STATEMENT

OF

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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

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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

[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

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[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.