# The NCUA REPORT

NATIONAL CREDIT UNION ADMINISTRATION

SEPTEMBER 2011 NUMBER 9 WWW.NCUA.GOV


## HIGHLIGHTS



# 2011 STABILIZATION FUND ASSESSMENT SET; FUTURE COSTS PROJECTED LOWER

In August, the NCUA Board set the 2011 Stabilization Fund assessment at 25 basis points for a total of $1.96 billion. The Board based the 2011 assessment of 25 basis points on projected fixed, near-term net cash flow needs with the expectation that future assessments would be considerably lower. Additionally, there is no anticipated 2011 Share Insurance Fund premium.

Funds generated from the 2011 assessment, along with borrowed funds from the U.S. Treasury, will pay the principal and interest on maturing medium term notes issued by corporate credit unions and guaranteed by the Stabilization Fund, and the guaranteed notes issued to the bridge corporate credit unions.

As required by law, the Board took into consideration the potential negative impact of this assessment on credit union earnings by annualizing June 30 call report figures.

NCUA will distribute invoices with the 2011 assessment due by Sept. 27. Credit unions should expense the assessment in September and report the full expense on their Sept. 30 call reports.

**New Quarterly Modeling Improves Outlook**—Recent economic volatility poses challenges in what was already a difficult forecasting environment. Attempting to project the performance of the approximately 4 million loans that comprise the securities underlying the NCUA Guaranteed Notes (NGNs) remains challenging. The performance of these loans ultimately feeds into the corporate loss estimates.

Through a competitive bid process, NCUA engaged securities expert firm, BlackRock, to conduct quarterly modeling of losses and cash flows on the securitized assets in the NGNs. BlackRock's new estimates forecast

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## STABILIZATION FUND PROJECTIONS

| STABILIZATION FUND | PREVIOUS ESTIMATE (IN BILLIONS) | CURRENT ESTIMATE (IN BILLIONS) |
|---|---|---|
| Range of Total Projected Assessments | $8.3 – $10.5 | $5.2 – $9.5 |
| Less 2009 and 2010 Assessments | ($1.3) | ($1.3) |
| Net Range of Post 2010 Projected Assessments | $7.0 – $9.2 | $3.9 – $8.2 |
| Less 2011 Assessment | ($2.0) | ($2.0) |
| Net Range of Post 2011 Projected Assessments | $5.0 – $7.2 | $1.9 – $6.2 |

Chairman's Corner

# REGULATING IN OUR MODERN MARKETPLACE

Debbie Matz
*Chairman*

We live in a lightning-fast age of 24/7 e-commerce where electronic transfers move billions of dollars in a nanosecond. Changes in the financial marketplace come rapidly, often on a breathtaking scale. Such fast-paced changes affect not only Wall Street but also Main Street financial entities—including credit unions—and how you conduct your day-to-day business.

All federal financial regulators are charged with monitoring wave upon wave of financial innovations and ingenious schemes to syndicate the inherent risks in financial products. Regulators must modernize or implement new regulations whenever appropriate to ensure safety and soundness.

> *"Better regulation, which provides for flexibility and empowerment within a framework that manages risk and maximizes safety and soundness, can lead to growth and improved service. That is my goal."*

We've all seen how a mortgage-backed securities crisis that originated on Wall Street crippled the global economy, caused the failure of five corporate credit unions and threatened the entire credit union system. New risks to the credit union system will undoubtedly emerge in this financially interconnected age.

Clearly, over the past 15 years, many credit unions have grown more complex and engage in more sophisticated risk-taking ventures. While this is generally a positive trend for the credit union industry, it presents a significant challenge to the regulator. A new product, service, tool or relationship may seem innocent enough to an individual credit union—but when utilized by many credit unions, could pose significant risk to the National Credit Union Share Insurance Fund (NCUSIF).

For instance, one or two credit unions participating in a relatively small business loan may not be an issue. But when a large number of credit unions participate, and the loan amounts to several million dollars, the stakes change. As we have experienced, each of these credit unions can be brought down by poor underwriting, a lack of due diligence, or a sudden change in the economic climate.

Likewise, a Credit Union Service Organization (CUSO) performing back-office functions for several small credit unions likely poses little risk to the NCUSIF. But, for example, when a CUSO originates speculative commercial loans or steers subprime, indirect auto loans to dozens of credit unions, it is another story. A poorly run CUSO poses significant risk to each of the member credit unions.

As the products, services, tools and relationships used by credit unions evolve, so must NCUA rules if we are to remain effective in protecting the NCUSIF. For this reason, I have asked NCUA staff to review our rules for those in need of modernization. Once the Board reviews all recommendations, we will be offering proposals for comment over the next 12-18 months. You will find that our intent is to target only those products, services, tools and relationships that pose the greatest threats to the NCUSIF, and affect only those credit unions most likely to cause a loss—which would be borne by other credit unions.

President Obama, in issuing Executive Order 13579, ordered independent regulatory agencies to periodically review existing significant regulations for those that may be "outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them" accordingly. Regulatory modernization is one step NCUA is taking to comply.

This Executive Order recognizes that better regulation is not always synonymous with less regulation. Clearly, many credit union officials are frustrated by rules they perceive as outdated, confusing or counterproductive. Our intent is to improve the regulatory environment by ensuring that NCUA rules are in sync with the modern marketplace, clearly written, and targeted to areas of risk.

Better regulation, which provides for flexibility and empowerment within a framework that manages risk and maximizes safety and soundness, can lead to growth and improved service. It can create a brighter future for credit unions. That is my goal.

Debbie Matz

Debbie Matz

# Board Actions Aug. 29, 2011

## NCUA GUARANTEED NOTES OVERSIGHT COMMITTEE ESTABLISHED; PROPOSED CORPORATE RULE TO RELIEVE REGULATORY BURDEN

The National Credit Union Administration (NCUA) Board convened a special open meeting at the agency's headquarters Aug. 29 and unanimously approved three items:

- The 2011 Temporary Corporate Credit Union Stabilization Fund Assessment to raise $1.96 billion to pay principal and interest on maturing notes guaranteed by the Stabilization Fund;
- The creation of an NCUA Guaranteed Notes (NGN) Securities Management and Oversight Committee to monitor the maintenance of the initiative; and
- Proposed technical amendments to the corporate credit union rule, relieving regulatory burden and clarifying certain provisions.

The Board also received a briefing on newly revised lower loss projections for the Stabilization Fund, and anticipated future assessments on the credit union industry.

### 2011 Assessments Set; Future Stabilization Fund Outlook Improves with New Quarterly Model

The Board set the 2011 Stabilization Fund Assessment at 25 basis points and received new quarterly projections on the fund. These new projections lower estimated future Stabilization Fund Assessment for credit unions. See the story on page 1 for more details.

### Board Creates Oversight Plan to Maintain NCUA Guaranteed Notes

To ensure the achievement of the objectives for the NGN initiative and sound management of the Stabilization Fund, the Board approved the creation of the NGN Securities Management and Oversight Committee and associated staff positions. In approving the delegation, the Board charged the group with ensuring that NCUA fulfills its ongoing responsibilities of the corporate resolution process in a manner that promotes transparency, efficiency and accountability.

The NGNs require long-term monitoring, managing, and reporting on very complex transactions for at least the next 10 years. Creation of the NGN Securities Management and Oversight Committee addresses the need for long-term, streamlined management of the NGN initiative's daily activities.

Comprised of the directors of the Asset Management and Assistance Center, the Office of Examination and Insurance, and the Office of the Chief Financial Officer, the group will initially be chaired by Larry Fazio. The Temporary Corporate Credit Union Stabilization Fund will fund costs associated with staffing and operating the committee, including consultants.

### Technical Changes to Corporate Rule Relieve Regulatory Burden

The Board approved a proposed rule with eight technical amendments to the

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## UPCOMING RULE DUE DATES

| TITLE | PART/ SECTION | STAGE | LAST BOARD ACTION | DATE EFFECTIVE | COMMENTS DUE DATE |
|---|---|---|---|---|---|
| Corporate Credit Unions | 704 | Proposed Rule | Aug. 29, 2011 | N/A | Oct. 6, 2011 |
| CUSOs | 712 & 741 | Proposed Rule | July 21, 2011 | N/A | Sept. 26, 2011 |
| Remittance Transfers | 701 | Interim Final | July 21, 2011 | July 27, 2011 | Sept. 26, 2011 |
| Accuracy of Advertising & Notice of Insured Status | 740 | Final Rule | May 19, 2011 Jan. 1, 2012* | June 27, 2011 & | N/A |
| Corporate Credit Unions | 704 | Final Rule | April 21, 2011 | May 31, 2011; Jan. 1, 2012**; April 29, 2013*** | N/A |

*Mandatory Compliance Date; **Amendments to §§ 704.2 & 704.15; ***Addition of § 704.21

## RISK IN PLAIN SIGHT

### BY GIGI HYLAND, NCUA BOARD MEMBER

Risk seems to be lurking around every corner these days—interest rate risk, credit risk, liquidity risk. In recent years, NCUA has issued a great deal of guidance in these areas. But how about the risk in plain sight? What about member risk?

By member risk, I don't mean the risk that your members won't pay off their loans. No, I'm speaking about a much more subtle form of risk—the risk of not reaching out to serve your entire membership.

This is not a new theme. For years, I've encouraged credit unions to stop and review their membership. Does it look the same as it did 5 or 10 years ago? If not, what is the credit union doing to respond to the shifting demographics? Does the board of directors, management, and staff reflect the diversity of the membership? Are the products and services responsive to today's membership? Are you meeting your diverse membership where the members are in life or where you would prefer them to be?

I believe credit unions have a tremendous opportunity to serve members who are not well-served or not served at all by other financial service providers. The tide, however, is turning against this opportunity.

Because the word subprime continues to carry a nasty connotation from this recent crisis, credit unions (with a little push from examiners) are relying more extensively on credit scoring models to decide who gets a loan and who doesn't. This dynamic fundamentally alters the credit union tradition of including character as part of the lending decision.

Not all members will have credit scores that suggest they are a good credit risk, yet those members are the very ones who may most need to borrow. In fact, according to FICO™, 25 percent of prospective members are "thin record" or "no-score" and will not be scored by the credit bureaus. One approach to rectify this would be for credit unions to have at least one consumer loan type that is not scored, but evaluated by hand using the five Cs of credit—character, capacity, capital, collateral, and conditions.

Service to members is the hallmark of credit unions. But it doesn't mean that credit unions can choose to serve some members and not choose to serve others. That goes against the very nature of cooperative finance. Be aware of this risk in plain sight and do everything you can to effectively manage it.

## STRIKING BALANCE: TO REGULATE CUSOs OR NOT?

### BY MICHAEL E. FRYZEL, NCUA BOARD MEMBER

Nothing generates comments or piques the interest of the credit union industry more than when its regulator proposes a rule that is quickly labeled as controversial. Such is the response to NCUA's proposed amendments to NCUA's rules on Credit Union Service Organizations (CUSOs) and the related portions of the deposit insurance rules (Parts 712 and 741).

In the letters I have read thus far, I have seen comments that state the proposed regulation will "stifle a CUSO's ability to innovate and provide collaborative solutions," "single-handedly kill the one competitive advantage the credit union industry has," and "dramatically change for the worse" the overall effect on a credit union's ability to invest in CUSOs.

While these comments are poignant and definitive in expressing strong views in opposition to the proposed rule, the majority of the letters, while opposing the rule, address why the rule is not needed, should not be adopted and, if a rule is needed, how it can be improved.

Everyone should understand the proposed rule was crafted in response to financial harm that was caused to some credit unions as a result of their investment in CUSOs and CUSO subsidiaries. This is what a regulation is supposed to do: When a problem is discovered, a solution must be put in place.

The proposed rule in no way implies CUSOs are bad, and it is not meant to stifle, make things worse, or kill competitive

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The NCUA Report is published by the National Credit Union Administration, the federal agency that supervises and insures most credit unions.

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## FUTURE STABILIZATION FUND ASSESSMENTS PROJECTED LOWER (FROM PAGE 1)

a wider range than previous projections given this ongoing economic volatility.

Based on BlackRock's June 30 model projections, actual performance of the legacy assets, and updated projections in monetizing the other assets in the asset management estates, the cumulative total projected Stabilization Fund costs for the corporate resolution program range from $5.2 billion to $9.5 billion.

As reflected in the table below, by deducting the $3.3 billion already assessed in 2009 and 2010, and subtracting the 2011 assessment, the projected remaining assessments over the life of the Stabilization Fund are between $1.9 billion and $6.2 billion.

These projections do not include any potential recoveries from settlements or litigation, which would reduce the cumulative total assessment costs.

**2012 Outlook**—Through NCUA's strong management of Stabilization Fund assets, near-term projected cash needs prior to 2013 have fallen from $2.94 billion to $2.7 billion. After the 2011 assessment pays the majority of this obligation, the projected requirement for 2012 cash needs will be around 9 basis points of June 30 insured shares, or approximately $700 million.

## BOARD ACTIONS (FROM PAGE 3)

regulation governing corporate credit unions (Part 704) in an effort to clarify the Board's intent related to certain provisions, relieve regulatory burden where warranted, and facilitate access to liquidity.

Previously, the Board decided that a daily calculation of net risk-weighted assets was unnecessary and over burdensome. The first technical amendment would remove a reference to this calculation unintentionally left in during the prior amendment.

Additionally, the Board proposed excluding Central Liquidity Facility (CLF) stock subscriptions from the definition of net assets because the credit risk of carrying this asset is negligible. Excluding stock subscriptions from the definition encourages continued CLF participation by corporate credit unions and thus facilitates a systemic liquidity benefit to natural person credit unions.

To reduce regulatory burden, the Board also determined that violations of the weighted average life of a corporate credit union's assets should not be subject to capital category reclassification. The proposed rule therefore requires the preparation of investment action plans for such violations.

Within the proposed rule, the Board further changed the phrase "the sum of its retained earnings and paid-in capital" to simply "core capital," defined elsewhere in the regulation. Additionally, the proposal changes the date instruction on Model Form D in Appendix A. These proposed technical changes align with prior amendments adopted in 2010.

Regarding the requirements for investment action plans, the proposed rule clarifies what events could trigger preparing such a plan. Finally, the Board corrected the title of the executive compensation section to harmonize with earlier changes to the text.

The proposed rule only applies to corporate credit unions. The Board seeks comments within 30 days of publication in the *Federal Register.*

**All open NCUA Board meetings are tweeted live. Follow @TheNCUA on Twitter. Board Action Memorandums are available online at www.ncua.gov under *Agency Leadership/NCUA Board and Actions/Draft Board Actions*. NCUA posts rule changes online at www.ncua.gov under *Resources/Legal/Regulations, Legal Opinions and Laws*.**

## BOARD PERSPECTIVES (FROM PAGE 4)

advantage. It is written to protect credit unions from future harm, prevent additional losses to the share insurance fund, and spot problems as early as possible.

Is it the best rule? Is it written in a way to handle the concerns of the regulator? Maybe not. Can it be improved? Maybe it can. Should it be withdrawn and never see the light of day? Maybe.

These are things we want to know from you. If you have strong feelings one way or the other, if you want to see action taken, a better rule or no rule at all, then you need to voice your opinion. You should tell NCUA how you feel, and most importantly, you need to provide constructive comments that will help us do what is best for the industry as a whole.

You run credit unions, NCUA does not. Our job is to safeguard the savings of the 91 million credit union members. Our jobs are different, but each of our different jobs enhance the industry in which we work and aim to make the day-to-day operations of credit unions better and easier and, most important, safer, so that next year and 10 years from now and 50 years from now people will be able to use financial products and services that are going to help them, not hurt them.

So as we work through this rule making process, together we can strike the right balance.

John D. Worth
*Chief Economist*

## Director's Column: Office of the Chief Economist

# ASSUMPTIONS MATTER WHEN PROJECTING EARNINGS GROWTH FOR STRATEGIC PLANNING

In developing strategic plans, credit unions need to think critically about how fast earnings have to grow to remain adequately capitalized, while the economy is growing slowly and regulations are potentially changing. Our analysis suggests that—under realistic assumptions—average or slightly above average earnings growth over the next several years maintain a well-capitalized credit union industry. Nevertheless, there is a great deal of variation at the individual credit union level. Credit union managers and boards, therefore, need to understand what happens under a variety of scenarios before finalizing strategic plans.

Three often mentioned factors that would affect credit union earnings growth are reductions in interchange fee income, higher assessments for corporate resolution, and potential increases in net worth requirements. To explore the impact of these factors, NCUA simulated five-year outcomes for the entire universe of federally insured credit unions starting with 2011 first quarter financial results. First, assume a rate for asset growth. Next, for each credit union, project the required annual net income growth *before assessments and reduction due to interchange losses*. This leaves the net worth ratio *after assessments and reduction in income due to interchange* above the assumed regulatory net worth requirement. It would not result in a decline from the credit union's 2010 net worth ratio.

Using reasonable assumptions, our results suggest that the credit union industry can experience healthy asset growth, while maintaining more than adequate capitalization. It can do this with a rate of annual increase in earnings of less than 7 percent per year, just slightly above historic norms during an economic recovery.

While the approach provides a framework for thinking through various scenarios, as in any analysis of this type, assumptions drive the results. Individual credit unions must both start with reasonable assumptions and consider a number of scenarios. The key assumptions for our analysis included:

- **Asset growth rate**—Assume a 7 percent annual asset growth rate, a figure just above the five-year asset growth rate experienced during the recovery and expansion from the last recession. The assumed growth rate directly affects required growth in earnings. For example, raising the asset growth rate from 7 percent to 10 percent increases the required earnings growth rate from under 7 percent to more than 16 percent.
- **Assessments**—The NCUA Board recently approved a 25 basis point Stabilization Fund assessment on insured shares in 2011. At the same time, NCUA announced outside experts have lowered best estimates of projected future assessments over the remaining life of the Stabilization Fund to between $1.9 and $6.2 billion (See page 1 for story). Assuming the midpoint of this range and evenly spreading costs between 2012 and 2020 results in annual assessment rates between 5 and 6 basis points, although the anticipated 2012 assessment will be somewhat higher because of short-term cash flow needs. Increasing projected future assessment to the upper bound of the estimate raises the required earnings growth rate about 0.8 percentage points—from under 7 percent to just over 7.5 percent.
- **Net worth requirements**—While NCUA cannot rule out increases in capital requirements, especially for institutions holding large concentrations of risky or complex assets, there is no reason to believe the leverage ratio of 7 percent capital to total assets required in Prompt Corrective Action for credit unions needs to be raised. In addition, it is safe to assume that any changes to the risk-based requirement would be targeted and phased in over reasonable periods. To capture this possibility assume net worth requirements in 2015 are 7.5 percent. Increasing the assumed net worth requirements has a dramatic impact on the results. For example, raising the assumed net worth requirement to more than 10 percent nearly triples the required earnings growth rate.
- **Interchange and Fee Income**—Potential reductions in fee income resulting from new interchange rules are difficult to forecast. For the baseline analysis, assume that fee income is reduced by 5 percent of the 2010 fee income every year after 2012, reducing fee income by roughly a quarter of 2010 income in 2015. If the annual reduction increases from 5 percent to 20 percent of 2010 fee income, the required earnings growth rate jumps to more than 10 percent.

The bottom line is that under *realistic* assumptions, return to historic rates of returns should provide ample earnings to maintain credit unions' net worth. This simple approach highlights that credit unions should develop their strategic plans using reasonable baseline assumptions and considering a wide range of alternatives in a structured way.

Larry Fazio
*Director,*
*Office of Examination and Insurance*

## Director's Column: Office of Examination and Insurance

# THE REAL RISK TO THE NCUSIF

Some have attempted recently to extrapolate potential losses to the National Credit Union Share Insurance Fund (NCUSIF) by taking the assets of all CAMEL 4 and 5 credit unions—assuming they would all fail—and applying the average loss ratio of 17 percent to come up with unfounded and inflated losses to the insurance fund.

It's easy to use speculative assumptions to quickly concoct a scary number in these admittedly challenging and uncertain times. But, let's get to the real math for the NCUSIF by putting some context on probable losses and reserve needs.

Reserving and loss-projection methodologies are based on historical data applied to assumptions about (1) the probability of default and (2) the loss given default.

First, the probability of default is well below 100 percent of CAMEL 4 and 5 credit unions. They are not all going to fail and all inflict a loss to the NCUSIF. That's very improbable.

So, what's a realistic estimate? Based on a two-year look back, which covers the most stressful period for credit unions in recent history, the annual failure rate is 3.7 percent for CAMEL 4s and 27 percent for CAMEL 5s. Keep in mind that failure is defined as a credit union that causes a direct loss to the NCUSIF. A higher percentage of CAMEL 4s and 5s do cease operations (*e.g.*, are merged) or are restored to health at no cost to the NCUSIF due to regulators' timely intervention and diligent resolution efforts to protect member deposits.

NCUA also includes failure probabilities for CAMEL 2s and 3s when calculating loss reserves. By multiplying the assets by CAMEL rating with the corresponding annual failure rate, the probable assets subject to failure is $3.46 billion.

To continue estimating reserve needs, take the $3.46 billion in assets subject to failure and multiply it by the 10-year adjusted average loss of 17.73 percent to get an initial estimate of $613 million. Apply a 90 percent confidence interval for an upper bound estimate, and the reserve need reaches $1 billion. Finally, adjust for other accounting requirements and you arrive at the $1.2 billion now in the NCUSIF reserves. This amount is based on conservative assumptions.

Admittedly, this math is a simplification of the actual process. NCUA's actual loss reserving methodology is much more complex in using confidence intervals, scenario analyses, and simulations. (For a full description, see footnote 6 of the 2010 NCUSIF audit at **www.ncua.gov**.)

Ironically, some think the NCUSIF is over-reserved. NCUA runs these numbers quarterly and makes adjustments to the reserve balance both up and down. And, of course, the process and annual year-end figures are audit tested by independent third parties.

On top of reserving for probable losses on credit union failures, NCUA conducts extensive stress testing on the NCUSIF equity ratio. The latest projections indicate the fund is performing well. Even under a pessimistic scenario, at this time it appears that an NCUSIF premium or a restoration plan will not be statutorily required in 2011.

One caveat: Dramatic changes to world events or an extraordinary failure of a very large credit union could create added stresses. Various economic uncertainties reinforce the importance of sound risk management in credit unions, a balanced prudential regulatory regime, and capable supervision by federal and state regulators.

Nevertheless, the NCUSIF is in fact strong and well-reserved based on a reasonable range of possible scenarios. The real math supports this conclusion.

## FAILURE RATES BY CAMEL CODE

| JUNE 30, 2011 | ASSETS | FAILURE RATE | ASSETS SUBJECT TO FAILURE |
|---|---|---|---|
| CAMEL 2 | $401,788,518,020 | 0.12% | $482,146,222 |
| CAMEL 3 | $146,879,010,221 | 0.51% | $749,082,952 |
| CAMEL 4 | $36,543,117,160 | 3.70% | $1,352,095,335 |
| CAMEL 5 | $3,242,701,637 | 27.00% | $875,529,442 |
| | | TOTAL | **$3,458,853,951** |


Office of Consumer Protection Report

# COMPLYING WITH RISK-BASED PRICING RULES

If a credit union offers risk-based-pricing (RBP) loan programs and uses information contained in a consumer report to set or adjust the price and other terms of credit, it must comply with the RBP notice requirements under the Fair Credit Reporting Act (FCRA) recently revised by the Federal Reserve Board.

The new RBP notice rules were set for a number of reasons. Consider consumers who have an error on their credit report but do not know about it. Ultimately, a lender could turn them down for a new car loan. This rule change, however, ensures that consumers will be notified of the denial and provided an opportunity to investigate their credit reports in order to fix the error.

Alternatively, lenders could have just choose to offer higher interest rates and grant the loan. This practice would hurt consumers because they would be paying a higher interest rate due to a credit report error about which they do not know. The new rule seeks to avoid such situations, allowing consumers to conduct due diligence on their own credit report and fix any errors of which they previously had no knowledge.

## Current Requirements

The Dodd-Frank Act amended, effective July 21, 2011, the FCRA to require the disclosure of credit scores and related information in RBP notices if a credit score is used in setting the material terms of credit. As a result, the Federal Reserve Board recently issued new rules for credit unions and other lenders to follow when using RBP. As revised, the new rules require lenders to do several things:

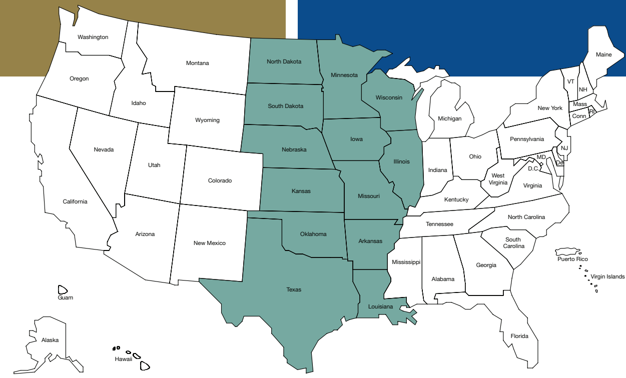
- A credit union must provide a RBP notice when using information contained in a consumer's report to grant or extend credit to the consumer on material terms less favorable than those extended to other consumers. Material terms generally mean the annual percentage rate (APR) or item having the most significant financial impact on the consumer.
- A credit union may use a direct comparison, credit score proxy, or tiered pricing method to determine the consumers to which it must provide a RBP notice.
- For outstanding loans, a credit union must also provide a RBP notice if the credit union performs an account review and increases the consumer's APR based on information contained in the consumer's report.
- The regulation contains specific content that must be included in the RBP notices, such as the consumer's right to request a free credit report. To facilitate compliance, the appendix to the regulation provides model notices and the use of a model notice results in a safe harbor.
- The timing for delivery of the RBP notice to the consumer depends on whether the transaction is closed-end credit, open-end credit, or based on an account review. In no instance, however, may the RBP notice be provided before the lending decision is communicated to the consumer.
- The regulation contains a few exceptions for when a RBP notice is not required. The most notable exception is if a credit union provides consumers who apply for credit with a disclosure containing their credit score.
- If a credit union elects to use a credit score disclosure instead of the RBP notice, the credit union must ensure the disclosure contains all of the other required information outlined in the regulation. The appendix to the regulation also provides model credit score disclosures.

Any credit union using RBP notices will likely need to incorporate these new requirements into existing procedures. If a credit union used credit score disclosures instead of RBP notices, it will not be affected as the disclosures already contain the credit score information.

For more information about the new risk-based pricing rules, including all of the model forms, visit **www.federalreserve.gov/bankinforeg/reglisting.htm#V**.

## Region IV Report

# CREDIT UNION SERVICE ORGANIZATION RISK




REGION IV

Credit unions have increasingly relied on Credit Union Service Organizations (CUSOs) to deliver products or services not offered in house. Like other areas of operation, NCUA examiners will be interested in knowing how the credit unions are monitoring and protecting against the related risks.

NCUA has focused a great deal of attention on third-party-vendor reviews during the past few years. Also, NCUA currently has a proposed rule that would add new requirements for CUSOs related to financial reporting and subsidiary CUSOs. The impetus for the added requirements and enhanced supervisory attention is to provide greater protection to credit unions and to safeguard the NCUSIF.

Due diligence is a key issue. NCUA examiners will carefully evaluate the due diligence credit union management performed prior to establishing a CUSO relationship. The due diligence process for deciding to use a CUSO should be no less stringent than that for selecting other third-party vendors.

At a minimum, credit union management should review the CUSO's:

- Financial strength—Is the CUSO self-sufficient or does it require ongoing funding? Who supplies the funding?
- Ability to honor client contracts—Is the CUSO a growing concern? If the CUSO fails, who inherits the contract liability?
- CUSO management—Does the CUSO management have the expertise and desire to make changes if necessary?
- Staff expertise—Do the employees have the required knowledge to support the CUSO's offerings?
- External risk reviews and audits—Is the CUSO complying with regulatory requirements? Does the CUSO obtain its own risk reviews or compliance audits?
- Policies and procedures—Do the CUSO's policies complement those of the credit union?
- Data security—How does the CUSO protect member information?
- Regulatory compliance—Does the CUSO comply with all regulatory agencies who oversee different venues, such as the SEC, FINRA, state insurance regulators, and other federal and state supervisors?
- Legal structure—Is the CUSO legally formed to protect the owners from corporate veil concerns? Are there legal opinions supporting the structure? If the structure has changed since origination, has a new opinion been obtained?
- Reporting and monitoring—Does the CUSO provide sufficient reports so the credit union can manage the relationship and accurately record activity?

There is no difference in the vendor management for a CUSO than that for a non-related vendor. Credit union management should hold the CUSO accountable for performance just as it would any other vendor.

Even though credit unions rely on CUSOs to fulfill services, the credit union must still have sufficient internal knowledge to understand the CUSO's offerings. For example, credit unions use CUSOs to originate and underwrite member business loans. If credit union staff do not have basic knowledge of the underwriting, cash flow analysis, collateral risks, risk ratings, geographical markets and business models of commercial borrowers, the CUSO could very well make a recommendation that goes beyond the credit union's internal risk tolerance and ability to monitor the loan going forward. A credit union therefore must have its own internal controls and policies that can limit risk, and a credit union should ensure those risk-tolerance measures are upheld for all third-party relationships, including CUSOs.

Credit unions with investments in CUSOs must monitor financial performance to protect their investment, too. In the last few years, a number of CUSOs have failed, causing irreparable harm to the credit union owners. Credit unions must have a realistic approach to cutting operational funding if a CUSO is suffering losses to the detriment of a credit union's net worth.

Credit union management should further review the CUSO's business plan and hold the CUSO accountable to perform in accordance with the plan. If the CUSO is unable to meet the business plan, credit union management will need to evaluate their continued involvement. In this instance, NCUA examiners would expect to find documentation supporting management's decision to provide additional funding of CUSO losses.

While CUSOs fill important roles, credit unions must understand a CUSO relationship is not risk free. A credit union must manage the CUSO relationship as it would any other vendor and take appropriate actions if performance does not meet contractual requirements or fails to make good business sense.

Financial Stability Oversight Council Report

# KEY MESSAGES FOR CREDIT UNIONS FROM THE FSOC ANNUAL REPORT

Created by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Financial Stability Oversight Council (FSOC) is charged with identifying risks to U.S. financial stability, promoting financial market discipline, and responding to emerging threats. The NCUA Chairman serves as one of ten voting members of the FSOC, along with the Treasury Secretary, the Chairman of the Federal Reserve Board of Governors, other federal banking and financial regulators, and an insurance expert.

In late July, the FSOC released its first annual report. The report provides an overview of the macroeconomic environment, developments in the financial services industry, regulatory reform developments, and potential emerging threats. The report also includes several recommendations.

With respect to emerging threats, the FSOC annual report identifies several potential dangers:

- With the rise of international banking and the important role of foreign banks in U.S. financial markets, global risks add to the complexity of the financial system.
- Market uncertainty exists about Europe and the impact of the evolving sovereign debt crisis.
- Financial sector exposure to the weakness in the residential and commercial real-estate sectors continues.
- Market participants have a temptation to "reach for yield" by extending maturities or taking seen or unseen risks during a sustained period of low interest rates.

The FSOC annual report also outlines four recommendations:

**Heightened Risk Management and Supervisory Attention**—The report identifies areas where financial institutions should increase risk management attention and regulators should enhance supervisory attention. The recommendations that are most critical for the credit union system include:

- Establishing robust capital, liquidity and resolutions plans;
- Enhancing resilience to overcome unexpected interest rate shifts, including robust processes for measuring and mitigating exposure to a range of interest rate scenarios; and
- Maintaining underwriting standards and undertaking due diligence on emerging financial products.

**Reforms to Address Structural Vulnerabilities**—The report recommends structural reforms to address vulnerabilities in tri-party repurchase agreement arrangements, money market funds, and the mortgage servicing system.

**Housing Finance**—The report also urges fundamental reform of the housing finance system to strengthen the system and encourage the return of private capital.

**Financial Regulatory Reform**—Finally, the report notes that the FSOC's member agencies remain committed to the implementation of financial services regulatory reform.

While the FSOC is new, it is already an important institution that is critical to ensuring financial stability. The first report can be found at **http://www.treasury.gov/initiatives/fsoc/Pages/annual-report.aspx**.

The NCUA REPORT

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