Summary of January 16, 2009
Analysis of Recommendations for Stabilization and Improvement of the Corporate Credit Union System

In November 2008, the NCUA Board engaged PricewaterhouseCoopers LLP ("PwC") to work with NCUA staff to review recommendations developed by NCUA staff for the strategic realignment of the corporate credit union (corporate) system. PwC worked in conjunction with NCUA to analyze the recommendations and the challenges to implementing them based on data from Federal Reserve System staff, NCUA staff, GAO reports, reports of other consultants who have reviewed the corporate credit union system, and meetings with corporate system representatives. The resulting confidential report dated January 16, 2009, identified good practice models from the industry and proposed actions to address corporate system needs. Specifically, the report set out guiding principles for its undertaking and identified issues and provided observations and recommendations in four areas: (1) liquidity; (2) capital; (3) structure; and, (4) risk management.

<u>Guiding Principles:</u>

- A strong center for payment systems and other specialized services is needed within the credit union system.
- The number of corporates should be justified by economies of scale and prudential considerations.
- Payment system activities should be distinguished and insulated from non-payment system activities to minimize systematic risk.
- Corporates should be well capitalized.
- Well-defined risk management standards and governance infrastructure are necessary to sustain corporates' systemic role.
- Investment risk should be borne by the ultimate owners.

<u>Liquidity:</u>

- Issues:
    - The primary purpose of corporates to provide short-term liquidity to natural person credit unions (NPCUs) has been constrained by the decline in market value of securities.
    - Corporates have borrowed from external sources that should not serve as a sustained daily source of liquidity.
    - The downgrade of corporates by ratings agencies negatively impacts liquidity.
    - A decline in NPCU confidence is leading to withdrawals.
- Recommendations:
    - NCUA collaborate with NPCUs to increase liquidity at corporates.

- Use the Central Liquidity Fund (CLF) to infuse liquidity into corporates.
- NCUA implement a deposit guarantee program for deposits at corporates.

Capital:

- Issues:
  - Current capital ratio requirements for corporates differ from global standards, such as Basel 1, and do not have a companion risk-based ratio.
  - Low Tier 1 capital levels and capacity of regulatory capital to absorb risk are a concern for external lenders.
  - Low Tier 1 capital levels put corporates at risk of a downgrade by Nationally Recognized Statistical Rating Organizations.
  - Risk of decline in confidence in the credit union system.
- Recommendations:
  - Create a capital restoration plan.
  - Corporates should become well-capitalized.
  - Implement risk-based capital.
  - Potential solutions for self-recapitalization
    - Create a central pool of lower rated securities.
    - Limit new investment activity to reduce corporate balance sheets.
    - Make NPCUs participation in corporates contingent on providing paid in capital (PIC).
    - Large, well-capitalized NPCUs provide capital to corporates on a voluntary basis.
    - Use NCUSIF.
    - Use CLF loans as a source of PIC or other form of capital.

Structure:

- Issues:
  - Risks from non-core activities jeopardize core, systemic clearing, settlement, and liquidity functions.
  - Redundant processing systems create inefficiencies across the system.
  - Many NPCUs use services from vendors outside the credit union system.
  - Diffuse leadership and limited stability within the corporate system.
  - Any change in the number of corporates requires a market analysis or individual cost analysis of corporate cost structures.
- Recommendations:
  - Comprehensively investigate restructuring options.
    - Define core and non-core corporate activities.
    - Define the entities required to provide non-core activities.

        - Define regulatory framework for entities providing non-core activities.
    - Define the restructuring plan and initiate implementation.

<u>Risk management:</u>
- Issues:
    - Expanded authorities enabled some corporates to handle riskier investments.
    - Some corporates offer investment services through U.S. Central, which has expanded authorities, without assuming direct risk.
    - Corporates have significant unrealized losses that may become realized other-than-temporary impairments.
- Recommendations:
    - Develop a comprehensive risk management system for all corporates.
    - Define composition requirements for corporate boards of directors.
    - Consider use of external advisors or professional board members.
    - Implement an enhanced enterprise risk management, monitoring and evaluation system.