example, 14 of 38 examination reports we reviewed had discussed the status of deficiencies and whether they were resolved. Moreover, the corporate examiners' guide did not stipulate that examiners should document the resolution of prior deficiencies when preparing the final examination report. NCUA officials told us that the examiner-in-charge tracked the status of deficiencies at individual institutions and reported this information in monthly examiner reports. While these reports documented the status of deficiencies, information on the status was not included or consolidated in monthly reports prepared for the OCCU Director or in quarterly reports to NCUA's Board. As a result, NCUA management may have been unaware of issues related to the resolution of examination deficiencies, as can be seen in the following examples:

- In the review of one corporate's examinations, we noted that its information system disaster recovery site did not meet NCUA requirements (for site location and a separate power system) for at least 3 years. The examination documentation we reviewed did not issue a deficiency finding detailing the weaknesses of the recovery site. After further review, we found that the disaster recovery site was located at the chief executive officer's home for at least 6 years before the examination report detailed the need to replace the disaster recovery site.

- At another corporate, NCUA acknowledged in the examination that the institution had not addressed information systems deficiencies related to information security for 3 years. However, in the prior year's examination, NCUA had no mention of recurring problems with information systems at this corporate.

- NCUA issued a deficiency finding in the area of accounting and financial reporting for a corporate after it had submitted 13 months of data inaccuracies in its 5310 call reports, exposing the corporate to financial and reputation risk.

NCUA management believed that its existing examination processes and available information (such as call reports, examiner reports on corporates, internal monthly management and quarterly reports, and staff's institutional knowledge) provided it with sufficient information to assess the adequacy and timeliness of corporates' corrective actions. For example, NCUA officials stated that OCCU management reviews all examination reports prior to issuance, including any noted deficiencies. In the regulator's view, this practice provides an additional layer of oversight and evaluation. Additionally, OCCU emphasized that its monthly management reports serve as a key supervision tool to assess issues, trends, and corrective action at individual corporates. Despite OCCU's practices for coordinating and overseeing individual examinations, these practices were informal (that is, we did not identify guidance or formal operating procedures) and appeared to operate independently of one another. Additionally, these processes and practices did not constitute a system that would aggregate the number and type of deficiencies occurring at all corporates.

According to NCUA officials, their current practices kept them abreast of potential overall issues affecting the network without the need for a separate system to catalogue the deficiencies. For example, OCCU has trained three corporate program specialists to support field examiners, who track issues and trends in their assigned corporates and meet periodically with OCCU management to discuss issues and trends across the corporate system. They also noted that the examination review process had identified a number of issues or trends such as the need to address Bank Secrecy Act-related issues. However, NCUA officials also said that at the request of their corporate program specialists, they were developing a database to track deficiencies identified in examinations to better track their resolution. They did not specify the planned completion date for this database.

NCUA's current system has relied on interaction between the different offices, examiners, and specialists involved in oversight of corporates. A tracking system may have helped NCUA to identify, anticipate, or otherwise address some of the information system weaknesses we noted above. More specifically, without such a system for tracking examination findings and their resolution, NCUA's ability to identify the extent and duration of a problem at an individual corporate is limited, which may prevent the timely resolution of deficiencies. Similarly, the lack of a tracking system that aggregates deficiencies diminishes NCUA's ability to identify networkwide problems readily, assist examiners-in-charge in developing examination plans, and devise strategies to address issues before they become a significant safety and soundness concern.

NCUA Did Not Systematically Consider Certain Risks When Allocating Resources or Scheduling Specialists for Examinations

NCUA has not systematically considered corporates' risk management (both quality and capacity) when allocating resources and scheduling specialists for examinations.[39] Federal depository institution regulators, under the auspices of the Federal Financial Institution Examination Council (FFIEC)—of which NCUA is a member—had issued guidance on how to systematically determine when to assign specialists to an examination.[40] In addition, FDIC and Office of the Comptroller of the Currency (OCC) have issued specific guidance on the frequency with which specialty examinations should be conducted. For example, OCC's guidance requires that information systems examinations be consistently conducted at least every 12 to 18 months for community banks with assets of less than $1 billion, with a minimum objective of assessing the quantity of transaction risk and the quality of risk management, including staff capacity and skills. By contrast, NCUA has not established a minimum level of involvement of specialists in examinations.

Since we noted that NCUA had identified a number of problems in information systems at the corporates and were concerned that they had relatively few specialists in this area, we reviewed *FFIEC's Information Systems Examination Handbook*, which also provides a process by which regulators can determine when and where to employ information systems specialists. We used this handbook to assess how NCUA deployed examiners, relative to best practices and guidance as exemplified in the handbook. According to this handbook, information systems examiners must judge risk posed by the quantity of transactions and quality of the

[39]Risk management includes the identification of risk to recognize and understand existing risks or risks that may arise from new business initiatives. It also includes the accurate and timely measurement of risks, policies, and procedures to control risk, and monitoring of risk to ensure timely review of risk positions of the institution. The staff responsible for risk management should be independent from the institutions risk-taking activities and the board of directors should be informed of the institution's risk management program. Capable management and appropriate staffing are critical to effective risk management.

[40]NCUA is a member of FFIEC, which is an interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions, and make recommendations to promote uniformity in the supervision of financial institutions. Other members include the Board of Governors of the Federal Reserve System, FDIC, OCC, and the Office of Thrift Supervision.

institution's risk management.[41] Assessing aggregate risk allows examiners to weigh the relative importance of both the quantity of transactions and the quality of risk management for a given institution and direct the activities and resources for the regulators' supervisory strategies. Under this approach, a smaller corporate with a low volume of transactions and weak risk management could pose a risk to the network equal to that of a large corporate with a high volume of transactions and a strong risk management program.

We reviewed examination-planning documents for all 31 corporates to determine how NCUA evaluated these risks when determining the frequency at which specialists would be assigned to examinations. We found that NCUA documented its assessment of operations risk in these planning documents, but did not explicitly discuss the quality of risk management for various functions and operations when determining if specialists should be assigned to examinations.[42] For example, in some cases, we found that the examination-planning documents only provided a single line stating that an information systems specialist was not needed on the next examination and did not document the reason for this assessment. While the planning documents were not clear about NCUA's decision process for assigning specialists to examinations, it also was not clear to us whether NCUA routinely or consistently considered various operational weaknesses at these corporates when assigning specialists.

An external review of OCCU in 2002 concluded that NCUA's complement of two information systems specialists and one payment system specialist did not appear to be sufficient to adequately oversee the corporate network and that OCCU should consider hiring additional specialists in these areas. NCUA believes it has sufficient specialists to examine the 31 corporates; however, it has made this determination without fully assessing the

[41]We focused on FFIEC guidance that was in place until March 2003, which covered the major portion of the exam periods we reviewed. FFIEC has updated this guidance in the form of various information technology examination handbooks that address various aspects of financial institutions' computerized operations. The updated guidance also suggests that information technology examinations should focus on institutions' management of technology.

[42]Operations risk is the risk that existing technology or support systems may malfunction or break down. For example, breakdowns in the information systems could limit the ability of a corporate to process payments and transfers or it could lead to mistakes in the estimation of risk, and thereby let the corporate undertake unwarranted risks and sustain potential losses.

corporates' business environment and networkwide challenges. NCUA tended to assign specialists on the examinations of larger corporates or those implementing newer systems and less so on examinations of smaller corporates or examinations of established systems at large corporates. According to NCUA, specialists had limited or no involvement in examinations at the 12 smallest corporates (with assets of less than $1 billion) from 2001 to 2003. During the same period, specialists were annually involved in the examination of the eight corporates with assets above $2.6 billion. While this approach appears reasonable, the limited involvement of specialists under such circumstances may have contributed to important information system weaknesses at corporates that were either not identified by NCUA or not promptly corrected. For example, U.S. Central's automated clearing house (ACH) software had deficiencies that led to a system failure that delayed payments to customers of 2,200 natural person credit unions for nearly 2 days. According to NCUA, information systems specialists had reviewed the system's performance in prior examinations. However, because the Automated Clearing House (ACH) software was mature and U.S. Central staff was monitoring its performance, NCUA did not consider it a high-risk component of U.S. Central's operations and had not reviewed it recently. As a result, weaknesses in their backup procedures and routine maintenance, insufficient capacity (noted in prior examinations but not satisfactorily resolved), and other deficiencies that resulted in the outage were not corrected. NCUA has stated that it is reviewing its procedures to determine if such systems should receive a minimum level of review. NCUA has also acknowledged that the ACH delay resulted in financial loss and increased reputation risk to the corporate network.

NCUA also faces other obstacles to conducting more systematic evaluations of risk—both in assuring that corporates have the capacity for managing risks and ensuring that, as a regulator, it has the staff to assess the quality and operations in corporates' risk management functions. As noted previously, corporates have been operating in a challenging investment environment, with additional authorities to make lower-rated investments. Consequently, the quality of risk management at corporates has grown in importance. While the results of our review of the risk management function at the three largest corporates suggested that these corporates were taking appropriate steps to assess and mitigate their risks, these corporates had a relatively small number of staff in their risk management functions. More specifically, the largest corporates and U.S. Central were using sophisticated financial models to assess and manage interest-rate, credit, and liquidity risks.[43] But a rating agency and external auditor have expressed concerns about small staff sizes and how they affect these corporates' continued ability to evaluate and manage risks and undertake succession planning should key staff leave. The loss of any such staff at a corporate could hamper its ability to undertake the sophisticated analyses needed to evaluate risks. The thinness of corporates' risk management staffs indicates that NCUA should routinely assess corporates' investment risk. However, as we noted earlier, NCUA also has a limited number of specialists to conduct comprehensive evaluations of risk management at corporates. Given that the risk-focused approach allows judgment in assigning resources to areas of greatest concern, the thinness of corporates' risk management staff, in combination with the limited number of specialists at NCUA, suggests that continued attention to corporates' investment strategies may help to ensure that corporates are adequately undertaking their risk management functions. Therefore, this may require NCUA to reassess its staffing levels and consider the costs and benefits of adding additional examiners or specialists to adequately monitor and oversee the growing complexity of corporates' operations.

As Corporate Network Consolidates, Merger Approval Process Could Be Improved with Better Guidance

As part of its regulatory authority to ensure the safety and soundness of corporates, NCUA reviews and approves corporate merger applications. Some corporates, NCUA, and trade-organization officials indicated that consolidation in the network—as a result of mergers—would likely continue over the next several years. However, with more mergers likely, NCUA has not developed specific guidance for corporates preparing merger proposal packages. In contrast, NCUA has issued guidance for natural person credit unions that provides step-by-step instructions for completing the merger process, and NCUA refers corporates to this guidance. However, NCUA has recognized that this guidance may be insufficient for corporates. In its guidance to examiners, who are responsible for evaluating merger proposal packages, NCUA has suggested that capital ratios unique to corporates, defined in Part 704 of NCUA's Rules and Regulations, were more appropriate than the probable asset share ratio

[43]We focused on the largest corporates and U.S. Central, since we judged them to have the most significant potential exposure to risk. We reviewed internal and corporate examiner documents, and independent third-party reviews, and discussed risk management with corporate officials and examiners. As a result, we have some confidence that the corporates appropriately staffed risk management functions and regularly evaluated and updated risk management models and the economic assumptions underlying them. Our analysis also was consistent with findings of a rating agency and independent analyses of larger corporates.

applicable to natural person credit unions.[44] However, in the guidance on mergers available to corporates on its Web site, NCUA has not indicated that corporates needed to include this information. In our review of five merger packages recently approved by NCUA, we found that three merger packages were initially submitted without the corporate capital ratios defined in Part 704. These merger packages required revision or additional analysis by the corporate and NCUA before the package could be approved, encumbering the approval process.

Other regulators such as OCC have provided detailed guidance to banks applying for mergers that listed specific data needed for evaluation and described the regulators' merger review process. OCC has stated that their approach is intended to avoid misunderstandings and unnecessary delays in the approval. NCUA officials told us they considered several factors when approving corporate mergers such as consolidated budgets and conversion and consolidation plans for information systems that it has not discussed in the natural person credit union guidance. However, only one of the five merger proposals we analyzed was submitted with this additional information. Other corporate's proposals required revisions or were approved without additional information being provided. One corporate stated they believed the merger process could be improved and made less cumbersome if NCUA provided clearer or more specific guidance for corporates. Finally, NCUA's guidance did not explicitly discuss how the effects of competition should be considered when approving corporate mergers, which may become more of an issue as the network continues to consolidate and corporates increasingly compete with each other or with other financial institutions.

Corporates Not Subject to Internal Control Reporting Requirements of FDICIA

As corporates react to a competitive environment by investing in technology and offering more products and services, NCUA's oversight of internal controls at corporates becomes even more critical. However, corporates with assets over $500 million were not required to report on the effectiveness of their internal controls for financial reporting.[45] Under the

[44]NCUA's Credit Union Merger Manual requires natural person credit unions to compute a "probable asset share" ratio for both the merging and continuing credit unions. The probable asset share ratio is computed by dividing the net value of a natural person credit union's assets by its total shares and reflects the relative worth of each dollar invested in shares.

[45]See GAO-04-91.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and its implementing regulations, banks and thrifts with assets over $500 million are required to prepare an annual management report that contains:

- a statement of management's responsibility for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness; and

- management's assessment of the effectiveness of the institution's internal control structure and procedures for financial reporting as of the end of the fiscal year and the institution's compliance with the designated safety and soundness laws and regulations during the fiscal year.[46]

Additionally, the institution's independent accountants are required to attest to management's assertions concerning the effectiveness of the institution's internal control structure and procedures for financial reporting. The institution's management report and the accountant's attestation report must be filed with the institution's primary federal regulator and any appropriate state depository institution supervisor, and must be available for public inspection. These reports allow depository institution regulators to gain increased assurance about the reliability of financial reporting.

The reporting requirement for banks and thrifts under FDICIA is similar to the reporting requirement included in the Sarbanes-Oxley Act of 2002.[47] Under Sarbanes-Oxley, public companies are required to establish and maintain adequate internal control structures and procedures for financial reporting. In addition, a company's auditor is required to attest to, and report on, the assessment made by company management on the effectiveness of internal controls. As a result of FDICIA and Sarbanes-Oxley, reports on management's assessment of the effectiveness of internal controls over financial reporting and the independent auditor's attestation on management's assessment have become a normal business practice for financial institutions and many companies.

[46]See 12 U.S.C. § 1831m; 12 C.F.R. Part 363 (2003).

[47]See e.g., 15 U.S.C. §§ 7241, 7262.

While NCUA has issued a letter to corporates indicating that selected provisions of the Sarbanes-Oxley Act of 2002, including the provision on internal control reporting standards, may be appropriate to consider, NCUA has not mandated that corporates adopt this standard.[48] Given that other depository institutions of similar size are required by FDICIA to adhere to the internal control reporting requirements to ensure safety and soundness, NCUA's lack of such a requirement for corporates raises the question of whether NCUA has the necessary information to adequately assess corporates' internal controls. This assessment has become more important as corporates' operations have grown in complexity due to their changing investment strategies, investments in technology, and introduction of new products and services.

Conclusions

Increased competition both inside and outside of the credit union system has challenged corporates to explore new technologies and introduce more products and services to retain their members. Increased competition, large fluctuations in inflows and outflows of deposits, in combination with low interest rates, have created potential stress on the financial condition of corporates and U.S. Central. While corporates' assets have increased rapidly, their ability to increase earnings remained constrained. As a result, corporates have increased their investments in privately issued, mortgage-related and asset-backed securities, which can increase returns but require more sophisticated analysis and monitoring. The change in corporates' investment profile is another indication of the growing complexity in their operations. Since some corporates have been allowed to invest in lower-rated securities (although few have), this could introduce increased risks in the system if not managed properly. With the changing operating and investment environments, this increases corporates' potential vulnerability to different financial stresses—and requires that corporates and their regulator, NCUA, place continued attention on their risk-assessment and monitoring strategies.

NCUA has made strides in strengthening its oversight of corporates, particularly with the adoption of a risk-focused approach, certain regulatory changes, and the hiring or training of specialists in information

[48]In October 2003, NCUA issued a Letter to Federal Credit Unions, 03-FCU-07, that discusses guidance on selected provisions of the Sarbanes-Oxley Act of 2002 for federally chartered credit unions, including federally chartered corporates. NCUA encouraged all corporates, regardless of their charter type to review this letter.

and payment systems and capital markets. We believe these actions have helped NCUA to more effectively oversee corporates. However, based on issues we identified, we believe NCUA should do more to anticipate and address emerging network issues. In particular, a tracking system used in conjunction with other measures, such as information from its management and call reports, could provide timely and significant information to NCUA that would help ensure that its risk-focused approach addressed individual as well as networkwide risks. The relatively small number of specialists during a time of increased competition and growing complexity in corporate operations raises additional concerns since NCUA had not systematically incorporated specialists in planning risk-focused examinations, or tracked recurring or pervasive issues throughout the network. We believe this makes it difficult for NCUA to determine the number and type of specialists that are needed or to anticipate problems to adequately monitor or oversee the corporate network. Further, with the continued consolidation in the network, NCUA's guidance was inadequate to ensure that examiners consistently evaluate proposed corporate mergers. Without sufficient guidance for corporates and examiners, NCUA lacks assurances that decisions on corporate mergers are consistently being made using appropriate criteria and information or that these decisions are consistently being made in the best interests of their members and NCUSIF. We believe that corporates and NCUA examiners would benefit from better guidance since consolidation, through mergers, is likely to continue. The growing complexity in operations and the products that corporates have introduced also raise important concerns about whether NCUA can ensure that corporates' internal controls, which are central to monitoring operations and risk management, are properly assessed and monitored. However, NCUA has not required corporates to follow the same internal control reporting requirements (defined under FDICIA) as other financial institutions that face similar risks. Finally, the changing profile of the industry introduces both greater opportunities and greater challenges for NCUA, as the regulator of these institutions, to achieve a balance that ensures the network's ability to introduce beneficial changes and properly manage its risks.

Recommendations for Executive Action

To promote a more systematic and consistent approach in NCUA's oversight of corporates to ensure they are safely providing financial services to natural person credit unions, we recommend that the Chairman of the National Credit Union Administration take the following five actions:

- Establish a process and structure to ensure more systematic involvement of specialists in identifying and addressing problems and developing and consistently applying policies, and reassess whether there are sufficient specialists to oversee corporates;

- Track and analyze examination deficiencies on a networkwide basis to identify and track recurring and pervasive issues throughout the network and to ensure that corporates take required corrective actions;

- Pay increased attention to oversight of corporates' risk management functions to ensure corporates have sufficient capacity and skills to monitor and manage their risks;

- Provide specific guidance to corporates for merger proposal packages to ensure they are providing sufficient and relevant information, and improve guidance to examiners to ensure that merger proposals are reviewed consistently and meet the goals of serving members while not placing NCUSIF at undue risk; and

- Require corporates with assets of $500 million or more to be subject to the internal control reporting requirements of the Federal Deposit Insurance Corporate Improvement Act of 1991 to ensure that corporates are held to the same standards as other financial institutions that face similar risks.

Agency Comments and Our Evaluation

We requested comments on a draft of this report from the Chairman of the National Credit Union Administration. We received written comments from NCUA that are summarized below and reprinted in appendix VIII. In addition, we received technical comments from NCUA that we incorporated into the report, as appropriate.

NCUA stated that it concurred with most of our assessments and conclusions contained in the report and plans to take actions to implement all but part of one of our recommendations.

Specifically, NCUA concurred with the report's assessment that corporates are operating in an increasingly challenging and competitive environment. In its comments on a draft of this report, NCUA stated that its changes to the corporate rule, made in response to the dynamic financial marketplace, functioned as intended, thus permitting the corporates' balance sheets to expand and contract, sometimes rapidly, depending on liquidity levels in credit unions, while not compromising safety and soundness. NCUA agreed that the influx of deposits, combined with decreasing interest rates had strained profitability and resulted in lower capital ratios. However, NCUA did not agree with the report's assessment that paid-in capital and membership capital are "weaker forms of capital." NCUA restated its requirements for these two forms of capital and, as stated in the report, believed that both paid-in capital and membership shares are available to cover losses that exceed retained earnings, and are not insured by either NCUSIF and cannot be pledged against borrowings. While we agree with NCUA's statements, as further discussed in the report, we remain concerned that both forms of capital are from external sources and are less permanent than retained earnings, therefore, providing a relatively weaker cushion against adverse financial events.

In commenting on corporates' investments, NCUA believed that the slight potential increase in credit risk exposure due to the 2002 rule change permitting corporates to purchase securities with lower credit quality is more than offset by the rule's decrease in exposure to credit concentration risk. Additionally, NCUA is of the opinion that the rule's "modest expansion" of permissible investment graded securities, combined with its reduction in credit concentration limits, results in a stronger corporate network—that corporate management is better positioned to compete, within prudent safety and soundness thresholds, than under the previous rule. NCUA also pointed out in its comments that as of June 30, 2004, 97 percent of the network's rated long-term securities are rated AAA. Based on the high quality and diversification of the network's investments, NCUA believes credit risk is minimal. NCUA stated that it has addressed controlling interest-rate risk in the corporate rule and its assessment of the network's investment portfolio interest-rate risk is minimal. We acknowledged in our report that corporates either have made few or no investments in BBB rated securities, and they indicated that they did not plan to use their authority to purchase such investments. However, it is not clear to what extent corporates will take advantage of this investment flexibility in the future, which has implications for NCUA's oversight, especially given the thinness of risk-management staff at corporates. Further, we share Treasury's concerns that allowing corporates to invest in BBB rated securities could weaken the safety and soundness of the corporate network because the amount of capital held in the corporates might not be commensurate with the risks associated with these lower credit quality investments.

While NCUA concurred with the report's recommendation for the need to provide corporates with specific merger guidance to facilitate the regulatory review process, NCUA did not concur with the report's conclusion that improved guidance to examiners is needed to ensure mergers meet the goals of serving members while not placing NCUSIF at undue risk. NCUA stated in its comments that it has adequate procedures in place, and that every corporate merger package prepared by OCCU is reviewed by NCUA's Office of General Counsel prior to being presented to the NCUA Board for action. As stated in the report, NCUA officials told us that they considered several factors when approving corporate mergers such as consolidated budgets and conversion plans for information systems that NCUA has not discussed in the natural person credit union guidance. However, we found that only one of the five merger proposals we analyzed was submitted with this additional information and, therefore, we do not believe that NCUA's guidance to examiners was sufficient to ensure that examiners consistently evaluate corporate mergers. As stated in the report's conclusions, without sufficient guidance, NCUA lacks assurances that decisions on corporate mergers are consistently made using appropriate criteria and information or that these decisions are made in the best interests of their members and NCUSIF. While clear criteria and consistency in review are important, improving examiner guidance for mergers is also necessary to help protect against forbearance on the part of NCUA.

As agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from its issuance. At that time, we will send copies of the report to the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs; the Chairman and Ranking Minority Member of the House Committee on Financial Services; and interested congressional committees. We also will send copies to the National Credit Union Administration and make copies available to others upon request. In addition, this report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions regarding this report, please contact me at (202) 512-8678 or hillmanr@gao.gov or Debra R. Johnson at (202) 512-9603 or johnsond@gao.gov. Key contributors are acknowledged in appendix IX.

Sincerely yours,

Richard J. Hillman
Director, Financial Markets
and Community Investment

Objectives, Scope, and Methodology

Our report objectives were to (1) assess the changes in financial condition of corporate credit unions (corporates) since 1992 and (2) assess the National Credit Union Administration's (NCUA) supervision and oversight of corporates, particularly with regard to how it identifies and addresses safety and soundness issues in the industry.

Financial Condition of Corporate Credit Unions Since 1992

To assess the changes in the financial condition of corporates since 1992, we analyzed corporate credit union call report data, which include balance sheet and income statement data for corporates. Our analysis, based on Forms 5300 and 5310 data supplied by NCUA, included calculating descriptive statistics and key financial ratios and describing trends in financial performance and the structure of the industry.[1] The information included Form 5300 data from the end of 1992 through the end of 1996 and monthly Form 5310 data from January 1997 through December 2003. Our analysis relied upon selected balance sheet and income statement data such as assets, shares, investments, capital, net economic value (NEV), and various income measures and ratios that are commonly used to assess the financial condition of financial institutions. The transition in 1997 from Form 5300 (still used by natural person credit unions) to Form 5310, which is specifically designed for corporates, entailed numerous changes in reporting. Furthermore, significant regulatory changes, effective in 1998, also resulted in numerous changes to the information reported on Form 5310 for 1998. Overall, these changes resulted in the deletion of some items from the financial reports and the addition of others. Subsequently, in some cases the data were not comparable across time. For example, NEV, which is a measure of interest-rate risk, was added to Form 5310 in 1998; thus, we were only able to conduct analysis on this measure from 1998 to 2003. In our prior report on natural person credit unions, we reviewed NCUA's procedures for verifying the accuracy of the Form 5300 database and found that the data were verified on an annual basis, either during the corporate credit union's examination, or through off-site supervision. We determined that the data were sufficiently reliable for the purposes of this report. We also performed a data reliability assessment on data from January 1997 through December 2003 for Form 5310, which involved electronic testing of the data and obtaining information from NCUA on its data verification procedures. We found that the data were verified for accuracy on a monthly

[1] NCUA provided most of the information in electronic form. Additional data were obtained from the regulator's Web site—www.ncua.gov.

basis and determined that the data were sufficiently reliable for the purposes of this report.

To augment our analysis and obtain a more comprehensive assessment of corporates' financial condition and risks, we reviewed internal corporate credit union financial analysis reports from selected corporates, independent evaluations of corporate risk controls and models, and external studies of the industry from major rating agencies, such as Fitch, Moody's, and Standard and Poor's. We also met with selected NCUA examiners and risk management staff at corporates to better assess how corporates were managing their risks. In addition, we reviewed internal documents and analyses dealing with risk monitoring and control from several corporates in order to assess how well these corporates could assess and manage risk.

NCUA's Supervision of Corporates

To assess how NCUA's supervision of corporates identifies and addresses safety and soundness issues, we conducted a review of key legislative and regulatory changes affecting corporates since 1992. We reviewed NCUA documentation on its risk-focused program, including NCUA examination reports, their corresponding three-year plans, and the Office of Corporate Credit Union (OCCU) management reports for all 31 corporates for 2001-2003.[2] We conducted interviews with OCCU management and with OCCU examiners-in-charge for 10 corporates.[3] In addition, we visited seven corporates. We developed a structured questionnaire for all 31 corporates to solicit their views on what challenges individual institutions and the collective corporate network faced. We reviewed past GAO and U.S. Department of the Treasury reports on corporates and NCUA, internal reviews of OCCU, and an external review of OCCU performed by an outside auditing firm. We also contacted officials from the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), the Office of the Comptroller of Currency (OCC), and the Board of Governors of the Federal Reserve System. Lastly, we interviewed trade association officials.

[2]Appendix II lists the 31 active corporates, including U.S. Central, as of December 31, 2003.

[3]Consistent with our policy on auditing financial institutions, we did not identify the locations of these 10 corporates, with the exception of U.S. Central (because of its unique role), because it would identify the operations of ongoing institutions.

As part of our legislative review, we reviewed the Federal Credit Union Act to determine the legislative authority for corporates and NCUA's Part 704, which is the primary regulation governing corporates. Specifically, we reviewed the *Federal Register* for all changes made to Part 704 since 1992 to understand the rationale behind these changes. We also obtained summaries from NCUA, which provided their rationale for the changes and brief descriptions of the changes to specific sections of Part 704.

To assess NCUA's documentation for its risk-focused program, we reviewed NCUA's Corporate Examiner's Guide, which describes the policies and procedures under which examiners are to implement the risk-focused program. The guide describes procedures for off-site monitoring, on-site examinations, information required in an examination report, and coordination with state supervisory authorities for corporates that have a state charter.

Also, as part of our assessment of NCUA's risk-focused examination program, we reviewed about 100 examinations for the 31 currently operating corporates, corresponding 3-year plans, and OCCU monthly management and quarterly reports for the period January 2001 through December 2003. For the review of examinations, we developed a data collection instrument (DCI) to collect 3 years' worth of information for each of the 31 corporates. The DCI enabled us to aggregate examination areas appearing in a large number of corporates over the time period reviewed that could be potential networkwide issues due to their prevalence or persistence. Examples of findings identified by NCUA in the various examination areas included errors or problems associated with 5310 reporting, accounting procedures, asset/liability management, Bank Secrecy Act compliance, contingency planning, corporate governance, credit analysis, funds transfer, information systems, interest-rate risk, investment, lending, and management.

The 3-year plans included information on the last examination and financial profiles—for example, daily average net assets (DANA), capital ratios, and net economic value (NEV). These plans also contained the supervision type of the corporate, supervision plans, Corporate Risk Information System (CRIS) ratings, and in some cases, requests for information system, payment system, or capital market specialists for the next examination or supervision contact.[4]

The OCCU monthly management reports covered areas such as OCCU's administration news, trends in corporates, significant problem case corporates, other significant program issues, miscellaneous corporate information, information on internal or external affairs, board action items, and the next month's calendar. The quarterly reports provided a brief update of events since the previous report, a summary of corporate network trends, the current status of e-commerce in corporates, specific discussions on 20 percent to 50 percent of individual corporates, and the future outlook for corporates and OCCU during the next quarter and beyond.

We met with OCCU management to follow up on questions generated from our review of the examinations, 3-year plans, and OCCU monthly management and quarterly reports. We also selected a judgmental sample of 10 corporates from which to gather additional information about NCUA oversight. These corporates were selected based on asset size, geographic location, charter type, level of expanded investment authority, and significant findings in the examinations. We obtained NCUA's most recent examiner workpapers for these 10 corporates to review how NCUA supported its findings. We also met with the examiner-in-charge and, when possible, capital market specialists for the 10 corporates to better comprehend their approach to examining the corporate credit union and to understand the support and rationale for some examination findings. In addition, we visited 7 of the 10 corporates to observe and discuss their operations, risk management practices, and interactions with NCUA. We selected these 7 based on their asset size, geographic location, type of charter (state or federal), and whether they had expanded investment authorities. We interviewed senior management and some board and supervisory committee members. We asked structured questions of officials from various departments within the corporates. The departments included investments, risk management, accounting, internal audit, external audit, information systems, and product support. We obtained policies and procedures for various areas within the corporates, including

[4]The supervision type is a code assigned to a corporate to determine the specific targeted examination and supervision program applied to the institution. It is not a rigid function of asset size, expanded authority level, or rating from an examination. Rather, it represents a combination of factors that may include these elements in addition to perceived risk levels, quality of changes in management, and financial condition.

investments, lending, and risk management. We also obtained documentation packages, which were submitted to the asset/liability committees of corporates for some of the institutions we visited, to review investments and their impact on the risk within the corporates. We also observed corporates' physical environment to determine the types of safeguards that were in place, particularly for information technology.

We developed a structured questionnaire to collect information from the corporate network that focused on their perspectives about various components of the industry. We pretested the questionnaire with one of the largest corporates and received numerous meaningful observations about our original version and made refinements. We administered the structured questionnaire to the entire population of active corporates (as of December 31, 2003) as shown in appendix II.

Appendix III includes a copy of our structured questionnaire, and appendix IV includes responses to the majority of questions in the questionnaire. The Association of Corporate Credit Unions (ACCU) oversaw the distribution of our structured questionnaire to its 30 corporate members. We administered the questionnaire to the one non-ACCU corporate member. The questionnaires were sent by e-mail at the end of March 2004. We received all responses to our questionnaire by mid-May 2004 and achieved a 100 percent response rate. We conducted follow-up telephone interviews with numerous corporates to obtain clarification on some of their responses. Our questionnaire covered the following areas:

- products and services that corporates offer to their natural person credit unions,
- Credit Union Service Organizations (CUSO),
- competition,
- investment authorities,
- corporate investments with U.S. Central,
- regulatory changes and impacts on corporates' operations,
- the effects of the risk-focused approach on corporates,
- corporates' fields of membership,

- challenges corporates face and their responses to these challenges, and
- corporates' immediate and future merger plans.

We analyzed the results by summarizing responses or providing simple statistics (for example, range, median, and average) to most of the quantitative questions. Specifically, we conducted quantitative analysis on questions 1, 3, 4, 5, 7, 7a, 11, 12, 13, 14, 17, and 21. We performed content analysis on most of the responses to the qualitative questions. Specifically, we conducted content analysis on questions 8, 9, 10, 16, 19, 20, 21a, and 22. The results of our analysis for most of the questions are presented in appendix IV.

To gain a better understanding on the challenges and problems NCUA has faced in overseeing corporates, we reviewed past GAO and U.S. Department of the Treasury reports on corporates and NCUA. These reports also provided recommendations for NCUA to improve its oversight. Additionally, we reviewed internal NCUA reviews on OCCU. These reviews are conducted about every 3 years by OCCU's Director and staff from outside OCCU, who review OCCU's operations and suggest improvements. Similarly, NCUA has contracted for an outside party to review OCCU's operations, and this party also has provided recommendations on improvements in OCCU management and oversight. OCCU's last external review was completed in 2002. We interviewed officials from the Department of the Treasury and academia who had studied corporates.

To obtain information on the experiences of other depository institution regulators with the risk-focused examination and supervision approach, we obtained written responses from officials at FDIC, OTS, OCC, and the Board of Governors of the Federal Reserve System.

Finally, to obtain perspectives on the business environment confronting the corporate network and their responses to a changing environment, we interviewed trade association officials from ACCU, the National Association of Federal Credit Unions, including its board of directors, and the National Association of State Credit Union Supervisors.

We conducted our work from December 2003 to September 2004 in Alexandria, Virginia, Washington, D.C., and other U.S. cities in accordance with generally accepted government auditing standards.

Corporate Credit Unions Active as of December 31, 2003

Corporate credit union	Federally or state-chartered
Central Corporate Credit Union	State
Central Credit Union Fund	State
Constitution State Corporate Credit Union	State
Corporate America Credit Union	State
Corporate Central Credit Union	State
Corporate One Federal Credit Union	Federal
Eastern Corporate Federal Credit Union	Federal
Empire Corporate Federal Credit Union	Federal
First Carolina Corporate Credit Union	State
First Corporate Credit Union	State
Georgia Central Corporate Credit Union	State
Iowa League Corporate Central Credit Union	State
Kansas Corporate Credit Union	State
Kentucky Corporate Federal Credit Union	Federal
LICU Corporate Federal Credit Union	Federal
Louisiana Corporate Credit Union	State
Mid-Atlantic Corporate Federal Credit Union	Federal
Mid-States Corporate Federal Credit Union	Federal
Midwest Corporate Federal Credit Union	Federal
Missouri Corporate Credit Union	State
Northwest Corporate Credit Union	State
Southeast Corporate Federal Credit Union	Federal
Southwest Corporate Federal Credit Union	Federal
Sun Corporate Credit Union	State
Treasure State Corporate Credit Union	State
Tricorp Corporate Federal Credit Union	Federal
U.S. Central Credit Union	State
Virginia League Corporate Federal Credit Union	Federal
Volunteer Corporate Credit Union	State
West Virginia Corporate Credit Union	State
Western Corporate Federal Credit Union	Federal

Source: NCUA.

Structured Questionnaire to Corporate Credit Unions on Their Current Makeup and Challenges Facing the Network

We distributed the following questionnaire to the entire network of corporates in the United States, including both federally and state-chartered institutions, and achieved a 100 percent response rate. (Appendix II lists the 31 corporates active as of December 31, 2003, and whether they are federally or state-chartered.) The questionnaire has three sections: products and services, regulatory changes, and challenges facing corporates. The first section addresses the types of products and services offered by corporates to their members, the issues they faced regarding competition, the type of investment authorities corporates had or sought, and the extent of their investments with U.S. Central Corporate Credit Union. The second section addresses various regulatory issues such as what regulatory changes affected their institution, a description of the corporate's field of membership (for example, whether they had a national field of membership), and their perception of NCUA's risk-focused supervisory approach. Finally, the questionnaire solicits the opinions of corporate managers on what future issues the corporate credit union industry faces. Appendix IV contains selected responses to the questionnaire.

United States General Accounting Office

GAO
Accountability * Integrity * Reliability

Survey of Corporate Credit Unions on Current Makeup and Challenges Facing the Network

Introduction

The U.S. General Accounting Office (GAO), an independent agency of the U.S. Congress, has been asked to review the National Credit Union Administration's (NCUA) oversight of corporate credit unions on behalf of the Senate Banking committee. As part of this review, we are collecting information from the corporate credit union network. We are sending this questionnaire, via the Association of Corporate Credit Unions, to each of the 31 corporate credit unions, in order to reflect corporate credit unions' perspective in our study.

Instructions

The questionnaire should be answered by the official (or officials) most familiar with the corporate credit union's operations. Specifically, our review is focused on examining the following three questions: (1) How has the financial condition and function of corporate credit unions changed over time and what have been the effects of that change; (2) To what extent does NCUA's supervision of corporate credit unions identify and address safety and soundness issues in the industry; and (3) What challenges do corporate credit unions face and what actions are they taking to address these challenges.

If you are using the Microsoft Word format, please save it to your computer first and then enter your answers directly into the marked areas. Many of the questions in this survey can be answered by checking a box or filling in a blank; some request a short narrative answer. The survey covers substantive questions and is largely fact-based for the purpose of allowing the GAO to accurately describe the current makeup of the corporate credit union network.

In addition, the survey asks for the opinion of the management of your corporate credit union on the future issues that face the industry. Those questions are included to ensure that the issues covered in our report reflect the perspective of the corporate network.

Your responses and all company information you provide will be treated to protect your privacy and that of the corporate credit union. Responses will be reported in aggregate, and therefore will not be used in any way that would identify you or your corporate credit union.

Please return your completed questionnaire to GAO by **April 15, 2004.** The response should be submitted electronically as a Microsoft Word file attachment sent to May Lee at **Leem@gao.gov** , or if you like, we could make other arrangements for your submission. Please call May Lee at (415) 904-2182 to make such arrangements.

If you have any questions about this survey or the GAO study, please contact José R. Peña, Analyst-in-Charge, at (415)-904-2268. or email him at penajr@gao.gov.

Thank you for your participation.

I. Products, Services and Investments

1) Please complete the following table describing the products and services that your corporate credit union offers:

Product or Service	Is currently offered? (Yes or No)	*If offered*, was product/service introduced in the last five years?	*If not offered*, are there plans to do so in the next two years?
A. Card/ATM Services			
1. ATM Cards (Issuing)	☐ Yes ☐ No	☐ Yes	☐ Yes
2. ATM Settlements/Terminal Driving	☐ Yes ☐ No	☐ Yes	☐ Yes
3. Credit Card Settlement	☐ Yes ☐ No	☐ Yes	☐ Yes
4. Debit Cards (Issuing)	☐ Yes ☐ No	☐ Yes	☐ Yes
B. Check Services			
1. Check Collection	☐ Yes ☐ No	☐ Yes	☐ Yes
2. Check Loss Reduction	☐ Yes ☐ No	☐ Yes	☐ Yes
3. Money Order Settlement	☐ Yes ☐ No	☐ Yes	☐ Yes
4. Share Draft Processing	☐ Yes ☐ No	☐ Yes	☐ Yes
5. Statement Prep and Mailing	☐ Yes ☐ No	☐ Yes	☐ Yes
6. Tellers Check	☐ Yes ☐ No	☐ Yes	☐ Yes
7. Travelers Check Settlement	☐ Yes ☐ No	☐ Yes	☐ Yes
C. Correspondence Services			
1. Coin and Currency	☐ Yes ☐ No	☐ Yes	☐ Yes
2. Federal Reserve Settlement	☐ Yes ☐ No	☐ Yes	☐ Yes
3. Financial Settlements	☐ Yes ☐ No	☐ Yes	☐ Yes
4. Foreign Check Collection	☐ Yes ☐ No	☐ Yes	☐ Yes
5. Foreign Currency Conversion	☐ Yes ☐ No	☐ Yes	☐ Yes
D. Education and Training			
1. Marketing	☐ Yes ☐ No	☐ Yes	☐ Yes
2. Online Training	☐ Yes ☐ No	☐ Yes	☐ Yes
3. Rates/Events Updates/News	☐ Yes ☐ No	☐ Yes	☐ Yes
E. E-Services			
1. ACH Services	☐ Yes ☐ No	☐ Yes	☐ Yes
2. Cash Concentration	☐ Yes ☐ No	☐ Yes	☐ Yes
3. Check Imaging	☐ Yes ☐ No	☐ Yes	☐ Yes
4. Electronic Bill Payment	☐ Yes ☐ No	☐ Yes	☐ Yes
5. Funds/Wire Transfers (In & Out)	☐ Yes ☐ No	☐ Yes	☐ Yes
6. Internet Banking	☐ Yes ☐ No	☐ Yes	☐ Yes
7. Website Design and Management	☐ Yes ☐ No	☐ Yes	☐ Yes

(continue on next page.)

2

(continuation of Q1.)

Product or Service	**Is currently offered? (Yes or No)**	***If offered*, was product/service introduced in the last five years?**	***If not offered*, are there plans to do so in the next two years?**
F. Funds Management/Financial Services			
1. Account Management & Statements	☐ Yes ☐ No	☐ Yes	☐ Yes
2. Amortizing Certificates (ACP)	☐ Yes ☐ No	☐ Yes	☐ Yes
3. Asset/Liability Management	☐ Yes ☐ No	☐ Yes	☐ Yes
4. Brokerage Services	☐ Yes ☐ No	☐ Yes	☐ Yes
5. CDs	☐ Yes ☐ No	☐ Yes	☐ Yes
6. Corporate Checking Accounts	☐ Yes ☐ No	☐ Yes	☐ Yes
7. Derivatives Hedging	☐ Yes ☐ No	☐ Yes	☐ Yes
8. Dividend Earning Accounts	☐ Yes ☐ No	☐ Yes	☐ Yes
9. Investment Advisory	☐ Yes ☐ No	☐ Yes	☐ Yes
10. Loans/Lending	☐ Yes ☐ No	☐ Yes	☐ Yes
11. Members' Business Accounts	☐ Yes ☐ No	☐ Yes	☐ Yes
12. Members' Capital Accounts	☐ Yes ☐ No	☐ Yes	☐ Yes
13. Money Market Accounts	☐ Yes ☐ No	☐ Yes	☐ Yes
14. Open-End and Term Credits	☐ Yes ☐ No	☐ Yes	☐ Yes
15. Overnight/Cash Management Accounts	☐ Yes ☐ No	☐ Yes	☐ Yes
16. Savings Bonds	☐ Yes ☐ No	☐ Yes	☐ Yes
17. Share Certificates (all kinds)	☐ Yes ☐ No	☐ Yes	☐ Yes
G. Miscellaneous			
1. Cash Letter Credit	☐ Yes ☐ No	☐ Yes	☐ Yes
2. CU Service Settlement	☐ Yes ☐ No	☐ Yes	☐ Yes
3. CUNA Service Group Settlement	☐ Yes ☐ No	☐ Yes	☐ Yes
4. CUNA Mutual Services	☐ Yes ☐ No	☐ Yes	☐ Yes
5. Reverse Purchase Program	☐ Yes ☐ No	☐ Yes	☐ Yes
6. Securities Safekeeping	☐ Yes ☐ No	☐ Yes	☐ Yes
H. Other *(Specify.)*			
1. [type here]	☐ Yes ☐ No	☐ Yes	☐ Yes
2. [type here]	☐ Yes ☐ No	☐ Yes	☐ Yes
3. [type here]	☐ Yes ☐ No	☐ Yes	☐ Yes
4. [type here]	☐ Yes ☐ No	☐ Yes	☐ Yes
5. [type here]	☐ Yes ☐ No	☐ Yes	☐ Yes

3

2) How are your member capital accounts structured?

[type here]

3) By size of assets, how many of your members are NPCUs, CCUs, or Others?
(Enter the number of your Corporate members in each cell. If none, enter "0".)

Size of Member CU	**Member Type**		
	Number of *NPCUs* in your membership	**Number of *CCUs* in your membership**	**Number of *Others* in your membership**
< $10 Million	[type # or 0]	[type # or 0]	[type # or 0]
>$10M but <$100M	[type # or 0]	[type # or 0]	[type # or 0]
>$100M but <$1 Billion	[type # or 0]	[type # or 0]	[type # or 0]
> $1 Billion	[type # or 0]	[type # or 0]	[type # or 0]
TOTAL	[type # or 0]	[type # or 0]	[type # or 0]

4) What percentage of your various lines of business are from the following Natural Person (or Corporate) Credit Union member size categories?
(Enter percent by size for each line of business. Percentages should total to 100%)

Size of Member Credit Union	**Line of Business**						
	Payments	Settlements	Loans or Liquidity Provision	Investments	Brokerage	ALM	Other
< $10 Million	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]
>$10M but <$100M	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]
>$100M but <$1 Billion	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]
> $1 Billion	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]	[Enter %]
TOTAL	100%	100%	100%	100%	100%	100%	100%

4

5) Has your Natural Person (or Corporate) Credit Union members' use of services increased (I), stayed the same (S), or decreased (D) since CY1992 , as broken out by member size? *(Select a letter for each cell in the table using the following indicators; then enter it in the cell.*

I *= INCREASED use of the service*
S *= SAME use of the service as before 1992*
D*= DECREASED use of the service*
NA = Not applicable)

Size of Member Credit Union	**Line of Business**						
	Payments	Settlements	Loans or Liquidity Provision	Investments	Brokerage	ALM	Other
< $10 Million	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter
>$10M but <$100M	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter
>$100M but <$1 Billion	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter
>$1 Billion	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter	enter letter

6) What do you think are the reasons for any changes in your members' use of your services?

[type here]

7) How many CUSOs does your corporate credit union have a stake in? *(Check one.)*

5

1. ☐ 0 (Skip to Question #8.)
2. ☐ 1
3. ☐ 2
4. ☐ 3 or more

7a) If 1 or more, please complete the following table and continue to question 7b.

Name of CUSO	Percentage of ownership stake	Primary function
[enter name]	[Enter %]	[enter function]
[enter name]	[Enter %]	[enter function]
[enter name]	[Enter %]	[enter function]

7b) How do the services that these CUSOs provide differ from the services the corporate credit union provides?

[type here]

6

8) In what ways does your corporate credit union face competition from outside the corporate credit union network? *(If no external competition, skip question 8a.)*

[type here]

8a) What are the sources of that competition, and which products services are most affected?

Source of competition	**Products and Services Affected**
[type here]	[type here]
[type here]	[type here]
[type here]	[type here]
[type here]	[type here]

8b) To what extent do you expect competition to continue to increase in the next several years?

[type here]

9) In what ways have you felt competition from other corporate credit unions increase in the last five years?

[type here]

7

10) To what extent do you expect competition from other corporate credit unions to continue to increase in the next several years?

[type here]

11) What investment authorities do you currently have? (*Check all that apply.)*

1. ☐ Base
2. ☐ Base Plus
3. ☐ Part I
4. ☐ Part II
5. ☐ Part III
6. ☐ Part IV
7. ☐ Part V
8. ☐ Other *(Specify.)* [type here]

12) Do you plan on asking for more authorities in the next two years? If yes, then which ones? (*Check all that apply.)*

1. ☐ Base
2. ☐ Base Plus
3. ☐ Part I
4. ☐ Part II
5. ☐ Part III
6. ☐ Part IV
7. ☐ Part V
8. ☐ Other *(Specify.)* [type here]

13) What percent of your investments are made through U.S. Central?

[enter %] = Percent of investments with U.S. Central.

8

14) Which of the following categories best describes your planned use of U.S. Central for investment purposes in the next two years?

1. ☐ To do Less with U.S. Central
2. ☐ To do the Same with U.S. Central
3. ☐ To do More with U.S. Central
4. ☐ Do not currently invest in U.S. Central AND do not plan to do so in next two years

II. **Regulatory Changes**

15) Which regulatory changes – including changes to Part 704 – have had the most impact on your corporate credit union?

[type here]

15a) Please describe how those changes have impacted your corporate credit union's operations?

[type here]

16) Please describe the effect of NCUA's more risk-based approach of corporate credit union examination on your corporate credit union?

[type here]

9

17) Do you have a national field of membership? *Check one.)*

1. ☐ Yes
2. ☐ No

18) How many NPCU members are within your Corporate field of membership in each of the following states? *(If other than "0", enter actual number of member NPCUs in each state.)*

Alabama [0]	Alaska [0]	Arizona [0]	Arkansas [0]	California [0]
Colorado [0]	Connecticut [0]	Delaware [0]	Florida [0]	Georgia [0]
Hawaii [0]	Idaho [0]	Illinois [0]	Indiana [0]	Iowa [0]
Kansas [0]	Kentucky [0]	Louisiana [0]	Maine [0]	Maryland [0]
Massachusetts [0]	Michigan [0]	Minnesota [0]	Mississippi [0]	Missouri [0]
Montana [0]	Nebraska [0]	Nevada [0]	New Hampshire [0]	New Jersey [0]
New Mexico [0]	New York [0]	North Carolina [0]	North Dakota [0]	Ohio [0]
Oklahoma [0]	Oregon [0]	Pennsylvania [0]	Rhode Island [0]	South Carolina [0]
South Dakota [0]	Tennessee [0]	Texas [0]	Utah [0]	Vermont [0]
Virginia [0]	Washington [0]	West Virginia [0]	Wisconsin [0]	Wyoming [0]

III. Challenges Facing Corporate Credit Unions

19) What are the primary challenges facing your corporate credit union as it attempts to maintain and/or grow its membership in the next two years?

[type here]

20) What is your corporate credit union doing to address these challenges?

[type here]

10

21) What is your corporate credit union's current merger plans?

1. ☐ In discussions to merge with another corporate credit union
2. ☐ Likely to merge with another corporate credit union in the next two years
3. ☐ Will consider a merger with another corporate credit union in the next two years

4. ☐ Will not consider a merger in the next two years
5. ☐ Uncertain

21a) If you checked either box 1, 2, or 3 in the previous question (#21), please describe the factors that contribute to your corporate credit union's decision to consider a merger?

[type here]

22) What are the three major challenges currently facing the corporate credit union industry as a whole?

1. [type here]

2. [type here]

3. [type here]

23) Please indicate the name, title, and phone number of the person(s) who was mainly *responsible for filling out this questionnaire.*

Name [enter name], Title [enter title],

Phone number: [enter area code & number]

11

24) Please indicate the name, title, and phone number of the person GAO staff should contact *if GAO has follow up questions.*

Name [enter name], Title [enter title]

Phone number: [enter area code & number]

25) Would you like to discuss any of the above questions in further depth, or anything else related to our review of the corporate credit union industry, with GAO?

1. ☐ No
2. ☐ Yes

If YES, please provide name, title, and phone number of the person to contact to schedule a follow-up conversation.

Name [enter name], Title [enter title]

Phone number: [enter area code & number]

Thank you for completing the Survey

(Save your completed survey as an MS Word document and send it as an attachment to May Lee at **Leem@gao.gov**)

12

Selected Responses to Structured Questionnaire Distributed to Corporate Credit Unions

As noted in appendix III, we distributed a questionnaire to the entire network of corporates. This appendix provides responses to the majority of questions posed in the questionnaire (see questions 1, 3-5, 7-14, 16-17, and 19-22). This information was analyzed in the aggregate to prevent specific responses from being associated with an individual institution.

Selected Questionnaire Results

The information included in this appendix is based on the responses of 31 corporates, unless otherwise indicated.

Question 1: Products and Services Corporate Credit Unions Offer

Product or service	Is currently offered? Yes	*If offered*, was product/service introduced in the last five years?	*If not offered*, are there plans to do so in the next two years?
A. Card/ATM Services			
1. ATM Cards (Issuing)	4	0	2
2. ATM Settlements/Terminal Driving	14	1	1
3. Credit Card Settlement	26	0	0
4. Debit Cards (Issuing)	4	0	2
B. Check Services			
1. Check Collection	26	2	1
2. Check Loss Reduction	6	3	4
3. Money Order Settlement	25	0	0
4. Share Draft Processing	18	3	1
5. Statement Prep and Mailing	4	0	2
6. Tellers Check	21	0	0
7. Travelers Check Settlement	25	0	0
C. Correspondence Services			
1. Coin and Currency	26	0	0
2. Federal Reserve Settlement	30	0	0
3. Financial Settlements	29	0	0
4. Foreign Check Collection	30	2	0
5. Foreign Currency Conversion	20	3	0
D. Education and Training			
1. Marketing	19	1	1
2. Online Training	23	13	2
3. Rates/Events Updates/News	31	4	0
E. E-Services			
1. ACH Services	30	2	0
2. Cash Concentration	29	1	0
3. Check Imaging	20	7	3
4. Electronic Bill Payment	22	15	2
5. Funds/Wire Transfers (In & Out)	31	0	0
6. Internet Banking	19	11	0
7. Website Design and Management	6	5	1
F. Funds Management/Financial Services			
1. Account Management & Statements	25	1	0
2. Amortizing Certificates (ACP)	28	3	1
3. Asset/Liability Management	21	8	2
4. Brokerage Services	22	14	4
5. CDs	30	2	0
6. Corporate Checking Accounts	28	1	0

Product or service	Is currently offered? Yes	*If offered*, was product/service introduced in the last five years?	*If not offered*, are there plans to do so in the next two years?
7. Derivatives Hedging	3	2	3
8. Dividend Earning Accounts	31	0	0
9. Investment Advisory	13	3	3
10. Loans/Lending	31	0	0
11. Members' Business Accounts	11	3	6
12. Members' Capital Accounts	30	0	0
13. Money Market Accounts	20	0	0
14. Open-End and Term Credits	26	1	0
15. Overnight/Cash Management Accounts	30	0	0
16. Savings Bonds	14	0	0
17. Share Certificates (all kinds)	28	0	0
G. Miscellaneous			
1. Cash Letter Credit	26	0	0
2. CU Service Settlement	26	0	0
3. CUNA Service Group Settlement	28	0	0
4. CUNA Mutual Services	15	0	0
5. Reverse Purchase Program	26	0	0
6. Securities Safekeeping	29	0	0
H. Other *(Specify.)*[a]			
1. ALM	1	1	0
2. ATM/Pay Card Services	2	1	0
3. CDs	6	4	0
4. Consulting Services	3	2	0
5. CUSO Products/Services	1	0	0
6. Education/Training	1	0	0
7. Financial/Liquidity Products	1	0	0
8. Fraud Protection Products	2	2	0
9. International Services	1	1	0
10. Loans	3	2	1
11. Lock box	1	0	0
12. Member Services	3	2	0
13. Money Transfers	1	0	0
14. Non-Member Deposits	1	0	0
15. Payment and Technology Products	1	0	0
16. Settlements	5	0	0
17. Share Draft Electronic Image Exchange	0	0	1
18. Transit Return Processing	1	0	0
19. WAVE/Web-Based Solution	2	1	0

Source: GAO Structured Questionnaire to Corporates.

[a]Responses displayed are as reported by corporates.

Question 3: Corporate Credit Union Membership by Asset Size

Size of natural person credit union	Number of n***atural person credit unions*** in your membership
< $10 Million	Range => 0-553 Median => 102
>$10M but <$100M	Range => 3-579 Median => 109
>$100M but <$1 Billion	Range => 3-232 Median => 25
> $1 Billion	Range => 0-65 Median => 2

Source: GAO Structured Questionnaire to Corporates.

Question 4: Member Credit Union Usage of Corporate Credit Union Services and Products Based on Member Asset Size

Size of member credit union	Line of business						
	Payments	Settlements	Loans or liquidity provision	Investments	Brokerage	ALM	Other
< $10 Million	Range 0-60% Ave 23.89%	Range 0-66% Ave 25.05%	Range 0-60% Ave 23.88%	Range 0-63% Ave 24.11%	Range 0-38% Ave 5.45%	Range 0-66% Ave 8.17%	Range 0-60% Ave 10.38%
>$10M but <$100M	Range 0-85% Ave 42.83%	Range 0-70% Ave 41.28%	Range 0-95% Ave 41.92%	Range 0-62% Ave 36.63%	Range 0-100% Ave 35.57%	Range 0-100% Ave 47.15%	Range 0-60% Ave 13.91%
>$100M but <$1 Bil	Range 0-62% Ave 22.02%	Range 0-63% Ave 22.27%	Range 0-77% Ave 24.62%	Range 0-60% Ave 25.72%	Range 0-70% Ave 19.44%	Range 0-100% Ave 15.43%	Range 0-70% Ave 8.42%
> $1 Billion	Range 0-50% Ave 3.65%	Range 0-81% Ave 6.59%	Range 0-88% Ave 6.02%	Range 0-88.7% Ave 10.15%	Range 0-82% Ave 5.80%	Range 0-46% Ave 2.42%	Range 0-26% Ave 1.21%

Source: GAO Structured Questionnaire to Corporates.

Question 5: Level of Member Credit Unions' Use of Services Since Calendar Year 1992

Size of member credit union	Line of business						
	Payments	Settlements	Loans or liquidity provision	Investments	Brokerage	ALM	Other
< $10 Million	I = 23 (74.19%) S = 4 (12.90%) D = 0 (0%) NA = 4 (12.90%)	I = 23 (74.19%) S = 5 (16.13%) D = 1 (3.23%) NA = 2 (6.45%)	I = 17 (54.84%) S = 7 (22.58%) D = 5 (16.13%) NA = 2 (6.45%)	I = 23 (74.19%) S = 5 (16.13%) D = 0 (0%) NA = 2 (6.45%)	I = 14 (45.16%) S = 3 (9.68%) D = 0 (0%) NA = 13 (41.94%)	I = 12 (38.71%) S = 5 (16.13%) D = 1 (3.23%) NA = 13 (41.94%)	I = 10 (32.26%) S = 2 (6.45%) D = 0 (0%) NA = 8 (25.81%)
>$10M but <$100M	I = 25 (80.65%) S = 2 (6.45%) D = 1 (3.23%) NA = 3 (9.68%)	I = 24 (77.42%) S = 4 (12.90%) D = 3 (9.68%) NA = 0 (0%)	I = 24 (77.42%) S = 4 (12.90%) D = 3 (9.68%) NA = 0 (0%)	I = 20 (64.52%) S = 5 (16.13%) D = 6 (19.35%) NA = 0 (0%)	I = 25 (80.65%) S = 3 (9.68%) D = 2 (6.45%) NA = 1 (3.23%)	I = 18 (58.06%) S = 0 (0%) D = 1 (3.23%) NA = 12 (38.71%)	I = 18 (58.06%) S = 0 (0%) D = 1 (3.23%) NA = 12 (38.71%)
>$100M but <$1 Bil	I = 24 (77.42%) S = 3 (9.68%) D = 1 (3.23%) NA = 3 (9.68%)	I = 23 (74.19%) S = 5 (16..13%) D = 3 (9.68%) NA = 0 (0%)	I = 19 (61.29%) S = 6 (19.35%) D = 6 (19.35%) NA = 0 (0%)	I = 23 (74.19%) S = 5 (16.13%) D = 2 (6.45%) NA = 1 (3.23%)	I = 16 (51.61%) S = 1 (3.23%) D = 1 (3.23%) NA = 11 (35.48%)	I = 17 (54.84%) S = 2 (6.45%) D = 1 (3.23%) NA = 11 (35.48%)	I = 11 (35.48%) S = 3 (9.68%) D = 0 (0%) NA = 6 (19.35%)
> $1 Billion	I = 17 (54.84%) S = 4 (12.90%) D = 0 (0%) NA = 10 (32.26%)	I = 19 (61.29%) S = 4 (12.90%) D = 1 (3.23%) NA = 7 (22.58%)	I = 15 (48.39%) S = 5 (16.13%) D = 4 (12.90%) NA = 7 (22.58%)	I = 19 (61.29%) S = 3 (9.68%) D = 1 (3.23%) NA = 8 (25.81%)	I = 11 (35.48%) S = 4 (12.90%) D = 0 (0%) NA = 15 (48.39%)	I = 8 (25.81%) S = 7 (22.58%) D = 0 (0%) NA = 16 (51.61%)	I = 5 (16.13%) S = 5 (16.13%) D = 0 (0%) NA = 10 (32.26%)

Source: GAO Structured Questionnaire to Corporates.

Note: I = increased, S = stayed the same, or D = decrease since calendar year 1992. N/A = not applicable.

Question 7: Number of Credit Union Service Organizations Corporate Credit Unions Have Stakes In

Response category	Number of corporates	Percent of corporates
None	1	3.23%
1	5	16.13%
2	11	35.48%
3 or more	14	45.16%

Source: GAO Structured Questionnaire to Corporates.

Question 7a: Credit Union Service Organization (CUSO) Names, Function, and Percentage Holdings

CUSO name	CUSO function	Number of corporates [a]	Percent holdings [b]
Primary Financial, Co LLC	CD brokerage services	24	67.25% [c]
CNBS, Inc. LLC	Broker/Dealer, ALM, advisory, and education	7	66.28%
CU Business Group, LLC	Business lending, deposit, and consulting	4	100%
Corporate Access	Loan participation, shared financial services	3	60%
Corporate Exchange	Brokered CDs	2	12%
CU eArchive Solutions (CUeas)	Image archive for share drafts	2	100%
CU National Item Capture (CUNIC)	Item processing for share drafts/check processing	2	100%
1909 Financial Advisors	CU Financial Services	1	100%
ALM First Financial Advisors	Balance sheet/investment risk management	1	85%
Callahan CU Financial Services (CUFSLP)	Investment services	1	2%
Carolina CU Services, Inc.	Shared branching network for credit unions	1	3%
CenCorp Business Solutions, LLC	Out-sourced business loan underwriting and other business services for CUs	1	100%
Centennial Lending LLC	Lending CUSO for member credit unions	1	25%
Charlie Mac, LLC	Purchase mortgage and auto loans; provide credit unions with a secondary market	1	100%
Constitution Investment	Investment advisory and risk reporting	1	100%
Corporate Network eCom, LLC	Low-cost electronic bill payment and related solutions	1	87%
Corporate Synergies, LLC	Operates new core processing system	1	75%
Credit Union Brokerage Services	Brokerage services	1	100%
Credit Union Direct Lending (CUDL)	Point of sale auto lending	1	.6%
CSC II, Inc.	Shared branching services to credit unions in New York	1	3.3%
CSI	Item processing for credit unions	1	6%
CU Business Partners (CUBP)	Member business lending	1	1%
CU Investment Solutions, Inc.	Offered fee-based, investment supervisory services to credit unions	1	100%
CU Service Co. of VA	Branching for retail credit unions	1	1%
CU West Mortgage (CUWM)	Mortgage origination	1	3%
CUC Mortgage Corp	Mortgage processing services for credit unions	1	10%
CUCKY	Shared service center for credit unions	1	0%
CUSOURCE, LLC	Investments	1	100%

CUSO name	CUSO function	Number of corporates [a]	Percent holdings [b]
First Carolina RE Services, LLC	Assist homebuyers in finding mortgage and real estate agents	1	50%
Georgia Credit Union Affiliates	Management services	1	33%
ICUL Service Corp	Various credit union services	1	6%
Member Business Solutions, LLC	Merchant services and entry into loans, deposits, payroll, commercial credit analysis	1	100%
Member Trade Advisory Services, LLC	ALM educational, analytical, and advisory products and services	1	100%
Member Trade Financial Services, LLC	Broker/dealer products and services	1	100%
Mid-States Investment Solutions, Inc.	Broker/dealer	1	100%
MY CU Services, LLC	Wholesale payment services	1	100%
Network Financial Services, LLC	Provides advice for government securities program	1	100%
Open Financial Solutions, Inc.	Provides e-bill payment services	1	11.1%
PA Shared Service Center	Shared branch facilities	1	4%
SimpliCD	CD brokerage	1	5%
SmartSource Solutions	Web development and hosting	1	100%
Synergent	League service corporation	1	1%
The Members Group	Outsourcing operations work for many corporate products and services	1	50%
VSOI	Sale of software to other corporate credit unions	1	100%
WesCorp Investment Services	Wholesale broker dealer	1	100%
Wisconsin CD Shared Service Center	Shared branches	1	
XCU Corporation	Retail broker dealer	1	6.7%

Source: GAO Structured Questionnaire to Corporates.

[a]This column indicates the total of corporate credit unions that indicated having ownership stakes in the Credit Union Service Organizations.

[b]This column represents the percentage stake owned by the corporate(s).

[c]Three corporates did not provide their percentage holdings in Primary Financial but indicated that each own 1 share. Therefore, the total percentage holdings for Primary Financial is 67.25 percent and 3 shares.

Question 8: **Source, Number and Percent of Corporate Credit Unions Experiencing Competition From Outside The Corporate Credit Union Network**

Response category	Number of corporates	Percent of corporates
Banks and savings and loans	23	74.19%
Broker/dealers and other investment entities	23	74.19%
Federal Home Loan Banks	19	61.29%
Federal Reserve Banks	19	61.29%
Third-party processors	13	41.94%
Competitors on a product-by-product basis	4	12.90%
Financial institutions in general	4	12.90%
Niche providers[a]	3	9.68%
Mutual funds	2	6.45%
Federal agencies	1	3.23%
Government Sponsored Enterprises	1	3.23%

Source: GAO Structured Questionnaire to Corporates.

[a]Electronic bill payment or business services are examples of products provided by niche providers.

Question 9: **Corporate Credit Unions' Experience with Competition Inside the Corporate Credit Union Network during the last five years**

Response category	Number of corporates	Percent of corporates
Experienced competition within corporate credit union network	27	87.10%
Did not experience competition within credit union network	2	6.45%
Do not compete	2	6.45%

Source: GAO Structured Questionnaire to Corporates.

Question 10: **Future Outlook on Competition within the Corporate Credit Union Network**

Response category	Number of corporates	Percent of corporates
Competition will increase	21	67.74%
Competition will continue	7	22.58%
Competition will remain about the same	1	3.23%
Increased partnerships because of competition	1	3.23%
Do not compete	2	6.45%

Source: GAO Structured Questionnaire to Corporates.

Note: Total percent exceeds 100 percent because 2 corporates provided multiple answers.

Question 11: Current Investment Authorities Held By Corporate Credit Unions

Response category [a]	Number of corporates
Base	20
Base Plus	13
Part I	4
Part II	3
Part III	3
Part IV	3
Part V	1
Other [b]	2

Source: GAO Structured Questionnaire to Corporates.

[a]The investment authorities are described in more detail in appendix VII.

[b]These two corporates offered loan participations through a waiver from NCUA. In addition, one of these two respondents has "derivatives vendor status," as approved by NCUA.

Question 12: Corporate Credit Unions' Plans to Seek Additional Expanded Authorities in the Next Two Years

Response category	Number of corporates
Base	0
Base Plus	3
Part I	7
Part II	1
Part III	1
Part IV	5
Part V	9
Other[a]	1

Source: GAO Structured Questionnaire to Corporates.

[a]This corporate credit union may ask for more investment authorities in the next two years.

Question 13: Percentage Of Corporate Credit Unions' Investments Made Through U.S. Central

Response category	Number of corporates	Percent of corporates
0-25%	2	6.67%
26-50%	6	20.00%
51-75%	8	26.67%
76-100%	13	43.33%
Did not respond	1	3.33%
Total [a]	**30**	**100%**

Source: GAO Structured Questionnaire to Corporates.

[a]Percent calculations did not include U.S. Central, therefore the base is 30 versus 31 corporate credit unions.

Question 14: Corporate Credit Unions' Planned Use of U.S. Central for Investment Activities Over the Next Two Years

Response category	Number of corporates	Percent of corporates[a]
Continue present level of investment with U.S. Central	22	73.33%
Less investment with U.S. Central	5	16.67%
Increase investments with U.S. Central [b]	2	6.67%
Do not currently invest with U.S. Central and do not plan to do so in next two years	1	3.33%
Did not respond	1	3.33%

Source: GAO Structured Questionnaire to Corporates.

[a]Percent calculations did not include U.S. Central, therefore the base is 30 versus 31 corporate credit unions. Total percent exceeds 100 percent because one corporate credit union responded to two response categories and was included in both categories.

Question 16: Corporate Credit Unions' Views On NCUA's Risk-Based Approach Of Corporate Credit Union Examination

Response category	Number of corporates	Percent of corporates[a]
Positive response to risk-based approach (for example, targeted exams)	26	83.87%
No discernable impact from risk-based approach	4	12.90%
Expressed concerns about targeted exam approach[b]	2	6.45%
Did not respond	1	3.23%

Source: GAO Structured Questionnaire to Corporates.

[a]Total of this column is greater than 100 percent because two respondents expressed concerns in addition to their comments (see table footnote b below).

[b]Two respondents expressed concerns in addition to their comments on their reaction to the risk-based approach. Specifically, one respondent had a positive reaction and the other experienced no discernable impact.

Question 17: Corporate Credit Unions' National Field of Membership Classification

Response category	Number of corporates	Percent of corporates
Currently have national field of membership	29	93.55%
Do not currently have national field of membership	2[a]	6.45%

Source: GAO Structured Questionnaire to Corporates.

[a]One of these corporates, Kentucky Corporate Federal Credit Union, has a regional field of membership; and the other, LICU Corporate Federal Credit Union, facilitates payment and payroll processing for a league of IBM credit unions.

Question 19: Primary Challenges Faced By Corporate Credit Unions

Response category	Number of corporates	Percent of corporates
Marketplace changes/challenges	19	61.29%
Competition	16	51.61%
Consolidation/mergers	12	38.71%
Issues associated with natural person credit unions	9	29.03%
Regulatory/legal Issues	6	19.35%
Other challenges	6	19.35%
No challenges	2	6.45%

Source: GAO Structured Questionnaire to Corporates.

Question 20: Strategies Used by Corporate Credit Unions to Address Challenges Reported in Question 19

Response category	Number of corporates	Percent of corporates
Process improvements[a]	20	64.52%
Increased products and services	16	51.61%
Market expansion activities	18	58.06%
Other strategies	9	29.03%

Source: GAO Structured Questionnaire to Corporates.

[a]Examples of process improvements include investments in human resources and technology; public relations, brand recognition activities; regular evaluation of account structures; and survey and visit.

Question 21: Corporate Credit Unions' Current Merger Plans

Response category	Number of corporates	Percent of corporates
Will not consider a merger within the next two years	14	45.16%
Uncertain	9	29.03%
Will consider a merger with another corporate credit union within the next two years	6	19.35%
Likely to merge with another corporate credit union within the next two years	1	3.23%
Not applicable	1	3.23%

Source: GAO Structured Questionnaire to Corporates.

Question 21a: Contributing Factors to Consider Mergers

Factors	Number of corporates	Percent of corporates
Benefits to corporate and members	5	71.43%
Management	3	42.86%
Increases in membership	3	42.86%
Asset quality and increases[a]	2	28.57%
Other[b]	4	57.14%

Source: GAO Structured Questionnaire to Corporates.

Note: Only includes the seven corporates that indicated they are likely to merge or will consider to merge within the next two years.

[a]Asset quality and increases include financial strength and capital resources and structure.

[b]Other includes geographic proximity and due diligence study.

Question 22: Major Challenges Currently Facing the Corporate Credit Union Network

Response category	Number of corporates	Percent of corporates
Evolving/changing marketplace	22	70.97%
Regulatory requirements/issues	21	67.74%
Competitive forces	17	54.84%
Consolidation	12	38.71%

Source: GAO Structured Questionnaire to Corporates.

Financial Condition of Corporates, 1992-2003

The corporate credit union network has consolidated since 1992, with asset concentration rising moderately. As corporates' investments have grown, their composition has changed, with relatively more emphasis on privately issued mortgage-related and asset-backed securities and a shift toward more variable-rate investments. Concurrent with net income ratios, interest-related income and expense ratios have declined recently. In recent years, natural person credit unions have invested less in corporates.

Corporate Credit Union Network Has Consolidated and Asset Concentration Has Risen Moderately

Since 1992, the corporate system has consolidated, a change primarily driven by mergers. This consolidation trend has resulted in a moderate increase in asset concentration. For more detailed, year-by-year information, see the table and figures below.

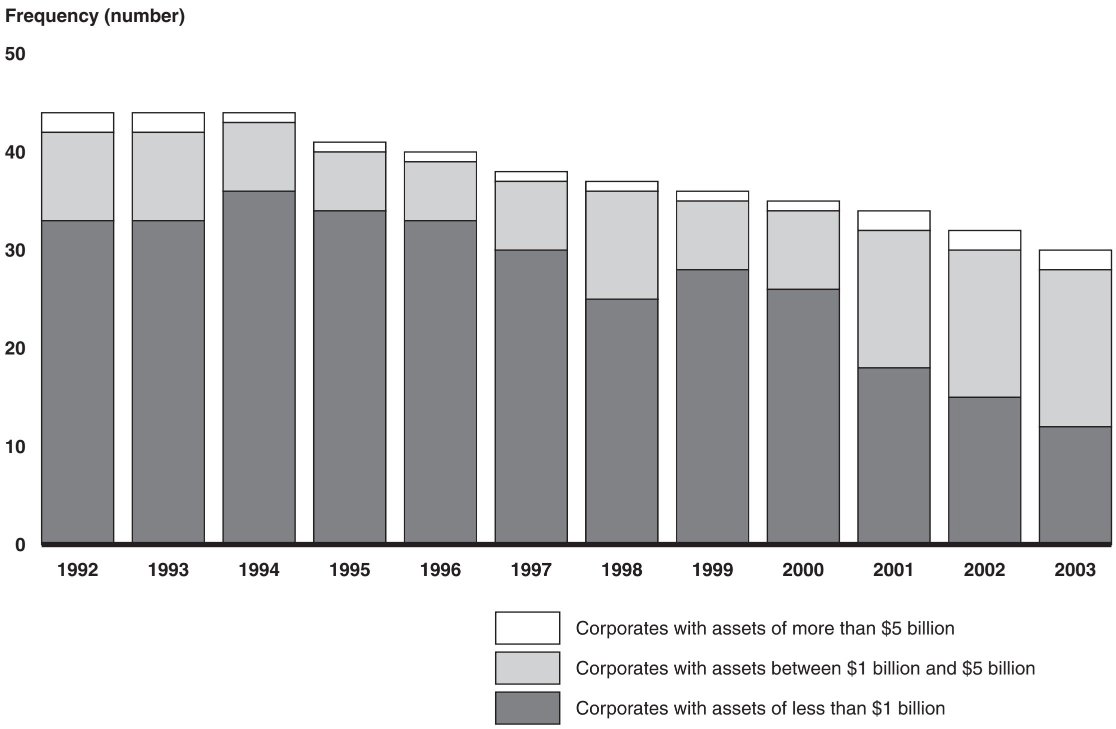
Table 2: Number of Institutions and Total Assets in the Corporate and Natural Person Credit Union Systems, 1992-2003

Year	Number of corporates, excluding U.S. Central	Total assets of corporates, excluding U.S. Central (in millions of dollars)	Total shares of corporates, excluding U.S. Central (in millions of dollars)	Number of natural person credit unions	Total assets of natural person credit unions (in millions of dollars)
1992	44	$43,447	$37,186	12,595	$258,365
1993	44	40,982	33,922	12,317	277,130
1994	44	35,993	29,217	11,991	289,453
1995	41	33,807	29,199	11,687	306,642
1996	40	30,154	24,196	11,392	326,887
1997	38	33,097	27,222	11,238	351,165
1998	37	43,555	38,743	10,995	388,700
1999	36	39,206	32,768	10,630	411,418
2000	35	39,627	32,248	10,316	438,219
2001	34	59,154	51,997	9,984	501,540
2002	32	68,968	60,421	9,688	557,075
2003	30	73,835	58,808	9,369	610,156

Source: NCUA call reports.

Note: This table includes only federally insured natural person credit unions.

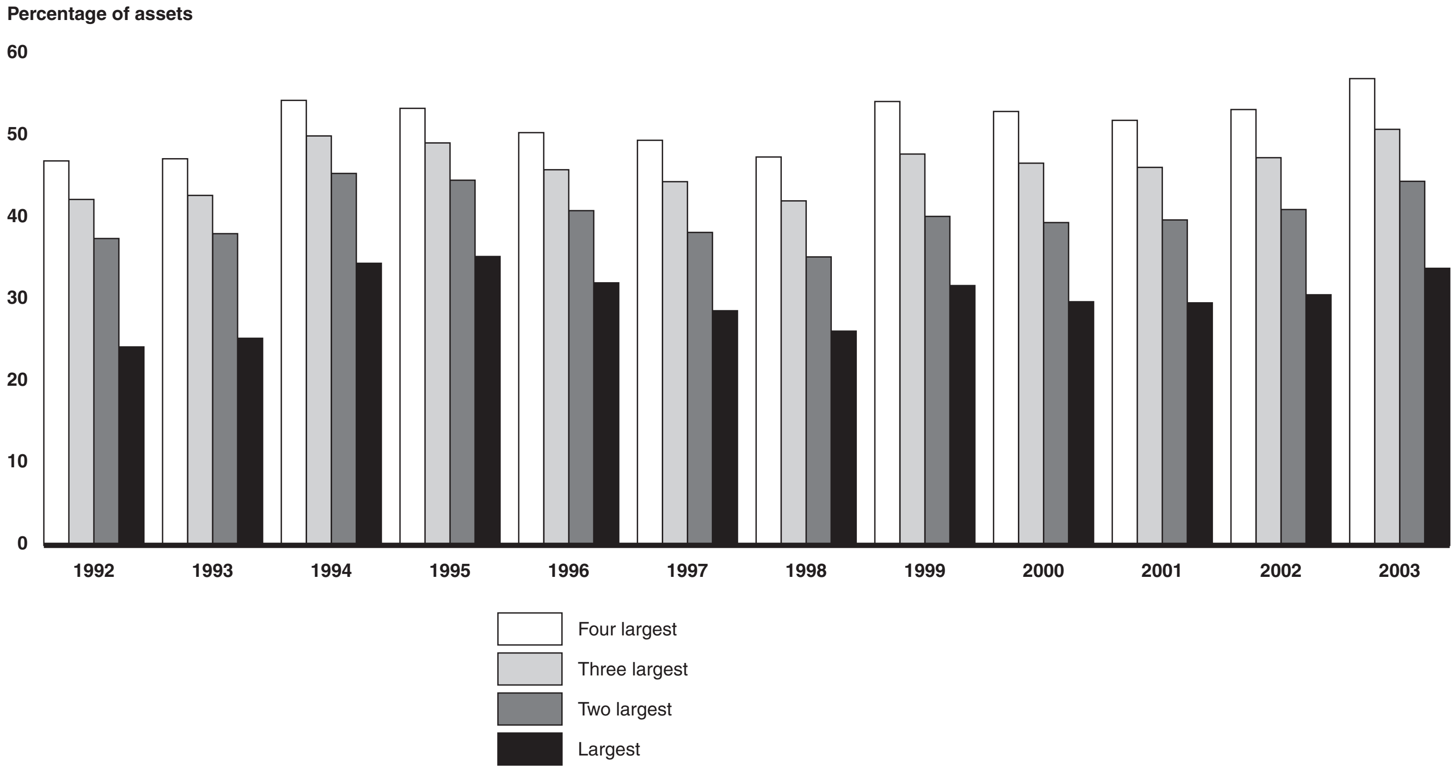
Figure 8: Size Distribution of Corporates, by Number, 1992-2003



Source: Call report data.

Note: This figure excludes data on U.S. Central.

Figure 9: Asset Concentration Levels of Corporates, 1992-2003



Source: NCUA call reports.

Note: While one corporate was the largest in each year from 1992 through 2003, this figure depicts the asset concentration in a given year for the largest corporates in that year, and the largest four corporates were not necessarily the same in all years. This figure excludes data on U.S. Central.

Investments of Corporates Have Grown since 1992, and Composition Has Changed

As noted earlier, investments, which are the vast majority of corporates' assets, have grown since 1992, but recently the percentage of corporates' investments in U.S. Central has declined somewhat and corporates have moved relatively more of their investments into privately issued mortgage-related and asset-backed securities. We made this determination using call reports and other data (for more information on our methodology see app. I). Since there were significant changes to NCUA's call reports in 1997, in the transition from Form 5300 to Form 5310, some account codes were not available previously and thus could not be disaggregated.

In general, corporates' investments in mortgage-backed securities (including mortgage pass-throughs, collateralized mortgage obligations, and real estate mortgage investment conduits) as a percentage of total investments declined from the mid-1990s through 1998 in the wake of the Cap Corp failure, which was largely driven by ineffective interest-rate risk management for collateralized mortgage obligations. However, since 1998, corporates steadily have been increasing their investments in mortgage-backed securities. In addition, corporates have been shifting more of their investments in mortgage-related and asset-backed securities to variable-rate securities, a move that tends to lessen interest-rate risk. In particular, while 41.7 percent of corporates' asset-backed securities were classified as fixed-rate at the end of 1997, by the end of 2003 this proportion stood at 18.0 percent. The trend in collateralized mortgage obligations and real estate mortgage investment conduits (REMIC) has been similar, with a relatively greater proportion now classified as variable rate.[1] Table 3 offers additional details of corporates' investments in U.S. Central, privately issued mortgage-related securities, and asset-backed securities, from 1997 through 2003.

Table 3: Composition of Selected Investments of Corporates, 1997-2003

U.S. Central obligations held by corporates							
U.S. Central obligations relative to total investments	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Daily shares	20.16%	24.17%	25.44%	21.03%	13.77%	9.37%	8.68%
Time certificates	18.38	20.11	18.53	17.41	15.44	18.08	17.42
Investments resulting from repurchase transactions	0.00	0.00	0.14	0.15	0.19	0.20	0.11
Amortizing certificates	1.42	0.40	0.18	0.30	0.11	0.52	0.88
Smart floaters	0.00	0.00	0.12	0.00	0.00	0.00	0.00
Step up certificates	1.57	0.86	1.88	2.14	1.23	1.64	2.36
FRAPs	5.43	6.84	4.45	6.58	10.64	8.68	9.21
Membership capital shares	2.25	1.93	2.61	2.10	1.47	1.58	1.74
Central Liquidity Facility share deposit	2.29	1.59	2.32	2.37	1.63	1.57	1.77
Paid-in capital	0.00	0.00	0.00	0.00	0.00	0.00	0.46

[1]A REMIC is a mortgage securities vehicle authorized by the Tax Reform Act of 1986 that holds commercial and residential mortgages in trust, and issues securities representing an undivided interest in the mortgage.

(Continued From Previous Page)

U.S. Central obligations relative to total investments	1997	1998	1999	2000	2001	2002	2003
Other	1.09[a]	0.48	0.87	1.04	0.54	0.70	2.12
Total U.S. Central obligations relative to total investments	**52.59%**	**56.38%**	**56.56%**	**53.12%**	**45.03%**	**42.35%**	**44.76%**
Total U.S. Central obligations (in millions)	**$15,634**	**$23,480**	**$20,159**	**$18,887**	**$24,966**	**$27,041**	**$29,220**
Privately Issued Mortgage-Related Issues, 1997-2003							
Privately issued mortgage-related issues relative to total investments							
Fixed-rate CMOs/REMICs	0.33%	1.68%	2.17%	3.04%	2.13%	2.44%	3.11%
Variable-rate CMOs/REMICs	0.32	0.54	0.83	1.20	1.08	3.19	5.69
Mortgage-backed pass-throughs	0.25	0.09	0.08	0.09	0.10	0.22	0.21
Other	0.00	0.00	0.00	0.00	2.69	3.00	5.08
Total privately issued mortgage-related issues relative to total investments	**0.90%**	**2.31%**	**3.08%**	**4.33%**	**6.01%**	**8.85%**	**14.09%**
Total privately issued mortgage-related issues (in millions)	**$267**	**$961**	**$1,098**	**$1,540**	**$3,333**	**$5,652**	**$9,199**
Asset-backed securities, 1997-2003							
Asset-backed securities relative to total investments							
CUGRs	0.00%[a]	0.47%	0.64%	0.00%	0.00%	0.00%	0.00%
Fixed-rate credit cards	2.44	1.24	1.58	1.75	1.96	1.42	0.68
Variable-rate credit cards	4.37	4.67	5.77	5.95	5.46	4.38	4.16
Fixed-rate autos	4.14	2.94	4.08	3.48	3.47	3.30	2.23
Variable-rate autos	1.67	1.12	0.99	1.06	2.29	2.34	2.03
Fixed-rate home equity	1.35	1.91	1.87	1.53	1.39	1.73	1.33
Variable-rate home equity	3.89	4.18	5.64	5.86	5.80	8.20	12.09
Fixed-rate other	0.21	0.31	0.67	0.67	0.33	0.33	0.20
Variable-rate other	1.43	1.38	2.80	3.07	1.92	1.54	1.94
Total asset-backed securities relative to total investments	**19.48%**	**18.23%**	**24.03%**	**23.37%**	**22.62%**	**23.24%**	**24.66%**
Total asset-backed securities (in millions)	**$5,792**	**$7,590**	**$8,563**	**$8,309**	**$12,541**	**$14,841**	**$16,100**

Source: NCUA call reports.

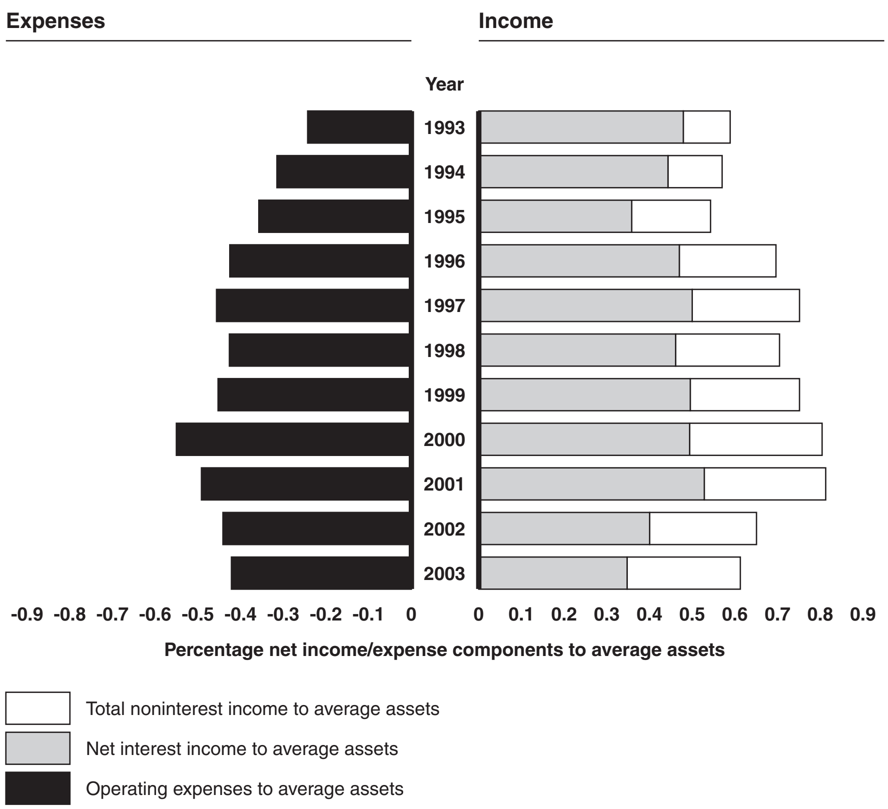
Notes: CUGR stands for U.S. Central Grantor Trusts, FRAP stands for Floating Rate Asset Program, CMO stands for collateralized mortgage obligation, and REMIC stands for real estate mortgage investment conduit. Totals may not add due to rounding. This table excludes data on U.S. Central.

[a]In the 1997 data in this table, the “Other” category of U.S Central obligations held by corporates includes CUGRs—which accounted for 0.81 percent of total investments—as NCUA specified CUGRs with U.S. Central obligations in Form 5310. Beginning in 1998, CUGRs were specified with asset-backed securities in Form 5310.

Concurrent with Net Income Ratios, Interest-Related Income and Expense Ratios Have Declined Recently

Concurrent with the recent low-interest rate environment, corporates' interest-related income and expenses, relative to average assets, have declined, as illustrated in figure 10. Net interest income, total noninterest income, and operating expense ratios cycled from 1993 through 2003, generally expanding from 1995 through 2000 and then contracting through 2003. Recently, net interest income and operating expense ratios were lower and total noninterest income ratios were higher, suggesting that fee income has become more important for corporates.

Figure 10: Income and Expense Ratios of Corporates, 1993-2003



Source: NCUA call reports.

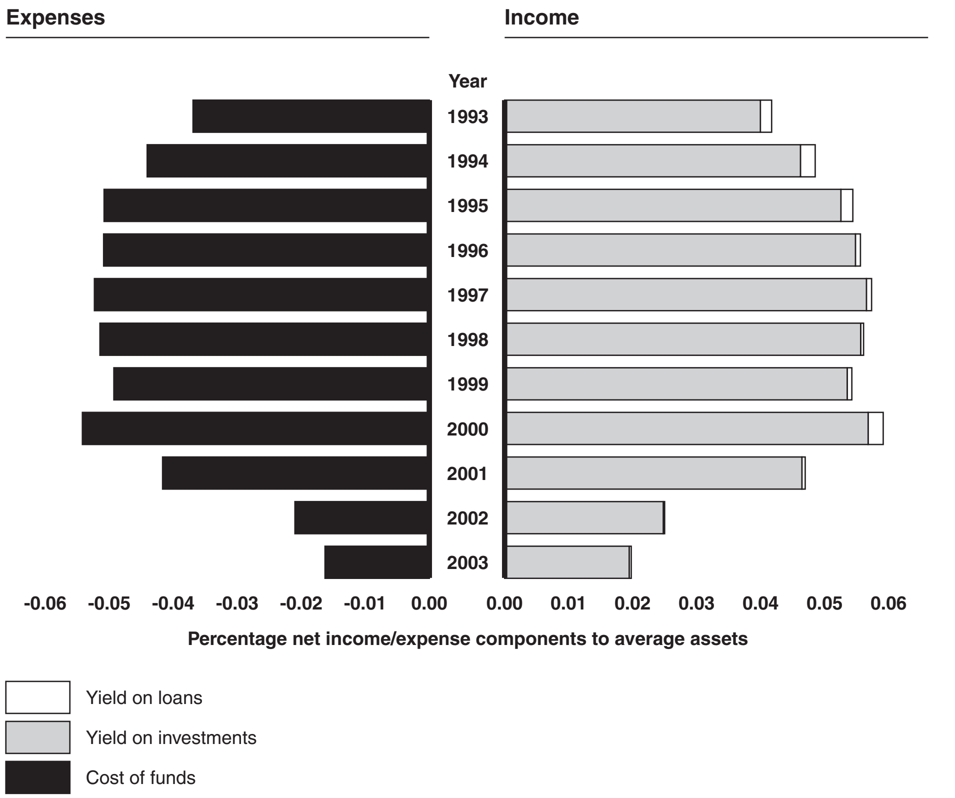
Note: In this figure, net income components in a given year are measured relative to the average of that year's total assets and the prior year's total assets. The operating expense ratio is shown as a negative number for illustrative purposes. This figure excludes data on U.S. Central.

Net interest income as a percentage of average assets is often referred to as net interest margin.[2] A corporate can maximize its net interest margin by effectively allocating resources among earning and nonearning assets, maintaining low levels of nonperforming assets, providing adequate funding through the lowest cost mix of funds, and maintaining a strong capital position. In a volatile interest-rate environment, large changes in a corporate's net interest margin are associated with high-interest-rate risk exposures and weak risk management.

Net interest income, which is interest income minus interest expense, is normally the primary source of income for a corporate and a key indicator of earnings performance and stability. Interest income consists of interest earned on loans and investments. The major contributor to interest income within a corporate is normally the investment portfolio. Interest expense consists of the corporate's cost of funding operations, or simply its "cost of funds." Interest expense in a corporate is realized through dividends on shares, share certificates, member capital accounts, and interest on borrowings (for example, loans and commercial paper). As illustrated in figure 11, interest income and expense have narrowed significantly since 2000.

[2]NCUA defines net interest margin in terms of moving DANA. As moving DANA was not calculated prior to 1998, we used the average of assets measured at year-end for the two most recent years in order to create consistency for 1998-2003.

Figure 11: Interest Income and Expense Ratios, 1993-2003



Source: NCUA call reports.

Note: In this figure, interest income (yields on investments and loans) and expense (cost of funds) ratios in a given year are measured relative to the average of that year's total assets and the prior year's total assets. The cost of funds is shown as a negative number for illustrative purposes. This figure excludes U.S. Central.

In Recent Years, Natural Person Credit Unions Have Invested Less in Corporates

Natural person credit unions' investments in corporates, which include membership capital, paid-in capital, and other investments, actually were lower at the end of 2003 than at the end of 1998—both in amount ($37.8 billion versus $29.1 billion) and as a percentage of investments (30.4 percent versus 18.1 percent). The smallest natural person credit unions (those with assets of less than $100 million) consistently invested more in corporates, as a percentage of their total investments, from 1998 through 2003. It is important to note that this measure does not include cash on deposit in corporates, since these data were not disaggregated from deposits in other financial institutions in the Form 5310 report until 2003.

At the end of 2003, natural person credit unions reported $26.2 billion in cash on deposit at corporates, which represented over three-quarters of natural person credit unions' total cash on deposit. Corporates held $55.3 billion, or 26.9 percent, of the total amount of natural person credit unions' cash on hand, cash on deposit, and investments at the end of 2003, with the smallest natural person credit unions (those with assets of less than $100 million) holding around 34 percent and the largest (those with assets in excess of $1 billion) holding around 23 percent of their total in corporates. While it cannot be confirmed given the available data, the growth in natural person credit unions' loans, coupled with the possibility that natural person credit unions have become more willing to invest their funds directly rather than through corporates, may have resulted in relatively less funds flowing from natural person credit unions into corporates.

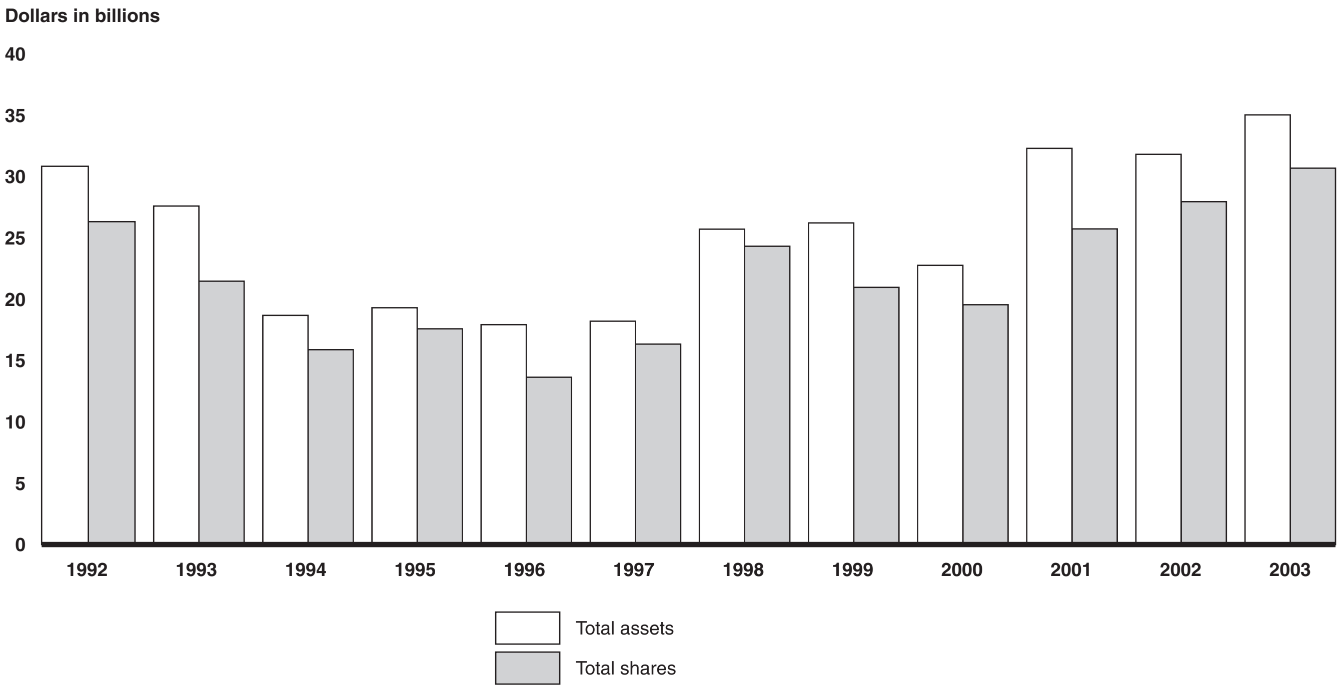
Financial Condition of U.S. Central Generally Mirrors Other Corporates

U.S. Central Credit Union (U.S. Central) is a nonprofit cooperative that is owned by corporates, and it serves these member-owners much like corporates serve their natural person credit union members. Trends in U.S. Central's balance sheet and income statement suggest that its financial condition has been similar to other corporates, with greater profitability and slightly higher capital ratios.

The balance sheet of U.S. Central grew overall from 1992 through 2003. However, as with the corporates, the dynamics of its asset and share growth have varied as the use of U.S. Central by its member-owners has varied. Investments, the vast majority of U.S. Central's assets, have mirrored the general growth pattern of its assets, declining through the early to mid-1990s and rising thereafter. Recently, U.S. Central has moved relatively more of its investments into privately issued mortgage-related securities.

Overall, total assets and shares of U.S. Central have grown since 1992; after generally declining in the early to mid-1990s, by the end of 2003 they were reported at $35 billion and $30.7 billion, respectively (see fig. 12).

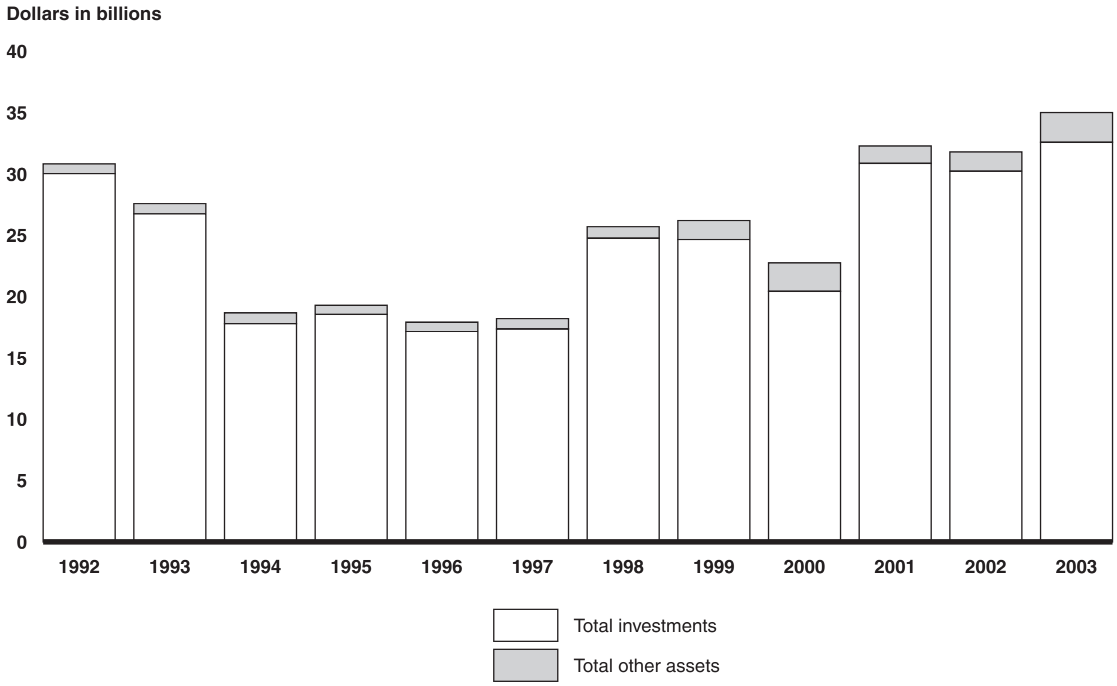
Figure 12: Balance Sheet of U.S. Central, 1992-2003



Source: Call report data.

U.S. Central's balance sheet is primarily influenced by the balance sheet dynamics of its underlying corporate member-owners, which have varied since 1992. As noted earlier, corporates saw their assets and shares decline in the early to mid-1990s but then rebound; corporates' assets and shares both grew by over 80 percent from 2000 through 2003. While displaying a similar cyclical trend from 1992 through 2003, U.S. Central did not experience the same degree of growth from 2000, as assets grew by around 54 percent and shares grew by around 57 percent. As with corporates, in general investments represent over 90 percent of U.S. Central's assets, as illustrated in figure 13.

Figure 13: U.S. Central's Investments Relative to Total Assets, 1992-2003



Source: NCUA call reports.

Note: Other assets include cash, loans, and fixed assets.

Investments in accounts at U.S. Central, including overnight accounts, term certificates, structured products, and membership shares, are important to many corporates, especially the smaller ones. As of the end of 2003, 17, or 57 percent of all corporates, had at least 70 percent of their total investments in accounts at U.S. Central and 4 had over 60 percent. With the recent investment environment characterized by historic low interest rates, U.S. Central's members may have increased their utilization of U.S. Central's economies of scale to help increase the spreads between the rates they offered their customers and the rates they earned on their investments. In general, it seems sensible for corporates—especially the smaller ones—to be able to rely on the services of U.S. Central given its economies of scale. This reliance, however, adds more weight to the need for U.S. Central to be a safe and sound investment.

As U.S. Central's total investments have grown, the composition of these investments has changed, particularly with increases in investments in mortgage-related securities since 1997 (see table 4). U.S. Central's investments in privately issued mortgage-related securities increased from 3.4 percent of its total investments in 1997 to 24.7 percent of its total investments in 2003. Overall, U.S. Central's mortgage-related investments, including government and agency mortgage-related issues, rose from 10.5 percent of its total investments to 32.7 percent of its total investments over this period. As with corporates, asset-backed securities have consistently been an important investment type for U.S. Central.

Table 4: Composition of Total Investments of U.S. Central, 1997-2003

Dollars in millions

Investments relative to total investments	1997	1998	1999	2000	2001	2002	2003
U.S. government and government-guaranteed obligations	5.17%	2.34%	1.23%	0.41%	0.55%	1.36%	1.35%
Obligations of U.S. government-sponsored enterprises	0.10	1.19	0.43	0.30	0.10	0.50	0.00
Central Liquidity Facility stock (direct)	4.06	2.96	3.39	4.16	2.96	3.36	3.58
U.S. banks	12.27	23.34	26.77	10.50	4.27	2.40	6.34
Foreign banks	0.00	2.02	0.00	15.41	6.80	0.83	1.84
Repurchase activity	14.73	9.89	17.65	4.51	10.41	5.38	0.94
Government and agency mortgage-related issues	7.10	3.80	2.61	3.01	2.74	4.55	8.05
Privately issued mortgage-related issues	3.35	0.69	1.04	2.94	13.17	19.24	24.66
Asset-backed securities	52.12	50.23	44.20	52.68	44.10	49.00	48.24
Mutual funds	0.00	0.00	0.00	0.00	7.12	1.49	0.00
Commercial debt obligations	1.10	3.55	2.68	6.09	7.77	11.90	4.99
Other	0.00	0.00	0.00	0.00	0.24	0.34	0.18
Total investments	**$17,364**	**$24,773**	**$24,668**	**$20,444**	**$30,952**	**$30,342**	**$32,656**

Source: NCUA call reports.

Note: Totals may not add due to rounding.

Holding variable-rate investments and securities with shorter weighted average lives tends to result in relatively lower interest-rate risk. U.S. Central, like the corporates, tends to have significant holdings of mortgage-related issues and asset-backed securities—80 percent of its portfolio was in such investments at the end of 2003—but holds most of these in the form of variable-rate and shorter weighted average life issues. Holdings of variable-rate asset-backed and privately issued mortgage-related securities accounted for 67 percent of all investments at the end of 2003. According to its 2003 annual report, at the end of the year, mortgage-related and asset-backed securities in U.S. Central's portfolio had weighted average lives of approximately 2.8 years and 3 years, respectively, and approximately 83 percent of interest-earning assets were set to reprice or mature within 1 year. Table 5 details selected investments of U.S. Central from 1997 through 2003.

Table 5: Composition of Selected Investments of U.S. Central, 1997-2003

Privately issued mortgage-related issues, 1997-2003							
Privately issued mortgage-related issues relative to total investments	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Fixed-rate CMOs/REMICs	1.15%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Variable-rate CMOs/REMICs	2.20	0.00	0.07	1.13	12.57	18.76	23.70
Mortgage-backed pass throughs	0.00	0.69	0.97	1.81	0.60	0.48	0.97
Other	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Total privately issued mortgage-related issues relative to total investments	**3.35%**	**0.69%**	**1.04%**	**2.94%**	**13.17%**	**19.24%**	**24.66%**
Total privately issued mortgage-related issues (in millions)	**$582**	**$170**	**$256**	**$600**	**$4,066**	**$5,817**	**$8,040**
Asset-backed securities, 1997-2003							
Asset-backed securities relative to total investments	1997	1998	1999	2000	2001	2002	2003
Fixed-rate credit cards	0.60%	1.07%	1.02%	0.98%	1.53%	1.69%	2.67%
Variable-rate credit cards	20.57	17.45	22.12	18.84	17.14	20.76	20.87
Fixed-rate autos	0.14	0.61	1.40	1.59	1.12	0.80	0.59
Variable-rate autos	0.34	2.82	6.24	5.21	7.85	4.76	5.17
Fixed-rate home equity	0.00	0.08	0.31	0.13	0.33	0.78	1.28
Variable-rate home equity	6.08	5.38	6.50	19.10	12.90	16.26	16.05
Fixed-rate other	0.27	1.40	0.09	0.04	0.06	0.06	0.35
Variable-rate other	24.13	21.41	6.52	6.78	3.16	3.89	1.26
Total asset-backed securities relative to total investments	**52.12%**	**50.23%**	**44.20%**	**52.68%**	**44.10%**	**49.00%**	**48.24%**
Total asset-backed securities (in millions)	**$9,051**	**$12,442**	**$10,904**	**$10,770**	**$13,617**	**$14,818**	**$15,727**

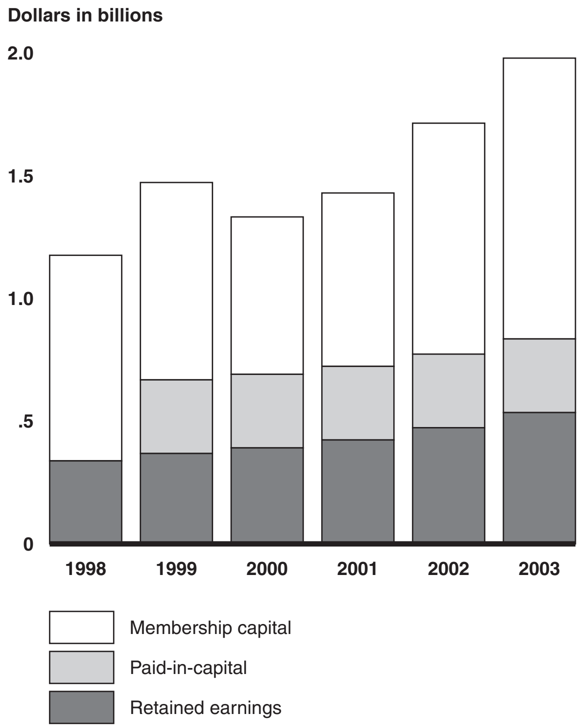
Source: NCUA call reports.

Note: CMO stands for collateralized mortgage obligation, and REMIC stands for real estate mortgage investment conduit. Totals may not add due to rounding.

U.S. Central's Capital Levels Generally Increased Since 1998 and, Despite Recent Asset Growth, Capital Ratios Were Higher in 2003 Than in 1998

Since 1998, U.S. Central's capital has generally been rising. Total capital, as defined in Part 704, rose from $1.2 billion in 1998 to $2 billion at the end of 2003. Figure 14 illustrates the growth in U.S. Central's total capital. Retained earnings and membership capital have grown overall, but paid-in capital has remained constant since 1999.

Figure 14: Total Capital of U.S. Central, 1998-2003

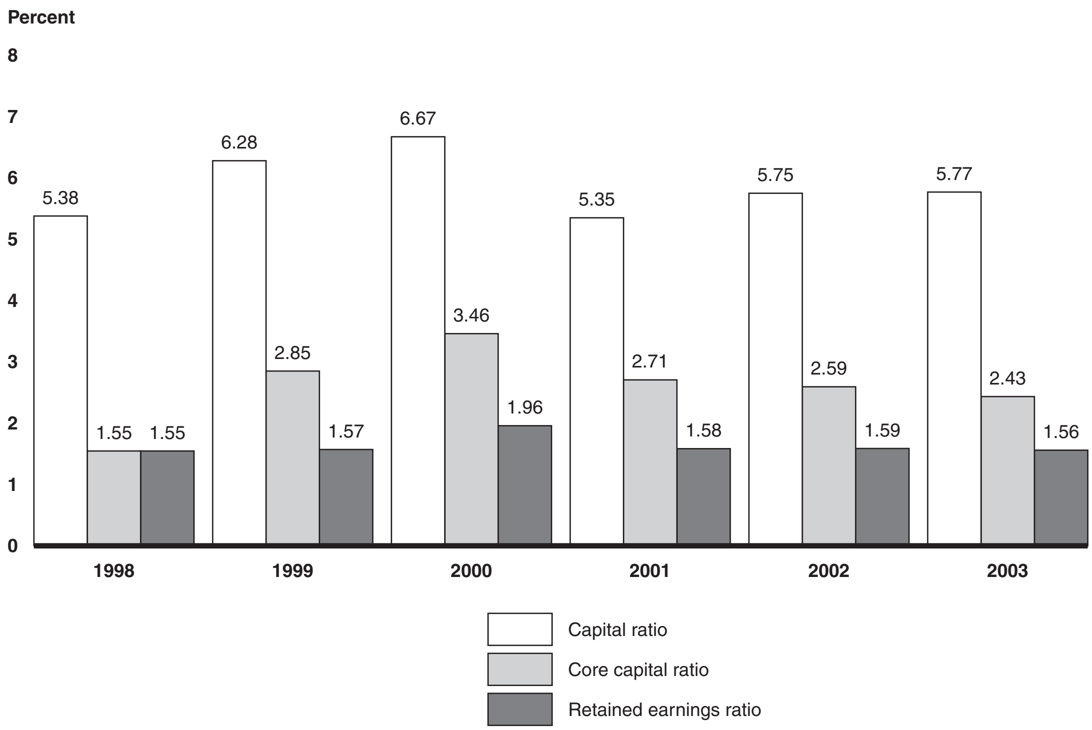


Source: NCUA call reports.

Since 1998, undivided earnings (a component of retained earnings) have provided the fastest growth, increasing 61 percent, while membership capital, the largest component, has grown 37 percent. At the end of 2003, membership capital accounted for 58 percent, or $1.1 billion, of U.S. Central's total capital.

Despite recent asset growth, U.S. Central's capital ratios have remained relatively stable, as shown in figure 15. After peaking in 2000, capital ratios declined in 2001 but have since leveled off. They remain above the current regulatory requirements.

Figure 15: Capital Ratios of U.S Central, 1998-2003



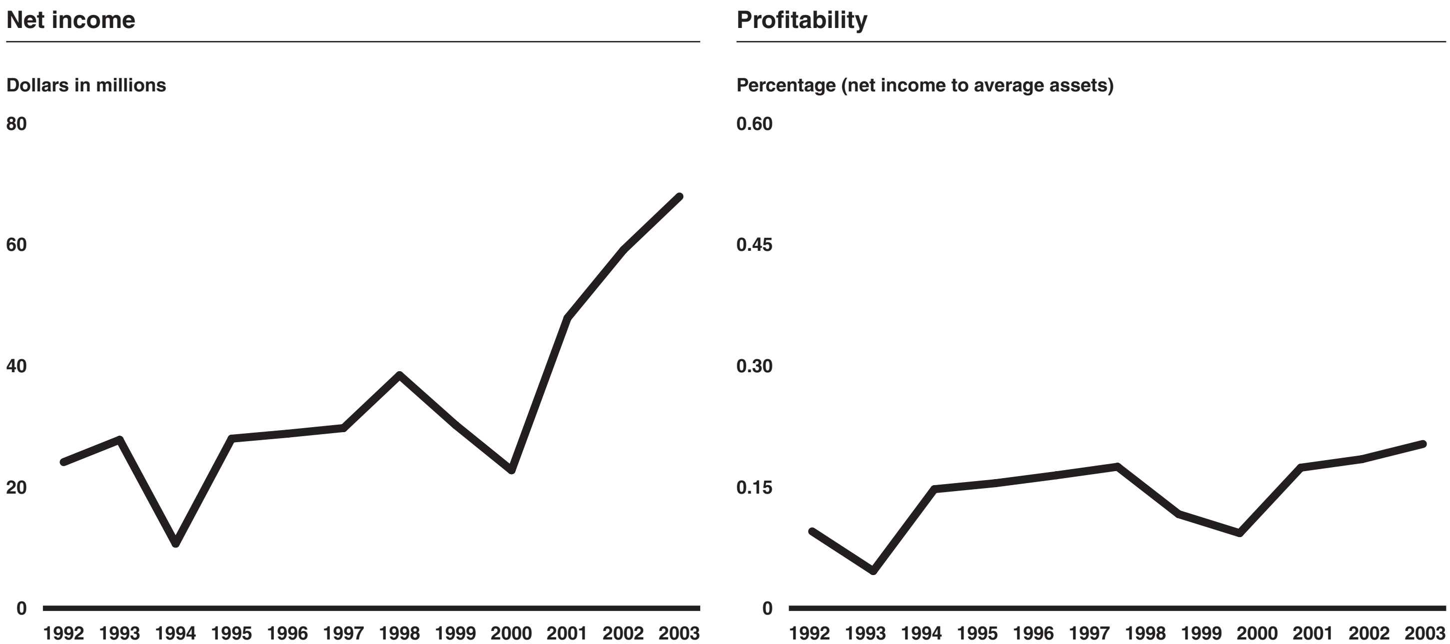
Source: Call report data.

Note: In this figure, capital ratios are calculated by dividing capital by the moving daily average of net assets (DANA), which is a measure of average assets as set forth in Part 704 in 1998. NCUA currently specifies three capital ratios: the capital ratio, which includes all forms of capital relative to moving DANA; the core capital ratio, which includes core capital (that is, retained earnings plus paid-in capital) relative to moving DANA; and the retained earnings ratio, which includes reserves plus undivided earnings relative to moving DANA.

U.S. Central's Net Income and Profitability Have Grown Since 1992

U.S. Central's net income has grown since 1992 and was at its highest level at the end of 2003. As depicted in figure 16, after declining to $10.7 million at the end of 1994, U.S. Central's net income rebounded, generally rising through 1998. After peaking in 1998 at $38.4 million, net income declined to $22.8 million at the end of 2000. However, by the end of 2003, net income had tripled to $67.9 million. U.S. Central's profitability—that is, net income divided by average assets—followed the general pattern exhibited by net income since 1992, and it was at its highest at the end of 2003.

Figure 16: Net Income and Profitability of U.S. Central, 1992-2003



Source: NCUA call reports.

Note: In this figure, profitability in a given year is measured by the ratio of that year's net income to the average of that year's total assets and the prior year's total assets.

As with the corporates, U.S. Central witnessed a narrowing of its yields on investments recently. However, while profitability suffered at the corporates since 2001, U.S. Central managed to increase its profitability, in part through increased noninterest income.

Expanded Authorities Available to Corporates

In 1998 NCUA revised Part 704. Among other things, the new regulations provided qualified corporates with expanded authorities that allowed corporates having a strong financial position, management, and infrastructure to exercise greater flexibility in managing their risks subject to NCUA approval.[1] For example, corporates with certain levels of expanded authorities were allowed to invest in foreign securities or A-rated securities, compared with the higher-rated AAA securities in which other corporates were allowed to invest. In 2002, NCUA again revised Part 704 to allow for further flexibilities in expanded investment authorities.[2] For example, qualified corporates were allowed to invest in BBB rated securities, subject to NCUA approval.[3] Table 6 provides more detail on the types of investments allowed under the various levels of expanded authorities, and the number of corporates that currently have these authorities.

[1] See 62 Fed. Reg. 12929, 12937 (Mar. 19, 1997).

[2] See 67 Fed. Reg. 65640 (Oct. 25, 2002).

[3] 12 C.F.R. Part 704, App. B (2004); see 67 Fed, Reg. 65649-50.

Table 6: Expanded Authorities and Number of Corporates Authorized to Engage in Investments under These Authorities, as of December 31, 2003

Expanded authority level	Number of corporates	Investments allowed under expanded authorities
Part I[a]	2	• Purchase investments with long-term ratings no lower than A- (or equivalent) • Purchase investments with short-term ratings no lower than A-2 (or equivalent), provided that the issuer has a long-term rating no lower than A- (or equivalent) or the investment is a domestically issued asset-backed security • Engage in short sales of permissible investments to reduce interest-rate risk • Purchase principal-only stripped mortgage-backed securities to reduce interest rate risk • Enter into a “dollar roll” transaction
Part II[b]	3	• Purchase investments with long-term ratings no lower than BBB (flat) (or equivalent); the aggregate of all investments rated BBB+ (or equivalent) or lower in any single obligor is not to exceed 25 percent of capital • Purchase investments with short-term ratings no lower than A-2 (or equivalent), provided that the issuer has a long-term rating no lower that BBB (flat) (or equivalent) or the investment is a domestically issued asset-backed security • Engage in short sales of permissible investments to reduce interest-rate risk • Purchase principal-only stripped mortgage-backed securities to reduce interest-rate risk • Enter into a “dollar roll” transaction
Part III[c]	3	• Invest in debt obligations of a foreign country • Invest in deposits and debt obligations of foreign banks or obligations guaranteed by these banks • Invest in marketable debt obligations of foreign corporations; this authority does not apply to debt obligations that are convertible into stock of the corporation • Invest in foreign-issued, asset-backed securities
Part IV[d]	3	• Enter into derivative transactions specifically approved by NCUA to create structured products, manage its own balance sheet, and hedge the balance sheets of its members
Part V[e]	1	• Participate in loans with member natural person credit unions as approved by the Office of Corporate Credit Union Director

Source: Part 704 of NCUA Rules and Regulations.

Notes: Corporates can be granted more than one expanded authority level.

[a]The investments under Part I authority are subject to certain conditions, including the requirement that aggregated investments in repurchase and securities lending agreements with any one counterparty are limited to 300 percent of capital.

[b]The investments under Part II authority are subject to certain conditions, including the requirement that aggregated investments in repurchase and securities lending agreements with any one counterparty are limited to 400 percent of capital.

[c]To engage in Part III expanded authorities, the corporate must have met the requirements of Part I or Part II, and additional requirements for Part III. Foreign investments are subject to the following requirements: The investments must be rated no lower than the minimum permissible domestic rating under the corporate’s Part I or Part II authority. The sovereign issuer, or the country in which an obligor is organized, must have a long-term foreign currency (nonlocal currency) debt rating no lower than AA- (or equivalent). For each approved foreign bank line, the corporate credit union must identify the specific banking centers and branches to which it will lend funds. Obligations of any single foreign obligor may not exceed 50 percent of capital. Finally, obligations in any single foreign country may not exceed 250 percent of capital.

[d]The derivative transactions under Part IV are subject to the following requirements: If the counterparty is domestic, the counterparty rating must be no lower than the minimum permissible rating for comparable term permissible investments. If the counterparty is foreign, the corporate must have Part III expanded authority and the counterparty rating must be no lower than the minimum permissible rating for a comparable term investment under Part III authority.

[e]The ability to engage in Part V authorities is subject to the maximum aggregate amount of participation loans with any one member credit union, which must not exceed 25 percent of capital. In addition, the maximum aggregate amount of participation loans with all member credit unions must be determined on a case-by-case basis by the Office of Corporate Credit Union Director.

Comments from the National Credit Union Administration

National Credit Union Administration

Office of the Chairman

September 8, 2004

Richard J. Hillman, Director
Financial Markets and Community Investment
United States General Accounting Office
Washington, D.C.

Re: Draft GAO Report 04-977

Dear Mr. Hillman:

Thank you for the opportunity to review and comment on GAO's draft report entitled *Corporate Credit Unions Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA Oversight* (Report). On behalf of the National Credit Union Administration (NCUA), I would like to express our appreciation for the professionalism exhibited by your staff and the thoroughness of their review, our gratitude for the dialogue between NCUA and GAO throughout your study, and our concurrence with most of your assessments and conclusions contained in the Report. The comments below respond specifically to your report's conclusions and recommendations.

Corporate Network Faces an Increasingly Challenging Business Environment, Creating Potential Stress on Its Financial Condition

NCUA concurs with the Report's assessment that corporate credit unions are operating in an increasingly challenging and competitive business environment. Recognizing the dynamic financial marketplace in which corporate credit unions operate and the need for NCUA's corporate rule to be current, NCUA, as noted in the Report, revised its corporate rule twice in recent years, once in 1998 and again in 2002. The important and timely revisions to the corporate rule considered the unique nature and mission of corporate credit unions, improved their ability to provide competitive products and services, and strengthened the financial soundness of the corporate system. The corporate rule has functioned as intended, permitting corporate balance sheets to expand and contract, sometimes rapidly, depending on liquidity levels in natural person credit unions, while not compromising safety and soundness.

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The Report correctly notes that since 2000 a significant inflow of share deposits, coupled with recent historic low interest rates, have put pressure on corporate earnings and capital ratios. Despite increases in overall capital levels, profitability, as well as capital ratios (retained earnings, core, and capital), has declined since December 2000. Notwithstanding these recent stresses, the corporate system has performed remarkably well since 2000 as evidenced by the 33 percent increase in retained earnings. This level of earnings retention was accomplished by corporate management prudently controlling credit, interest-rate, and liquidity risks while, at the same time, expanding the menu of products and services being made available to their member credit unions.

To illustrate the rapid influx of corporate share deposits, network assets increased by $42 billion, or 79 percent, during the 5 month period ending March 2001. Assets continued to increase, reaching a record aggregate level of $126 billion at the end of May 2003, before subsequently subsiding to $109 billion as of December 2003. This rapid expansion of the network's assets (October 2000 to December 2003) occurred at the same time the Fed Fund Effective Rate declined from 6.51 percent to 1.00 percent. Due to the high credit quality and short duration of the network's investment portfolio, corporate earnings did not increase proportionately to asset growth. This influx of deposits combined with decreasing interest rates did strain profitability and resulted in lower capital ratios. However, because the corporate network and the corporate rule performed as intended, corporate credit unions were capable of absorbing the credit union industry's excess liquidity while not compromising safety and soundness.

The Report further explains that despite declining capital ratios since 2000, overall levels of capital have increased since 1998. The Report indicates, however, there is an increasing reliance on weaker, less permanent, forms of capital suggesting that these capital instruments provide a weaker cushion against adverse financial trends. NCUA does not concur with the assessment that either paid-in capital or membership capital are "weaker forms" of capital.[1] Both capital instruments are available to cover losses that exceed retained earnings, are not insured by either the National Credit Union Share Insurance Fund (NCUSIF) or any other deposit insurer, and cannot be pledged against borrowings. With the 2002 corporate rule change, paid-in capital issued must be perpetual maturity, non-cumulative dividend accounts. Prior to the 2002 rule change, paid-in capital required an initial 20 year minimum maturity. When a paid-in capital instrument issued prior to the rule change has a remaining maturity of 5 years, the amount of the instrument that may be considered as paid-in capital is reduced by a constant monthly amortization which ensures the recognition of paid-in capital is fully amortized when the instrument has a

[1] Capital Corporate Federal Credit Union failed in 1995. The corporate's losses exceeded their retained earnings. Capital Corporate's membership capital accounts absorbed all losses in excess of their retained earnings. The NCUSIF incurred no losses as a result of this corporate's failure.

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remaining maturity of 3 years. Membership capital requires a minimum withdrawal notice of 3 years. When a membership capital account has been placed on notice or has a remaining maturity of less than 3 years, the amount that can be considered membership capital is reduced by a constant monthly amortization that ensures membership capital is fully amortized one year before the date of maturity or one year before the end of the notice period. The full balance of both paid-in capital and membership capital being amortized, not just the remaining non-amortized portion, are available to absorb losses in excess of retained earnings. Neither paid-in nor membership capital accounts are releasable due to a merger, charter conversion, or liquidation of a member credit union.

The Report confirms that despite the rapid expansion in corporate balance sheets since 2000, the rule's minimum 4 percent capital requirement was exceeded by all corporates. This was achieved as a result of the flexibility incorporated in the rule which allows corporates to adjust their membership capital accounts in relation to either their member credit unions' assets or other measure. The rule functioned as intended, recognizing that if corporate credit unions are to fulfill their mission, they must have the ability to either expand or contract their deposit base depending on the liquidity level of their member credit unions.

Importantly, corporates continue to improve. For the period ending July 2004, the network's capital ratios (retained earnings, core, and capital) have increased for each of the last six months. The retained earnings, core, and capital ratios are 2.31 percent, 3.09 percent, and 6.75 percent, respectively.

The Report observes that the percentage of corporates' investments in U.S. Central obligations has declined, particularly for the largest corporates, as a result of corporates shifting some of their investments into potentially higher yielding, more volatile securities such as privately issued mortgage-related and asset-backed securities. The Report further states the 2002 rule change, permitting corporates to purchase securities with lower credit quality, may lead to increased credit risk if not properly managed. NCUA believes the slight potential increase in credit risk exposure is more than offset by the rule's decrease in exposure to credit concentration risk. Additionally, NCUA is of the opinion the rule's modest expansion of permissible investment graded securities, combined with its reduction in credit concentration limits, results in a stronger corporate network. Corporate management is better positioned to compete, within prudent safety and soundness thresholds, than under the previous rule.

The 2002 rule change permits corporates to purchase lower credit quality securities, but only marginally. As the Report notes, all corporate investments are required to be of investment grade. Base and Base Plus corporates (26 of 31 corporates) are only permitted to purchase short-term securities having a minimum short-term credit rating of A-1 and long-term securities having a

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minimum long-term credit rating AA-. The rule did not change the short-term credit rating, but lowered the long-term credit rating from AA to AA-. Corporates approved for Part I expanded authorities (2 of 31 corporates) are permitted to purchase short-term securities having a minimum short-term credit rating of A-2, provided that the issuer has a long-term rating no lower than A-, and long-term securities having a minimum long-term credit rating of A-. The rule change lowered the short-term credit rating from A-1 to A-2 and the long-term credit rating from AA- to A-. Finally, corporates approved for Part II expanded authorities (3 of 31 corporates) are permitted to purchase short-term securities having a minimum short-term credit rating of A-2, provided that the issuer has a long-term rating no lower than BBB, and long-term securities having a minimum long-term credit rating no lower than BBB. The rule change lowered the short-term credit rating from A-1 to A-2 and the long-term credit rating from A- to BBB.

Credit risk is also controlled by a single obligor concentration limit. With investments rated higher than BBB+, the aggregate investment in a single obligor is 50 percent of capital or $5 million, whichever is greater. However, for investments rated BBB or BBB+, the aggregate investment in a single obligor is restricted to 25 percent of capital.

As of June 30, 2004, 97 percent of the network's rated long-term securities (excludes government and agency securities) are rated AAA, or equivalent, by at least one nationally recognized statistical rating organization. Only 0.2 percent of the network's rated long-term securities are rated BBB+ or lower. Credit risk is well diversified over a reasonable universe of counterparties (360 issuers). The largest single obligor concentration is Fannie Mae at 8.9 percent. Based on the high quality and diversification of the network's investments, NCUA believes credit risk is minimal.

Recognizing there is a potential for increased credit risk based on investments granted above the Base Plus level, NCUA requires corporates applying for greater expanded authorities to have an appropriate infrastructure in place (systems, people, and processes) and to submit to a rigorous review process prior to approval being granted. NCUA has developed the *Guidelines for Submission of Requests for Expanded Authority* to assist interested corporates in preparing and applying for expanded authorities. In addition, NCUA's capital markets specialists provide monthly supervision to the 5 corporates granted expanded authorities above Base Plus. On-site monthly supervision is provided to the 3 corporates granted Part II expanded authorities. Investments of either Base or Base Plus corporates receive monthly monitoring by corporate examiners.

Your analysis correctly asserts that with potentially higher yields from privately issued mortgage-related and asset-backed securities, as opposed to government-guaranteed obligations, corporates may potentially be increasing interest-rate risk. You note, however, the 3 largest corporates you reviewed are

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managing interest-rate risk by shifting toward more variable-rate and shorter–term securities, providing a potentially better match for the relatively short-term nature of their members' deposits. The Report concludes the investment portfolios of these 3 corporates have relatively short weighted-average lives, most being less than 3 years.

NCUA has addressed controlling interest-rate risk in the corporate rule. The rule establishes a minimum net economic value (NEV) ratio of 2 percent and limits risk exposures to levels that do not result in a decline in NEV of more than 15 percent in an instantaneous, permanent, and parallel shock in the yield curve of plus and minus 100, 200, and 300 basis points. As of June 30, 2004, the network's NEV ratio is 7.04 percent and NEV volatility is (8.07) percent in a +300 basis point shock scenario. Seventy-six percent of the network's marketable securities are variable rate. The majority of these variable rate securities, 86 percent, reset to the one-month U.S. Libor rate and another 8 percent reset to the three-month U.S. Libor rate. The network's estimated dollar weighted-average life and dollar weighted-average life to call are 4.5 and 3.4 years, respectively. NCUA's assessment of the network's investment portfolio is interest-rate risk is minimal.

NCUA Strengthened Its Oversight of Corporates, but Could Do More to Anticipate and Address Emerging Network Issues

The Report comments on several major improvements in NCUA's oversight of corporates, the most notable being the creation of a separate office within NCUA charged with examining and supervising corporates, revising the corporate rule to address corporates' management of credit, interest-rate, and liquidity risks, implementing risk-focused supervision and examinations, and hiring specialists in the areas of capital markets, information systems, and payment systems. Additionally, it is important to note that NCUA is committed to providing effective oversight of the corporate system as demonstrated by the above improvements. On-going agency efforts include periodic independent Office of Corporate Credit Unions (OCCU) reviews that evaluate OCCU's structure and operations, assess corporate examination policies and practices, and oversee the completion and review of OCCU internal and external audits and reviews. Annually, OCCU performs a self-assessment review that results in recommendations to structure, staffing, education, and specialty needs (contractors and tools) to ensure NCUA is positioned to properly assess risks in the rapidly changing corporate environment.

5

Tracking Problem Resolution

Your review of examination reports found examiners had identified deficiencies and had established time frames for correcting deficiencies, however, in some cases, you were unable to locate documentation to support problem resolution. You cite that only 9 of 38 examination reports reviewed addressed resolution of the prior examination's deficiencies in the current examination report's Executive Summary. Examiners document prior examination's unresolved deficiencies in the Executive Summary, Document of Resolution, and/or Examiner's Findings section(s) of the current examination report depending on the issue's materiality and severity. All prior examination report deficiencies, either corrected or not, are addressed in the current examination's work papers, specifically in the Corporate Examiner's Memorandum.

NCUA concurs with your recommendation that implementing an aggregate tracking system will enhance our ability to identify and monitor resolution of deficiencies and to evaluate trends in examination data on a system-wide basis. OCCU is developing a Global Tracking System (GTS) to track resolution of problems areas, monitor examination trends, identify emerging examination issues, and assist in ensuring consistency in its supervision approach. The GTS prototype is presently being tested. GTS will be fully functional and implemented by December 31, 2004.

Systematic Procedures for Allocating Resources

The Report suggests NCUA systematically consider corporates' risk management (quality and capacity) when allocating resources and scheduling specialists for examinations. Since the inception of specialist positions in 1998, OCCU has prioritized assigning specialists to examinations based on potential risk exposures identified by corporate examiners and specialists. As noted in the Report, NCUA documented its assessment of operations risk in its planning documents, but did not always explicitly discuss the quality of risk management when determining if specialists should be assigned to examinations. Whether or not specialists participate on an examination, operation reviews are conducted and detailed questionnaires and examination procedures are completed by examiner staff for each specialist's discipline area. However, NCUA agrees that a more formalized process and structure to ensure a more systematic involvement of specialists in identifying and addressing problems as well as developing and applying policies consistently will improve oversight effectiveness. OCCU will implement such a formalized process and structure by December 31, 2004.

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Assessing Risk Management Functions

NCUA agrees with the assessment that there is a need for strong risk management practices at corporates to properly manage and mitigate credit, interest-rate, and liquidity risks. One of the challenges you suggest NCUA faces is OCCU's ability to assess the quality and operations in corporates' risk management functions based on its present staffing level. Annually, OCCU reassesses its staffing requirements to evaluate not only the number of staff needed, but also the type of specialists needed to ensure it has the ability to adequately monitor the increasing complexity of corporates' operations. As a result of OCCU's recent staffing assessments, NCUA has increased the number of information systems specialist and payment systems specialist positions by 2 and 1, respectively. NCUA agrees with the report's recommendation to reassess OCCU's staffing of examiners and specialists to ensure OCCU has the resources to adequately monitor corporates' operations.

Merger Guidance

NCUA concurs with the Report's recommendation for the need to provide corporates with specific merger guidance to facilitate the regulatory review process. Accordingly, major revisions to the *Credit Union Merger Procedures and Merger Forms Manual* are currently in process. Rather than developing a separate merger manual for corporates, which would be largely redundant, revisions to the existing manual will include guidance specific to corporates.

However, NCUA does not concur with the Report's conclusion that improved guidance to examiners is needed to ensure mergers meet the goals of serving members while not placing the NCUSIF at undue risk. These procedures are already in place. OCCU has issued internal instructions providing specific guidance to examiners on assessing merger proposals and preparing merger packages for further agency review. Every corporate merger package prepared by OCCU is reviewed by NCUA's Office of General Counsel prior to being presented to the NCUA Board for action. Each merger package documents whether or not the merger is in the members' best interest, both of the merging and continuing corporates. Additionally, the merger is reviewed to determine if it will adversely impact the continuing corporate, thereby potentially presenting undue risk to the NCUSIF.

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Internal Control Reporting

NCUA concurs with the Report's recommendation that corporates with assets greater than $500 million should provide an annual management report assessing the effectiveness of their internal control structure, and the independent auditor's attestation to management's assertions. This is consistent with expectations and best practices already established for banks and thrifts under the Federal Deposit Insurance Corporation Improvement Act of 1991 and for public companies under the Sarbanes-Oxley Act of 2002. NCUA agrees this reporting will further assist its ability to assess corporates' internal controls. NCUA will pursue a Part 704 rule change to require this reporting.

Thank you for the opportunity to comment on the draft report. If you have any questions or need further information, please feel free to contact NCUA Executive Director J. Leonard Skiles at (703) 518-6321.

Sincerely,

JoAnn Johnson

JoAnn Johnson
Chairman

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In addition to those named in the body of this report, the following individuals made key contributions: William Chatlos, May Lee, John Lord, Alexandra Martin-Arseneau, Kimberley Mcgatlin, José R. Peña, Julie Phillips, Mitch Rachlis, Barbara Roesmann, Paul Thompson, and Richard Vagnoni.

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