NCUA LETTER TO CREDIT UNIONS

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: **January 2009** **LETTER NO.: 09-CU-02**

TO: **Federally Insured Credit Unions**

SUBJ: **Corporate Credit Union System Strategy**

ENCL: **(1) Corporate Credit Union Advanced Notice of Proposed Rulemaking**
(2) Share Guarantee Term Notice

Dear Board of Directors:

For over three decades, natural person credit unions have supported the corporate credit union system. In turn, the corporate system has provided vital investment, liquidity and payment system services to credit unions. Many credit unions, especially those of smaller asset size, would face significant challenges without the services and assistance provided by corporate credit unions.

The corporate credit union system is now facing unprecedented strains on its liquidity and capital due to credit market disruptions and the current economic climate. NCUA has developed a strategy to address the issues facing the corporate system, with three primary objectives:

1. Maintain liquidity;
2. Strengthen capital; and
3. Restructure the existing corporate system.

NCUA will use all available resources to successfully achieve these objectives. It is essential that natural person credit unions continue to support the system as well. While economic uncertainty will continue to affect corporate credit unions, it is clear that achievement of the objectives listed above requires your continued support of the corporate system.

Actions you can take to support the system include maintaining your current deposits and placing additional excess liquidity in your corporate credit union(s), utilizing the Central

Liquidity Facility (CLF) for your own cash needs, and participating in the new programs NCUA has developed to ease the liquidity stress in the corporate system. In particular, participation in the Credit Union System Investment Program (CU SIP) provides a credit-risk free opportunity for you to enhance your earnings and provide liquidity to the corporate system. Information concerning all of the corporate liquidity programs is available on NCUA's website at www.ncua.gov, or by contacting your NCUA examiner or Regional Office.

NCUA is announcing two additional actions which provide immediate enhancement to the corporate credit union system's liquidity and capital position. The actions include:

- Offering a temporary National Credit Union Share Insurance Fund (NCUSIF) guarantee of member shares in corporate credit unions. The guarantee will cover all shares, but does not include paid-in-capital and membership capital accounts, through December 31, 2010. This guarantee is the equivalent of full share insurance on member shares and will be extended beyond that date by the NCUA Board if necessary. A condition of the guarantee requires the management team of each participating corporate credit union to be subject to supervisory conditions and terms defined by NCUA. Refer to the Share Guarantee Term Notice for full details concerning the guarantee.
- Injecting $1.0 billion in cash from the NCUSIF into U.S. Central Federal Credit Union (U.S. Central) in the form of capital. The capital will provide reserves to the system in order to offset the anticipated realized losses on some of the mortgage and asset-backed securities held by U.S. Central.

Given the importance of U.S. Central as a liquidity and payment systems provider to both corporate credit unions and by extension, natural person credit unions, NCUA is taking decisive action to stabilize U.S. Central's financial position. This includes both the capital infusion and U.S. Central's participation in the uninsured share guarantee. These actions bring immediate stability to not only U.S. Central but the entire corporate system.

Background and Current Condition of Corporate Credit Unions

By regulation, corporate credit unions are only allowed to invest in highly rated securities, and their interest rate risk exposure is constrained by net economic value limits. Corporate credit unions have used these securities as part of their overall balance sheet management in meeting their member liquidity needs. Historically, the securities could be readily sold in the market or used for collateralized borrowing to obtain liquidity, and the values of the securities have experienced little or no loss.

Current financial market conditions, however, are like nothing experienced since the Great Depression. Credit markets have been disrupted world-wide, resulting in depressed pricing, inactive trading of debt securities, and a severe contraction of wholesale lending. Like other financial institutions in the United States and around the world, corporate credit unions have not been immune to the effects of these conditions. The corporate system is experiencing a strain on liquidity due to approximately $64 billion held in mortgage and asset-backed securities for which, in most cases, there is currently a limited active trading market.

Nearly 80 percent of the securities held in the corporate credit union system remain highly rated, but a portion of the securities has been downgraded below investment grade due to the underlying collateral performance. As of November 30, 2008, corporate credit unions reported approximately $18 billion in unrealized losses on securities. However, context must be placed on this figure. These unrealized losses likely overstate the actual credit losses to be absorbed by corporate credit unions should the securities be held to maturity. The credit losses are largely determined by the evaluation of the expected securities cash flows and include the amount of principal that may not be paid to the holder of the securities. The credit exposure is difficult to define as it is predicated on estimates about the economy and performance of underlying collateral (e.g., mortgages and credit card and auto loans). NCUA and the corporate credit unions continue to evaluate the credit exposure of the corporate system's portfolio.

Selling securities in the current environment is problematic as there is no active market for many mortgage-backed and asset-backed securities. Should a corporate sell its securities at this time, such transactions will likely occur only at "fire sale prices" resulting in losses that may far exceed the current unrealized losses and the $8.7 billion in corporate total capital. For these reasons, the NCUA Board believes the lowest cost option to stabilize the corporate system is to maintain liquidity in the corporate system and prevent distressed price liquidation of securities.

Steps to Address the Problem

NCUA, the corporate credit union system, and others are working diligently to sustain the long-term viability of the corporate system. Our goal is to ensure the corporate credit union system is strengthened. We have developed a strategy that will ensure appropriate levels of capital, effective diversification of investments, and a restructuring of the system to produce more efficient institutions that will continue to provide critically needed investment and payment system services to credit unions. These changes will be accomplished by NCUA using our rulemaking and supervisory authority and with the full participation of the credit union community. It will take time, however, to resolve the issues facing corporate credit unions and accomplish these goals. Meanwhile, it is essential that we maintain an adequate level of liquidity not only in corporate credit unions, but also the whole credit union system. **Success requires credit unions working together in the cooperative spirit that is the very foundation of the credit union system.**

Maintaining Liquidity in the System

NCUA has taken important steps to help the corporate credit unions weather the current liquidity crisis.

- We established the Temporary Corporate Credit Union Liquidity Guarantee Program, providing an NCUSIF guarantee for unsecured borrowings by the corporate credit unions. Loans that you and other creditors make to the corporate credit unions under this program are guaranteed by the NCUSIF, which in turn is backed by the full faith and credit of the U.S. Treasury.

- We obtained Congressional authorization of the CLF's full statutory borrowing cap (approximately $41 billion) for new liquidity loans to natural person credit unions.

- We established the CU SIP and Credit Union Homeowners Affordability Relief Program (CU HARP), both of which involve natural person credit unions borrowing from the CLF and investing the funds in corporate credit unions, again with a full guarantee from the NCUSIF and the backing of the U.S. Treasury.

These programs will enable corporate credit unions to reduce reliance on borrowings from outside of the credit union system. We continue to work with the Federal Reserve and the Treasury Department to consider additional ways to provide federal support in the form of direct liquidity funding for corporate credit unions. However, NCUA believes the long-term viability of the entire credit union system is best served by a solution that comes from within the credit union community.

Along with these actions, we are announcing the previously discussed full guarantee of uninsured member shares for the period through December 31, 2010 for each corporate credit union that elects to participate. The NCUA Board will consider extending the guarantee beyond that date, if necessary, to maintain liquidity in the corporate credit unions system. The guarantee helps provide stability to meet the liquidity needs of the corporate system which will allow for the orderly pay down of the stressed securities. In turn, it reduces the overall resolution cost.

This guarantee requires the establishment of a liability that will impact the NCUSIF. Based on current corporate credit union balance sheets and modeling various market scenarios, the amount of the liability will initially be $3.7 billion with the participation of all corporate credit unions.[1] U.S. Central has agreed to participate, and NCUA strongly encourages all corporate credit unions to participate in order to maintain confidence and liquidity in the corporate credit union system. In order to ensure a smooth transition to final decisions by corporate credit unions on their participation, NCUA is guaranteeing all uninsured member shares in all corporate credit unions through February 28, 2009. By that date, NCUA requires each corporate credit union to determine its participation status.

[1] The liability amount reflects the potential credit losses within the securities portfolio as well as other factors that could prompt payments under the guarantee and impact the fair value of the guarantee obligation. Thus, this figure could change significantly depending on a host of factors including, but not limited to, credit loss estimates.

NCUA continues to study and evaluate the potential credit risks within the corporate securities portfolio. In the coming weeks, a systematic review of the $64 billion in mortgage and asset-backed securities held by corporate credit unions will be completed. This subsequent information will refine the ultimate liability and subsequent charge to each credit union. As a result, you won't be assessed a charge until later in 2009. Discussion of the actual projected costs for each credit union is provided later in this letter. The assessment of the securities will continue throughout the resolution process and if future estimates of potential losses decline, you can anticipate a return of funds in the form of dividends from the NCUSIF.

For these various liquidity steps to be effective, natural person credit unions need to maintain their deposits in corporate credit unions and participate in the programs established by NCUA. Maintaining funds with your corporate credit union represents the lowest cost alternative for the entire credit union industry to weather the current world-wide financial crisis.

Strengthening the Capital Position

As part of the restructuring of the corporate system, new capital requirements for corporate credit unions will emerge. In the interim, maintaining a strong capital position in the corporate system is necessary. **As we work through the various resolution scenarios, the capital position of natural person credit unions remains a constant source of strength for the industry.** The funding for the new corporate system structure will come from voluntary capitalization by natural person credit unions. In the near-term, NCUA will infuse capital as necessary into corporate credit unions in the form of cash contributions from the NCUSIF to provide stability during the resolution process.

While a capital infusion has cost implications for all credit unions, it is a lower cost alternative than liquidation and sale of the distressed securities in today's market. Future cash infusions will depend on both the level of continued support of the corporate credit unions by their members and the expected performance of the approximately $64 billion in mortgage-backed and other asset-backed securities held by corporate credit unions. NCUA will continue the comprehensive review of the securities, and make a judgment as to the need for further cash infusions as the circumstances warrant.

An event that necessitates this infusion is the other-than-temporary-impairment (OTTI) accounting charges required of some corporate credit unions.[2] These OTTI charges turn

[2] If the fair value of an available-for-sale or held-to-maturity debt security is less than its amortized cost basis at the measurement date, the investment is impaired. U.S. generally accepted accounting principles (GAAP) require that the reporting entity assess the impaired security to determine whether the impairment is other-than-temporary. Other-than-temporary impairments are recognized in earnings if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security. As of the balance sheet date that the impairment is recognized, the fair value of the investment would then become the new cost basis. [FAS 115, para. 16; FSP 115-1/124-1].

previously unrealized losses on the securities into realized losses. The result is a reduction in a corporate credit union's capital level. The first capital infusion will be a $1.0 billion NCUSIF capital note with U.S. Central. As this transaction represents capital for U.S. Central, the liability for the NCUSIF is equal to the amount of the injection.

Restructuring the Existing Corporate System

The current market conditions and the adverse impact on the balance sheets of several corporate credit unions necessitate a comprehensive look at the regulatory and functional structure of the corporate system. The NCUA Board approved an Advanced Notice of Proposed Rulemaking (ANPR) on January 28, 2009 to solicit input from all stakeholders in the credit union industry as NCUA looks for effective reforms to enhance the corporate system. We plan to follow-up the ANPR with various public forums to discuss the corporate system so all stakeholders receive an opportunity to provide input. You will have a direct influence on the future of the corporate credit union system.

Financial Impact on Credit Unions

The expense of the actions will be passed on proportionately to all federally-insured credit unions through a partial write-off of your existing 1 percent NCUSIF deposit, as well as the assessment of a premium, sufficient to return the NCUSIF's equity ratio to 1.30 percent. The projected average cost for credit unions for the share guarantee is an approximate 48 basis point decline in annual return on assets and a 43 basis point decline in the net worth ratio. The impact on credit unions for the capital infusion to U.S. Central will be an average additional decline in the return on assets of 14 basis points and 13 basis points of net worth. The combination of both actions results in the average credit union absorbing a total 62 basis point decline in the return on assets and a total 56 basis point reduction in the net worth ratio. Correct regulatory reporting of this action will be included in the supplemental March 31, 2009 Call Report instructions.

Conclusion

Given the cost to the entire credit union industry as outlined in this letter, the NCUA Board has carefully evaluated the alternatives to provide stability and strengthen the corporate credit union system. This letter provides cost projections for the uninsured share guarantee as well as the initial capital injection. These costs are not final, but rather are provided to you as a reasonable gauge to determine the impact on your credit union. Several factors will continue to impact the cost to the industry including OTTI charges, further evaluation of the credit risk in the securities, additional changes in the credit ratings of each corporate credit union, and liquidity levels. As these factors change, the cost may change in either direction. If the cost estimates decline, you will see a return of your charge in the form of future dividends from the NCUSIF.

In view of the extreme costs of the alternative for all insured credit unions, we cannot over-emphasize the importance of all credit unions cooperating at this time to maintain their deposits in and continue their support of the corporate system. For its part, NCUA will continue to utilize the full extent of its authorities to maintain stability in the system and resolve these conditions. The cooperative nature of credit unions has served the industry well over the last 75 years and we have no doubt that with your support it will remain vibrant well into the future. NCUA is committed to work with you to weather the liquidity crisis, restore capital adequacy and reform and restructure the corporate credit union system.

The NCUA Board is unified in its support of this action and unanimously agreed to this Letter to Credit Unions.

Sincerely,

/s/

Michael E. Fryzel
Chairman

Enclosure