H.R. 2351, THE CREDIT UNION SHARE INSURANCE STABILIZATION ACT

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

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H.R. 2351, THE CREDIT UNION SHARE INSURANCE STABILIZATION ACT

Wednesday, May 20, 2009

U.S. House of Representatives,
Subcommittee on Financial Institutions and Consumer Credit,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:30 p.m., in room 2128, Rayburn House Office Building, Hon. Luis V. Gutierrez [chairman of the subcommittee] presiding.

Members present: Representatives Gutierrez, Sherman, Kanjorski, McCarthy of New York, Baca, Green, Scott; Hensarling, Royce, Neugebauer, Marchant, Paulsen, and Lance.

Chairman Gutierrez. This hearing of the Subcommittee on Financial Institutions and Consumer Credit will come to order.

Good afternoon and thanks to all of the witnesses for agreeing to appear before the subcommittee today.

Today's hearing is a legislative hearing on a piece of legislation that is vital to maintaining the safety and soundness of our financial system, H.R. 2351, the Credit Union Share Insurance Stabilization Act.

The subcommittee has asked our witnesses to discuss recent developments in the seizures of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union in March, as well as the stability of the National Credit Union Share Insurance Fund.

We will be limiting opening statements to 10 minutes per side, but without objection, all members' opening statements will be made a part of the record.

I yield myself 5 minutes.

The 4,900 Federal credit unions and almost 3,000 federally-insured, State-chartered credit unions in the United States play a vital role in our economy by providing access to credit for nearly 82 million Americans with the total credit union assets exceeding $800 billion. Maintaining the continuous stability of these institutions is vital to the economic health of the Nation and even that of the global financial systems.

Congress acted recently to increase the amount of an insured deposit at these institutions from $100,000 to $250,000, but we must also take steps to maintain the health of the insurance funds themselves.

On March 20, 2009, the National Credit Union Administration seized controls of U.S. Central Corporate Federal Credit Union and Western Corporate Federal Credit Union, one of the largest wholesale credit unions in the Nation. The NCUA made its decision based on mounting losses at the two corporate credit unions from their investments in mortgage-backed securities. The combined weight of the $57 billion in assets of the two credit unions forced a substantial drawdown in the National Credit Union Share Insurance Fund, which now must be re-capitalized at a cost of nearly $6 billion. However, attempts to re-capitalize this fund by immediately increasing assessments on retail credit unions would constrain lending at these institutions at a time when the exact opposite is what is needed.

To address the re-capitalization and continued health of the Share Insurance Fund, Representative Kanjorski, along with myself and Representatives LaTourette, Royce, and Scott introduced the Credit Union Share and Stabilization Act. This legislation would authorize the NCUA to establish a stabilization fund which would allow the credit unions to pay back the nearly $6 billion over 8 years and eventually merge this fund with the Share Insurance Fund. The legislation would also permanently increase the Fund's borrowing authority from its current $100 million to $6 billion and allow for up to $30 billion in emergency circumstances.

While similar language was included in S. 896, which passed the House yesterday and is scheduled to be signed into law today, this legislative hearing is necessary to establish a legislative record on this issue in the House. Additionally, I believe that this committee should hear from the stakeholders about the steps that they are taking to ensure—and this I think is vitally important—that similar losses to the Share Insurance Fund can be avoided in the future.

I believe this legislation is vital to maintaining the health and stability of our financial systems, and I am proud to be an original cosponsor. I commend Mr. Kanjorski for his work on this bipartisan legislation and I look forward to hearing from our witnesses.

I yield 5 minutes to the ranking member, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. In a complete breach of tradition, I do not intend to take the full 5 minutes, but I thank you for yielding the time nonetheless. I want to thank you for holding this hearing. I want to thank the gentleman from Pennsylvania and the gentlemen from California, Mr. Royce, and Mr. LaTourette, for their participation and I thank you for your leadership, Mr. Chairman, for your work on the bill and for your work on this matter.

It is important I think that we establish for the record that the failures we are discussing today are of corporate credit unions and not the natural-person credit unions that serve so many of our constituents each and everyday.

Credit unions, along with community banks, play an incredibly important role in the communities they serve. I know how they important they are in the Fifth District of Texas. And along with you, Mr. Chairman, I believe it is critical that we keep them lending at this challenging period in our Nation's economic history.

Clearly, without the benefit of the underlying legislation, our credit unions would be forced to need a very heavy and immediate assessment that one could argue ultimately subsidizes their competitors' failures. And so I think it is important that at this time of a national credit crunch, that certainly not be done.

As important as this legislation is though, it does remind us of another important fundamental concern about our financial markets and that is the Federal Government cannot continue making great promises of funding guarantees to everyone who has or expects to have a funding problem. We have already extended funding promises to banks via the FDIC, banks via the Fed, banks via TARP, life insurance via TARP, ABS lending via TARP, automakers via the TARP, homeowners via FHA, not to mention our liabilities under the Federal Flood Insurance Program, TRIA, and the list goes on and on and on.

After passing a budget that will triple our national debt in just 10 years, and create more debt in the next 10 years than was created in the previous 220, as we look at legislation, we need to always be very, very mindful about the implications of future generations, and we must be looking to create more economic opportunity and competitiveness in our land because the greatest anecdote to our funding problems is certainly a robust and healthy economy.

Again, Mr. Chairman, I thank you for your leadership on this issue, and I thank you for holding this hearing. I yield back the balance of my time.

Chairman GUTIERREZ. I thank the ranking member. Mr. Sherman is recognized for 3 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman. As a result of legislation that has passed the Senate, I know this hearing is a little broader than originally conceived. And I want to focus on an effort of mine for a long time to allow credit unions to issue alternative capital.

Now, let's look at other sectors of the banking and depository world. We are now begging the banks to issue preferred stock and common stock. We wanted the big banks to issue preferred stock so much, we bought it. Credit unions also need capital. With capital, they can achieve the purposes, including lending to their members and to business members. Instead of talking about how much money are we going to spend or risk, the first thing we should do is say, why don't we allow the credit unions to issue alternative capital, subordinated debt, whatever term you want to use for it. Allow them to go to investors and say, "You invest, you take a risk." With that risk, we can then accept deposits without that risk falling onto the Federal Government or onto the stabilization fund or insurance entity.

We ought to allow this. It is the one thing we can do to help the economy now at zero risk to the Federal Government and at zero cost to the Federal Government. And I, for the life of me, cannot figure out why we have not done so promptly.

Now, if credit unions were allowed to issue subordinated debt, that debt could be purchased with TARP funds. Whether that is a good idea or not, a better way to ask it is, is that a better use of TARP funds than anything else that might be used with them? But my proposal to allow credit unions to raise capital by issuing alternative capital is independent of the existence of TARP and was made long before anybody imagined that the Federal Government would be investing in the capital of depository institutions.

I look forward to the credit unions being in a position to help us get out of this mess and the least we ought to do is untie their hands. It is a lot cheaper than anything else that is being suggested.

I yield back.

Chairman GUTIERREZ. Mr. Royce is recognized for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman GUTIERREZ. You are welcome, sir.

Mr. ROYCE. Since the 108th Congress, Representative Kanjorski and I have co-authored the Credit Union Regulatory Improvements Act, and last week, I was pleased to once again join the chairman in introducing legislation, H.R. 2351, the Credit Union Share Insurance Stabilization Act. As has been noted, this legislation increases the NCUA's borrowing capacity with the Treasury, it extends the repayment plan for natural-person credit unions, and it creates a temporary corporate credit union stabilization fund as put forward in a proposal by the NCUA in March of this year.

With headlines over the last couple of years focused on those financial institutions that were highly leveraged and quick to underwrite risky loans, for the most part the natural-person credit unions were conservative in loans they originated, holding most of their mortgages they made on their balance sheets. Clearly, however, there was a problem experienced at the corporate credit union level. The exact structure and function of the corporate credit union system is not widely understood. The various corporate credit unions throughout the country are owned in a cooperative fashion by the natural-person credit unions. These corporate credit unions supply liquidity to their members, as well as provide everyday services, such as wire transfers, ATM processing, and bill payment services for the natural-person credit unions.

The failures that led to this request for expanded authority by the NCUA must be fully vetted. I believe significant changes need to occur at the corporate level to ensure future actions taken are consistent with the mission of the credit union model. As this legislation moves closer to becoming law, I am hopeful that this authority will be enough to stabilize and in fact strengthen the broader credit union system.

And, again, I thank you for holding this hearing, Mr. Chairman. I look forward to hearing from our witnesses.

Chairman GUTIERREZ. Thank you very much, Mr. Royce, for your work on the legislation and our joint efforts. And now to my friend and senior colleague on this committee, on the full committee, and the co-author, Mr. Kanjorski, for 3 minutes. Thank you.

Mr. KANJORSKI. Thank you very much, Mr. Chairman. And thank you for convening this hearing to examine H.R. 2351, the Credit Union Share Insurance Stabilization Act. Our bipartisan bill allows the managers of retail credit unions to focus on their most important mission—providing credit—to their members rather than worrying about how they will pay for an excessive one-time charge to rebuild deposit insurance reserves and paring back lending during these difficult economic times.

As you know, Mr. Chairman, we first planned to convene this hearing about 2 months ago. At the time, we had expected to consider the legislative proposals to create a Temporary Corporate

Credit Union Stabilization Fund and adopt other needed deposit insurance reforms. These plans respond to the recent $5.9 billion rescue of the corporate credit unions by permitting the re-capitalization of the credit union deposit insurance system to occur over several years, rather than in a matter of months. We have, however, been overtaken by events.

Several weeks ago, Mr. Chairman, you joined Chairman Frank and me in sending a letter to Senator Dodd urging him to incorporate the plan to create a Credit Union Stabilization Fund into S. 896, the Helping Families Save Their Homes Act, a bill that contains many important deposit insurance reforms. I am pleased that Senator Dodd did as we asked. The House and Senate have now passed the bill and President Obama will sign it into law later today.

As a result of these events, the focus of today's hearing has shifted from the need for this bill to ensuring the efficient implementation of this law. Without this law, two-thirds of the credit unions would have had negative earnings in 2009, as a result of the need to rebuild deposit insurance reserves. Moreover, around 225 credit unions, through no fault of their own, would have fallen below limits where they would be deemed adequately capitalized.

As members of a cooperative movement, credit unions are willing to help one another and to pay their fair share to recapitalize their deposit insurance system. The provisions found in H.R. 2351 and incorporated in S. 896 represent a viable and appropriate response to the problems now facing the credit union movement. The National Credit Union Administration must tell us today how it will swiftly and effectively implement this new law.

Mr. Chairman, I am particularly pleased Mr. William Lavage, the president and CEO of Service 1st Federal Credit Union in Danville, Pennsylvania, will testify today. I have worked closely with him in the past and Service 1st has developed a unique model program of educating school children about financial matters. I look forward to his participation.

In sum, I am very pleased that our bill will become law within a matter of hours and that we are convening this hearing today to examine how the National Credit Union Administration will work to implement these reforms quickly. The fact that we have considered and resolved these problems within a matter of weeks demonstrates that the Congress and the Administration can work together to solve problems facing the American people in a pragmatic way.

Thank you, Mr. Chairman. I yield back my time.

Chairman GUTIERREZ. Thank you, Mr. Kanjorski. Now, we have Congressman Paulsen for 2 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. It is abundantly clear that the current financial crisis has exposed a number of issues within deposit insurance that do need to be dealt with. Credit unions provide an extremely valuable service to their members and to all of our communities. Unfortunately, some credit unions, just like some banks, have made some bad bets on mortgage-backed securities. We need to make sure that the credit unions which were more prudent are not unfairly penalized from the resolution of those seized firms and subsequent re-capitalization of the insurance fund. In this time of very tight credit, it is important for Congress to act quickly and swiftly and effectively in response to the problems facing the credit unions so they can also stop worrying about the losses resulting from premium increases and start extending the badly needed credit to our small businesses again and retaining the confidence of their membership.

So I thank you, Mr. Chairman, for holding this hearing today, and I do look forward to hearing the witnesses' testimony. I yield back.

Chairman GUTIERREZ. Thank you. Thank you very much, Congressman Paulsen. Next, we have—let's see who is on the list, my friend, Congressman Green, for 1 minute.

Mr. GREEN. Thank you, Mr. Chairman. I would like to associate myself with the comments of the chairman as well as Chairman Kanjorski. Credit unions do play a vital role in our communities, especially in my community in Houston, Texas, and I think that this legislation was absolutely needed to give credit unions the boost that they need so that they can continue to fulfill their role.

Credit unions across the length and breadth of the country have been a lifeline for many persons who were not able to access the assets that they need or the financing that they need from other sources. I am honored to say that I gladly support this effort and look forward to the bill being signed today. I yield back.

Chairman GUTIERREZ. Mr. Scott, you are recognized for 1 minute.

Mr. SCOTT. Thank you very much, Mr. Chairman. First of all, I want to welcome from the State of Georgia, Mr. George Reynolds, who is the commissioner of our banking system in Georgia. It is good to have you here with us, and I look forward to your testimony.

I do want to also add that I am pleased to be a co-sponsor with Chairman Kanjorski on his bill, H.R. 2351, the Credit Union Share Insurance Stabilization Act. This measure is necessary and it is very important. Increasing the amount the National Credit Union Administration may borrow from the Treasury to $6 billion from $100 million is an effective way to make sure credit unions are increasingly viable and that they have the tools they need in these uncertain economic times.

These are indeed tough, trying economic times, and we have to give our financial institutions the tools they need to weather the storm and come out strong in the end. Of course, there are many issues we will need to work on together in the future, but I believe this measure is a good measure and it is a strong measure that we can all agree on. And I look forward to hearing the views and concerns of our distinguished witnesses.

Thank you, Mr. Chairman.

Chairman GUTIERREZ. Thank you very much. And now we will go to our witnesses. Mr. Michael Fryzel is the chairman of the National Credit Union Administration. Mr. Fryzel has been chairman since July of 2008. Prior to that appointment, he has served in both private practice and in numerous capacities for the State of Illinois.

Mr. George Reynolds is the chairman of the National Association of State Credit Union Supervisors. And, as we heard earlier from

Mr. Scott, he is senior deputy commissioner of the George Department of Banking and Finance.

I thank you both for appearing before the committee, and I would like to ask Mr. Fryzel to begin his testimony. Each of you will be limited to 5 minutes. The light will turn—when you have 30 seconds left, it will turn yellow, and then red means stop, like in most other situations. I really do not mind using this gavel with that side of that aisle, much more with this side, so watch the clock.

Thank you so much for coming.

STATEMENT OF THE HONORABLE MICHAEL E. FRYZEL, CHAIRMAN, NATIONAL CREDIT UNION ADMINISTRATION (NCUA)

Mr. FRYZEL. Thank you, Chairman Gutierrez, Ranking Member Hensarling, and members of the subcommittee. I appreciate this opportunity to provide the NCUA's views on H.R. 2351, the Credit Union Share Insurance Stabilization Act, and the situation in the corporate credit union system in general.

The 28 corporate credit unions have been a vehicle for investments, liquidity, and payment system services for retail credit unions for 3 decades. They were created and directed by the credit unions themselves and are a valuable component of the overall industry.

Beginning last summer, unrealized losses from investments in mortgage-backed securities placed significant pressure on corporate liquidity. I had just taken office as NCUA chairman in late July and had begun a review of all NCUA activities. When the seriousness of this situation became apparent, as a first step, I immediately asked Congress for full borrowing authority from the Central Liquidity Facility, a seldom-used liquidity backstop administered by NCUA.

In the last 7 years, the CLF had made $20 million in loans to credit unions. In September 2008 alone, the CLF received requests for almost $2 billion. Congress granted our request to have full CLF borrowing authority of approximately $41.5 billion and in turn, NCUA has infused almost $21 billion into the credit union system, stabilizing a very tenuous situation.

The good news was that the liquidity situation had been addressed. The bad news was that the distressed investments remained on the corporate books and continued to deteriorate. In January, the declining financial condition of U.S. Central, the wholesale corporate that provides services to other corporates, prompted the NCUA board to infuse $1 billion into that corporate, and guarantee deposits in all corporates through at least September 2011. Without swift and direct action, the corporate system would have been placed in jeopardy and service to members throughout the system would have been disrupted.

It has always been my objective to do everything necessary to protect the nearly 90 million consumers who are members of credit unions. I could not permit the corporate system to cease functioning, for the impact on retail credit unions and consumers would have been devastating.

In March, NCUA placed U.S. Central and West Corp., the second largest corporate, into conservatorship. This action preserved retail credit union deposits, enabled NCUA to gain more information about the portfolios at these two institutions, and allowed us to take necessary steps to mitigate future losses.

The impact of these stabilizing actions on the Credit Union Insurance Fund was considerable. The cost of the Fund is $5.9 billion, which translates to a 99 basis point assessment for each natural-person credit union. While industry capital stands at over 10 percent, it is undeniable that this cost, taken all at once, would come at a time of economic difficulty, a time when Americans need the kind of fairly priced financial services that credit unions provide.

Recognizing this, NCUA developed a plan to replenish the Fund over 7 years. The plan, which was incorporated in the recently passed legislation and is now the heart of H.R. 2351, represents a real solution to the problem: It preserves the strong and well-capitalized insurance fund that Congress, NCUA, and the public demand. It enables credit unions to bear the cost in a more manageable way and it complies with GAAP accounting, which is mandated by the Federal Credit Union Act and which must be adhered to if we are to maintain public confidence in the industry.

This proposal also relies on increased borrowing authority from the Treasury and it changes the time period on collection of a premium, both of which are included in the bill.

I welcome and appreciate your support for this plan. Congress has been a very responsive partner to NCUA during this time of financial difficulty. And I am grateful that the House and Senate have approved the plan and sent it to President Obama for his signature. But this is not the end of the story. NCUA has embarked on a broad set of corporate reforms that will address such issues as: investment authority; risk concentration; corporate governance; and other aspects of corporate credit union operations. This new rule will yield a stronger, more doable corporate network that will better serve the needs of credit union members.

My commitment to you is to make certain that NCUA puts the hard lessons we have learned to good use. I will look to the industry for their input. I will look to the Congress for your input. I will incorporate the best ideas that we, as the Federal regulator, have at our disposal. Above all, I will keep a clear focus on the central mission of protecting credit union members. I appreciate this opportunity to provide testimony and would be pleased to answer any questions.

[The prepared statement of Mr. Fryzel can be found on page 46 of the appendix.]

Chairman GUTIERREZ. Thank you very much.

Commissioner Reynolds, you are recognized for 5 minutes, sir.

STATEMENT OF GEORGE REYNOLDS, CHAIRMAN, NATIONAL ASSOCIATION OF STATE CREDIT UNION SUPERVISORS (NASCUS), AND SENIOR DEPUTY COMMISSIONER, GEORGIA DEPARTMENT OF BANKING AND FINANCE

Mr. REYNOLDS. Thank you. Good afternoon, Chairman Gutierrez, Ranking Member Hensarling, and distinguished members of the subcommittee. I appear on behalf of NASCUS, the professional association of State credit union supervisors.

We are pleased that Congress passed S. 896. The provisions are consistent with the priority of State credit union regulators to mitigate the impact of corporate credit union losses on natural-person credit unions.

The NASCUS' testimony today will focus on four key points: the State credit union system and its relationship to corporate credit unions; mitigating the impact of corporate losses on natural-person credit unions; preventing the current situation from occurring again; and the future of corporate credit unions.

State regulators monitor the corporate credit union system and conduct ongoing dialogue with the NCUA. State regulators are confident that by continuing to work closely with NCUA, we will address the problems in the corporate credit union system and ensure a vibrant, healthy, safe, and sound credit union system in the future. Transparency between State and Federal regulators is key to this relationship.

We support establishing a restoration plan period for NCUSIF as provided in the legislation. Allowing 8 years would provide the flexibility to credit unions that they need to re-capitalize the NCUSIF, as well as continue to serve their members. This provision also provides parity with the FDIC Act's proposed 8 year restoration authority.

In addition, the legislation provides for the creation of a Temporary Corporate Credit Union Stabilization Fund and other provisions that allow solutions for credit unions to mitigate the impact of the dislocated credit markets. This allows credit unions to protect capital and liquidity so they can continue to serve member needs.

Going forward, we must analyze the situation and seek ways to ensure that it will not occur again. First, to identify factors that resulted in material losses that led to the NCUA's recapitalizing U.S. Central and then to the conservatorship of U.S. Central and WesCorp, the NCUA inspector general should conduct a material loss review. A review would provide meaningful data for both State and Federal regulators. It would suggest needed regulatory and supervisory changes and identify weaknesses in the system.

Next, we want to ensure that NCUA and State regulators share real time information to manage this fluid situation. We encourage greater transparency between NCUA and State regulators, the primary regulators of State-chartered corporates. Furthermore, NASCUS proposes a process for NCUA to work cooperatively with State regulators to identify corporates that pose material systemic risk and jointly examine them. This would help identify risk in an economic situation that is still unfolding.

We must look beyond the structure of corporate credit unions. We do not believe that structural issues caused the conservatorship of U.S. Central and WesCorp. The problems at these institutions centered on risk management, risk mitigation, and supervisory issues. From a regulatory perspective, we must identify contributing factors and critically analyze each regulation to ensure proper policies and procedures.

NCUA should work with NASCUS and State regulators to develop more comprehensive capital requirements, including risk-based capital. NASCUS has urged Congress, the NCUA, and the credit union system that supplemental capital should be enacted for natural-person credit unions. During the corporate stabilization process, supplemental capital might have mitigated some of the unintended consequences to net worth categories and natural-person credit unions. Natural-person credit unions would benefit from a risk-based capital system as well.

In closing, we encourage Congress to consider the following points: Improve regulatory oversight and require more prudent risk management expertise for corporate credit unions; recognize State authority and encourage transparency between State and Federal credit union regulators; and improve capital standards for credit unions by allowing supplemental capital for all credit unions.

NASCUS appreciates the opportunity to testify, and we welcome questions from subcommittee members.

[The prepared statement of Mr. Reynolds can be found on page 83 of the appendix.]

Chairman GUTIERREZ. Thank you very much, Mr. Reynolds. Chairman Fryzel, you state in your testimony that corporate credit unions were allowed under NCUA rules to invest in riskier mortgage-backed securities but that those corporates with expanded corporate risk authority rarely exercised it. Does not the seizure and subsequent rescue of both U.S. Central and WesCorp, as a result of their exposure to mortgage-back securities show that the NCUA has allowed corporates to hold more high-risk investments than they should? And are you evaluating and reconsidering this policy?

Mr. FRYZEL. Mr. Chairman, at the time these investments were made by U.S. Central and WesCorp, they were considered to be sound and good investments. They were mortgage-backed securities, and at that time, mortgage-backed securities were yielding a good return on the investments. I think the major problem occurred when these corporates were allowed to invest too heavily in those mortgage-backed securities. They did not diversify their investments as they should have, and perhaps if that would have been picked up earlier and perhaps the regulators would have said, "Start to diversify," some of these problems would not have occurred.

Chairman GUTIERREZ. So picking up on—so I grant you that point, that no one might have been able to foresee that. So what are you doing to make sure that things that look good today, that turn out to be really bad tomorrow in terms of regulation that you were talking about, that they bought too much and that their portfolio was not balanced, explain that, what steps you are taking there?

Mr. FRYZEL. Congressman, what we have asked is we have asked the industry and interested individuals to come to us to provide the changes that they believe will be needed in the corporate system going forward. We put out a request for rulemaking, and we have had almost 500 responses to that request, which we are now going through. And it varied from one end of the spectrum to the other in regards to what corporates should be doing in the future, what type of services they should provide for the credit unions, the natural-person credit unions.

And certainly one of the major things we will be looking at is the type of investments that they will be allowed to make. And, again, that will probably be a limitation that will be placed at some point in time on the corporates as to just what they could invest in so that we do not get into these situations where we have the high concentration in one end that there could be a problem occur and, as a result, we will be faced with what we are facing with today.

Chairman GUTIERREZ. So, Mr. Reynolds, in your view, what changes in the NCUA regulatory structure should be made so that we prevent this situation from happening again?

Mr. REYNOLDS. Well, I have to agree with Chairman Fryzel, I think we need to look at the concentration limitations on investments. We need to look at the possibility of establishing limitations in terms of individual types of investments, obligor type limits. We need to look at the reliance on external rating agencies. Like a lot of other financial institutions, U.S. Central relied extensively on credit rating agencies that turned out to be overly optimistic. We need to look at the use of credit enhancement features in insurance products that were used to make mortgage-backed investments that had underlying subprime mortgages, into higher rate investments. And I think we need to also look at the internal risk management processes in place at corporates, including—all corporates—and also corporate governance procedures in place at those institutions. All those areas need to be a part of a comprehensive analysis as one of the reasons I think that we think there needs to be a thorough independent review of this issue.

Chairman GUTIERREZ. Thank you. I see my time—just so at least I follow my own instructions to the panelists, I see my time is coming up, so I will wrap up. Chairman Fryzel, we will not have another—unless it is unnecessary—the subcommittee will not have another hearing around the credit unions so I will be calling you and members of your board to come in so we can talk a few months from now and see how things are going and follow up because I think it is very, very important that we have some continuity and oversight in terms of just how the regulations and the changes that you are going to be making, regulatory decisions are made.

Thank you both so much for coming this afternoon.

Mr. FRYZEL. Thank you.

Mr. REYNOLDS. Thank you.

Chairman GUTIERREZ. My colleague, the ranking member, Mr. Hensarling, is recognized for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Commissioner Reynolds, in answer to Chairman Gutierrez's question, you mentioned the role of the rating agencies. Can you go into a little more detail as far as your opinion on precisely what role they played in the demise of these corporate credit unions, if you had to rate it on a scale of 1 to 10, and what do you do going forward?

Mr. REYNOLDS. Well, personally, I think it was a fairly significant issue. In my experience, and I regulate different types of financial institutions, a number of which have invested in private label CMO type securities, and a lot of them have bought investments based on the rating of the particular security. If it was rated a triple A or a double A rating, they considered it to be a safe investment. And one of the things that we found in the current environment with the changes in the residential real estate market is that the security that was initially rated a triple A or a double A can drop to a sub-investment grade security with changes in the marketplace, increasing defaults, and other changes in terms of the portfolio composition. And I think what is needed is more stress testing of the underlying security, not taking for granted the rating that is assigned, but looking at the underlying composition of the mortgages that back up that security.

Mr. HENSARLING. Chairman Fryzel, the same question for you, the role credit rating agencies played in the demise of these corporate credit unions and what do we do going forward?

Mr. FRYZEL. Well, Congressman, as I said previously, all of these securities when purchased were highly rated and sound investments at the time. I agree with Chairman Reynolds in regards to the fact that perhaps the corporates, the investing firms have to do a little more due diligence in regards to accepting whether or not these ratings are true, looking at the securities in a little more detail and going deeper as to just what they are all about. I think if we have those type of regulations in place, we are not going to experience and we are not going to have worry about what the rating companies say if the due diligence is done by the corporate investment firm.

Mr. HENSARLING. Another question, Chairman Fryzel, do you see any correlation between the national field of memberships and increased risk-taking by the corporate credit unions?

Mr. FRYZEL. Congressman, I think that the theory behind the national fields of membership was basically for competition, in order for the corporates to compete against one another to obtain the natural-person credit unions. Now, certainly when you get that type of competition, you get corporates going for the higher rate to get the greater number of natural-person credit unions coming to them for their investments, so we do face that problem. But I think if we have in place the proper regulations to monitor the corporates, a national field of membership should not be a problem.

Mr. HENSARLING. Have there been any actual—what are the actual losses incurred to date on the securities of these two corporate credit unions?

Mr. FRYZEL. Well, the actual number, Congressman, is actually a moving number and that is based on what occurs in the economy over time as to whether or not these investments could get better or perhaps could get worse. With our best calculations, and this is why we asked for the amount of $5.9 billion, that is the best estimate as to what we are going to have to deal with. Now, there could be a lower or there could be a higher estimate, and that could fluctuate over time, but that is what we are looking at right now.

Mr. HENSARLING. Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman GUTIERREZ. You are very welcome. Mr. Sherman, you are recognized for 5 minutes.

Mr. SHERMAN. Thank you. I may have to disagree slightly with our witness on credit unions—credit rating agencies because we had hearings in this room of another subcommittee just yesterday, and there was a division of opinion. There were some who said, "Well, just don't rely on the credit rating agency," and there were others who thought, well, maybe you ought to make the credit rating agencies more reliable. I do not think there is ever going to be a way that you are going to tell people not to rely on the credit rating agencies because if one bond analyst puts together a portfolio and says, "My yield is 3.8 percent and my average rating is double A," that person is going to look better to their boss than somebody who comes in and says, "My average rating is lower than double A and my interest rate is the same." I would hope that we would move toward credit rating agencies that are selected from a panel by the SEC, so you would not have credit rating agencies having to lean a little bit to the left for the issuer's benefit in order to get the next issuer to pay them another half million or $1 million.

A lot of disputes about TARP, but I would think sitting where you do, Mr. Chairman, that you would want credit unions not to be the only part of the depository institutional world that does not benefit from TARP. Now, it is my understanding that even if the Treasury deposited money with credit unions for the purpose of supporting their capital, you would not count it as capital. So I would like to know what interaction your agencies had with the Treasury Department in support of what I think was congressional intent and that is that credit unions would be included along with the other depository institutions? Did you meet with Treasury Department officials in the past Administration or the current Administration to facilitate credit union participation? And can you share with the committee your correspondence with Treasury? And are you going to change your rules so that if Treasury puts in money at risk for the purpose of serving as capital for a credit union, that you will count it as capital?

Mr. FRYZEL. Thank you, Congressman. We have always felt that it was congressional intent that credit unions be allowed into the TARP program, and we have asked for that since the day that legislation passed from former Secretary Paulsen. We wrote numerous letters to him but Secretary Paulsen did not believe apparently that credit unions should be included in that program. But that did not stop us from continuing to ask for it. We have asked now Secretary Geithner and we met with Treasury last week, and it appears that credit unions may be eligible to participate in the Troubled Asset Purchase Program, which is now being developed.

Mr. SHERMAN. But not the capital infusion?

Mr. FRYZEL. Not the capital infusion.

Mr. SHERMAN. Is that a matter of your rules blocking your intent, that is, if the Federal Government put some money into a credit union and said, "We mean this to be risk capital," would you count it as capital?

Mr. FRYZEL. We interact frequently with Treasury, Congressman. We have to consult with them on a number of things that NCUA does before we can move forward, so if Treasury—

Mr. SHERMAN. I was asking a simple yes/no question.

Mr. FRYZEL. If Treasury says to us, "Here is a bundle of money, use it for what you want."

Mr. SHERMAN. No, no, they would invest in the credit unions obviously, they would expect to get it back but they would want you to count it as capital.

Mr. FRYZEL. Well, actually, that is what we are going to be doing with these loans they are going to be giving us. They are going to be getting money back, they are going to be getting interest back with the Corporate Stabilization Plan, but they have not told us that they are ready to give us money to invest into credit unions.

Mr. SHERMAN. If they were, would you count it as capital? If they put the money in the credit union, it is supposed to be capital, would you count it as capital?

Mr. FRYZEL. I do not believe the Credit Union Act allows us to do that at this time, Congressman.

Mr. SHERMAN. I would hope that you would immediately submit whatever statutory language you would think is necessary to achieve that goal.

Now, you took into conservatorship the two corporate credit unions, and I have a number of questions for the record that I will be asking you about that, but one to ask orally is, given that there were NCUA examiners stationed permanently at both U.S. Central and WesCorp well before the credit unions were taken into conservatorship, why did not the agency take the action sooner to forestall the problems and possibly prevent the conservatorship?

Mr. FRYZEL. Congressman, the last thing any Federal agency wants to do is place an institution into conservatorship, so that is a decision that is not made very easily. We had been monitoring U.S. Central and WesCorp for a long period of time with always the consideration being that if at any point in time we had to take that action, we would be prepared to do so. Again, like I had mentioned, when these investments were originally made—

Mr. SHERMAN. Excuse me, my time has expired. I hope you would answer for the record, and I am sorry I did not leave you enough time to answer the question.

Chairman GUTIERREZ. The chairman should know before I touch this, it was 38 seconds over, I want to make sure that all the members of the committee. And I would ask that the members also look at the colors, so you ask your last question when we are in yellow, that way the witnesses do not have to be called out of order.

Mr. Neugebauer, for 5 minutes, sir, you are recognized.

Mr. NEUGEBAUER. I thank the chairman. We have had a lot of people come and testify about banks and now for credit unions and many of those were people responsible for regulating and overseeing those entities, and the overriding term that keeps being used, "Well, if we had known this, if we had known that, we would have done things differently." I think the American people are kind of to the point that, well, why did you not know? Who was watching? Who was asleep at the switch? And I think they are ready for Donald Trump to come over and say to most of them, "You are fired," because what has happened is the American taxpayers are going to have to pick up the tab for those people who did not know or did not do their jobs.

Many of my colleagues, we are going to start down a road of looking at major regulatory reform. Well, I thought we had regulators in place, and I thought those regulators were supposed to be doing their job. And so before we add another layer of regulators to this process, I think what we do owe the American people is a pretty thorough vetting of exactly what happened and whose responsibility it was to be watching this. That is the editorial part.

But the question I have, I guess for both of our witnesses, is do we need to look at the way we restructure the capital requirements of these corporate credit unions? We use risk-based capital structure for other financial institutions, and that has not always worked, obviously, but is it time to possibly, as part of this process, think about how we ask these entities to be capitalized? Chairman, I will start with you?

Mr. FRYZEL. Congressman, I think you are 100 percent right, now is the time to ask those questions, now is the time to look at how they are capitalized and what they should look like moving forward, and that is what our intention is going to be with the corporate stabilization plan in place and moving ahead with the new rules pertaining to corporates. We are going to look at everything. And you are 100 percent right; now is the time for that to be asked.

Mr. NEUGEBAUER. Commissioner?

Mr. REYNOLDS. Congressman, I would echo those comments. NASCUS has testified previously that we are in support of comprehensive capital reform for natural-person credit unions, including risk-based capital, and including supplemental capital. I think we also need capital reform for the corporate system. We need to look not only at risk-based capital but also ask if we need to increase core capital in corporates, and increase the basic leverage capital for corporates. But we are very much in support of that.

Mr. NEUGEBAUER. I have actually had that same conversation basically for the entire industry because I have a lot of credit unions that come in and say, "We have a much more conservative portfolio, but we are being treated the same as other credit unions that maybe have taken a more aggressive approach." So if that is good for the corporates, is that something—I know that is not the focus of this hearing today, but I think the focus of this hearing, and hopefully in every hearing we have in here, is how do we make this better? Is that something that needs to be a part of the total industry?

Mr. REYNOLDS. Absolutely. I think it works both ways. For institutions that have riskier loan portfolios, you have higher capital requirements. For institutions that are plain vanilla type institutions that do not take as many risks with their lending and their investments, it is appropriate to recognize that in terms of the capital requirements.

Mr. NEUGEBAUER. Chairman?

Mr. FRYZEL. I agree.

Mr. NEUGEBAUER. What about the role of these corporates with what I call the "bread and butter credit unions," the ones that are actually dealing with customers, the exposure that some of those credit unions had with some of those corporate entities, can you kind of walk me through what was—have you observed something there that we need to think about, making sure that we need to protect the assets or the investments or the relationships that some of these smaller credit unions have with the corporate ones?

Mr. FRYZEL. Congressman, I think what we have seen at work here is the Share Insurance Fund which Congress had put in place to prevent a failure of the credit union system, and it has worked. The smaller credit unions, the natural-person credit unions were at risk certainly of the loss of their capital that they had invested in the corporate credit unions but that is the purpose of the fund, to protect that. And that is the purpose of credit unions building up capital. And what the credit unions have now said of course is that we are going to solve this problem within the system.

We are going to borrow from the Treasury, we are going to pay it back, and we are going to pay it back with interest, and we do not need the capital infusion, we do not need a bailout of any type. We are going to solve it within the system, and we are going to go forward from there.

Chairman GUTIERREZ. Thank you. The time of the gentleman has expired. The gentlelady from New York, Congresswoman McCarthy, is recognized for 5 minutes.

Ms. MCCARTHY. Thank you, Mr. Chairman. I appreciate it, and I thank the witnesses for testifying. A couple of things, under the bill, the provision of S. 896 that are headed to the President for his signature, many credit unions have spread out insurance costs over several years, but some credit unions may want to write down all of the expenses now, while others may have already written down the expenses. When these provisions become law, will credit unions that want to write down all of the expenses right away, will they be permitted to do that? And will credit unions that have recorded the expenses be able to avail themselves of the new legislation? And I guess one of the other questions too from what I had heard from my credit union guys is, are you able to give the bridge loans to small businesses, have your credit unions been doing that?

Mr. FRYZEL. Congresswoman, to answer the first part of your question, under GAAP accounting rules, once you write it off, it is written off, so you can never get it back. And that is why we have instructed credit unions to speak to their CPAs and discuss with them how it is best to be handled for that particular credit union.

In regards to member business loans, credit unions are involved in member business loans, and some of them very successfully, some of them not successfully. It is a very tight field where you need expertise to know what type of businesses to lend to and, unfortunately, some of our credit unions do not have that expertise in-house and run into problems. But for some of them, it has been very, very good.

Ms. MCCARTHY. And the second part as far as small business loans?

Mr. FRYZEL. Right.

Ms. MCCARTHY. Thank you.

Mr. FRYZEL. Correct.

Chairman GUTIERREZ. Mr. Marchant is recognized for 5 minutes. Congressman?

Mr. MARCHANT. Thank you, Mr. Chairman. Commissioner, what has been the reaction of the credit unions to the NCUA's handling of the corporate credit union crisis?

Mr. FRYZEL. In all frankness, I have to admit the reaction has been mixed in terms of my credit unions. I think most of them recognize that NCUA had some extremely serious issues to deal with in the corporate system. They had some difficult choices to make, but some of them are a little unhappy that the natural-person credit unions are having to pay higher premiums as a result of actions that did not occur in natural-person credit unions. That being said, I think they are very much in support of S. 896 and the relief that is provided there to give them additional flexibility to write that expense off over an extended period.

Mr. MARCHANT. Chairman, what motivates or drives a corporate credit union, would you expand on an earlier comment that you made that the corporate credit unions compete for customers, so is this what drives or motivates them to chase a rate or try to buy an investment that will bring a higher yield? What is the incentive of an ostensibly nonprofit, people-helping-people kind of industry that in my State are the most conservative of all of the financial institutions, what motivates this group of credit unions to have these kinds of assets on their books?

Mr. FRYZEL. Congressman, I think every financial institution, a bank or a credit union, attempts to earn income and for different reasons, certainly bank for their stockholders. Credit unions earn the income so that they are able to provide better services for their members, offer services at cheaper rates than they could get elsewhere. In order to do that, you have to have money and you have to earn money to do that.

Mr. MARCHANT. Let's talk about the corporates now.

Mr. FRYZEL. Well, the corporates do the investments for the natural-person credit unions. So many of the natural credit unions invest into corporates who then invest in the high-yield returns so that they can get better returns for the natural-person credit unions. And here again the natural credit unions would be looking for the corporate that provides them the greatest return so that they could do more things for their members.

Mr. MARCHANT. So the corporates are competing with each other constantly for customers among these 7,000 credit unions?

Mr. FRYZEL. That is right, sir.

Mr. MARCHANT. Is it your view that there are an adequate number of corporates or too many corporates?

Mr. FRYZEL. Well, there are 28 corporates now, and that is one of the things we have asked the credit union industry, is that too many, is that too little, how many do you think there should be? And, of course, we have gotten a variety of different answers as to the answer there should be, and I think over time that is going to all shake out with the new rules and determination as to the economics of whether or not a particular corporate can live within those rules and whether or not they want to continue to provide some of the products that they are providing. So I think that is all going to over the next year shake out as to just what the corporate structure will look like.

Mr. MARCHANT. Is there any incentive for NCUA to liquidate the assets of these corporate credit unions at any price above the insurance fund exposure and allow the recovery of the assets to the credit unions themselves?

Mr. FRYZEL. Congressman, it is our plan to hold these securities until such time as the disposition of them becomes a viable alternative, for however how long that may take. We want to make sure that we get the best dollar for these assets, so we are not going to be in any hurry to sell these securities.

Mr. MARCHANT. Okay, thank you.

Mr. REYNOLDS. Congressman, can I make one comment too?

Mr. MARCHANT. Sure.

Mr. REYNOLDS. I want to make sure that people understand that not all corporates are identical in terms of the function and composition. We have a small corporate in the State of Georgia. It has between $2- and $3 billion in total assets. It has no asset-backed securities on its portfolio, and is very conservatively run. I think it is important that the credit unions in our State that capitalize that institution, that utilize that institution, have the right to determine what happens to that institution in terms of a future. And I just want to make sure that everyone understands that there is that variation among corporates.

Chairman GUTIERREZ. And another turn on this side. Congressman Royce, you are recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. The first question I would ask of Mr. Fryzel, should the provisions within this bill not become law, can you explain what steps the NCUA would be forced to take?

Mr. FRYZEL. Congressman, if this bill did not become law, the natural-person credit unions would have to absorb this loss this year all at once. There would be no provision to spread it out over time. In turn, as it was previously stated, a number of credit unions would fall below the required capital limit and would be put on a prompt corrective action, and we would have to monitor them very carefully. It is our intention, even with the spreading out over this cost, to work with the credit unions to make sure that they all can continue to survive and provide the services that they do to their members, but it would be very, very difficult for NCUA to work with the credit unions if we did not have the stabilization in place.

Mr. ROYCE. Now, are you confident that the authority contained in this bill is going to be sufficient to stabilize the credit union system and that of course assumes that the necessary changes are enacted on your end in terms of oversight and regulation but give me your suggestions?

Mr. FRYZEL. Yes, Congressman, I do. I believe the way the bill is set up, it will enable us to provide the necessary oversight to stabilize the corporate credit union system and enable us to move forward to make the required changes in the rules to make sure that this does not happen again.

Mr. ROYCE. You note in your testimony that over a 4-year period, the percentage of corporate credit unions investments in mortgage-backed securities grew from 24 percent to 37 percent. Looking forward, what is going to be done to ensure that investments taken by the corporate credit unions are better aligned with the cooperative, conservative nature that we see in the credit union by the individual credit union members?

Mr. FRYZEL. Congressman, I think we have to look at limitations on the investments as to where they can be placed. We have to look at diversification of investments, and we have to make sure, again, that the corporates do not place all their eggs in one basket, as they did, so we do not have this situation in the future.

Mr. ROYCE. Yesterday, the committee held a hearing on the rating agencies. I think the main take-away from that was the over-reliance on NRSROs, especially by the regulators. Do you believe the NCUA relied too heavily on credit rating agencies?

Mr. FRYZEL. I think, as you pointed out, Congressman, everybody relied heavily on the rating industries, probably to a greater degree than everyone should have. And I think going forward in the future, I had mentioned earlier that in addition to looking at whatever rates have been placed on investments, the corporates need to do greater due diligence in regards to whether or not these investments are everything they are supposed to be.

Mr. ROYCE. Let me ask a question of you in terms of, again, how you are going to rectify that problem, and maybe ask Commissioner Reynolds as well?

Mr. REYNOLDS. Well, I think, as I mentioned earlier, one of the things that can be done is to make a greater reliance on risk management and risk mitigation procedures in the institution. We need higher expectations for management in terms of what they do, and greater reliance on stress testing of individual securities. And I think, like one of my colleagues said recently, regulators sort of planned on the 50- to 100-year flood, and what we had was the 500-year flood. So we need to do stress testing, but at higher levels of stress, to make sure that we predict when those types of things happen.

Mr. ROYCE. Let me quickly ask you a transparency question, Commissioner. How aware are the natural-person credit unions, do you think, how cognizant were they of the risks taken by the corporate credit unions?

Mr. REYNOLDS. Well, speaking from personal experience as far as the credit unions in my State, I think they were very aware of what was going on in their corporate. They were less aware perhaps of what was going on at U.S. Central. And obviously, since not many of them are members of WesCorp, they would have had limited knowledge of that corporate credit union. I think that is one of the issues that I hear a lot from my credit unions is they want to see greater transparency in the process. This is a cooperative system, they are members of the corporate, and their corporate are members of U.S. Central, and they think there needs to be more transparency for all stakeholders in the system.

Mr. ROYCE. Thank you. Commissioner, thank you. My time has expired, Mr. Chairman. Thank you very much.

Chairman GUTIERREZ. Thank you. I would like to thank you both for coming before the committee. We will be inviting Mr. Hensarling and other members of the Minority in the fall to try to get together with Chairman Fryzel to see how things are going. And I just wanted to add that most of the members, as I talk to them, they come here knowing and recognizing natural-person institutions and there is a growing concern about the corporate institutions, so bear that in mind in terms of the level of support that exists here and the traditions that exist here and kind of who we meet with when the Chamber of Commerce gets together.

We kind of meet with the Ukranian and the Polish, the local credit unions that people are members of and those are the kind of people we know. So that into consideration. And thank you both so much, chairman, for your work. And, commissioner, for coming down—or coming up from Georgia to see us. Thank you so much.

Mr. FRYZEL. Thank you, Mr. Chairman.

Chairman GUTIERREZ. Now, we have our two remaining witnesses for panel number two. Mr. Jim Bedinger is the chief operations officer of the Chicago Patrolmen's Federal Credit Union from my City of Chicago, and he is testifying on behalf of the National Association of Federal Credit Unions. Jim has been working in the credit union industry for the past 15 years. He has been with Chicago Patrolmen's for over 12 years, with over 9 of them being in senior management. He is currently the chief operations officer, a position that he has held for the last 4 years. We welcome you.

And Mr. William Lavage, is that correct? Mr. William Lavage is the president and chief executive officer of Service 1st Federal Credit Union, and he is testifying on behalf of the Credit Union National Association. He has been with Service 1st since 1981. In 2001, he received the William S. Pratt Lifetime Achievement Award for being the outstanding credit union professional of 2000.

I want to share with everybody that I have not smoked a cigarette for like 11 days, and I thought that was supposed to clear my mind.

[laughter]

Chairman GUTIERREZ. I think it takes a while, so excuse me if there is any lack—some fogginess there. Thank you so much.

Please begin. You each have 5 minutes.

Mr. Bedinger?

STATEMENT OF JIM BEDINGER, CHIEF OPERATIONS OFFICER, CHICAGO PATROLMEN'S FEDERAL CREDIT UNION, ON BEHALF OF THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS (NAFCU)

Mr. BEDINGER. Thank you. Good afternoon, Chairman Gutierrez, Ranking Member Hensarling, and members of the subcommittee. My name is Jim Bedinger, and I am testifying today on behalf of the National Association of Federal Credit Unions or NAFCU. I serve as chief operations officer of Chicago Patrolmen's Federal Credit Union, which is headquartered in Chicago, Illinois. I have been COO of the Chicago Patrolmen's Federal Credit Union for the last 4 years, have worked at the credit union for the last 12 years, and have been in the credit union community for the last 15 years.

Chicago Patrolmen's Federal Credit Union field of membership includes all Chicago police officers, regardless of their rank, all full-time civilian employees of the Chicago Police Department and the Office of Emergency Management or the 911 center, and all employees of the credit union.

NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding share insurance and corporate credit union issues for America's credit unions.

While the credit union industry has fared much better than most financial institutions in these turbulent times, many individual credit unions have been impacted, through no fault of their own, by the current economic environment. In particular, the corporate credit union system has felt the biggest impact, leading NCUA, starting in January, to take a series of steps using the National Credit Union Share Insurance Fund to help stabilize the system.

In March, the NCUA placed two corporate credit unions, U.S. Central Federal Credit Union and Western Corporate Federal

Credit Union, into conservatorship. An independent third party analysis of the portfolios of these two credit unions led the NCUA to estimate that the resulting impact of the Insurance Fund will be approximately $5.9 billion, dropping the Fund's equity ratio to an estimated 0.31 percent.

Because credit unions follow GAAP accounting, there is an immediate impairment to the one percent deposit credit unions must hold for the insurance fund. Federally-insured credit unions have to recognize this impairment by setting aside enough money in a contingency liability account to bring the deposit fund back to the one percent level.

The Federal Credit Union Act also requires the NCUA to assess a premium when the fund's equity ratio drops below 1.2 percent. The impairment and the premium combined would have an approximately 99 basis point impact on all natural-person credit unions in 2009, absent the creation of a stabilization fund.

We are pleased that the House yesterday acted to support the provisions of H.R. 2351 by passing S. 896, the Helping Families Save Their Homes Act of 2009. We applaud Representatives Kanjorski, Scott, Royce, LaTourette, and you, Mr. Chairman, for your leadership in getting this done.

Enactment of this legislation and creation of the stabilization fund will allow credit unions to have billions more to lend to consumers and small businesses in the current economy. At Chicago Patrolmen's, we estimate that the expense that we were facing was approximately $2.24 million, meaning that we would have the potential for nearly $14 million in decreased lending capacity to our members in the Chicago area this year.

Looking ahead, NAFCU believes that it is imperative that the NCUA provide full and open transparency about its actions leading up to, and throughout, the resolution of the current situation. We also believe that it is important that the NCUA provide clarification on how credit unions would treat or reverse the present write-down resulting from the impairment of the one percent deposit if, and when, the fund is no longer impaired.

The corporate credit union system is an important resource for natural-person credit unions. At Chicago Patrolmen's, we are members of two corporate credit unions. We use over two dozen corporate services that are key to providing many of the services that we offer to our membership.

NAFCU believes that the NCUA and Congress should work to find additional ways to help stabilize and strengthen the corporate credit union system as well. Going forward, other changes, such as modernizing the Central Liquidity Facility, or CLF, should be examined. The CLF provides loans to natural-person credit unions to meet their liquidity needs in turbulent times, but cannot loan directly to corporate credit unions. We believe some changes to the Federal Credit Union Act to modernize the CLF and allow it to directly help the corporate credit union system could help address future challenges when they occur.

As the NCUA looks to reform the corporate credit union system, the NAFCU board has outlined a series of three principles that we believe should be adhered to:

Number one, corporate credit unions should continue to serve the liquidity and operational payment system needs of natural-person credit unions. Number two, corporate credit unions should operate under a risk-based capital system. And, number three, corporate credit unions should operate under corporate governance standards created and policed within the industry.

In conclusion, NAFCU thanks you for your leadership with H.R. 2351 and your support for its important provisions contained in S. 896. The NCUA should provide clarification again on how credit unions would treat or reverse the present write-down resulting from the impairment of the one percent deposit if and when the fund is no longer impaired.

Maintaining a healthy and well-regulated corporate credit union system, as many natural-person credit unions rely on corporates for essential services. Additional legislative changes to the CLF and action by NCUA to reform the corporate credit union system are important steps to make sure that future crises can be avoided.

Thank you for the opportunity to appear before the subcommittee today, and I welcome any questions.

[The prepared statement of Mr. Bedinger can be found on page 31 of the appendix.]

Chairman GUTIERREZ. Thank you for being here.

Mr. Lavage?

STATEMENT OF WILLIAM LAVAGE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, SERVICE 1ST FEDERAL CREDIT UNION, ON BEHALF OF THE CREDIT UNION NATIONAL ASSOCIATION (CUNA)

Mr. LAVAGE. Chairman Gutierrez and Ranking Member Hensarling, thank you for inviting me to appear before the subcommittee today on behalf of the Credit Union National Association to discuss H.R. 2351. I am Bill Lavage, president and CEO of Service 1st Federal Credit Union in Danville, Pennsylvania. My credit union has $140 million in assets, and we serve 18,000 members.

CUNA is the Nation's largest credit union advocacy organization, representing about 90 percent of our Nation's approximately 8,000 State- and federally-charted credit unions and their 92 million members. We want to thank Representatives Kanjorski, Royce, Scott, LaTourette, and you, Mr. Chairman, for introducing H.R. 2351. CUNA, its member credit unions, State leagues, and the Association of Corporate Credit Unions strongly support this critical and timely legislation. We also appreciate that the House and Senate both passed S. 896 yesterday, which includes the provisions of H.R. 2351.

I want to emphasize that CUNA supports rigorous supervision and balanced regulation for all credit unions to promote safety and soundness and the interests of credit unions members. We also continue to urge Congress as it reviews regulatory reform to maintain NCUA as an independent regulatory agency for credit unions, for which Chairman Frank has indicated his support.

Even while we support NCUA's independence as the only regulatory framework to ensure that the unique cooperative nature of credit unions will be preserved, we also feel it is fair and appropriate to bring to this subcommittee the serious concerns federally-insured credit unions have about the handling of the assistance for the corporate credit unions.

I also want it to be very clear that credit unions understand there are critical problems within the corporate credit union system that must be addressed expeditiously. We want to work with NCUA in that endeavor.

Mr. Chairman, I would like to ask permission to submit our comment letter to NCUA for the record.

Chairman GUTIERREZ. Without objection, it is so ordered.

Mr. LAVAGE. Two major concerns of credit unions and NCUA's handling of the corporate stabilization are the lack of transparency of its process and an apparent unwillingness to make the most of regulatory authority to manage and minimize what has become the largest single shock ever to the Share Insurance Fund.

Credit unions face substantial future losses on securities held by corporate credit unions and these losses may have been absorbed by the Share Insurance Fund. That much is certain. What is not certain is the amount of those losses and how they will be managed, minimized, and borne. In this world of uncertainty, the more transparent NCUA's processes and actions, the better for all involved. So far, that transparency has been lacking.

NCUA initially engaged a bond firm, PIMCO, to analyze potential credit losses in the securities held by corporate credit unions. PIMCO's loss estimates range from a low of $6 billion to a high of $16 billion, with the most likely estimate of $10.6 billion. This served as the basis for NCUA's judgment that total cost to the Share Insurance Fund would be $5.9 billion. Since then, most recent loss estimates from Clayton Fixed Income Services suggest that the losses may be much less. Clearly, the estimates are highly sensitive to a number of varying assumptions and NCUA has not shared them with credit unions. Fully recognizing the current expensed amount is just an estimate requires the actions that follow to take into account the uncertain future.

In the case of credit unions' impaired capital in corporate credit unions, the agency has not been willing to exercise sufficient flexibility in dealing with these very complicated issues. Facing similarly trying circumstances, the FDIC has shown greater creativity in responding to and managing the crisis in a responsible manner, presumably consistent with GAAP.

Going forward, CUNA encourages the agency to provide more information to credit unions on the condition of the corporate credit unions and their conservatorship, on the condition of the securities held by these credit unions, on how the agency is dealing with these issues, and on how these actions will affect credit unions.

We further request the subcommittee and encourage the agency to develop a mechanism whereby a credit union whose capital deposits in WesCorp and U.S. Central, which may soon be impaired, have the possibility of recovering their capital if the ultimate losses on the securities turn out to be significantly less than expected. Let me emphasize this point: The capital of some credit unions is being wiped out on the basis of estimates. We need a mechanism that if the estimates are wrong, the capital can be returned.

Another concern is the agency set in place mechanisms to ensure the management of the portfolio of mortgage- and asset-backed securities is handled in such a manner so as to minimize losses on the portfolio. The expected losses are driven by two factors, the estimated credit losses on the underlying securities and market losses that would result from selling them before they mature or are amortized.

Currently, NCUA has insufficient reserves to sell the portfolio at current market values. The agency has assured credit unions it has no intention of selling the securities in the near future. However, in a few years, the market values of the securities are likely to move closer to the underlying credit losses. There is concern among credit unions, NCUA will sell the securities once the remaining market losses fall below the funds the agency is accumulating from credit unions to cover those losses.

CUNA encourages NCUA to establish portfolio management guidelines for the portfolios to be managed for a long enough period that essentially only credit losses are incurred and further to engage a portfolio manager to follow these guidelines.

Mr. Chairman, in closing, we appreciate your working with Representatives Kanjorski, Royce, Scott, and LaTourette on these issues and for the opportunity to express our concerns regarding the corporate credit union situation. I look forward to your questions.

[The prepared statement of Mr. Lavage can be found on page 68 of the appendix.]

Chairman GUTIERREZ. Number one, you are both welcome. I am happy to work with you and with credit unions. I just have one question for both of you, and it is from Mr. Bedinger's testimony. And you correct me if I am wrong, okay, just say, "Luis, you got it wrong." You distinguish, you say that natural-person credit unions are different than corporate to the extent of the risk that they take, that maybe they should pay different amounts of money into the pool, the insurance pool. Fix it if I did not put it right?

Mr. BEDINGER. Well, I think if I understand what you are saying, on natural-person credit unions, it is different in the regulation thereof.

Chairman GUTIERREZ. And in the insurance that they should pay into the fund, the amount of insurance they should pay into their fund, is that right?

Mr. BEDINGER. Well, yes, the way that the natural-person credit unions are doing it right now obviously is what the one percent.

Chairman GUTIERREZ. Yes, do you think it should be different?

Mr. BEDINGER. Well, the corporate credit unions right now do operate a little differently. They have a different capital requirement than we have at natural-person credit unions and maybe that would have mitigated some of this had their capital requirement been a little higher or if there was at least some flexibility in it. I think that is where some of us as natural credit unions have a little frustration. We are footing the bill and yet they were making different types of investments maybe than we would have made and those types of things. So there are some differences there. I think being a cooperative movement, certainly we are trying to figure this out ourselves and do it altogether. It does not mean we are happy about it, it is our members' money, it is the police officers' money that we have to send the check for to shore them up, but they should be playing by the same rules I think that natural-person credit unions should.

Chairman GUTIERREZ. They should be playing by the same rules, but is it your testimony here today that they are different to the extent that they should have different rules?

Mr. BEDINGER. Well, no, they are different in the sense that they service natural-person credit unions, we service actual people out on the streets. So by what they do, obviously if they are more complex, and in the way that they are set up now, they are more complex than we are at natural-person credit unions.

Chairman GUTIERREZ. So you do not feel, representing your association, that there should be any difference in terms of future liabilities or insurance risks. We have heard from community bankers, for example, why should we pay into the FDIC fund when indeed we are solvent, make good loans, we are good members of our community. It is the big shots that had all the losses.

Mr. BEDINGER. Right.

Chairman GUTIERREZ. So do you think there should be a difference in terms—so if you even look at our regular banking institutions, they are all FDIC insured but they are kind of saying we are different. You do not see a difference?

Mr. BEDINGER. Well, NAFCU, I think, feels that the NCUA should look into them, on how they invest in their corporate—I mean into the Insurance Fund, at least in how they are paying into it as opposed to the natural-person credit unions. So if the risk is there, maybe it should be risk-based, in the sense that if they are riskier, pay more into it. That is one of the things I think, as the NCUA goes through it and looks at all different possibilities, is their restructuring.

Chairman GUTIERREZ. Let me ask you something, so how is the policemen's credit union doing?

Mr. BEDINGER. We are doing very well, actually, I am very happy to say. Obviously, by passing this yesterday, that was a big, big help to us.

Chairman GUTIERREZ. Did you have any losses last year like the corporate ones?

Mr. BEDINGER. No, no, we are actually very well capitalized. We have over 9 percent capital in our credit union right now. We make very, very good loans. Just to give you an example, we have over 600 mortgages that we have put on the books since we started our mortgage program, since mortgages kind of caused this problem, and we have currently one that is going into default over the history of that loan period.

Mr. LAVAGE. Mr. Chairman?

Chairman GUTIERREZ. Mr. Lavage?

Mr. LAVAGE. Yes, I would like to answer that too. Service 1st is very strong and well-capitalized. Obviously, if we did not have this problem, we would be happier and ready to move on even more expeditiously. As far as the corporate credit unions, they differ in that they serve credit unions where as we serve natural persons. CUNA and other credit unions are willing to work with NCUA to look at ways to restructure the corporate system, possibly including the insurance involved.

Chairman GUTIERREZ. Okay, I think that is a logical step that maybe we should look at. If you are different, you are different. Again, thank you both for being here.

Mr. BEDINGER. Thank you.

Mr. LAVAGE. Thank you.

Chairman GUTIERREZ. My time has expired. My friend, Mr. Hensarling, is recognized for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Mr. Lavage, did I understand in your testimony that you advocated that TARP funds be made available for the NCUSIF, is that correct?

Mr. LAVAGE. On a borrowed basis, and they would be repaid.

Mr. HENSARLING. Well, supposedly, most of the TARP funds are to be repaid. We will see ultimately how the taxpayer comes out on that deal.

Mr. LAVAGE. Right.

Mr. HENSARLING. I have high hopes and low expectations myself. Your organization's understanding of the TARP Act, its purposes, its legislative language, how do you see that to be consistent with the TARP statute, potential loans to the fund?

Mr. LAVAGE. We differ, as you are probably aware, from other financial institutions in that we are member-owned and therefore nonprofit, so I am not in-depth aware of all of the guidelines of TARP as it stands. My understanding is that credit unions are not eligible for those funds at this time.

Mr. HENSARLING. But you are advocating that they be made available to the fund?

Mr. LAVAGE. Yes, yes.

Mr. HENSARLING. Okay. Mr. Chairman, I think I am going to follow your lead and restrict myself to one question. With that—

Chairman GUTIERREZ. Thank you very much, Mr. Hensarling.

Mr. BEDINGER. Could I answer that as well?

Chairman GUTIERREZ. One additional minute to Mr. Bedinger.

Mr. BEDINGER. Sorry, I just wanted to say, obviously, speaking on behalf of the Chicago police officers, whom I represent at the credit union, we are not really for that. We actually have members who come in and say, "Hey, did you take TARP funds?" And we are like, "No, we did not. There is no need to." And they actually bring money to our financial institution. But if that were to ever be the case, where TARP would be required or something that would be needed down the road, at least have parity with it. Obviously, one of the things that makes us unique is the fact that our capital comes from our members, and you do not want undue influence coming from the outside from somebody who is giving that in there, it just kind of opens things up. Parity, if it is allowed to other financial institutions, okay, fine, it may be good, but we view it individually at our credit union as probably not a very good thing.

Mr. HENSARLING. Mr. Chairman, could I ask for unanimous consent for 30 seconds?

Chairman GUTIERREZ. Absolutely.

Mr. HENSARLING. I would point out to both our panelists that of all the financial institutions, the banks who took the TARP money, there is now a fairly long line of those wishing to pay it back. You may learn something from that. Thank you, Mr. Chairman.

Mr. LAVAGE. If I could add one more comment just to clarify, CUNA is not suggesting all credit unions use TARP, a few do, and should have access.

Chairman GUTIERREZ. Thank you very much. We are going to spend an additional 5 minutes. We gave you the time and the Congressman showed up, so you are recognized for 5 minutes, sir.

Mr. SHERMAN. Yes, I would point out that the reason some Wall Street banks want to give back the money is that they feel that holding onto their fleet of private jets or paying bonuses of over $2- or $3 million to any one person is a bit inconsistent with continuing to hold TARP funds, or at least they get criticized. Do your members have any of these fleets of private planes or give out bonuses of over a couple million dollars to any particular employee? I will ask each witness for a yes or no?

Mr. BEDINGER. No.

Mr. LAVAGE. No, sir.

Mr. SHERMAN. Okay. Mr. Lavage, have you heard personally, or have you heard from other credit unions, that their examiners are forcing them to develop net worth restoration plans if their capital had been reduced because of share insurance costs even if the institution is well capitalized and why is this a concern?

Mr. LAVAGE. Coincidentally, our NCUA examiner has just concluded his exam and the exit interview is Tuesday. I will be anxious to hear after my testimony how that goes. But, yes, I have heard of credit unions who are above the limit, still well capitalized, even after the corporate stabilization program costs, have been asked by their examiner to develop a capital restoration plan and that is a concern.

Mr. SHERMAN. So they used to be very, very well capitalized. They have suffered some declines. Now, they are still well capitalized, and they are being told that being well-capitalized is not good enough?

Mr. LAVAGE. That is correct. It is almost like they are ignoring the costs of the corporate stabilization program caused the drop in the capital/net worth and are asking them to develop a plan to restore it.

Mr. SHERMAN. Okay. I agree that the corporate credit unions' financial challenges should not be permitted to interfere with the mission of member credit unions, to provide low-cost lending and services to their members. In this challenging economic climate, we cannot allow credit union lending to decrease by over $46 billion in response to a $5.9 billion reduction in capital. How do you think NCUA should permit credit unions to reverse the present writedown and is there a way to get through this that is both financially stable and allows you to continue your mission? When I say, "financially stable," provides enough capital to protect the fund and ultimately the taxpayers?

Mr. LAVAGE. I think that the bill that was passed provides NCUA that flexibility when it allows us to write off this expense over up to 7 to 8 years, so that is a flexibility needed.

Mr. SHERMAN. I will ask the other witness as well. Mr. Bedinger?

Mr. BEDINGER. I agree exactly with what he was saying. I think by allowing us to spread it over time, we can actually manage that, rather than taking it all at once, and actually try to budget for it because we do budgets every year obviously looking forward to see what we have, and try to figure out exactly how we are going to cover that expense. And with it being a smaller expense, it will be a lot easier to do over that time period.

Mr. SHERMAN. Mr. Chairman, let the record show that for the first time, I can yield back before the light is red.

[laughter]

Chairman GUTIERREZ. So recognized, and it will be made a part of our record.

I want to thank the witnesses and all of the members for their participation in the hearing. The Chair notes that some members may have additional questions for the witnesses, which they may wish to submit in writing. Therefore, without objection, the hearing record will remain open for 30 days for members to submit written questions to the witnesses and to place their responses in the record.

This subcommittee is now adjourned. Thank you.

[Whereupon, at 4:07 p.m., the hearing was adjourned.]

A P P E N D I X

May 20, 2009

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
HEARING ON STABILIZING CREDIT UNION DEPOSIT INSURANCE
WEDNESDAY, MAY 20, 2009

Mr. Chairman, thank you for convening this hearing to examine H.R. 2351, the Credit Union Share Insurance Stabilization Act. Our bipartisan bill allows managers of retail credit unions to focus on their most important mission -- providing credit to their members -- rather than worrying about how they will pay for an excessive one-time charge to rebuild deposit insurance reserves and paring back lending during these difficult economic times.

As you know, Mr. Chairman, we first planned to convene this hearing about two months ago. At the time, we had expected to consider the legislative proposal to create a Temporary Corporate Credit Union Stabilization Fund and adopt other needed deposit insurance reforms. These plans respond to the recent $5.9 billion rescue of corporate credit unions by permitting the recapitalization of the credit union deposit insurance system to occur over several years, rather than in a matter of months. We have, however, been overtaken by events.

Several weeks ago, Mr. Chairman, you joined Chairman Frank and me in sending a letter to Senator Dodd urging him to incorporate the plan to create a credit union Stabilization Fund into S. 896, the Helping Families Save Their Homes Act, a bill that contains many important deposit insurance reforms. I am very pleased that Senator Dodd did as we asked, the House and Senate have now passed the bill, and President Obama will sign it into law later today.

As a result of these events, the focus of today's hearing has shifted from the need for this bill to ensuring the efficient implementation of this law. Without this law, two-thirds of credit unions would have had negative earnings in 2009 as a result of the need to rebuild deposit insurance reserves. Moreover, around 225 credit unions, through no fault of their own, would have fallen below limits where they would be deemed adequately capitalized.

As members of a cooperative movement, credit unions are willing to help one another and to pay their fair share to recapitalize their deposit insurance system. The provisions found in H.R. 2351 and incorporated into S. 896 represent a viable and appropriate response to the problems now facing the credit union movement. The National Credit Union Administration must tell us today how it will swiftly and effectively implement this new law.

Mr. Chairman, I am particularly pleased that Mr. William Lavage, the President and CEO of Service 1st Federal Credit Union in Danville, Pennsylvania, will testify today. I have worked closely with him in the past, and Service 1st has developed a model program for educating school children about financial matters. I look forward to his participation.

In sum, I am very pleased that our bill will become law within a matter of hours and that we are convening this hearing today to examine how the National Credit Union Administration will work to implement these reforms quickly. The fact that we have considered and resolved these problems within a matter of weeks demonstrates that Congress and the Administration can work together to solve the problems facing the American people in a pragmatic way.

NAFCU

Testimony of

Jim Bedinger
Chief Operations Officer of Chicago Patrolmen's Federal Credit Union

on Behalf of

The National Association of Federal Credit Unions

"H.R. 2351, The Credit Union Share Insurance Stabilization Act"

Before the

House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit

United States House of Representatives

May 20, 2009

Introduction

Good afternoon Chairman Gutierrez, Ranking Member Hensarling and Members of the Subcommittee. My name is Jim Bedinger and I am testifying today on behalf of the National Association of Federal Credit Unions (NAFCU). I serve as the Chief Operations Officer (COO) of Chicago Patrolmen's Federal Credit Union, headquartered in Chicago, Illinois. I have been COO of Chicago Patrolmen's FCU for the last four years, have worked at the credit union for the last 12 years, and have been in the credit union community for the last 15 years. Chicago Patrolmen's FCU field of membership includes all Chicago Police Officers, regardless of their rank, all full-time civilian employees of the Chicago Police Department and the Office of Emergency Management (911 Center), and all employees of the credit union. The credit union has some 20,800 members and assets of $318 million. Chicago Patrolmen's FCU offers a broad range of products and services to our members, including a Financial Planning and Education Center, which offers both investment services and free financial counseling for all members.

NAFCU is the only national organization exclusively representing the interests of the nation's federally chartered credit unions. NAFCU–member credit unions collectively account for approximately 65.4 percent of the assets of all federally chartered credit unions. NAFCU and the entire credit union community appreciate the opportunity to participate in this discussion regarding share insurance corporate credit union issues for America's credit unions.

Historically, credit unions have served a unique function in the delivery of necessary financial services to Americans. Established by an act of Congress in 1934, the federal credit union system was created, and has been recognized, as a way to promote thrift and to make financial services available to all Americans, many of whom would otherwise have limited access to financial services. Congress established credit unions as an alternative to banks and to meet a precise public need—a niche that credit unions fill today for nearly 90 million Americans. Every credit union is a cooperative institution organized "for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 USC 1752(1)). While nearly 75 years have passed since the *Federal Credit Union Act* (FCUA) was signed into law, two fundamental principles regarding the operation of credit unions remain every bit as important today as they did in 1934:

- credit unions remain fully committed to providing their members with efficient, low-cost, personal financial service; and
- credit unions continue to emphasize traditional cooperative values, such as democracy and volunteerism.

Credit unions are not banks. The nation's approximately 7,800 federally insured credit unions serve a different purpose and have a fundamentally different structure than banks. Credit unions exist solely for the purpose of providing financial services to all of their members, while banks aim to make a profit for a limited number of shareholders. As owners of cooperative financial institutions united by a common bond, all credit union members have an equal say in the operation of their credit union—"one member, one vote"—regardless of the dollar amount they have on account. These singular rights extend all the way from making basic operating decisions to electing the board of directors—something unheard of among for-profit, stock-owned banks. Unlike their counterparts at banks and thrifts, federal credit union directors generally serve without remuneration—a fact epitomizing the true "volunteer spirit" permeating the credit union community.

Credit unions have grown steadily in membership and assets, but in relative terms, they make up a small portion of the financial services marketplace. Federally insured credit unions have approximately $813.4 billion in assets as of year-end 2008. By contrast, institutions insured by the Federal Deposit Insurance Corporation (FDIC) held $13.9 trillion in assets, and last year grew by an amount that exceeds the total assets of credit unions. The average size of a federal credit union is $92.5 million, compared to $1.672 billion for banks. Over 3,200 credit unions have less than $10 million in assets. The credit union share of total household financial assets is also relatively small, just 1.4 percent as of December 2008.

Size has no bearing on a credit union's structure or adherence to the credit union philosophy of service to members and the community. While credit unions may have grown, their relative size is still small when compared with banks. Even the world's largest credit union, Navy Federal Credit Union, with $36.4 billion in assets, is dwarfed by the nation's biggest banks, which hold trillions of dollars in assets.

America's credit unions have always remained true to their original mission of "promoting thrift" and providing "a source of credit for provident or productive purposes." In fact, Congress acknowledged this point when it adopted the *Credit Union Membership Access Act* (CUMAA – P.L. 105-219) a decade ago.

Credit unions continue to play a very important role in the lives of millions of Americans from all walks of life. As consolidation of the commercial banking sector has progressed with the resulting depersonalization in the delivery of financial services by banks, the emphasis in consumers' minds has begun to shift not only to services provided, but also—more importantly—to quality and cost. Credit unions are second to none in providing their members with quality personal financial service at the lowest possible cost as indicated by recent consumer satisfaction surveys.

While the lending practices of many other financial institutions led to the nation's subprime mortgage debacle, data collected under the *Home Mortgage Disclosure Act* (HMDA) illustrates the value of credit unions to their communities. The difference between credit unions and banks is highlighted when one examines the 2007 HMDA data for loans to minority applicants with household incomes under $40,000. According to the 2007 HMDA data, banks have a significantly higher percentage of their mortgage purchase loans (20.8 percent) charging at least 3 percent higher than the comparable Treasury yield to minority applicants with household income under $40,000. Credit unions, on the other hand, had only 4.4 percent of their mortgage purchase loans charging the higher interest rate in to the same applicant category.

The National Credit Union Share Insurance Fund (NCUSIF)

I would like to share with the subcommittee how the National Credit Union Share Insurance Fund (NCUSIF) is structured, and our assessment of the current challenges facing credit unions and their impact on the fund.

As you may know, the primary reason credit unions came together in 1967 and formed NAFCU was to lobby Congress for the establishment of a federal insurance fund for credit unions—a goal that was realized just three years later, in 1970. Like the credit unions whose accounts it insures, the NCUSIF itself is *cooperative* in nature. Unlike FDIC insurance, which was initially funded with taxpayer dollars from the United States Treasury as seed money, every dollar that has gone into the NCUSIF since its inception has come solely from the credit unions it insures.

The NCUSIF was originally structured in the same manner as the FDIC, meaning that the source of funding was based on premiums collected from insured institutions. In 1985, the amount of money at the NCUSIF began to dwindle as a result of losses, low earnings on investments and extensive growth in credit union insured savings. Credit unions realized that the NCUSIF needed to be recapitalized, and in 1985, every insured credit union made a deposit of one percent of its members' insured savings to the NCUSIF. By making this deposit, the mutual or cooperative structure of the NCUSIF began. As of March 2009, the NCUSIF has $23.4 billion in total assets with a total equity of $8 billion. As a percentage of total insured savings, the NCUSIF has an equity ratio of 1.3 percent.

Credit unions insured by the NCUSIF are required by statute to maintain an "insurance deposit" equal to one percent (1%) of their insured shares in the insurance fund (12 USC 1782(c)(1)(A)(i)). This "insurance deposit" is adjusted annually in the case of a credit union with total assets of not more than $50 million, and semi-annually for those credit unions with total assets of $50 million or more (12 USC 1782(c)(1)(A)(iii)). The National Credit Union Administration (NCUA) Board has a statutory obligation to establish a "normal operating level" for the fund which "shall not be less than

1.2 percent and not more than 1.5 percent" (12 USC 1782(h)(4)) on an annual basis. If the equity level of the NCUSIF is in the 1.2 percent to 1.3 percent range, the NCUA Board may assess a premium in order to restore the equity level back to the normal operating level. If it falls below 1.2 percent, the statutory floor, the NCUA Board is required to assess an insurance premium to restore the fund to a 1.2 percent equity level (12 USC 1782(c)(2)(C)).

Current Challenges

While the credit union industry has fared much better than most financial institutions in these turbulent economic times, many individual credit unions have been impacted, through no fault of their own, by the current economic environment.

In particular, the corporate credit union system has felt the biggest impact. In examining the corporates in January 2009, NCUA noted that "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 underlying collateral performance." It is with these facts in mind that on January 28, 2009, the NCUA Board approved a series of actions regarding the corporate credit union system.

Among the actions taken, NCUA:

- Guaranteed "all" the uninsured shares of corporate credit unions (i.e. shares owned by natural person credit unions) through February 2009 and established a voluntary guarantee program for the uninsured shares of 23 corporate credit unions through December 31, 2010 (the guarantee will cover all shares, but does not include paid-in capital and membership capital accounts). NCUA subsequently extended the program to accommodate a two-year rolling expiration date and provide the option of quarterly extensions through December 2012. If the option to extend each quarter is fully utilized, the final guarantee would expire December 31, 2014;

- Issued a $1 billion capital note to U.S. Central Federal Credit Union;
- Issued an Advance Notice of Proposed Rulemaking (ANPR) on restructuring the corporate credit union system; and
- Will be declaring a premium assessment to restore the NCUSIF equity ratio to 1.30 percent, to be collected in late 2009.

Additionally, the NCUA contracted with Pacific Investment Management Company LLC (PIMCO) to perform an analysis on the portfolios of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union. The resulting analysis led the NCUA to estimate that the resulting impact on the NCUSIF will be approximately $5.9 billion, dropping the NCUSIF's equity ratio to an estimated 0.31 percent. PIMCO's analysis also provided a range of possible results, which included the possibility that the impact could be greater than $5.9 billion. Because credit unions follow Generally Accepted Accounting Principles (GAAP), there is an immediate impairment to the one percent deposit. FICUs have to recognize this impairment by setting aside enough money in a contingency liability account to bring the deposit at the NCUSIF back to the one percent level. As previously noted, the FCUA requires NCUA to assess a premium when the fund's equity ratio drops below 1.2 percent. That premium assessment must occur before the end of 2009 and the NCUA, absent legislation, will bring the NCUSIF equity ratio up to 1.3 percent by assessing a premium of

0.3 percent later this year. The impairment and the premium combined will have an approximate 99-basis-point impact on all natural person credit unions in 2009.

The consequence of the 99-basis-point impact is that over 6,000 federally-insured credit unions (approximately 77.4 percent of all FICUs) will be in the "red" in 2009. Approximately 310 FICUs will be downgraded in their Prompt Corrective Action (PCA) levels, which could lead to further NCUA actions to help stabilize those institutions.

NAFCU's analysis of fourth quarter call report data on credit unions indicates that, absent legislation, FICU member services will be adversely impacted in 2009. Such adverse impacts could include increased fees, higher rates, lower dividends and/or decreased lending. With a $5.9 billion reduction in capital in 2009, the impact on consumer and business lending alone (based on NCUA estimates that credit unions make approximately $7 worth of loans for every $1 in capital) could reduce total lending by $41.3 billion, further adversely impacting the economy as the nation strives to rebound from its current economic malaise. At Chicago Patrolmen's, we estimate that the expense to us of this approach is approximately $2.24 million, meaning we could face nearly $14 million in decreased lending capacity to our members in the Chicago area this year.

Given the fact that credit unions provide the funds to operate the NCUA and the significant impact stabilization of the corporate credit union system is having on the credit union community, NAFCU believes it is imperative that the NCUA provide full and open transparency about its actions leading up to and throughout the resolution of the current situation. This should include details of how

NCUA reached the $5.9 billion figure and the cost to the NCUA of its actions in this regard, since it will impact natural person credit unions (this cost is borne by them, and ultimately their members).

The Credit Union Share Insurance Stabilization Act

When the NCUA first announced its corporate stabilization plan in late January, NAFCU immediately recognized the detrimental impact it could have on natural person credit unions and strongly urged the NCUA to seek additional legislative solutions to ease the burden, including examining ways to use existing mechanisms such as the Central Liquidity Facility (CLF) or to create new mechanisms such as a stabilization fund. We are pleased that on March 26, Chairman Fryzel and the NCUA Board submitted an alternative proposal to Congress to create a temporary corporate credit union stabilization fund, and we are grateful to Chairman Paul Kanjorski, Chairman Gutierrez, and Representatives Scott, Royce and LaTourette for introducing H.R. 2351, the *Credit Union Share Insurance Stabilization Act.*

NAFCU supports this legislation and urges the immediate adoption of the temporary corporate credit union stabilization fund proposal and updates to the share insurance fund contained in H.R. 2351. NCUA's borrowing authority has not been updated since 1971 and the current $100 million limit has not been modified for the growth of credit unions and their member deposits over time. Establishing a restoration plan to rebuild the Share Insurance Fund within eight years (or such longer period as the NCUA Board may determine to be necessary due to extraordinary circumstances) will allow the NCUA Board to ease the burden on credit unions when the fund experiences a drop, while limiting any potential negative "ripple" throughout the credit union community that the current one-year restoration would otherwise create.

We would offer two suggested changes to improve the bill's ability to help natural person credit unions. First, we urge an increase in initial NCUA borrowing authority from $6 billion to $10 billion. Second, we ask that the repayment period for the stabilization fund be extended to eight years. By lengthening the repayment term of the stabilization fund, Congress would help credit unions focus more of their resources on making loans that will strengthen the economy, rather than having to divert more resources annually to the fund, and would provide increased flexibility should the economy continue to deteriorate.

While NAFCU is pleased the legislation would increase in emergency borrowing authority for the NCUSIF to $30 billion, we urge the House to adopt a higher initial borrowing authority of $10 billion. This change is long overdue, since the current level of $100 million was established in 1971 and has not been modified for the growth of credit unions and their member deposits over time. While NCUA's initial request for borrowing authority was only $6 billion, we believe more prudent action would be to enact an amount of $10 billion, in case additional factors emerge that would increase the current estimate of $5.9 billion. The extended emergency borrowing authority of up to $30 billion will help ensure the NCUA has the tools it needs should a new crisis emerge in these difficult times and serves as an important addition to the legislation.

If these provisions were to be enacted, NAFCU believes it is important that the agency provide clarification on how credit unions would treat or reverse the present write-down resulting from the impairment of the one percent NCUSIF deposit, if and when the NCUSIF is no longer impaired.

This is an important issue given NCUA's recent guidance regarding treatment of the impairment in the current environment.

Additional Changes to the Corporate Credit Union System

The corporate credit union system is an important resource for natural person credit unions. At Chicago Patrolmen's FCU, we are members of two corporate credit unions. We use over two dozen corporate services that are key to providing many of the services we offer to our membership. We employ them for electronic services such as the Automated Clearing House, funds transfers, wire transfers and more. We also use savings and lending products and services, check clearing/payment services, investment services, and lines of credit, and we have used them for consultation and asset liability management services. We currently have approximately $45 million in overnight accounts and certificates. This is in addition to the $1.5 million of Membership Capital Shares in Members United Corporate and $900,000 in Corporate One.

NAFCU believes that the NCUA and Congress should work to find additional ways to help stabilize and strengthen the corporate credit union system as well. Going forward, other changes such as a modernization of the Central Liquidity Facility (CLF) should be examined. Established by the FCUA and funded by Congress, the CLF provides loans to natural person credit unions to meet their liquidity needs in turbulent times but cannot loan directly to corporate credit unions. We believe some changes to the FCUA to allow the CLF to directly help the corporate credit union system and a modernization of the CLF's operations could help address future challenges when they occur.

NAFCU also supports separating the risk of insuring member shares at corporate credit unions with the risk of insuring member shares at natural person credit unions. It is NAFCU's belief that the industry-wide crisis has made it apparent that the risks posed by corporate credit unions and natural person credit unions are so different that it is no longer advisable for NCUA to insure them under one share insurance structure, without implementing additional measures to protect natural person credit unions. We have asked the NCUA to create a permanent buffer between the corporates and natural person credit unions, either though a proper capital regime or other mechanism.

NAFCU's Corporate Credit Union Task Force and NCUA's ANPR

After NCUA released its Advance Notice of Proposed Rulemaking (ANPR) on corporate credit unions in January, the NAFCU Board of Directors appointed a task force to examine the various issues surrounding corporate credit unions addressed in the ANPR and construct principles on which NAFCU would base its comments. The principles, which were refined by the NAFCU Board of Directors, are set out below.

- *Corporate credit unions should continue to serve the liquidity and operational/payment systems needs of natural person credit unions.*
    1. Any solvent corporate credit union should be permitted to survive; voluntary mergers will achieve economies of scale.
    2. Corporates investment authority should be carefully regulated: for investment authority going forward, knowledge is key and independent risk analysis must be performed.

• *Corporate credit unions should operate under a risk-based capital system.*

1. Maintaining membership capital should not be mandatory.

2. Voluntary membership capital should be structured with a maximum cap and assessments based on usage.

• *Corporate credit unions should operate under corporate governance standards created and policed within the industry.*

1. Board members should consist of only qualified natural person credit union directors and staff.

2. There should be term limit requirements such as 3 years, 3 terms.

3. There should be no trade association or league staff members allowed on corporate boards.

4. There should be an independent supervisory committee that can hire outside expertise as needed.

5. There should be an investment oversight committee; it should be permissible for outsiders to be members of the committee to access requisite expertise.

In our comments to the NCUA Board, NAFCU also provided more specifics in these areas. These are included in our ANPR comment letter to the NCUA, which is attached to the end of my statement.

Conclusion

In conclusion, NAFCU supports H.R. 2351 and urges expeditious enactment of its provisions. Once enacted, the NCUA should provide clarification on how credit unions would treat or reverse the present write-down resulting from the impairment of the one percent NCUSIF deposit, if and when the NCUSIF is no longer impaired. Enactment of this legislation, coupled with a reversal of the impairment, could help credit unions make billions more in consumer and business loans this year to aid in our nation's economic recovery.

Maintaining a healthy and well-regulated corporate credit union system is important, as many natural person credit unions rely on corporates for essential services. Additional legislative changes to the CLF and action by NCUA and/or the Congress to separate the risk from insuring corporates from the risk of insuring member shares at natural person credit unions would help in this regard.

As NCUA works to restructure the corporate credit union system, NAFCU believes that three over-arching principles should be adhered to:

- *Corporate credit unions should continue to serve the liquidity and operational/payment systems needs of natural person credit unions.*
- *Corporate credit unions should operate under a risk-based capital system.*
- *Corporate credit unions should operate under corporate governance standards created and policed within the industry.*

Thank you for the opportunity to appear before the Subcommittee today. I welcome any questions that you may have.

STATEMENT

OF

MICHAEL E. FRYZEL
CHAIRMAN
NATIONAL CREDIT UNION ADMINISTRATION

ON

"H.R. 2351, The Credit Union Share Insurance Stabilization Act"

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES, COMMITTEE ON FINANCIAL SERVICES
Subcommittee on Financial Institutions and Consumer Credit

WEDNESDAY, MAY 20, 2009

This written statement is provided by Michael E. Fryzel, Chairman of the National Credit Union Administration (NCUA), concerning the subject of corporate credit unions. The statement is organized in five parts: **Part I** provides background on the corporate credit union system and a discussion of how the problems currently confronting the system arose; **Part II** describes the extraordinary actions NCUA has taken since last fall to address the immediate problems and to stabilize the system; **Part III** discusses credit losses arising from mortgage related securities and associated accounting issues; **Part IV** discusses the proposed creation of a Corporate Credit Union Stabilization Fund; and **Part V** describes some of the long-term changes and reforms the NCUA anticipates making to ensure that the system operates on a safe and sound basis going forward.

I. Background.

The NCUA's primary mission is to ensure the safety and soundness of federally-insured credit unions. It performs this important public function by examining all federal credit unions, participating in the examination and supervision of federally-insured state chartered credit unions in coordination with state regulators, and insuring federally-insured credit union members' accounts. In its statutory role as the administrator of the NCUSIF, the NCUA insures and supervises 7,749 federally-insured credit unions, representing 98 percent of all credit unions and approximately 89 million members.[1]

Over 95% of natural person credit unions (NPCUs) belong to, and receive services from, corporate credit unions (corporates). There are 27 "retail" corporates that provide services directly to NPCUs, and there is one "wholesale" corporate, U.S. Central Federal Credit Union (USC), that provides services to many of the 27 retail corporate credit unions.

USC, the wholesale corporate, has approximately $35 billion in assets. USC provides liquidity, payment system services and aggregation, and other correspondent services to the twenty-seven (27) retail corporate, which range in size from approximately $4 million to approximately $25 billion in assets. Fourteen of the corporates are federally chartered and 14 are state chartered. All of the corporates are federally insured.

The corporate credit union system offers a broad range of support to NPCUs. The range of products and services provided by retail corporates includes: investment/deposit services, wire transfers, share draft processing and imaging, automatic clearinghouse transactions (ACH) processing, automatic teller machine (ATM) processing, bill payment services and security safekeeping to credit unions.

[1] Approximately 160 state-chartered credit unions are privately insured and are not subject to NCUA oversight. Based on March 31, 2009 Call Report (NCUA Form 5300) data.

The volume of payment systems-related transactions throughout the system annually runs into the millions and the dollar amounts associated with those transactions are in the billions each month. It is imperative for NPCUs and to maintain confidence in the entire U.S. financial system that these processes continue.

Corporates also serve as liquidity providers for NPCUs. Natural person credit unions invest excess liquidity in a corporate when the NPCU has lower loan demand and draw down the invested liquidity when loan demand increases.

Corporate system: Prior to 2000.

Up until the late 1990s, federally chartered corporates had a defined field of membership (FOM) serving a specific state or geographic region. Most state chartered corporates had national FOMs, but primarily serviced the state in which they were incorporated. In 1998, the NCUA Board began to approve national FOMs for federal corporates, in part to provide requested parity with state charters. Within a few years most corporates had a national FOM.

NCUA's intention in allowing national FOMs was to provide NPCUs with the ability to select membership in a corporate that best meets the needs of each NPCU in serving its members. The anticipated level of competition was expected to spur consolidation within the industry to build scale and improve efficiencies. In turn, this would build capital through increased earnings. While a few mergers occurred, one of the primary consequences of competition was to reduce margins on services and put pressure on the corporates to seek greater yields on their investments.

Corporate system: 2000 through mid-2007.

The investment provisions of NCUA's corporate regulation, located at 12 C.F.R. Part 704, have historically permitted corporates to purchase private label mortgage-backed and mortgage-related securities (collectively referred to herein as "MBS"). Part 704, however, restricts most corporates (those without expanded investment authority) to investing in only the highest credit quality rated securities by at least one Nationally Recognized Statistical Rating Organization (NRSRO).[2] Historically, highly rated securities have experienced minimal defaults and have been very liquid. Under NCUA rules, some corporates were permitted to exercise expanded investment

[2] The term nationally recognized statistical rating organization (NRSRO) is used in federal and state statutes and regulations to confer regulatory benefits or prescribe requirements based on credit ratings issued by credit rating agencies identified by the Securities and Exchange Commission (SEC) as NRSROs. The Credit Rating Agency Reform Act of 2006 requires a credit rating agency seeking to be treated as an NRSRO to apply for, and be granted, registration with the SEC. See final SEC Rule, *Oversight of Credit Rating Agencies Registered as Nationally Recognized Statistical Rating Organizations*, at 72 Fed. Reg. 33564 (June 18, 2007).

authority and to purchase investment grade securities rated down to BBB because they had higher capital ratios, more highly trained personnel, and more capacity in their systems to monitor and model their portfolios. Even those corporates that had expanded credit risk authority, however, rarely exercised it. In addition to being limited to securities with very high NRSRO ratings, corporates were required to perform a comprehensive credit analysis of the underlying collateral supporting the marketable security.

Either through direct purchase, or indirectly through investments at USC, the corporate system became heavily invested in privately issued MBS. Between 2003 and mid-2007, the percentage of investments in MBS grew from 24 percent to 37 percent. At purchase, these securities provided the corporates with a modest increase in yield over traditional investments in asset backed securities (e.g., securitized credit card and auto receivables). The vast majority of MBS were of high credit ratings (AA equivalent or above) and had interest rates that reset on a monthly or quarterly basis, which closely matched the corporates' need to fund dividends on member shares.[3] These features had made MBS highly marketable and thus provided adequate liquidity to the corporates so they, in turn, could provide liquidity to their NPCU members.

USC and Western Corporate Federal Credit Union (WesCorp), the two corporates currently under NCUA conservatorship, had the highest concentrations of MBS in the entire corporate system. The advent of national FOMs produced the competition that may, in turn, have helped generate these MBS concentrations. WesCorp was able to attract new NPCU members in part by offering dividend rates higher than other corporates. Consequently, it maintained an aggressive earnings strategy that was achieved by acquiring higher yielding (i.e., riskier, though still highly rated) MBS with greater amounts of credit risk.. In direct response to WesCorp's market share success, other corporates likely pressured their wholesale corporate U.S. Central to pay higher more competitive dividends which they could pass along to their members. As a result, USC changed its portfolio strategy and also invested heavily in higher yielding MBS.

NCUA communicated to corporates the need to establish reasonable concentration limits in their board policies. In January 2003, NCUA issued *Corporate Credit Union Guidance Letter 2003-01*, which expressly highlighted the risks associated with credit concentrations and specifically addressed the need for corporates to establish appropriate limitations within their credit risk management policies.

During this timeframe, NCUA was also beginning to focus efforts on identifying and educating NPCUs on emerging risks associated with proper credit risk management

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[3] Overnight share dividends repriced daily. Fixed rate share certificates were funded by investing in interest rate swaps. The swaps converted the variable rates paid by the MBS to fixed rates that could be used to pay the certificate dividends.

of lending, including real estate lending, given a noted increase of alternative lending arrangements. Over the next few years, NCUA and the federal banking agencies worked cooperatively to provide numerous pieces of industry guidance on non-traditional mortgage products. NCUA warned of the potential adverse impact these types of loans could have on consumers and credit union balance sheets. Natural person credit unions have responded favorably to the supervision oversight of NCUA; to date, these types of mortgage loans represent less than 4 percent of all first mortgage loans outstanding in the industry.

In April 2007, several months before the distress in the mortgage market surfaced, NCUA issued *Corporate Credit Union Guidance Letter No. 2007-02*, focusing on credit and market value risks of MBS. This letter addressed credit risk, liquidity risk, market value risk, and concentration risk associated with MBS.

By and large, corporates ceased the purchase of non-agency mortgage related securities by mid-2007. For example, at the April 30, 2007, NCUA examination of WesCorp, NCUA and WesCorp reached agreement on steps to address WesCorp's concentration issues and limit its exposure. WesCorp ceased making MBS purchases in July 2007. Starting in the second half of 2007, USC began purchasing only MBS that were backed by loans originated prior to 2006, the time frame when subprime and Alt-A loans began to proliferate.

However, by the summer of 2007 the MBS at the heart of the corporate problem were already on the books of USC and WesCorp. At that time, all investments, including MBS, were rated investment grade, and 98 percent were rated AA or higher. It was not until a year later (June 2008) that the corporate's MBS credit ratings began migrating downward, and even then 96 percent were investment grade and 92 percent were rated AA or better.

Corporate system: Mid-2007 through mid-2008.

Beginning mid-year 2007, real estate values declined across many markets in the U.S. and greater numbers of mortgages became delinquent leading to higher foreclosures. The higher number of foreclosures further eroded housing prices, resulting in lower recovery of principal and even higher losses when the foreclosed properties were liquidated. This resulted in sharp price declines for MBS and a corresponding shallowing of the market as a flight to quality arose.

Initially, market participants believed the market disturbance was limited to the subprime market and would be short-lived, and the performance of the senior credit positions in MBS, such as those primarily held by corporates, would not be at risk; however, that has proven not to be the case. By the end of 2007 and early into 2008, what started out as concerns over sub-prime mortgages spread to Alt-A loans, option ARM loans and finally to prime mortgage loans.

Some MBS were backed by underlying loans NCUA now knows had imprudent underwriting. These alternative mortgage loans were aggressively made to buyers in high-price home markets as a means to address home affordability. The weak credit fundamentals of the underlying mortgages, the inherent risk of the MBS structures, and the declining home market combined to severely affect the performance of MBS holdings of some corporates.

MBS prices and marketability declined significantly. Even bonds that held AA ratings or higher were unable to be sold at prices close to par, discouraging investors, including corporates, to continue to hold them. Corporate credit unions increasingly looked to borrowings to meet liquidity demands. By pledging their MBS assets as security, corporates were able to obtain financing from external lenders.

In hindsight, it would have been preferable for the corporates to have sold the problem MBS in 2007. However, any sale following the MBS market dislocation would have forced unrealized losses to become realized losses at a time when actual credit impairment of the underlying assets was viewed by many as unlikely. Absent a market of willing buyers, private label MBS increasingly could only be sold at a very severe discount (distressed prices) – causing losses even more significant than the accumulated unrealized losses on available-for-securities reflected on the financial statements. The conventional market wisdom at the time was that the problems in the MBS markets were temporary and it did not make economic sense to sell securities until market liquidity and counterparty trust improved.

Conditions did not improve and as the MBS markets became more distressed and illiquid, the margin requirements set by lenders for MBS collateral pledged by their corporate credit union borrowers increased. The cost of primary borrowing sources available to corporates became prohibitively expensive as a result. Due to the continued price devaluation of MBS, the ability to borrow by pledging corporate investment portfolios diminished significantly, thereby increasing liquidity pressures. In turn, this reduced leverage diminished the yields paid by the corporates and made them less attractive., NPCUs began to invest part of their excess liquidity elsewhere, further increasing corporate liquidity concerns.

In response to these concerns, NCUA directed corporates to consider a number of steps to ensure adequate sources of liquidity, including: encouraging the establishment of commercial paper and medium-term note programs; encouraging additional liquidity sources (both advised and committed); encouraging an increase in the number of repo transaction counterparties; encouraging membership in a Federal Home Loan Bank (FHLB); requiring independent third party stress test modeling of mortgage-related securities to determine if the securities would continue to cash flow; assisting USC to gain access to the Federal Reserve Board's discount window; and encouraging education and communication with their members about what was occurring in the financial market and how it was affecting their balance sheets. Corporates have done a good job of communicating these issues with their members and this did assist in preventing significant outflows of funds from the corporate system.

On August 11, 2008, the Wall Street Journal published an article on the unrealized losses on available for sale securities in the corporate system. The article generated questions and concerns throughout the credit union industry and increased the possibility of a run on corporate shares. A run would have forced some corporates to sell their MBS at severely depressed prices, leading to loss of not only all the member capital in the affected corporates but also most member shares.[4] The loss of these shares would have likely caused the failure of many member NPCUs and required numerous recapitalizations of the NCUSIF, with catastrophic effects on the credit union system as a whole.

Also in that August 2008 timeframe the media publicized problems with Fannie Mae, Freddie Mac, Bear Stearns, Countrywide, and numerous other financial entities. Liquidity in the global markets froze: liquidity had become not only expensive, but almost impossible to obtain. Unfortunately, these events coincided with seasonal liquidity demands placed by NPCUs on their corporates. Traditionally, NPCUs withdraw funds during August and September, and funds begin to flow back into the corporates in October. The tightening liquidity environment was of significant concern to NCUA and the corporate system, because corporates must maintain adequate liquidity to ensure the uninterrupted and ongoing processing and settlement of the payment systems functions.

The potential loss of member confidence in their corporates, ever-increasing concerns about the credit quality of MBS, and the seasonal liquidity outflows all created the "perfect storm" for the corporate system. NCUA was concerned that some corporates would be unable to meet the liquidity demands of their members in the short-term or be unable to fund payment systems activity. In addition, NCUA had indications of an exodus of NPCU funds from the corporate system due to a lack of confidence. Accordingly, in the fall of 2008 it became critical for NCUA to initiate dramatic action to bolster confidence in the corporates and ensure the continuing flow of liquidity in the credit union system.

II. NCUA Takes Stabilization Actions Through the CLF and NCUSIF.

In the last half of 2008 NCUA acted to stabilize and strengthen corporates utilizing a three-pronged approach designed to: 1) maintain liquidity, 2) strengthen capital, and 3) restructure the corporate system. The first step in the stabilization program was to

[4] The vast majority of shares in corporates are uninsured because the account balances are well above the $250,000 federal insurance limit.

increase liquidity throughout the entire credit union system, especially within the corporates.

Representatives of the Central Liquidity Facility (CLF) worked regularly with staff at both the Board of Governors of the Federal Reserve (FRB) and at the Department of Treasury during the past year to coordinate efforts to address market disruptions and preserve contingency funding arrangements for NPCUs. The following provides an approximate chronology of actions taken by the CLF and the National Credit Union Share Insurance Fund (NCUSIF) to help stabilize the corporate system.

August 2008: To address increasing liquidity pressures, NCUA encouraged corporates with large unrealized losses on holdings of MBS to make application to the Federal Reserve Discount Window. NCUA initiated contact with FRB staff to discuss NCUA's intentions and seek the FRB's views on liquidity contingency options for lending to NPCUs.

September 2008: To alleviate liquidity pressures in corporates, CLF began converting loans of NPCUs funded by corporates to CLF-funded loans. Total corporate loans to NPCUs were, at that time, approximately $6 billion. CLF was operating under a congressionally-imposed borrowing cap of $1.5 billion and the NCUA Board requested Congress raise CLF's borrowing cap to its full statutory limit of approximately $41 billion (twelve times the subscribed capital stock and surplus of the CLF). Ultimately, the lifting of the cap proved to be one of the primary reasons NCUA could successfully develop and implement a series of critical liquidity measures that served as the foundation for its corporate stabilization efforts.

At the NCUA Board's direction, staff worked to develop programs to stabilize the corporate system and extensive contingency plans. In addition, the NCUA Board retained the consulting firm PricewaterhouseCoopers to provide an independent perspective on NCUA's resolution and contingency planning efforts.

October 2008: NCUA staff continued to meet with staff of the FRB, Treasury and the Federal Financing Bank to discuss NCUA contingency plans to handle payment system operations in the event of an escalation of problems in the corporate system and to discuss the current liquidity situation facing corporates.

The NCUA Board approved the "Temporary Corporate Credit Union Liquidity Guarantee Program" (TCCULGP) on October 16, 2008. The TCCULGP is similar to the "Temporary Liquidity Guarantee Program" announced by the FDIC on October 14, 2008. Under the TCCULGP, the NCUSIF provides a 100 percent guarantee on new unsecured debt obligations issued by eligible corporates on or before June 30, 2009, and maturing on or before June 30, 2012.

At NCUA's urging, Congress did remove the CLF borrowing cap, permitting CLF to borrow and subsequently lend up to its statutory limit, currently approximately $41 billion. As described below, CLF rapidly expanded its liquidity lending.

November/December 2008: In November, after consultation with - and concurrence by - the Board of Governors of the Federal Reserve and the Secretary of the Treasury, the NCUA Board approved two new programs: the Credit Union System Investment Program (CU SIP) and the Credit Union Homeowners Affordability Relief Program (CU HARP).

NCUA designed the CU SIP to provide contingent liquidity to the credit union system. The CU SIP allows participating NPCUs to borrow funds from the CLF and invest those funds in CU SIP notes issued by corporates. The notes have maturities of one year and are guaranteed by the NCUSIF using the TCCULGP. Corporate credit unions must use the loan proceeds to retire external borrowings, which frees collateral and increases contingent borrowing capacity, thereby increasing the liquidity of the credit union system.

The CU HARP has two purposes: to break the repeating cycle of delinquency, default, foreclosure, and diminished home prices, and also to provide liquidity to the credit union system. Participating credit unions borrow from the CLF and invest in a CU HARP note issued by a participating corporate which is fully guaranteed by the NCUSIF. A feature of the CU HARP note involves a bonus coupon which is applied toward rate relief for the homeowner. This feature helps eligible members keep their homes.

January 2009: With the launch of CU HARP and CU SIP, NCUA provided almost $5 billion of additional funding to corporates to pay down external borrowings.[5] At its January 28, 2009, meeting the NCUA Board took the following actions:

1. Approved issuance of a $1 billion NCUSIF capital note to USC as a result of pending realized losses on MBS and other asset-backed securities. This action was necessary to preserve confidence in USC, given its pivotal role in the corporate system, and maintain external sources of funding.

2. Approved the "Temporary Corporate Credit Union Share Guarantee Program" (TCCUSGP), which guarantees uninsured shares at participating corporates through September 30, 2011. This program was vital in maintaining NPCU confidence and stabilizing the precarious liquidity situation, and has proven very successful in so doing. Participating corporates have the option to select

[5] The CLF provided $4.8 billion under the CU SIP and $164 million under CU HARP. The SIP and HARP programs were key in providing liquidity to the corporates and the credit union system at this critical juncture. These two programs, and other CLF lending, would not have been possible without NCUA's advocacy the previous September for lifting the CLF cap.

quarterly extensions of the expiration date, to a maximum maturity of two years, for any share subject to the TCCUSGP. This guarantee is in addition to the guarantee of unsecured corporate debt provided by the TCCULGP.

3. Authorized the engagement of Pacific Investment Management Company, L.L.C. (PIMCO), an independent third party, to conduct a comprehensive analysis of expected non-recoverable credit losses for distressed securities held by corporates. This information served to augment NCUA's analysis of potential losses to the NCUSIF and provided an independent assessment of the reliability of information provided by the corporates. The focus on non recoverable credit losses rather than the higher and more volatile losses due to other market factors was more congruent with actual NCUSIF exposure. The insurance exposure from the higher losses due to other market factors would arise only if the corporates were required to sell the securities for liquidity purposes.

4. Issued an Advance Notice of Public Rulemaking (ANPR) on restructuring the corporate system; the sixty-day comment period expired in April 2009. NCUA received almost five hundred comment letters, providing suggestions on possible future regulatory reforms to the corporate network. An expanded discussion of the ANPR and of some of the regulatory changes NCUA anticipates is set out in Part V of this statement.

5. Declared a premium assessment for 2009 to restore the NCUSIF equity ratio to 1.30 percent. Given the costs to the NCUSIF associated with the $1 billion capital note and the TCCUSGP, the premium declaration was necessary to satisfy the statutory authority to maintain the NCUSIF's equity ratio above 1.20 percent. Given ongoing uncertainties in the economy, the NCUA Board chose to restore the NCUSIF equity ratio to the maximum level allowed via a premium assessment to reduce the likelihood of needing to charge another premium shortly thereafter.

February 2009: CLF provided an additional $2.9 billion to credit unions participating in the CU SIP.

March 2009: The NCUA Board placed USC and WesCorp into conservatorship. The action protected retail credit union share deposits and the interests of the NCUSIF, and it also helped clear the way for NCUA to take any additional mitigating actions that may become necessary in the future with respect to these two large corporates.

The NCUSIF borrowed $10 billion from the CLF (which in turn borrowed the funds from the FFB) to pre-position funding in the two conserved corporates to address any unusual outflows of members' funds. CLF provided an additional $500 million to credit unions participating in the CU SIP. The NCUA Board approved the concept of a Corporate Credit Union Stabilization Fund and authorized the effort to secure legislation necessary for its implementation. This issue is discussed in greater detail in Section IV of this statement.

April 2009 – present. NCUA began providing periodic reports to stakeholders concerning its efforts in administering the conservatorships of USC and WesCorp. NCUA also reviewed and summarized comments received on its ANPR. The NCUA Board adopted a revision to the TCCUSGP by extending the program to accommodate a 2-year rolling expiration date and providing the option of quarterly extensions through December 2012. If the option to extend each quarter is fully utilized, the final guarantee would expire December 31, 2014. NCUA has also been involved in assisting in the legislative process necessary to create the Corporate Credit Union Stabilization Fund.

NCUA continued to make good use of its CLF lending authority to pump liquidity into the credit union system. As of May 15, 2009, CLF loans outstanding stood at approximately $18.7 billion, and the cumulative total of loans granted from September 2007 through May 15, 2009 was approximately $21.6 billion.

III. Credit and Accounting Losses.

In addition to the liquidity challenges confronting corporate credit unions, there were serious issues relating to the valuation of MBS credit losses and the accounting for MBS losses.

Throughout 2008, the market values of many corporate securities, primarily privately issued MBS, progressively declined. Much of the decline was attributable to the dislocation of the credit markets as liquidity premiums soared. Accordingly, corporates recognized much of these price declines as unrealized losses.

Consistent with generally accepted accounting principles (GAAP), corporates recognized the amount by which the amortized cost of these securities exceeded fair (i.e., market) value as unrealized losses. Under GAAP, as long as these declines are judged to be temporary they are recorded on the balance sheet as unrealized losses and do not affect earnings or retained earnings. Further, unrealized gains or losses are not counted in computing regulatory capital.

The unrealized losses in the corporate system grew to nearly $18 billion by year-end 2008. The severity of the MBS price declines and credit downgrades, along with the erosion of subordinated classes within the MBS structures held by corporates, required reconsideration by some corporate credit unions that all such fair value declines were temporary.[6] Under GAAP as it existed in 2008, when the decline in the fair value of the securities below cost was judged to be "other-than-temporary" the corporate credit union had to write the security down through the income statement to the full fair value (both the credit portion and the market portion)[7] thus decreasing current earnings. It did not matter under "then existing" GAAP that a portion of such declines were credit losses and the other portion was simply due to other market factors.[8]

At the time, external parties were projecting unrecoverable credit losses from the underlying mortgages on MBS, even those that were rated AA or higher at issuance.[9] The increasing credit loss expectations further depressed fair values for the bonds and increased the amount of losses that had to be booked as "other than temporary." (If conditions existed that indicated the price declines were other-than-temporary, in essence "then existing" GAAP required the recognition of the entire fair value price declines below cost be recognized through earnings and, thus, retained earnings,. Had current GAAP had been in place during the 2008 period, the amount of loss on these securities that had been recognized against income would have been limited to "credit losses only."

Many securities held within the corporate system have deteriorated so dramatically that credit losses are inevitable. The range of projected losses can be quantified using the current collateral performance and projections based on numerous factors (e.g., documentation, loan-to-values, and geography) which are, in turn, applied to the bond structure to project security losses. As a rule-of-thumb, the riskiest security tranches are those that protect more senior securities (i.e., they are subordinate) and/or have longer average lives.

The unfortunate reality is that even for the lower end of the range, there are relatively large projected credit losses within the corporate system. The largest concentrations

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[6] The term "subordinated" means that the security will absorb credit losses in the underlying pool of loans before other, more senior, securities absorb credit losses. In general, the principal of the subordinated security will be exhausted before the more senior securities absorb any loss.

[7] Market losses arise from fluctuations in bond prices. Credit losses arise from mortgage defaults and are unrecoverable losses of investment principal. Both elements affect fair value.

[8] The NCUA is appreciative the House Financial Services Committee held a hearing in March 2008 in which the Committee strongly encouraged the Office of the SEC Chief Accountant and the Chairman of the Financial Accounting Standards Board to reconsider in the immediate future the GAAP governing "other-than-temporary" impairment of debt securities. Subsequently, the FASB changed the OTTI impairment model to require that only the credit portion of the fair value declines below cost be reflected in the income statement. The Committee's intervention on this critical financial reporting matter was necessary and beneficial to financial institutions in relation to subsequent periods (2009 and beyond).

[9] Both USC and WesCorp engaged the services of a securities analytics firm to estimate the level of credit losses embedded in their holdings of mortgage backed securities. The corporates subsequently determined that because these losses were deemed to be other than temporary, they had to record losses through earnings and capital.

of projected losses are in the subordinated securities backed by Alt-A and Option ARM collateral that protect more senior securities, with the second largest source of projected losses from securities backed by sub-prime mortgages. Alt-A and Option ARM loans have performed, and are expected to continue to perform, exponentially worse than expectations forecast at origination. Improvements in collateral performance for these types of securities can still have a marginal effect on losses, but NCUA is highly confident that significant losses will result under any reasonable scenario.

When evaluating the credit losses for the corporates' residential mortgage backed securities, NCUA considered the current collateral performance and loan type. By way of example, one such security that is typical for one of the largest portfolios has 9.6 percent subordination (protection against losses built into the bond's structure), delinquencies over 60 days, and current foreclosures and real estate owned in excess of 42 percent. Considering the fact that the underlying loans are Option ARMs (large California concentrations) and observed losses on liquidated loans are approximately 55 percent, significant losses are likely to occur in the next year in any reasonable scenario.

Given the complexity of projecting credit losses, the NCUA has relied on multiple expert sources to validate NCUA's internal results. These external sources include the analysis done for USC and WesCorp by their external vendors; a detailed, bond-by-bond analysis done by the Pacific Investment Management Company (PIMCO) expressly for NCUA; and a more general credit loss analysis based on the NRSRO MBS ratings and the associated NRSRO correlation of ratings to expected credit losses.

Both external and internal analyses have consistently shown that the projected MBS credit losses in the corporate system are real, highly likely, and relatively large. Of course, these analyses rest to some extent on assumptions about future economic events. But even analyses using the most optimistic future scenarios produce large system wide MBS credit losses, albeit less than base case projections. NCUA currently projects that the system-wide MBS credit losses will range from a best case of $7 billion to a worst case of about $16 billion, with a likely case of about $11 billion. In terms of the resulting losses to the NCUSIF, NCUA currently projects a best case of about $3.4 billion, a worst case of about $8.1 billion, and a likely case of about $5.9 billion.

IV. Corporate Stabilization Fund Legislation (S. 896 and H.R. 2351).

At this time, NCUA estimates that the losses to the NCUSIF caused by MBS losses in the corporate system have exceeded the NCUSIF's entire retained earnings and have impaired approximately 69% of the capitalization deposit that all federally insured credit unions maintain with the NCUSIF. In total, the cost to credit unions is

0.99 percent of insured shares, which equates to a 72 basis point (bp) reduction in each credit union's return on assets and 65 bp reduction in net worth. Many NPCUs are also facing impairment write-downs of the paid-in-capital and membership capital accounts held at corporates.

Though the credit union system as a whole has the net worth to absorb these costs and remain well capitalized, the current structure of the NCUSIF requires that credit unions take all these insurance expense charges at once, which would result in a contraction of credit union lending and other services. This would come at a particularly difficult time, when it is vital that credit unions be a source of consumer confidence and continue to make credit available to support an economic recovery. In fact, such a large, sudden impact on credit unions' financial statements could further destabilize consumer confidence.

NCUA has, accordingly, sought the passage of legislation that would ameliorate this situation through the creation of a Temporary Corporate Credit Union Stabilization Fund (CCUSF). The Board would use the CCUSF to pay expenses associated with the ongoing problems in the corporate credit union system, such as capital injections into U.S. Central and WesCorp. The primary purpose of this new CCUSF is to spread over multiple years the costs to insured credit unions associated with the corporate credit union stabilization effort.

To pay for these corporate expenses, the CCUSF would borrow money from the Treasury on a revolving basis in an amount up to $6 billion. The CCUSF must repay the Treasury, with interest, all amounts borrowed, but the CCUSF has discretion as to the timing of each repayment to the Treasury and the amount of principal included with each repayment. The CCUSF would make assessments on federally-insured credit unions as it determined necessary to make each repayment.

The discretion as to the timing of each repayment to the Treasury, and other factors, should allow credit unions to expense CCUSF premiums when assessed, and not all at once as would be required for NCUSIF deposit replenishments. The CCUSF would be a temporary fund, and NCUA has proposed that the CCUSF repay the Treasury and close down within seven years, since the MBS held by corporates should, by the end of that period, amortize to a point where the remaining values of these bonds will be relatively insignificant.

The CCUSF enabling language would be added at the end of Title II of the Federal Credit Union Act as a new §217. A brief section-by-section analysis of the draft statute follows.

§217(a). Establishment of the CCUSF. This subsection establishes the Fund and establishes the Board as responsible for administering the Fund. The Board has the same administrative powers over the CCUSF as the Board has over the NCUSIF.

§217(b). Expenditures from the CCUSF. This subsection limits the authority of the Board to make payments out of the CCUSF to payments the Board could otherwise make from the NCUSIF, such as loans, cash assistance payments, payments to purchase assets, or payments to establish accounts, including capital accounts. The subsection further requires such expenditures be connected to "the conservatorship, liquidation, or threatened conservatorship or liquidation, of a corporate credit union," and requires that the Board certify that, absent the existence of the CCUSF, the Board would have made the identical payment from the NCUSIF. These provisions are intended to ensure that the activities of the Fund are restricted to resolving problems in the corporate credit union system, and not used for other purposes, such as for dealing with natural person credit union problems. These restrictions will also ensure that any assessments made on behalf of the CCUSF are not ex post facto assessments, since they would be assessments that the NCUSIF would otherwise have the authority to make -- and insured credit unions to pay. The Board must report each certification to the Committee on Financial Services of the House and the Committee on Banking, Housing, and Urban Affairs of the Senate.

§217(c). Authority to Borrow. This subsection states that the CCUSF will be funded by borrowings from the Secretary of the Treasury. The Board must, within 7 years, repay all advances with interest, but the Board has discretion to determine the timing and principal amount of each repayment. The interest rate is a variable rate. The rate is based on Treasury obligations of average maturities of 12 months, and the rate reset occurs every 12 months. The Board, with the prior concurrence of the Secretary of the Treasury, may extend the final date for repayment. If there is an extension, the Secretary must also concur with the terms and conditions of the extended repayment.

§217(d). Assessments to Repay Advance. This subsection provides that at least ninety days before each repayment the Board will assess a special premium on all insured credit unions as necessary to fund that particular repayment. The premium calculation mirrors that of a NCUSIF premium calculation, and insured credit unions that fail to make timely payment of a CCUSF assessment will be subject to the same special procedures and penalties as credit unions that fail to make a timely NCUSIF premium payment. Insured credit unions that are no longer federally-insured at the time of an assessment because they terminate their insurance or convert from it before the assessment date are not liable to pay the assessment.

§217(e). Distributions from Insurance Fund. This subsection suspends any equity distributions by the NCUSIF to insured credit unions while the CCUSF has any outstanding advances from the Treasury. Instead, the NCUSIF must pay the entire distribution to the CCUSF. The CCUSF will use the distribution proceeds to assist it in meeting its future repayments to the Treasury. If the distribution exceeds the

amount of all Treasury advances and associated interest, the excess amounts will be returned to the NCUSIF when the CCUSF closes.

§217(f) Investment of CCUSF Assets. This subsection provides that money in the CCUSF, when not being used by the Board, will be invested in public debt securities, with maturities as directed by the Board and bearing interest as determined by the Secretary of the Treasury. The Board anticipates, however, that at any given time, there will be little or no money in the CCUSF that is not being used by the Board.

§217(g) Reports. This subsection requires the Board make annual reports to Congress on the status of the CCUSF. Section 217(f) also acknowledges that the CCUSF may operate at a deficit since the Fund has authority to incur expenses up to its borrowing authority without collecting corresponding revenue until future periods.

§217(h) Closing of CCUSF. This subsection requires the Board close the CCUSF within 90 days following the seventh anniversary of the initial advance, subject to any extension of the final repayment date. Any remaining assets in the Fund after final repayment will be distributed to the NCUSIF.

The section-by-section analysis above tracks the CCUSF language as introduced in the House in §4 of H.R. 2351, the "Credit Union Share Insurance Stabilization Act." Similar CCUSF language appears in §204(f) of S. 896, the "Helping Families Save Their Homes Act of 2009," which passed the Senate on May 9, 2009.

In addition to this CCUSF language, H.R. 2351 and S. 896 contain other important provisions that would help the NCUA guide the credit union system through the problems with corporates. For example, both H.R. 2351 and S.896 would increase the NCUSIF's current authority to borrow from the Treasury from $100 million to $6 billion. These two bills further provide that the aggregate amount that the NCUSIF and the CCUSF could borrow at any one time, combined, is limited to this $6 billion. Both bills also provide an additional temporary authority, if an emergency arises, for the Treasury, with the recommendation of the NCUA and the Federal Reserve, to further increase this $6 billion borrowing authority up to $30 billion.[10]

H.R. 2351 and S. 896 would also grant NCUA the authority to establish a fund restoration plan to restore the NCUSIF's minimum equity ratio over an 8 year period. While this restoration plan authority is useful, and would allow the NCUSIF to make premium assessments over multiple years, this authority would not allow credit unions to avoid expensing the replenishment of their entire NCUSIF deposit at one time. Only the CCUSF legislation would allow credit unions to expense the entire cost of the corporate problem, both premium assessments and deposit replenishment

[10] H.R. 1106, passed by the House, also includes the $6 billion authority, but not the temporary emergency $30 billion authority.

assessments, over time.[11] NCUA anticipates that it can employ the NCUSIF and CCUSF, working in tandem, to fairly and effectively distribute the insurance costs associated with the current economic downturn, including not just the costs of the corporate problem but also other costs that may arise.

V. Reforming the Corporate System

NCUA is committed to taking any and all steps necessary to preserve a well-functioning system of corporates and to protect the assets of NPCUs and their members during the ongoing broader financial market dislocation. During the coming months, NCUA will continue to focus its efforts on minimizing the adverse impact of the current U.S. financial and economic turmoil on credit unions. In relation to the corporate system, NCUA intends to:

- Seek ways to reduce the financial cost to the credit union community from the stabilization action;
- Determine the least cost alternative to absorb the losses within the system; and
- Explore alternate methods to manage the distressed assets held by the corporates.

At the structural level, NCUA anticipates making substantial changes in the existing corporate system based on input from stakeholders and future safety and soundness considerations. To help achieve that goal, NCUA intends to make significant revisions to Part 704, its primary corporate credit union rule. The process NCUA intends to follow, and the topics NCUA intends to address, are described below.

Process. NCUA has sought, and will continue to seek, input from all stakeholders, including the credit union industry, the general public, and other components of the financial sector, concerning the best course of action in developing a new corporate rule. NCUA have, accordingly, already issued an Advanced Notice of Proposed Rulemaking (ANPR) identifying several broad areas of potential reform and soliciting public comment on all aspects of the corporate system. NCUA published the ANPR on February 4, 2009, in the *Federal Register,* with a sixty-day comment period. The agency received 496 comments from credit unions, trade associations, individuals and other entities, offering views and suggestions on a myriad of aspects of the corporate system and how best to regulate it. NCUA has reviewed and evaluated each of these comments.

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[11] S. 896 and H.R. 1106 contain other provisions, such as the increase in share insurance coverage to $250,000, that are important to credit unions but are not directly related to the current problems in the corporate credit union system.

NCUA's next step will be to develop a proposed rule for public comment to be published in the fall. The proposal will reflect our best judgment on appropriate changes to the corporate rule. NCUA also anticipates hosting a series of town hall meetings in major metropolitan areas across the country in which interested parties will be invited to share their views in a public forum about NCUA's proposed rule changes. A final rule will be completed as soon as possible.

Substance. The ANPR public comment process has already informed our approach to the rulemaking and will undoubtedly continue to do so as NCUA moves through the stages described above. Nevertheless, NCUA knows that the effectiveness of its new rule, if it is to bring about meaningful reform in the corporate system, will depend largely on how well it addresses the following areas: investment authority, asset-liability management, capital requirements, and corporate governance.

Investments. As more fully discussed in Part I of this testimony, the investments that corporates purchased and that caused losses in the corporate system were, in fact, permissible investments under current NCUA regulations. Accordingly, I believe that NCUA must amend the corporate rule to impose new investment standards and create significant new limitations on investment risk exposure for corporates. To be effective, the new rule must establish each of the following limitations:

- *Concentration limits, including sector limits and limits on investments with a single obligor;*
- *Restrictions on acquisition of highly leveraged investments;*
- *Limitations on the acquisition of subordinated investments;*
- *Reduced reliance on debt ratings issued by nationally recognized statistical rating organizations; and*
- *Prohibition of certain specific categories and types of investments.*

NCUA is looking to various sources in constructing relevant concentration limits, including standards for concentration limits applicable to how insurance companies invest their reserves. NCUA is likely to identify limits for various investment types, including mortgage backed securities, other asset backed securities, corporate debt, municipal bonds, and a "catch-all" miscellaneous category. The rule will also likely limit the ability of a corporate to acquire highly leveraged investments, including any that are structured in a way that concentrates the risk within a specific segment or tranche, or that create a "multiplier" effect with respect to risk. In addition, the rule will likely prohibit a corporate from relying solely on ratings issued by national rating agencies as a gauge of appropriate credit risk, and will, most likely, specify that such ratings may be used only to exclude investments that might otherwise be permissible. Some investment types should be prohibited outright, such as subordinated investments that occupy a lower position relative to risk of credit loss, collateralized debt obligations, and net interest margin securities.

Asset – Liability Management. Providing a source of liquidity for the credit union system ranks among the most important roles fulfilled by corporates. To assure that this ability is preserved and protected, NCUA intends to strengthen standards to ensure that corporates better identify, measure, monitor and control their risk exposure arising from their asset/liability mix. I anticipate that the new rule will impose, at a minimum, new liquidity requirements directing that corporates maintain sufficient cash on hand (determined as a percentage of assets) to insulate the payment system aspects of their business. NCUA will also likely establish limits on a corporate's ability to incur secured indebtedness for purposes other than liquidity. Other subjects that may be addressed in the new corporate rule include the following:

- *Average-life mismatches between assets and liabilities;*
- *Stress test modeling with explicit regulatory limits; and*
- *Exposure to early withdrawal of member share certificates.*

Accordingly, NCUA anticipates that the new rule will establish benchmarks so that cash flow mismatches will remain within an acceptable range. In addition, the rule should require testing for credit spread widening and net interest income modeling, accompanied by specific consequences when standards are exceeded. Finally, the rule should remove incentives currently available for members seeking early withdrawal of shares. If adopted this would eliminate the corporate's option to reward a member seeking to make a share withdrawal and receive a premium when rates go down. Early withdrawals should also be prohibited outright if capital falls below specified limits.

Capital. The extent and depth of the market dislocation that began in 2007 is unprecedented, and the largest corporates would have suffered significant losses under virtually any realistic capital structure. Still, some corporates had an insufficient level of capital for the level of risk they assumed, and so NCUA's minimum required levels of corporate capital need to better correlate to the risks associated with particular corporate activities. Also, to the extent possible, corporates need to reduce their reliance on contributed capital since losses in contributed capital flow downstream directly to NPCUs.

Accordingly, capital reform is an important part of any changes in the corporate system. Subject to final approval by the NCUA Board, it is my intent that NCUA will revise the capital standards corporates are subject to, ensuring they are consistent with capital and prompt corrective action standards for all other federally insured financial institutions. Elements of the new corporate rule, which NCUA will phase in over time, should include:

- *A minimum leverage ratio of core capital (including capital instruments only if they are perpetual and non-cumulative) to total assets;*

- *A requirement that a percentage of total core capital included in the leverage ratio must be retained earnings;*
- *A minimum risk-based capital ratio, based on Basel standards; and*
- *A requirement that all capital instruments qualify as capital under the Basel standards.*

As with banks, to be considered well capitalized a corporate should be required to maintain a minimum 5% core capital leverage ratio, which could be accomplished either through raising capital or shrinking assets. Increased merger activity may also follow the adoption of a leverage ratio standard, since credit unions generally do not have available to them the entire range of options to generate capital that other institutions have. NCUA also anticipates that some corporates will need to develop capital restoration plans to meet this new leverage requirement. The majority of corporates already have signed Letters of Understanding and Agreement in place with NCUA, some of which may need to be amended as this leverage requirement is phased in.

It is also not advisable to have a capital base which consists entirely of contributed capital, because, as we have seen, contributed capital results in the downstreaming of corporate credit union losses into NPCUs when those institutions can least afford those losses. Accordingly, NCUA will likely require that a significant amount of a corporate's core capital consist of retained earnings. The rule is also likely to include risk weighted capital standards, and require that all capital instruments qualify as either "tier one" or "tier two" capital in accordance with Basel.

Corporate Governance. As noted in the ANPR, successful management of a corporate requires a high level of sophistication and expertise. NCUA intends to improve corporate governance standards and thereby support and strengthen the corporate system. The new rule will likely include the following:

- *Minimum qualifications for board members;*
- *Transparency of senior management compensation arrangements;*
- *Restrictions on certain severance and retirement provisions in senior management employment contracts; and*
- *Restrictions on the number of board members who are employees or officers of other corporates.*

Corporate boards consist primarily of officers or employees of NPCUs. The new rule may establish minimum qualifications requiring that board members of corporates hold the equivalent of either a CEO or CFO position at their institution. NCUA believes that the compensation arrangements of a corporate's senior management should also be fully transparent and disclosed to the corporate's members. NCUA will also examine provisions in the Federal Credit Union Act governing certain golden parachute arrangements (12 U.S.C. §1786(t)) and may elect to use the corporate rule as a vehicle for implementation of those statutory provisions, at least as they relate to corporates. In terms of restricting corporate representation on other corporates' boards, our intention is to prevent one corporate from becoming "captive" to other corporates ostensibly in competition with it. NCUA thinks the best way to accomplish this will be to require a majority of all corporate boards to consist of representatives from entities other than corporates.

Other Components. As discussed in the ANPR, NCUA believes that the current two-tier corporate system of retail and wholesale corporates needs reform. Over time, much of the rationale that originally supported the creation of this structure has eroded. NCUA and state regulators have gradually eliminated restrictions on fields of membership among the retail corporates, so that there is now competition among the corporates for members on a nationwide level. NCUA believes, as do many of the ANPR commenters, that nationwide competition among corporates facilitates efficiency and the availability of services throughout the credit union system. Changes to the corporate rule are necessary to reflect market realities and to preserve these benefits. Elements should include:

- *Eliminating the current regulatory distinctions between wholesale and retail corporates;*
- *Permitting the continuation of national fields of membership (FOMs), but ensuring that those FOMs are more consistent between corporates; and*
- *Permitting any corporate to provide services to other corporates.*

The rule should also address the dislocation that can arise from undue concentration of member assets in corporates. I anticipate new restrictions governing the percentage of total assets any single credit union may invest with one or more corporates. This restriction would help assure that no single credit union commits too much of its business with a single corporate and that no credit union places too much reliance on the performance of the corporate sector as a whole. The rule should also restrict the amount of total assets a corporate may accept from any single member. This restriction would also protect a corporate from undue reliance on any single member.

Not all the issues in the corporate system can be resolved through regulatory reform. As noted above, this past March NCUA placed WesCorp and U.S. Central into conservatorship. These are the two largest corporates in the system, with substantial holdings of troubled mortgage backed securities. NCUA recognizes it must deal with these troubled assets as part of any meaningful corporate reform. NCUA is exploring options to address the issues at WesCorp and U.S. Central, but intends to reach a resolution that isolates losses and preserves funding alternatives within the credit union system.

Conclusion.

The nation's credit union system has proven its value to the people of the United States for over 100 years. Through good times and bad, through the Great Depression and numerous recessions, credit unions have continuously delivered high quality and affordable financial services to their members. In tough times, credit unions have worked together within the credit union system to fix systemic problems, always without any cost to taxpayers. NCUA and credit unions are again working together to resolve the current corporate crisis. While no single element of the reforms described above will be sufficient, in itself, to deal with existing problems in the corporate system, taken together we are confident they will succeed. Working collectively with credit unions and industry leaders NCUA believe the nation's credit unions will emerge from this period stronger than ever.

WRITTEN TESTIMONY
OF
WILLIAM LAVAGE
PRESIDENT AND CEO
SERVICE 1st FEDERAL CREDIT UNION
ON BEHALF OF
THE CREDIT UNION NATIONAL ASSOCIATION
BEFORE THE
HOUSE COMMITTEE ON FINANCIAL SERVICES
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

MAY 20, 2009

Introduction

Chairman Gutierrez and Ranking Subcommittee Member Hensarling, thank you for inviting me to appear before the Subcommittee today on behalf of the Credit Union National Association to discuss H.R. 2351, the Credit Union Share Insurance Stabilization Act. I am William Lavage, President and CEO of Service 1st Federal Credit Union in Danville, Pennsylvania. My credit union has $140 million in assets and we serve 18,000 members. Our original sponsor was Geisinger Medical Center in Danville. Today, Geisinger accounts for the vast majority of our members, even though we serve a number of additional select employee groups.

By way of background, CUNA is the nation's largest credit union advocacy organization, representing about 90% of our nation's approximately 8,000 state and federally chartered credit unions and their 92 million members.

We are grateful to long-time credit union champion Representative Paul Kanjorski (D-PA) for his leadership in introducing H.R. 2351. CUNA, its member credit unions, state credit union leagues, the Association of Corporate Credit Unions and others strongly support this critical and timely legislation. We also appreciate that the House passed S. 896, the Helping Families Save Their Homes Act, yesterday. S. 896 includes the provisions of H.R. 2351. We look forward to the expeditious enactment of S. 896.

Why This Legislation is Needed

Most natural person credit unions are generally performing well. Unlike many other lenders, credit unions saw their loans rise by 7% to over $575 billion in 2008, up about $35 billion from the previous year. Meanwhile, banks in this country saw loans decline about $31 billion in 2007, from $7.9 to $7.876 trillion, as reported in the Wall Street Journal March 19, 2009.

Still, no one is immune from the effect of the financial crisis and there are some natural person credit unions in states such as California, Florida, Arizona, Nevada and Michigan that are experiencing serious financial stresses, including net worth strains, primarily as a result of the collateral effects of their economic environment.

Within the credit union system, the corporate credit union network has been particularly hard hit, due in part to the impact of $64 billion in mortgage-backed and asset-backed securities.

There are currently 28 corporate credit unions, which are owned by their natural person credit union members. Corporate credit unions are wholesale financial institutions that provide settlement, payment, liquidity, and investment services to their members. The powers of corporate credit unions differ from natural person credit unions. For example, the mortgage backed and asset backed securities that are permissible investments for corporate credit unions and not generally permissible for natural person credit unions.

For the most part, the problematic securities were tripled-A rated at the time the corporate credit unions purchased them. However, as a result of the impact of the economy on the securities, and the mortgages and other assets underlying the securities, the National

Credit Union Administration (NCUA) has projected substantial credit losses relating to these securities.

Since January 29, 2009, when it announced its Corporate Stabilization Plan, the NCUA has taken a number of steps to address the problems within the corporate credit union system. These actions have included a $1 billion capital infusion into U.S. Central Corporate Federal Credit Union (U.S. Central), a National Credit Union Share Insurance Fund (NCUSIF) guarantee for uninsured shares in corporate credit unions, and programs to encourage credit unions to make, increase or maintain deposits in the corporate system. The most serious NCUA action to date has been the conservatorship of U.S. Central and Western Corporate Federal Credit Union (WesCorp), which began March 20, 2009. All of these steps have been funded through the NCUSIF, the costs of which must be borne by federally insured credit unions.

For my own credit union, I am facing potential NCUSIF costs this year of $1.04 million and will need to set aside additional capital to restore the credit union's net worth to its previous level prior to the NCUSIF charges. These are funds that would otherwise have been used to help meet the consumer, home mortgage and small business borrowing needs of my credit union's members. Credit unions fully acknowledge that we will have to pay the eventual losses on the securities held by corporate credit unions. But, having to do so all in one year or two, at a time in which a severe recession is already stressing credit union income statements, will place unnecessary burdens on credit unions and their members.

In light of the corporate credit union problems and the toll that credit unions are facing to address these problems, we think it is imperative that NCUA have the statutory authority it needs to manage insurance costs both to facilitate operation of the NCUSIF, and to help credit unions handle their NCUSIF expenses, as H.R. 2351 would provide. More specifically, H.R. 2351 includes the following provisions.

Increased Agency Borrowing Authority

Currently, the NCUSIF may only borrow up to $100 million. (This borrowing cap was established by Congress in 1970 when the NCUSIF was established.) Yet, the NCUSIF costs associated with NCUA's assistance to the corporate credit union are estimated by the agency to be $5.9 billion, far exceeding the current borrowing cap. If the limit on agency borrowing is not increased, NCUA will not be able to amortize the NCUSIF costs and as a result, federally insured credit unions will have to fund unbudgeted assessments of approximately 100 basis points in a foreshortened time frame, dramatically reducing the net worth of federally-insured credit unions. More importantly, the lower net worth levels will make credit unions less able to lend to their members, and will require unnecessarily draconian measures to restore net worth.

To make it possible for NCUSIF costs to be amortized, H.R. 2351 would raise the agency's borrowing authority and create a new, temporary, Corporate Credit Union Stabilization Fund (CCUSF) within the U.S. Treasury to be operated by NCUA. NCUA would be authorized to borrow up to $6 billion in the aggregate for the NCUSIF and the temporary CCUSF. In addition, NCUA would be authorized to borrow up to $30 billion (an additional $24 billion over the $6 billion mentioned above) through December 31, 2010, for the NCUSIF and CCUSF combined.

The increased borrowing authority will allow NCUA to use the loan proceeds from the U.S. Treasury to fund the CCUSF and current NCUSIF costs associated with assisting corporate credit unions. Federally insured credit unions would still be obligated to repay all U.S. Treasury borrowings. However, rather than paying for them in a condensed time frame, which would be the case without the legislation, credit unions would be able to fund their NCUSIF and CCUSF charges over seven to eight years, as discussed in greater detail below.

H.R. 2351 provides several safeguards on the use of the borrowing authority. Under Section 2, Treasury loans of up to $6 billion must be approved by the NCUA Board and under terms fixed by agreement between the Board and Treasury, as for the current borrowings. Any loan amounts that exceed the $6 billion general borrowing cap would require a two-thirds vote for approval of the NCUA Board and Federal Reserve Board.

The Secretary of the Treasury, in consultation with the President, would also have to approve the additional borrowing. If the agency's borrowing exceeds $6 billion, the agency must promptly provide a report to the House Financial Services Committee and Senate Banking Committee on the need for the additional funds and their intended uses.

We appreciate the leadership of Chairman Gutierrez, who originally offered an amendment during the full Committee consideration of H.R. 786 to increase the borrowing authority of the agency.

Spreading Out the Costs to Federally Insured Credit Unions of Assisting Corporate Credit Unions

Like the Federal Deposit Insurance Corporation, the NCUSIF provides account insurance, backed by the full faith and credit of the U.S. Government, to the institutions it covers. However, the NCUSIF differs from the FDIC in its structure and how it is funded. The FDIC is generally funded by assessing premiums to insured banks. The NCUSIF follows a somewhat different approach. The equity of the share insurance fund is comprised of two components, 1% of insured shares that all federally insured credit unions must maintain with the NCUSIF in the form of contributed capital and the 0.2 percent to 0.3 percent range of insured shares held in retained earnings that are funded through earnings on the fund and insurance premiums. Federally insured credit unions may be assessed an insurance premium, twice a year, to bring the NCUSIF to its normal operating level, which is set by the NCUA Board within a range of 1.2% to 1.3% of equity as a percentage of insured shares, as directed by the *Federal Credit Union Act*. The current operating level is 1.3% of insured shares. Absent passage of H.R. 2351, all of the assistance to the corporate credit unions must be provided through the NCUSIF.

As a result of NCUA's assistance to the corporate credit unions, the agency is estimating that all of the 0.3 percent retained earnings in the NCUSIF will be absorbed and must be replaced. Under current law, NCUA and federally insured credit unions replace the retained earnings in the calendar year; however, we note that S. 896 includes a provision that permits NCUA and credit unions to replenish this component over as many as eight years.

This would be accomplished through the establishment by NCUA of a restoration plan to repay the retained earnings, if the equity ratio of the NCUSIF fund falls below 1.2%, or the NCUA Board projects that it will do so within 6 months. The restoration plan must permit federally insured credit unions to pay the insurance premium costs over 8 years (or longer if the NCUA Board determines there are extraordinary circumstances.) The restoration plan must be established within 90 days and must provide that the equity ratio of the NCUSIF will be restored to 1.2% before the end of the 8-year or longer period. And, within 30 days after the NCUA Board establishes the restoration plan, the agency must publish in the Federal Register a detailed analysis of the basis for its actions.

We appreciate the leadership of Representative Kanjorski who offered an amendment during the full Committee consideration of H.R. 786 to give credit unions the ability to replenish this component over multiple years.

Also as a result of its assistance to the corporate credit unions, NCUA is estimating that about 69 percent of federally insured credit unions' 1% of insured shares deposit (1% deposit) with the NCUSIF will be depleted, as a result of its assistance to the corporate credit unions.

Federally insured credit unions have an ownership interest in the 1% deposit and it is treated as an asset on their books. As a result, it is not possible under Generally Accepted Accounting Principles (GAAP) to amortize the costs to credit unions to write-down and replenish the 1% deposit because any known and estimable impairment to the NCUSIF's 1% of insured shares must be reflected in the same accounting period by federally insured credit unions.

Therefore, it is necessary to create a new mechanism that will repay the NCUSIF and spread out the costs to federally insured credit unions associated with restoring their 1% NCUSIF deposits.

H.R. 2351 would establish a new, temporary Corporate Credit Union Stabilization Fund (CCUSF) which would allow NCUA to spread out costs to federally insured credit unions associated with replenishing their 1% NCUSIF deposits.

NCUA would be able to borrow for the Stabilization Fund from the Treasury to make expenditures only in connection with the conservatorship, liquidation or threatened conservatorship or liquidation of a corporate credit union. The new CCUSF would repay all advances plus interest to the Treasury. NCUA would have seven years from the time of the first advance to repay Treasury, unless with Treasury's approval, it extends the final repayment date. At least 90 days prior to each prepayment to Treasury, the Board will determine the amount of the upcoming repayment and if the CCUSF has a deficit, it must assess each federally insured credit union an amount in the aggregate that is necessary to make the payment to Treasury. The charge will be stated as a percent of insured shares as represented on the credit union's previous call report and will be identical for each credit union. Credit unions that fail to make their payments will be subject to penalties.

The NCUSIF would be prohibited from paying dividends to federally insured credit unions while the CCUSF Fund has an outstanding advance from the Treasury. Instead, the NCUSIF would make the distribution to the CCUSF of the maximum amount possible as long as the NCUSIF equity rate is not reduced below the normal operating level and available assets of the NCUSIF do not fall below 1%. The CCUSF would be authorized to operate with a deficit for accounting purposes, as long as future repayments are planned and all deficits are resolved prior to the termination of the Fund. The Board must submit an annual report to Congress on the CCSUF. Within 90 days of the 7th anniversary of the first advance, the NCUA Board would be required to distribute any funds or assets in the CCUSF to the NCUSIF and close the Stabilization Fund.

CUNA feels strongly that the increased borrowing authority for NCUA and the new, temporary CCUSF are imperative in view of the significant costs NCUA estimates the NCUSIF will expend to assist the corporate credit unions and the impact of those costs on the credit union system.

For perspective, the FDIC is seeking an increase in its borrowing authority from $30 billion to $100 billion, with additional authority to borrow up to $500 billion with the concurrence of the Federal Reserve Board, the Treasury Department and in consultation with the President. As credit unions continue to be affected by the economy, and in recognition of the $250,000 insurance ceiling which may be extended thereby increasing the NCUSIF's exposure, we urge the Subcommittee to support an increase in the agency's borrowing authority and the establishment of a temporary CCUSF fund that will facilitate the ability of NCUA to manage the costs associated with the assistance to the corporate credit unions and allow credit unions to pay for those costs over time.

CUNA Supports Additional Tools for NCUA

I would also like to point out that CUNA supports enhanced authority for NCUA through its Central Liquidity Facility to provide liquidity to all member credit unions, including corporate credit unions. Currently, the CLF may provide loans to natural person credit unions for liquidity purposes, but is not authorized to lend directly to corporate credit unions. To address liquidity issues within the corporate credit unions, NCUA has developed programs such as the Credit Union System Investment Program (CUSIP) under which natural person credit unions borrow from the CLF at a favorable rate, and provide the proceeds to their corporate, also at a favorable rate. While this program has been beneficial, we feel it would also be useful for NCUA to have another mechanism to ensure there is sufficient liquidity within the corporate system, which would allow corporate credit unions to obtain short-term loans directly from the CLF. We urge the Subcommittee to consider this additional authority for the CLF.

In addition, CUNA supports systemic risk authority for NCUA, on a similar basis to that provided to FDIC. While we cannot imagine that Congress intended NCUA would not have such authority, the FDIC was able to point to specific provisions in its Act to provide unlimited deposit insurance coverage for non-interest bearing transaction accounts. These accounts are often held by small businesses. Without a specific systemic risk provision, NCUA believes it has not been able to provide such insurance coverage through the NCUSIF for these accounts at credit unions, creating a disadvantage for credit unions in certain markets. Businesses often want to maintain their deposit accounts at the same institutions they receive loans. Because credit unions are not able to offer full insurance on these accounts, some small businesses have felt it necessary to turn elsewhere for their deposit and loan account needs. We urge the Subcommittee to look into this issue with NCUA.

We also note that limited assistance -- up to $10 billion -- from the Treasury's Troubled Assets Purchase Program (TARP) to the NCUSIF and to a small number of individual credit unions could be extremely important in helping to blunt the impact of the insurance expenses on the credit union system. We believe such funding, which would be fully repaid by the credit union system in a reasonable amount of time, is appropriate under the circumstances.

Some banker groups have charged that credit unions' tax exemption would be threatened if we receive such funds. In our view, this should not be the case, because any funds from TARP would be reimbursed by credit unions. Further, the Treasury has developed a TARP program specifically for Subchapter S Banks, which receive very favorable tax treatment. No one is suggesting that this step undermines their generous tax benefits the Subchapter S banks receive from the federal government. We would welcome the Subcommittee's support of TARP assistance for some credit unions—and we appreciate the House passage of H.R. 384, which would permit credit unions to count certain forms of government assistance as capital for the purposes of prompt corrective action.

Ongoing Accounting Issues

While the focus of this hearing is not accounting issues, the impact of accounting rules regarding fair value and assets that have to be reported as "other than temporarily impaired" (OTTI) have placed a heavy burden on the credit union system, particularly for corporate credit unions. At the urging of Representative Kanjorski and others, the Financial Accounting Standards Board (FASB) issued new accounting rulings April 9, 2009 that, among other things, provide only credit losses for "other than temporarily impaired" assets have to be deducted from earnings. We sincerely appreciate these efforts. However, FASB has not taken the additional step of allowing OTTI-classified assets to reflect any recovery on the assets prior to maturity or sale. We urge Congress to remain vigilant and keep the pressure on FASB to address these fair value accounting issues in a timely and effective manner.

NCUA's Actions to Assist Corporate Credit Unions

Because of the concerns of the credit union system, including my own, regarding the costs and other matters associated with the corporate credit union assistance, I want to raise a few issues about the process for handling the corporate credit unions' problems thus far and in the future. We feel it is appropriate and necessary to bring these concerns to your attention, consistent with the House Financial Services Committee's oversight role over the federal financial regulators.

Before addressing these concerns, I want to emphasize that CUNA supports rigorous supervision and balanced regulation for all credit unions to promote safety and soundness and the interests of credit union members. We also continue to support and urge Congress as it reviews regulatory reform to maintain NCUA as an independent regulatory agency for credit unions, for which House Financial Services Committee Chairman Barney Frank has indicated his support.

Even while we support NCUA's independence as the only regulatory framework to insure the unique cooperative nature of credit unions will be preserved, we also feel it is fair and appropriate to bring up to this Subcommittee the serious concerns federally insured credit unions have raised relating to the handling of the assistance for the corporate credit unions. I also want to be very clear that virtually all credit unions we have heard from understand there are critical problems within the corporate credit union system that must be addressed expeditiously. We want to work with NCUA in that endeavor.

Two major concerns of credit unions in NCUA's handling for the corporate stabilization thus far are the opaqueness of their process, and an apparent lack of creativity in seeking ways to manage and minimize what has become the largest single shock ever to the share insurance fund. Credit unions face substantial future losses on investment securities held by corporate credit unions, and these losses may have to be absorbed by the share insurance fund. That much is certain. What is much less certain is the amount of those losses, and how they will be managed, minimized and borne. In this world of uncertainty, the more transparent NCUA's processes and actions, the better for all involved. So far that transparency has been lacking.

The NCUA initially engaged the bond firm PIMCO to analyze potential credit losses in the portfolio of securities held by corporate credit unions. PIMCO's loss estimates ranged from a low of around $6 billion to a high of around $16 billion with a "most likely" estimate of $10.6 billion, which served as the basis for NCUA's judgment that the total costs to the share insurance fund of the corporate stabilization would be $5.9 billion. The estimates are highly sensitive to assumptions pertaining to a number of details surrounding mortgage- and asset-backed securities such as default rates, prepayment rates, and loss severities which in turn depend on a variety of possible assumptions about the future course of the economy, interest rates, housing markets and housing finance. Credit unions do not believe that NCUA has been sufficiently forthcoming with enough details about the nature of the securities and the analysis given the magnitude of the implications for credit unions.

NCUA follows Generally Accepted Accounting Principles (GAAP), but has not shown sufficient flexibility in dealing with some of the shortcomings of GAAP. In particular, GAAP directs NCUSIF to record a single, exact figure on its financial statements for the cost of guaranteeing deposits in corporate credit unions, which cost depends on expected losses on the securities held by the corporate credit unions. That estimated cost is the $5.9 billion figure I mentioned above. Although that may be the appropriate accounting treatment, in reality the actual losses will certainly be different from PIMCO's estimate, either higher or lower. Fully recognizing that the current expensed amount is just an estimate of an, as yet, unknown amount requires that the actions that follow from that assessment take into account the uncertain future. As I describe below, in the case of dealing with credit unions' impaired capital in corporate credit unions, the Agency has not been sufficiently flexible or creative in dealing with these very complicated issues. Facing similarly trying circumstances, the Federal Deposit Insurance Corporation has shown greater creativity in responding to and managing the crisis in a responsible manner, and apparently in a manner that does not undermine accounting principles.

Going forward, CUNA encourages the Agency to provide more information to credit unions as it becomes available on the condition of the corporate credit unions under conservatorship, on the condition of the securities held by these credit unions, on how the agency is dealing with these issues and the implications those actions will have on credit unions.

We further request that the Subcommittee encourage the agency to develop a mechanism under which credit unions with capital accounts in WesCorp and U.S. Central that may soon be depleted have the possibility of recovering some of their absorbed capital in the event that the ultimate losses on the securities held by these corporate credit unions turn out to be significantly less than expected. Credit unions have no basis to evaluate the current estimates that require the depletion of their capital deposits in these corporate credit unions. Further, if the losses on the securities turn out to be sufficient to have warranted that depletion, credit unions do not expect any replenishment of their capital out of the general future earnings of the two corporate credit unions. However, in the event the actual, realized losses on the securities turn out to be small enough such that, had they been estimated accurately, the depletion of capital would not have been required, such depletion should be returned to the relevant credit unions. We are not suggesting that the estimates are intentionally misleading or inaccurate, but we are pointing out that the estimates are uncertain, and we encourage the Agency to arrange the transactions so that appropriate measures can be taken once the uncertainty has been resolved.

Another concern for the future is that the agency set in place mechanisms to ensure that the management of the portfolio of mortgage- and asset-backed securities is handled in such a manner so as to minimize losses on the portfolio. Currently, the expected losses on the portfolio are driven by two factors: the eventual credit losses on the underlying securities, and market losses that would result from selling the securities before they mature or amortize. Currently, the market losses are likely the greater of these two components, and NCUA has insufficient reserves to sell the portfolio at current market values. The agency has assured credit unions that they have no intention of selling the securities in the near future.

However, in a few years, the market values of the securities are likely to move closer to the underlying credit losses. There is concern among credit unions that pressures will build on NCUA to sell the securities once the remaining market losses fall below the funds that the Agency has accumulated from credit unions to cover those losses. To address this issue, CUNA encourages NCUA to establish portfolio management guidelines that specify that the portfolios be managed with the goal of holding the securities for a long enough period that essentially only credit losses be incurred, and further to engage a portfolio manager to manage the portfolios under those guidelines.

CUNA's Recommendations to Transform the Corporate CU System

While CUNA is supporting additional resources for the NCUSIF and urging Congress to help with these and other issues, such as accounting concerns, that will have an impact on the credit union system including corporate credit unions, CUNA's Corporate Credit Union Task Force, which was created in 2008, has developed a range of structural and regulatory changes to the corporate credit union system. In response to NCUA's Advance Notice of Proposed Rulemaking on the corporate credit unions, CUNA filed a comment letter to the agency based on our Task Force's recommendations. Among the key principles regarding the corporate credit unions that CUNA advocates are:

- How the corporate credit union system can best meet the needs of natural person credit unions now and into the future must be the first priority in revamping the corporate credit union system.

- The core services of the corporate credit unions should focus on what natural person credit unions need the most: settlement, payment and liquidity services.

- As problems in the corporate have centered on investments, longer-term investments should be dramatically curtailed.

- Capital/net worth is a critical component in the successful operation of any credit union and federally insured corporate credit unions should maintain at least 4% net worth. If riskier activities are permitted, such as longer-term investments, there should be risked based capital requirements that support such additional activities.

- The number of corporate credit unions should be substantially reduced to a single digit number to achieve economies of scale, while promoting safety and soundness, but remain large enough to foster innovative services and service delivery.

- Corporate credit unions should have national fields of membership, which will also promote efficiency.

- Corporate governance issues are critical for all credit unions, including the corporate credit unions. To help promote effective corporate governance, corporate credit unions should be allowed to have up to 20% of their directors come from outside the credit unions system and be permitted to provide reasonable compensation to directors.

All of these changes are designed to prevent problems of the nature and magnitude that the credit union system is currently facing. We hope to work with NCUA as it develops a proposed and final regulation this year on corporate credit unions that will help minimize safety and soundness concerns but will allow corporate credit unions to operate without undue constraints that will undermine their ability to meet natural person credit unions' needs for settlement, payment and liquidity services. We hope this Subcommittee will be mindful of the development of that regulation to encourage reasonable safeguards that do not unnecessarily limit the ability of corporate credit unions to operate and provide needed services to natural person credit unions.

Conclusion

In closing, Chairman Gutierrez, Ranking Member Hensarling and all the members of this Subcommittee, we appreciate your review of these issues today. Every day, credit unions reinforce their commitment to workers, small business owners and a host of others seeking to better their quality of life by providing loans on terms they can afford and savings rates that are favorable. We look forward to working with you to enact the provisions of H.R. 2351 and ensure the credit union system continues to be an important bulwark for the 92 million individuals and small businesses that look to their credit union for financial strength and support.

NASCUS

Prepared Testimony of George Reynolds
Senior Deputy Commissioner
Georgia Department of Banking and Finance
On behalf of the
National Association of State Credit Union Supervisors
Before the Subcommittee on Financial Institutions and Consumer Credit
United States House of Representatives
May 20, 2009

NASCUS History and Purpose

Good afternoon, Chairman Gutierrez, Ranking Member Hensarling and distinguished members of the Subcommittee on Financial Institutions and Consumer Credit. I am George Reynolds, Senior Deputy Commissioner of Georgia Department of Banking and Finance and chairman of the National Association of State Credit Union Supervisors (NASCUS)[1]. I appear today on behalf of NASCUS, the professional association of state credit union regulators.

The mission of NASCUS is to enhance state credit union supervision and advocate for a safe and sound state credit union system. We achieve our mission by serving as an advocate for the dual chartering system, a system that recognizes the traditional and essential role of state governments in the national framework of depository financial institutions.

Thank you for holding this important hearing today on H.R. 2351, the Credit Union Share Insurance Stabilization Act. We appreciate the opportunity to discuss the stabilization of the corporate credit union system and ways to mitigate the impact on natural person credit unions. We also address ways to guard against the repeated convergence of issues that contributed to the current situation.

[1] NASCUS is the professional association of the 47 state credit union regulatory agencies that charter and supervise the nation's 3,100 state-chartered credit unions.

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NASCUS acknowledges the severity of the corporate credit union situation. State regulators continue to monitor the corporate credit union system and conduct ongoing dialogue with the National Credit Union Administration (NCUA). In addition, we are committed to finding ways to mitigate the impact on natural-person credit unions. State regulators are confident that by continuing to work closely with the NCUA, we will address the problems in the corporate credit union system and ensure a vibrant healthy, safe and sound credit union system in the future.

Today, the NASCUS testimony will focus on four key points:

- The State Credit Union System and Its Relationship to Corporate Credit Union Network
- Mitigating the Impact of Corporate Losses on Natural Person Credit Unions
- Preventing the Current Situation from Happening Again
- The Future of Corporate Credit Unions

State Credit Union System and Its Relationship to the Corporate Credit Union Network

State regulators play an ongoing role in the safety and soundness of the corporate credit union system. Half of the 28 corporate credit unions[2] in this country are state-chartered, and forty percent of the natural person credit unions are state-chartered. Natural person credit unions can belong to any corporate credit union, regardless of their charter, and use their services. Additionally, retail corporate credit unions invest capital and obtain services from the wholesale corporate credit union, which is federally chartered.

State regulators partner with the federal regulator to ensure appropriate oversight of natural person credit unions and the 14 state-chartered retail corporate credit unions. Cooperation and transparency are crucial in the relationship between state and federal credit union regulators to ensure adequate oversight and examination of the entire credit union system, including corporate credit unions.

[2] There are 27 retail corporate credit unions, which provide investment, liquidity and payment system services to credit unions and one federal wholesale corporate that acts as a liquidity and payment systems provider to the corporate system and indirectly to consumer credit unions.

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The corporate credit union system is unique: while belonging to a Corporate Credit Union Network (Network), each corporate is an individual entity. The "pre-network" concept of a corporate credit union, sometimes referred to as a central credit union, dates back to the 1930s, with the modern Network taking form in the 1970s. The Network was developed by natural person credit unions to provide correspondent services for credit unions.

The Network has grown and today, corporate credit unions provide credit unions with payment and clearing services, access to money transfer services such as wire facilities and automated clearinghouse transactions, and investment services. In addition, the Network serves as an important source of liquidity for credit unions and as agents on behalf of NCUA's Central Liquidity Facility (CLF) in connection with loans funded by the CLF. Corporate credit unions also provide operational and educational services to the credit union system.

Mitigating the Impact of Corporate Losses on Natural Person Credit Unions: Legislative Solutions

The affect of the corporate stabilization plan has cascaded downward and is affecting otherwise healthy, natural person credit union balance sheets.

NCUA is using the NCUSIF to stabilize the corporate credit union system. The cost of using the NCUSIF is impacting natural personal credit unions in several ways. This action impairs their 1 percent capital deposit with the NCUSIF. Additionally, natural person credit unions will be assessed a premium to bring the NCUSIF to its statutory limit required by law.

State regulators want to mitigate the impact of losses on state-chartered, natural person credit unions, thereby protecting safety and soundness of the credit union system.

Legislation

H.R. 2351 and S. 896 would mitigate the impact of corporate credit union losses on natural person credit unions. NASCUS supports natural person credit unions having the ability to expense premium costs to the NCUSIF over an extended period of time. We believe this promotes safety and soundness for the entire credit union system and provides necessary flexibility for credit unions to best serve their members.

Both H.R. 2351 and S. 896 provide the establishment of an NCUSIF restoration plan period to recapitalize the NCUSIF's equity ratio. This legislation contains provisions that the NCUA Board

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shall establish and implement a restoration plan to rebuild the NCUSIF within eight years, and provides for a longer period if the NCUA Board determines there are extraordinary circumstances.

We support providing an extension of the restoration period to the NCUSIF as provided in H.R. 2351 and S. 896. Allowing eight years would provide the flexibility credit unions need to recapitalize the NCUSIF as well as continue to serve their members. This provision also provides parity with the Federal Deposit Insurance Act's proposed eight-year restoration authority. NASCUS urges Congress to provide parity for the NCUA with the FDIC.

H.R. 2351 and S. 896 also provide for a Temporary Corporate Credit Union Stabilization Fund, which will further mitigate the impact of the corporate stabilization on credit unions. The Stabilization Fund is set up within the U.S. Treasury. It provides the NCUA with the same powers to administer the Stabilization Fund as it currently has over the Share Insurance Fund. The purpose and duration of the fund are limited, so it will provide relief specifically for corporate stabilization.

These bills also permanently increase the borrowing authority of the NCUA, as well as the Temporary Corporate Credit Union Stabilization Fund, to $6 billion in aggregate. Additionally, the bill gives NCUA emergency borrowing authority of $30 billion.

Both H.R. 2351 and S. 896 provide critical solutions for credit unions to mitigate the impact of the dislocated credit markets. The provisions will help credit unions protect their capital and liquidity in a safe and sound manner so that they can continue to serve their member needs, thereby helping to promote economic recovery for our nation.

Preventing the Current Situation from Happening Again:
Regulatory Solutions

Several things can be done from a regulatory perspective to guard against the repeated confluence of factors that contributed to the current situation. Several regulatory fixes might include the following:

- Identifying contributing factors and critically analyzing regulation.

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- Revisiting past regulatory assumptions regarding concentration and systemic structure.

- Developing improved oversight and regulation.

- Reaffirming the consultation and cooperation between state and federal regulators.

As part of its corporate stabilization efforts, several months ago the NCUA issued an Advance Notice of Public Rulemaking (ANPR) on restructuring the corporate credit union system. NASCUS believes the ANPR was an important opportunity for stakeholders of the corporate system to provide comments about restructuring the corporate system, concentration and systemic risk, risk management oversight and other issues related to the corporate credit unions going forward.

NASCUS and state regulators believe we must look beyond the structure of corporate credit unions. We believe that it was not a structural issue that caused the conservatorships of U.S. Central and WesCorp federal corporate credit unions. Likewise, NASCUS is not persuaded that field of membership or general board makeup of these corporate credit unions led directly to the safety and soundness issues of the corporate credit union system. The problems at these institutions centered on risk management, risk mitigation and supervisory issues.

Regulators must identify the contributing factors that resulted in material losses that led to NCUA's recapitalizing U.S. Central (the federal wholesale corporate credit union) and then the conservatorship of U.S. Central and WesCorp (the federal retail corporate credit union).

Going forward, we should determine how much of a role rating agencies and their credit ratings should play in determining confidence that regulators and the industry place in mortgage-backed securities purchased by corporate credit unions. As regulators, we must determine if there is sufficient stress testing on investments. We must also monitor risk management policies to determine if proper policies are in place. In addition, if the risk management function is outsourced, regulators must determine if there is ample oversight of the function. Moreover, we must ensure the internal staff at a corporate credit union are well versed in risk management and mitigation and understand the assumptions being made.

Regulators should focus on ensuring any credit union, natural person or corporate, has robust risk management and mitigation policies in place to balance its investment portfolios. Such

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policies should include adequate reserves, requisite expertise, meaningful shock testing and valuation mechanisms, and concentration limits.

NASCUS believes state agencies and the federal regulator need to discuss the regulatory oversight that allowed concentration risks to go unchallenged. From a regulatory perspective, we must identify contributing factors and critically analyze future regulation to ensure proper policies and procedures to prevent this from happening again.

NASCUS believes there is no question that after recent events corporate credit unions must retain higher capital reserves. NCUA should work with NASCUS and state regulators to develop more comprehensive capital requirements, including risk-based capital.[3]

The regulatory capital program for corporate credit unions should consider an institution's status as a wholesale or retail corporate, its mix of products and services (investment, payment systems, pass through, etc.) and establish parameters of actions for state and federal regulators if capital falls below defined thresholds.

Capital is important to both the corporate credit union system and the natural person credit unions that support the corporate credit unions. NASCUS has been urging Congress, the NCUA and the credit union system to enact supplemental capital for all natural person credit unions. During the corporate stabilization process, supplemental capital may have mitigated some of the unintended consequences to net worth categories at natural person credit unions. Additionally, access to a risk-based capital system would foster safety and soundness for the entire credit union system.

Access to Supplemental Capital

Allowing natural person credit unions access to supplemental capital would protect the safety and soundness of the credit union system and provide a tool for credit unions to use when they face declining net worth or liquidity needs.

Allowing natural person credit unions access to supplemental capital would require a simple fix to the Federal Credit Union Act authorizing state and federal regulators the discretion, when appropriate, to allow credit unions to use supplemental capital.

[3] It is significant that Congress specifically mandated NCUA consultation with state regulators when developing PCA for natural person credit unions. 12 U.S.C. 1790d [216] (l)(1). Public Law 105–219, Credit Union Membership Access Act (August 7, 1998) amended sections 102a(b), 109, 202(a)(6), 202(b), 202(c), 202(h), 205(b), 206(h), 206(k), and 207(a); repealed section 116; and added new sections 107A and 216.

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NASCUS has studied this issue and follows several guiding principles in our quest for supplemental capital for natural person credit unions. First, a capital instrument must preserve the not-for-profit, mutual, member-owned and cooperative structure of credit unions. Next, it must preserve credit unions' tax-exempt status.[4] Finally, regulatory approval would be required before a credit union could access supplemental capital. We realize that supplemental capital will not be allowed for every credit union, nor would every credit union need access to supplemental capital.

Access to supplemental capital will enhance the safety and soundness of natural person credit unions and provide further stability, especially with efforts to stabilize the corporate credit union system. Further, supplemental capital will provide an additional layer of protection to the NCUSIF thereby maintaining credit unions' independence from the federal government and taxpayers.

Risk-Based Capital for Credit Unions

Today, every insured depository institution, with the exception of credit unions, uses risk-based capital requirements to build and to monitor capital levels. Risk-based capital requirements enable financial institutions to better measure capital adequacy and to avoid excessive risk on their balance sheets. A risk-based capital system acknowledges the diversity and complexity between financial institutions. It requires increased capital levels for financial institutions that choose to maintain a more complex balance sheet, while reducing the burden of capital requirements for institutions holding assets with lower levels or risk. This system recognizes that a one-size-fits-all capital system does not work. It makes sense that credit unions should have access to risk-based capital; it is a practical and necessary step in addressing capital reform for credit unions.

Additionally, throughout our testimony, we have detailed the relationship between natural person credit unions and corporate credit unions. The complex relationship suggests the importance of transparency and cooperation between the NCUA and state regulators in the examination and supervision of corporate credit unions. State regulators need continued access to information to regulate corporate credit union activities because of their impact on all natural person credit unions. State regulators are essential elements of proper oversight and invaluable participants in working to ensure the credit union system is safe and sound.

[4] State-chartered credit unions are exempt from federal income taxes under Section 501(c)(14) of the Internal Revenue Code, which requires that a) credit union cannot access capital stock; b) they are organized/operated for mutual purposes; and without profit. The NASCUS white paper "Alternative Capital for Credit Unions ... Why Not?" addresses Section 501(c)(14).

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It is important that Congress continue to recognize and to affirm the distinct roles played by state regulatory agencies and the NCUA. The relationship between state and federal credit union regulators has been successful, in part, because the Federal Credit Union Act provides a system of "consultation and cooperation" between state and federal regulators.[5] This system creates the appropriate balance of power between state regulatory agencies and the NCUA. The intent of Congress was that credit union regulators share information and work together and in practice, we do work together.

Future of Corporate Credit Unions

As changes to the corporate credit union network are considered, it is important to recognize that each corporate credit union has its own governance, risk profile and risk management practices. Any regulatory reshaping of the Network must be carefully determined to allow any well run corporate to adapt to changes in the marketplace on its own terms. NASCUS believes the marketplace has the ability to appropriately reshape the corporate system within the regulatory framework and to determine which corporate credit unions continue as ongoing concerns.

Corporate credit unions belong to credit unions: ultimately, it will be the credit unions who decide the future of the corporate system. Regulators will provide the regulatory parameters to ensure activities are safe and sound and concentration risk is managed appropriately.

Conclusion

In closing, to ensure a strong corporate credit union system and to protect state-chartered credit unions, we encourage Congress to consider the following points:

- Pass legislation to mitigate the impact of corporate credit union losses on natural person credit unions.
- Improve regulatory oversight and require more prudent risk management expertise for corporate credit unions.
- Recognize state authority and encourage transparency between state and federal credit union regulators.
- Improve capital standards for the credit union system by allowing supplemental capital for all credit unions.

[5] The Consultation and Cooperation With State Credit Union Supervisors provision contained in The Federal Credit Union Act, 12 U.S. Code §1757a(e) and 12 U.S. Code §1790d(l).

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Further, an important ingredient of sound regulation for credit unions is consultation and cooperation between state and federal regulators. We recommend this strong working relationship continue in the future and encourage Congress to include the "consult and cooperate" language as found in the Federal Credit Union Act in appropriate legislation going forward.

NASCUS firmly believes that by working together, state and federal credit union regulators will address the problems in the corporate credit union system and ensure a vibrant, healthy, safe and sound credit union system in the future.

NASCUS appreciates the opportunity to testify today and discuss the stabilization of the corporate credit union system and H.R. 2351, the Credit Union Share Insurance Stabilization Act. NASCUS supports this legislation to mitigate the impact of corporate stabilization efforts on natural person credit unions and to guard against the repeated factors contributing to the current situation.

We welcome questions from Subcommittee members.

Thank you.

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VIA E-MAIL – regcomments@ncua.gov

April 6, 2009

Ms. Mary F. Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

RE: CUNA's Comments on Advanced Notice of Proposed Rulemaking for Part 704, Corporate Credit Unions

Dear Ms. Rupp:

On behalf of the Credit Union National Association, we are filing this letter with the National Credit Union Administration to address the future of the corporate credit union system, in response to NCUA's Advance Notice of Proposed Rulemaking (ANPR) on the corporate credit unions. By way of background, CUNA is the largest credit union advocacy organization in this country, representing approximately 90% of our nation's 8,000 state and federal credit unions, which serve 92 million members.

This letter was developed under the auspices of CUNA's Corporate Credit Union Task Force (CCUTF), which is chaired by Terry West, President and CEO of VyStar Credit Union in Jacksonville, FL. The other members of the Task Force are: Robert Allen, President and CEO of Teachers FCU in Farmingville, NY; Dale Dalbey, President and CEO of Mutual Savings Credit Union in Birmingham, AL; Tom Gaines, President and CEO of the Tennessee Credit Union League; Frank Michael, President and CEO of Allied Credit Union in Stockton, CA; David Rhamy, President and CEO of Silver State Schools CU in Las Vegas, NV; and Jane Watkins, President and CEO of Virginia Credit Union in Richmond, VA. Kris Mecham, CUNA Chairman and President and CEO of Deseret First FCU in Salt Lake City, UT; Tom Dorety, Immediate Past CUNA Chairman and President and CEO of Suncoast Schools FCU in Tampa, FL; and Harriet May, CUNA Vice Chairman and President and CEO of GECU in El Paso, TX, serve as ex officio members.

While the restructuring of the corporate credit union system is very significant, most federally insured credit unions have been focused on, and are extremely concerned about, the costs they must bear in connection with the National Credit Union Share Insurance Fund's (NCUSIF) assistance for corporate credit unions.

These include the write down and replenishment of their 1% NCUSIF deposit, their insurance premium costs, and the impairment of their capital in their corporate credit unions that many credit unions must reflect. This letter addresses both the immediate issues related to NCUA's recent actions on corporate credit unions and the longer-term restructuring questions, beginning with a summary of the issues and our responses.

I. Summary of CUNA's Views

A. Costs of NCUA's Assistance for Corporate CUs

- The costs associated with the NCUSIF's assistance to the corporate credit unions, along with the impairment of credit unions' capital in their corporate credit union, will have a deleterious impact on the credit union system if they must be absorbed in one year.
- CUNA and the Corporate Credit Union Task Force have urged NCUA since January 28th, when it announced the NCUA Corporate Credit Union Stabilization Plan, to provide a mechanism to allow credit unions to spread out their costs, as the Federal Deposit Insurance Corporation (FDIC) has done for banks. Most in the credit union system feel the Board should not have announced the Corporate Stabilization Plan in January without having developed a mechanism to spread out the costs to credit unions.
- CUNA will continue to do all we can to attain a better outcome for credit unions than the current situation, including through assistance from the U.S. Treasury
- However, CUNA strongly commends the Board for its work on its new legislative proposal, which is addressed below, and we want to continue to work with NCUA and others to achieve amendments that will help mitigate the impact of the costs on credit unions.
- We particularly support NCUA's proposal to establish a Stabilization Fund that, if approved by Congress, could borrow from the Treasury to fund assistance to corporate credit unions, which will help spread out the costs to federally insured credit unions.
- NCUA's proposed amendment calls for $6 billion in borrowing authority for the new Stabilization Fund – a figure very close to NCUA's estimated $5.9 billion in insurance costs to fund the assistance to the corporate credit unions. Additional authority for NCUA to borrow up to $18 billion in emergencies, with approval from the Treasury and others, is also pending. CUNA agrees these changes are an improvement over the current $100 million in borrowing authority for the agency. However, we support seeking greater borrowing authority for the NCUSIF or the new Stabilization Fund, to give NCUA and credit unions even more flexibility in dealing with insurance costs, to the extent efforts to pursue higher borrowing authority do not

jeopardize our ability to achieve legislation that will mitigate the impact of the costs on the credit union system

- CUNA also supports statutory amendments that will give credit unions up to eight years to pay for insurance costs.
- In addition, we are advocating an amendment that will allow the Central Liquidity Facility to provide liquidity directly to the corporate credit unions, as another tool to assist NCUA and the credit union system.
- From the time NCUA announced it had contracted with PIMCO to analyze the securities held by corporate credit unions, CUNA has been urging NCUA to provide adequate information to credit unions from the report, particularly the assumptions and analyses regarding losses.
- Credit unions need the information so they can determine the reasonableness of the agency's cost estimates relating to the losses within the corporate credit unions and the resulting insurance assessments to credit unions. These assumptions have an additional negative impact on many credit unions because of the impairment of their capital in their corporate, which will not be addressed by the new legislation.
- Until now, credit unions have had no way to assess the agency's assumptions regarding these costs.
- On April 3, 2009, NCUA Board Chairman Michael Fryzel announced that key information from the PIMCO report will be provided to the members of the two corporate credit unions placed into conservatorship, WesCorp and U.S. Central, and the state regulators. A summary of significant information from the report will be provided to others. He also announced that the two corporate credit unions are each obtaining an independent, third-party assessment of the credit losses for their asset-backed securities.
- CUNA commends this NCUA Board action and wants to continue to work with NCUA to achieve transparency regarding the agency's corporate credit union actions to the fullest extent possible and appropriate. This includes providing sufficient information regarding the PIMCO report and other key information to the entire credit union system so that credit unions will be able to evaluate whether the agency's credit loss evaluations and the various agency decisions, which were based on those evaluations, are reasonable.
- The actual losses that credit unions will ultimately have to bear from the asset- and mortgage-backed securities in corporate credit union portfolios will depend in large part on those securities being held until they have been largely amortized. While NCUA has indicated it plans to hold the securities to maturity, we believe it is imperative that NCUA take additional steps to assure credit unions that, unless it can work with Treasury to obtain a favorable price well above the current market value for the securities before

they mature, these securities will not be sold prior to almost complete amortization.

- A number of accounting issues have arisen since the announcement of the assistance to the corporate credit unions and the two corporate credit union conservatorships. The issues generally relate to when and to what extent natural person credit unions must report the impairments of their NCUSIF deposits and capital in their corporate credit unions. While credit unions have raised concerns about NCUA's accounting guidance in Accounting Bulletin (AB 09-2) CUNA appreciates the latest agency memorandum to examiners, which indicates credit unions will not be dealt with harshly if they do not report their NCUSIF deposit impairment on their March 31, 2009 statements. CUNA wants to continue working with NCUA to achieve as much clarity for credit unions on these issues as possible.

B. Corporate CU Services

- Corporate credit unions should focus on core services of settlement, payment systems, and meeting the short-term investment and liquidity needs of their member credit unions.
- Long-term investments have created serious problems for the corporate credit union system that natural person credit unions are now having to pay for.
- Corporate credit unions should not be permitted to concentrate their assets in long-term, on-balance sheet investments because such activities have resulted in some corporate credit unions taking on more risk than they could reasonably manage or mitigate.

C. Corporate CU Structure

- The current two-tier corporate system has outlived its utility and characteristics of the system that have facilitated undue risk taking, reduced credit unions' capital, and created inefficiencies must be eliminated.
- Requiring corporate credit unions to focus on payments, settlement and short-term investments and liquidity will reduce the number of corporate credit unions.
- CUNA is not advancing a specific number of corporate credit unions, and it is not recommending that NCUA determine the appropriate number.
- However, the number of corporate credit unions should be small enough to reflect operational efficiencies that benefit natural person credit union members.

- Further, a single interface between the corporate credit union system and key payment and settlement entities could be extremely beneficial as it could combine and strengthen credit unions' ability to influence governmental and private sector decisions in these areas that impact credit unions' operations.
- At the same time, having more than one corporate credit union to provide one or more of the core services for natural person credit unions could prove to be beneficial.
- In any event, the number of corporate credit unions should be sufficient to promote innovation among the remaining corporate credit unions and avoid a potential single point of failure that could arise if only one corporate credit union survives.

D. Capital of Corporate CUs

- Corporate credit unions' Tier 1 capital requirement should be at least 4% and could be as high as 6%. Risk- based capital should also be required.
- Natural person credit unions that use corporate credit unions should be required to maintain contributed capital in their corporate.

E. Corporate Governance

- Corporate credit unions should be permitted to have outside, non-member directors who can contribute diverse experiences to a corporate credit union's board.
- A corporate should be permitted to have up to 20 percent of its board comprised of non-members and also be permitted to pay a non-member director a reasonable director's fee.
- Such fees should be comparable to those paid by federally-insured depository institutions of similar asset size, so long as the amount of this fee and any other director compensation is fully disclosed to the corporate credit union's members.

F. Fields of Membership

- CUNA supports allowing corporate credit unions to have national fields of membership.

II. Discussion of CUNA's Recommendations and Key Points

A. NCUA's Corporate Credit Union Stabilization Program

Few, if any, issues confronting the credit union system are of greater significance than the National Credit Union Administration's handling of the financial predicament that has confronted the corporate credit union system. That is because the economic, political, and member/public relations issues associated with NCUA's decision to place U.S. Central Corporate Federal Credit Union and Western Corporate Federal Credit Union into conservatorship, as well as the NCUSIF assistance to corporate credit unions announced in January which combined are now estimated to cost federally insured credit unions $5.9 billion, will have serious ramifications now and well into the future – particularly if credit unions have to write down these costs all in one year.

While issues relating to the funding of the assistance to the corporate credit unions are not part of the ANPR, our members have urged us to address these matters in the context of this comment letter.

Our members feel strongly that they should be able to spread out as much of their insurance costs as possible over time, particularly in light of the fact that the FDIC determined that a special insurance premium amounting to 20 basis points of insured deposits, on top of the regular 12 to 16 basis point premium, was too much for the banks to fund in one year. Following complaints from the banks, the FDIC reduced this year's special assessment to 10 basis points, for a total of 22 to 26 basis points. – far less than the insurance costs credit unions are expected to pay.

Since January 28, 2009, when NCUA announced the corporate assistance, CUNA and its Corporate Credit Union Task Force have been urging NCUA to adopt alternative approaches for funding the assistance that will help spread out the program's insurance costs to credit unions.[1] As we have discussed with the agency, while some options would take time to implement, in our view NCUA has the legal authority to spread out all premium costs that restore the NCUSIF equity to over 1% of insured shares.[2] NCUA does not need approval from Congress or Treasury to take this action.

We do applaud NCUA's efforts to develop legislation that will help spread out all the insurance costs for credit unions, and we want to work with the agency as well as the National Association of State Credit Union Supervisors, the National Association of Federal Credit Unions, and the National Federation of Community Development Credit Unions to achieve its passage as quickly as possible. In particular, CUNA supports:

- The new proposal developed by NCUA to establish a Stabilization Fund that could borrow from the U.S. Treasury to fund assistance to corporate credit unions; and
- Legislation that will give credit unions up to seven or eight years to pay for insurance costs and increase the authority of the NCUSIF to borrow from the Treasury in exigent circumstances.

NCUA's new proposal calls for $6 billion in borrowing authority for the Stabilization Fund, absent exigent circumstances. This level is very close to the $5.9 billion estimate NCUA has indicated the insurance costs to credit unions will e as a result of the corporate credit union assistance. Pending legislation will allow NCUA to borrow up to another $12 billion from Treasury in emergencies, but only with the approval of Treasury and others. These proposed limits are improvement over the current $100 million borrowing authority, and we appreciate efforts to expand NCUA's borrowing authority. However, we hope to partner with NCUA to pursue even higher borrowing authority for the NCUSIF or the new Stabilization Fund, as long as such efforts will not place the legislation to mitigate the impact of the costs on the credit union system at risk.

We also support an amendment to allow the Central Liquidity Facility to provide short-term loans directly to corporate credit unions, and we would welcome NCUA's support to include this amendment in the Stabilization Fund legislation.

While CUNA commends the Board for its work on this proposal, our members feel the Board should not have announced the assistance for the corporate credit unions without providing an acceptable mechanism to spread out the costs credit unions will bear – particularly given the impact of these costs on credit unions in some areas, which have already been weakened by the current economic crisis.

The decisions NCUA has made this year regarding the corporate credit union system are among the most monumental the agency has ever made and will continue to impact the entire system for years to come. Since NCUA announced it had contracted with PIMCO to analyze the securities held by corporate credit unions, CUNA has been urging NCUA to provide adequate information to credit unions so they could determine the reasonableness of the agency's cost estimates relating to losses within the corporate credit unions and the resulting insurance assessments to credit unions. These assumptions will have an additional negative impact on many credit unions because of the impairment of their capital in their corporate credit unions, which will not be addressed by the new legislation.

Until now, credit unions have had no way to assess the validity of the agency's assumptions regarding these costs. On April 3, 2009, NCUA Board Chairman Michael Fryzel announced that key information from the PIMCO report will be provided to the members of the two corporate credit unions placed into conservatorship, WesCorp and U.S. Central, as well as to the state regulators. A summary of significant information from the report will be provided to others. He also announced that the two corporate credit unions are each obtaining an independent, third-party assessment of the credit losses for their asset-backed securities.

CUNA commends this NCUA Board response and wants to continue to work with NCUA to achieve transparency regarding the agency's corporate credit union actions to the fullest extent possible and appropriate. We are hopeful that sufficient information regarding the PIMCO report will be provided to the entire credit union system so that credit unions will be able to evaluate whether the agency's credit loss evaluations and the various agency decisions, which were based on those evaluations, are reasonable.

The estimate of the costs to the share insurance fund for the Corporate Stabilization Program ($5.9 billion as of this writing) is indeed just that, an estimate. The ultimate losses derived from the portfolio of securities held by the corporate credit unions depends on two factors: the actual credit losses on the securities (determined by various and complicated future economic events), and the extent to which the securities might be sold prior to full amortization, resulting in market losses that could exceed the eventual credit losses.

Credit unions understand that they will eventually be responsible through the share insurance fund for the actual credit losses in the portfolio, and that the extent of these losses is currently unknowable. They are, however, very concerned that they might be forced to pay additional market losses resulting from premature sales of the securities.

Credit unions understand that the agency would not be in a position to sell the securities so long as the market losses exceed the available reserves (including the $5.9 billion added to available funds). Yet they are anxious that once the Fund is "in the money," counting existing capital and the additional $5.9 billion, the pressure on the agency to sell the remaining securities and lock out any future increases in losses could become acute.

NCUA has released a statement and Board members have indicated the agency's intent to hold the securities until maturity, which is positive. However, credit unions continue to seek assurances that the agency will be able to withstand pressure and hold the securities until they are largely amortized or essentially back to par, unless it is able to work with the Treasury to sell corporate credit unions' assets before they mature at favorable prices well above their current market values.

Finally, a number of accounting issues have arisen since the announcement of the assistance to the corporate credit unions and the two corporate credit union conservatorships. These relate to when and to what extent natural person credit unions must report the impairments of their NCUSIF deposit and capital in their corporate credit unions. These are not easy issues and questions remain concerning appropriate accounting treatments. The latest agency memorandum to examiners indicates credit unions will not be dealt with harshly if they do not report their NCUSIF deposit impairment on their March 31, 2009 statements. CUNA appreciates this development and wants to continue working with NCUA to achieve as much clarity for credit unions on these accounting issues as possible in a timely fashion.

B. CUNA's Corporate Credit Union Task Force

Prior to NCUA's issuance of the ANPR, in recognition of the serious issues facing corporate credit unions, CUNA formed the Corporate Credit Union Task Force (CCUTF) earlier this year.[3] The CCUTF has met a number of times to consider the issues outlined in the ANPR. The role of the Task Force has been to review the current corporate credit union network, assess the nature and scope of the problems within the network, and to develop forward thinking, feasible recommendations to address those problems responsibly.

A key objective for the Task Force in crafting its recommendations for reform of the corporate system has been to ensure the interests and needs of natural person credit unions for payment and settlement services as well as short-term liquidity are met. The Task Force also sought to develop recommendations that would mitigate the risks associated with corporate credit union operations. This letter reflects their views, as well as those of numerous credit unions and Leagues that responded to this request for comments. It has also been reviewed by CUNA's Governmental Affairs Committee as well as our Board of Directors, and it represents CUNA's official positions. CUNA's GAC and Board reflect a broad cross-section of American's credit unions by size, region, and charter types.

C. The Future Structure of the Corporate System

CUNA is aware that the first task the Board must deal with regarding corporate credit unions is stabilizing the system in the near-term. Once that has been accomplished, a transition to a revised system will be necessary. In our comments that follow, we deal only with what the optimal system should be, not with the mechanism of how to transform the current system to its future form.

Corporate credit unions have historically fulfilled an important role by providing natural person credit unions with settlement and payment services. In addition, corporate credit unions have played a major role in meeting both the short- and long-term investment needs of credit unions, and in providing short- and medium-term loans to credit unions.

As a result of the current economic crisis, many corporate credit unions have experienced a dramatic reduction in the market value of their investments. These reductions have been exacerbated by the virtual shutdown of the market for mortgage-backed securities and other investments. This series of events has severely undermined the stability of the corporate credit union system.

CUNA believes that the future structure of the corporate credit union system must be very different from the one that has evolved over the past three decades, if it is going to be well positioned to meet the needs of member credit unions while successfully managing risk. Changes must be made to the number of tiers within the system, the number of corporate credit unions, the services they provide, their capitalization, and governance. Ultimately, the driving factor must be the set of services that it is essential for credit unions to receive from a corporate system. Once those services are established, the remaining issues concerning the future of the corporate system can be determined.

D. Services Provided by the Restructured Corporate System

Services currently provided by corporate credit unions can be divided into the following mutually exclusive categories:

- Payment processing, such as checks, ACH, Wire Transfers, ATM and debit, etc. Payment processing involves transferring information about financial transactions (payments) so that the financial institutions of both the payor and payee know when to debit or credit whose account by how much. In addition to corporate credit unions, a number of other vendors provide various types of payment processing to credit unions.

- Settlement. This function involves transferring money among financial institutions to settle out the net effect of inflows and outflows resulting from payments and other credit union transactions. Settlement requires a financial institution charter, and maintaining accounts at a Federal Reserve Bank and other financial institutions to execute and manage the transfer of funds.

- Short-term investments. This function involves investments credit unions make with overnight funds, and other short-term investments. The limit for short-term investments could be as short as three months, but no longer than one year.

- Short-term liquidity. This function involves providing short-term lending to credit unions. This could be for as short as overnight to facilitate a credit union's settlement accounts, to slightly longer to allow credit unions to adjust to monthly or seasonal liquidity flows.

- Long-term investing. This involves portfolio investing for credit unions with longer maturities than defined as short-term investing.

- Long-term liquidity. This involves longer term lending to credit unions. Credit unions typically undertake such borrowing not to adjust to net loan and savings inflows, but instead for asset/liability management purposes such as holding longer term loans.

Among these services, **the** core function that credit unions require from a corporate credit union system is settlement. Settlement provides the point of contact of the credit union movement with the rest of the financial system, and we believe that credit unions would be placed at a significant disadvantage if they had to individually arrange for settlement services with correspondent or Federal Reserve banks. Settlement is a function that can be performed efficiently at scale by a very few endpoints for the entire credit union system.

Whatever institution provides settlement services must also be able to provide short-term investing and liquidity. A credit union's settlement account is its overnight, interest-earning account. Access to overnight or very short-term loans is also necessary for settlement.

These then comprise the core functions that the future corporate system must be designed to offer: settlement, short-term investments, and short-term liquidity.

Payment processing is often linked to settlement and short-term liquidity and investment, and there can be efficiencies in a corporate credit union offering various types of payment processing. CUNA supports payment processing as a permissible activity for corporate credit unions because it is often so closely related to settlement.

E. Long-Term Investments and Concentrations in Such Investments for Corporate Credit Unions Should Be Curtailed and Managed

Many believe that, in the future, corporate credit unions should not be engaged in longer-term investing (on the corporate credit union's balance sheet). Long-term investments and liquidity are not crucial to the settlement function, and longer-term investing has been the source of most of the serious problems in the corporate system, such as the failure of CapCorp and the current problem of unrealized losses on illiquid securities. Corporate credit unions could in theory successfully and safely engage in providing term investment services on their own balance sheets, but permissible investment activities would need to be more restrictive than current regulations, and corporate credit unions would have to be required to hold capital levels far in excess of what credit unions would likely be willing to provide. A number of credit unions believe there is not enough capital in the credit union movement to fund long-term investments on the balance sheets of both natural person and corporate credit unions. Another consideration in removing long-term investing from corporate credit unions is the fact that it is feasible for credit unions to meet their long-term investing needs through means already available outside corporate credit union balance sheets: securities purchases, mutual funds, investment advisory services, and deposits in other financial institutions.

Corporate credit unions have traditionally held relatively broad authority to engage in long-term (greater than one year) investing. Absent such authority, corporate credit unions likely would not have been able to obtain the favorable yields they have been able to garner and pass on to their member credit unions. Obtaining such yields, however, has not been without substantial risk for the corporate credit union system. Furthermore, as the system is currently structured, losses stemming from these long-term investments can have a direct, detrimental affect on natural person credit unions and on other aspects of the corporate credit unions' operations, including payment, settlement, and liquidity services.

Part 12 C. F. R. 704.5(c), Investments, of NCUA's Rules and Regulations, describes corporate credit unions' current basic investment activities, which CUNA supports for corporate credit unions going forward. These include investments in:

- Securities, deposits, and obligations set fort in Sections 107(7), 107(8), and 107(15) of the Federal Credit Union Act;
- Deposits in, the sale of federal funds to, and debt obligations of corporate credit unions, Section 107(8) institutions, and state banks, trust companies, and certain mutual savings banks;
- Corporate CUSOs;
- Marketable debt obligations of certain corporations; and
- Domestically-issued asset-backed securities.

Additionally, Appendix B to Part 704, Expanded Authorities and Requirements, details the riskier investments that qualifying corporate credit unions can purchase, such as long-term investments rated no lower than BBB. NCUA attempts, in Appendix B, to mitigate the risk involved with these investments by mandating that participating corporate credit unions fulfill "additional management, infrastructure, and asset and liability requirements." Corporate credit unions seeking to purchase long-term, Appendix B investments must first be granted prior approval—which can subsequently be removed at any time—by NCUA.

Even with the above-mentioned safeguards, the risk to the entire credit union system associated with certain short-term investments, such as asset-backed securities, and long-term investments in Appendix B may be too great. The possible long-term investments enumerated under the appendix include those that have resulted in much of the corporate credit unions' unrealized losses and other-than-temporarily impaired assets.

However, while removing the authority to invest in riskier long-term investments will reduce the risk to the entire credit union system, such limitations will also have the consequence of reducing the earning potential of natural person credit unions. Many of these credit unions have already been heavily invested in their corporate credit unions.

In light of these concerns about investments and concentrations of assets in a limited number of investment vehicles, CUNA encourages NCUA to consider the extent to which longer-term, riskier investments for corporate credit unions should be dramatically curtailed and whether alternative means for natural person credit unions to invest in some additional investments should be pursued.

To be clear, CUNA encourages NCUA to consider supporting natural person, not corporate, credit unions to have the option to purchase alternative investments vehicles, such as those authorized under the proposed Credit Union Regulatory Improvement Act (CURIA). Section 301, Investments in Securities by FCUs, of CURIA, for example, would authorize the Board to permit natural person credit unions to purchase certain investment securities as the Board sees appropriate. Allowing natural person credit unions to make such investments through providers outside the credit union system would have the effect of moving some of the risk away from the National Credit Union Share Insurance Fund (NCUSIF). Any investment losses suffered by natural person credit unions would affect the NCUSIF only if they substantially reduce the credit unions' net worth, and even then might be covered by FDIC insurance if the investment provider were a federally insured bank.

F. The Number of Corporate Credit Unions and Their Tiers

Once the primary function of corporate credit unions has been determined to be the provision of settlement services and closely related activities, the issue of the appropriate number of corporate credit unions can be addressed. Processing payments and handing settlement are scale businesses, so the number of corporate credit unions can be sharply reduced to a very small number. With only a few, large corporate credit unions serving natural person credit unions, there would no longer be the need for a two-tiered structure.

Achieving economies of scale and enhancing the ability of the credit union system to influence and interface with the settlement process supports a good case for having only one corporate credit union. Under this approach, the remaining corporate credit union would serve as the settlement gateway from the entire credit union movement to the rest of the financial system on settlement and related issues. The principles and recommendations outlined in this letter would not preclude that outcome.

However, economies of scale are not the only considerations regarding the number of corporate credit unions into the future. Beneficial effects on pricing and innovation are also needed, which may be harder to attain without some direct credit union-market competition.

In any event, CUNA does not support having NCUA determine the appropriate number of corporate credit unions. Rather, we believe that as a result of capital requirements and limits on services and investments, member credit union owners should contemplate no more than a very limited number of corporate credit unions – small enough to take advantage of economies of scale, but large enough to foster innovation and competition.

G. Corporate Credit Union Capital

CUNA believes that a corporate credit union's minimum Tier 1 capital ratio should be at least 4 percent and possibly higher, up to 6 percent over a reasonable period of time. If NCUA chooses to institute risk-based capital requirements for corporate credit unions, such risk-based capital should be comparable to those applicable to similarly situated FDIC-insured depository institutions. CUNA believes that market factors, such as corporate credit unions' payments system counterparties' concerns about counterparty risk, will generally encourage corporate credit unions to maintain higher net worth ratios of up to 6 percent.

CUNA believes, however, that risk-based capital requirements are likely unnecessary for corporate credit unions if NCUA adopts CUNA's recommendations for limitations on corporate credit unions' business and investment activities, as outlined above. CUNA believes that if NCUA has concerns regarding the amount of capital necessary to cover corporate credit unions' payment and settlement risks, it should consider requiring a payment and settlement risk reserve that would be deducted from Tier 1 capital but included in Tier 2 capital to some degree, as discussed below under "4."

1. Components of Corporate Credit Union Capital and Capital Ratios

CUNA believes that a corporate credit union's regulatory capital should consist of Tier 1 capital—reserves and undivided earnings (RUDE) as well as paid-in capital (PIC)—and Tier 2 capital. Corporate credit union Tier 2 capital should include member capital shares (MCS) as well as subordinated term debt and general reserves such as the "Reserve for Payment and Settlement Risk" discussed below.

CUNA also believes that Tier 2 capital for corporate credit unions could include subordinated term debt because U.S. low-income credit unions count subordinated debt—in the form of a "secondary capital account"—as regulatory capital, because Canadian credit unions count subordinated debt as regulatory capital, and because U.S. federal banking regulators and the Basel Committee on Banking Supervision also consider subordinated debt to be Tier 2 capital.[4]

2. Require PIC Investments for Access to Corporate Services and Lengthen MCS

CUNA believes that natural-person credit unions should make meaningful PIC investments in a corporate in order to use that corporate credit union's services, that the callable period of member capital shares (MCS) should be extended to five years from three years, and that corporate credit unions should be permitted to write down called MCS over five years rather than two.

In general, a natural person credit union's required PIC investment in a corporate credit union should be calculated based on the investing credit union's asset size, and its required MCS balance should be based upon its usage of the corporate credit union's services.

Requiring natural person credit unions to contribute perpetual or 20-year-callable PIC to their corporate and extending the callablility and write-down periods for MCS will strengthen the corporate credit unions' capital positions. In addition, required PIC subscriptions by a corporate credit union's natural person credit unions members would give all users of a corporate credit union's services an increased incentive to monitor their corporate credit union's management and business activities.

CUNA also believes that NCUA should consider making natural person credit unions' PIC investments transferable from one corporate to another, so long as the PIC of state-chartered corporate credit unions would not be considered "capital stock" within the meaning of 26 U.S.C. § 501(c)(14)(A). CUNA believes that transferable PIC would not likely qualify as "capital stock" so long as it is clearly designated as a form of deposit.

3. Risk-Based Capital

If NCUA restricts corporate credit union business and investment in the manner suggested by CUNA, above, risk-based capital requirements for the corporate credit unions would likely not be necessary. However, if such investments are not restricted, then risk-based capital for corporate credit unions engaging in those activities is essential.

If the Basel II risk-based capital rules developed by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the FDIC applied to corporate credit unions,[5] a corporate credit union that is invested solely in U.S. Treasury securities and other highly-rated fixed-income investments[6] would have an 8 percent risk-based capital ratio requirement that would generally be lower than the amount of capital required by a 4 percent net worth ratio.

Stated another way, risk-based capital requirements for corporate credit unions would generally be irrelevant—if corporate credit unions were subject to a minimum 4 percent net worth ratio and a minimum 8 percent risk-based capital ratio—until a corporate made significant investments in assets in the Basel II 50 percent risk category or the 100 percent or 150 percent risk-weight categories.

Most potential corporate credit union investments would be placed in the 50 percent (or a higher) risk-weight category if they are rated below AA-.

4. Reserves for Payment and Settlement Risk

CUNA believes that corporate credit unions should hold sufficient capital to be insulated from operational risk arising from payment and settlement activities, possibly including a capital charge deducted from Tier 1 capital to establish appropriate reserves for payment and settlement risk.

Under the Basel II standardized approach to controlling for payment and settlement operational risk, a corporate credit union's payments and settlement risk capital charge would be 18 percent of the three-year average of the corporate credit union's annual gross income from payment and settlement activities.

CUNA believes that this reserve for payment and settlement risk should be deducted from Tier 1 capital but should be included in Tier 2 capital (possibly subject to a percentage of assets limitation, such as 1% of assets) because, under Basel II rules, this reserve would qualify as Tier 2 capital. This reserve qualifies under Basel II as Tier 2 capital because it is a general reserve that does not reflect a known loss or deterioration in a particular asset, and would be available to meet unidentified losses that may subsequently arise.

H. Corporate Credit Union Governance

CUNA believes that the boards of directors of corporate credit unions should generally consist of representatives of their member natural person credit unions, but that a corporate credit union should have the option of having up to 20 percent of its board consist of non-member directors if its members so choose.

CUNA wishes to note that most current corporate credit union directors are "outside directors" or "independent directors" within the common definitions of those terms, since they are not officers of the corporate credit union and, as individuals, have no direct financial interest in the corporate.[7] These directors are typically representatives of the corporate credit unions' member natural person credit unions, none of which are individually able to exert control over a corporate because credit unions' one-member-one-vote voting structure prevents the concentration of voting power in the hands of a few. CUNA believes, therefore, that comparisons between the governance of corporate credit unions and that of for-profit, stock corporations with significant numbers of "inside directors"—i.e. those who are also officers of the corporation and/or who represent the interests of controlling stockholders—are inapt.

Outside directors "are considered important because they are presumed to bring unbiased opinions to major corporate decisions and also can contribute diverse experience to the decision-making process."[8] CUNA believes that the outside directors representing the interests of corporate credit unions' member natural person credit unions currently serving on corporate credit unions' boards already bring unbiased opinions to major corporate decisions. CUNA does not believe that corporate credit unions should be required to have outside, non-member directors because most current corporate directors already qualify as "outside directors" and because non-members may have interests that do not align with those of the corporate, or with the interests of credit unions generally.

CUNA believes, however, that corporate credit unions should be permitted the option to have non-member directors who can contribute diverse experience to a corporate credit union's board, if the corporate credit union's member natural person credit unions so choose. A corporate should be permitted to have up to 20 percent of its board be composed of non-members and also be permitted to offer a non-member director a reasonable director's fee comparable to that paid by federally-insured depository institutions of similar asset size, so long as the amount of this fee and any other director compensation is disclosed to the corporate credit union's members. The NCUA Board has authority under section 120(a) of the Federal Credit Union Act to authorize a corporate to have non-member outside directors and to pay those non-member directors a reasonable fee.

I. National Fields of Membership

CUNA believes that the small number of corporate credit unions that operate in the future should continue to have national fields of membership. Without overlapping fields of membership, there would be no competition among corporate credit unions, and therefore, no need to have more than one. CUNA understands that competition among corporate credit unions may have in the past contributed to thinly capitalized institutions, operating on very low margins, taking significant investment risks. However, with sufficient capital requirements and with investments restricted to only those necessary to perform short-term investing and liquidity for credit unions, CUNA believes that competition among corporate credit unions would provide for better service to credit unions in a context of full safety and soundness

III. Conclusion

Thank you for the opportunity to comment on the ANPR regarding the structure and operations of corporate credit unions. The issues raised in the ANPR are critical for all credit unions, and changes to the current corporate credit union structure, as outlined above, are imperative to ensure the continued vitality of both corporate and natural person credit unions.

The entire credit union system is now in the process of absorbing the recent losses associated with corporate credit union investments. Although these losses will never be fully recovered, we strongly believe that adopting the principles and recommendations outlined in this letter will demonstrate the resiliency of the credit union system while helping to help ensure the unfortunate events involving the corporate credit unions are never, ever repeated.

As stated above, CUNA supports NCUA's efforts to help spread out credit unions' costs associated with the Corporate Credit Union Stabilization Plan, including the proposed legislation, and to address related issues. We hope NCUA will work with us to:

- Seek statutory authority for the CLF to provide liquidity directly to corporate credit unions;
- Achieve higher statutory borrower authority for the agency beyond current proposals, to the extent such an effort does not jeopardize the success of any other aspect of the legislations;
- Reassure credit unions it plans to hold asset-backed securities of the two conserved corporate credit unions until maturity; and
- Help clarify remaining accounting issues concerning the reporting of impaired capital in corporate credit unions and the write-down of the NCUSIF deposit.

We also welcome NCUA's announcement that a separate review of the securities of U.S. Central and WesCorp has been undertaken, and that the agency will make critical information from the PIMCO available to the credit union system. We look forward to reviewing the data.

We also recognize that the restructuring of the corporate credit union system will continue to be a difficult process. CUNA and the CCUTF will be available throughout this process to meet with NCUA to work through these very complex issues. Meanwhile, please do not hesitate to contact us at (202) 638-5777 if you have any questions about our comments.

Sincerely,

Daniel A. Mica
President and CEO

Terry West
President/CEO of VyStar CU
and CUNA Corporate Credit Union Task Force Chairman

[1] In addition to spreading out the insurance costs, CUNA has urged NCUA to pursue other means to mitigate credit unions' costs associated with the Corporate Stabilization Program, including funds from the Treasury's TARP, amendments to the FCU Act to allow the CLF to provide loans and capital to corporate credit unions, and options consistent with accounting rules that allow the agency to deviate from GAAP in recognizing its own costs to the NCUSIF.

[2] The 1% deposit is required to be replenished in the year the NCUSIF incurs an impairment that would reduce the Fund balance to below 1%, under the Federal Credit Union Act. However, for the premium costs which fund the .30% balance in the Fund, NCUA has authority under the FCUA to spread those costs out over time. 12 U.S.C. §§ 1782(c)(1)(A), (c)(2).

[3] Members of the Task Force are Terry West, chair, Robert Allen, Dale Dalbey, Tom Gaines, Frank Michael, David Rhamy, and Jane Watkins; Kris Mecham, Tom Dorety , and Harriet May serve as ex officio members.

[4] See, e.g., 12 C.F.R. Appendix A to part 325.

[5] See, e.g., Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 Fed. Reg. 43982 (proposed July 29, 2008). FDIC-insured depository institutions are subject to a 3 percent absolute leverage ratio on Tier 1 capital and a risk-based capital ratio of 8 percent. See 12 C.F.R. § 325.3; see also, e.g., 12 C.F.R. §§ 3.6, Appendix A to 12 C.F.R. pt. 3 (national banks).

[6] I.e., generally AAA to AA- rated investments. These investments are typically assigned a risk-weighting of 20 percent, meaning that their value for risk-based capital calculation purposes is discounted to 20 percent of face value. See, e.g., Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework, 73 Fed. Reg. 43982, 43991-98 (proposed July 29, 2008).

[7] E.g., "Outside Director," John Downes & Jordan Elliot Goodman, Dictionary of Finance and Investment Terms (Barron's, 7th ed. 2006) ("[A] member of a company's board of directors who is not an employee of the company."); id. at "Independent Director" ("Independent Director: same as Outside Director"); Black's Law Dictionary 473 (7th ed. 1999) ("A non-employee director with little or no direct interest in the corporation.").

[8] "Outside Director", Dictionary of Finance and Investment Terms.

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