

Initial CUNA Summary of NCUA's Corporate Actions
September 27, 2010

For nearly two years, credit unions have been operating under a great deal of uncertainty related to the challenges in the corporate credit union sector. On Friday, September 24th, the NCUA removed a great deal of that uncertainty by taking several important actions in their three-phase effort to stabilize, resolve and reform the corporate credit union system.

NCUA made three very significant announcements on Friday:

- I. They placed three more corporates into conservatorship: Southwest Corporate FCU, Members United FCU, and Constitution Corporate FCU. Along with Western Corporate FCU and U.S. Central FCU, that brings the total number of corporates under conservatorship to five.
- II. They announced the long-awaited "legacy asset" plan to deal with the roughly \$50 billion of distressed assets still on the books of the five conserved corporates.
- III. They released the final corporate rule, which once implemented will require major changes in the corporate system.

CUNA staff has been examining all of the just-released documents, and continues to dialogue with senior NCUA staff. While questions remain, we believe we have a fairly decent handle on what this all means. Looking at each of the three announcements in turn, we find the following:

I. Conservatorships

We believe it is unfortunate that the NCUA found it necessary to conserve three additional corporates, but the agency clearly believed that prospective losses on their portfolios were so large that recovery was not possible. NCUA explained that removing the legacy assets from the books of these three corporates would have required realizing the losses, which would have rendered them insolvent.

In essence, NCUA's plan is for four of the five conserved corporates to operate as "bridge" corporates for about two years.* During this time, the bridge corporates will continue to provide their current payment, settlement and liquidity services. This means that credit unions that currently use these services at these corporates will have plenty of time to figure out options, and CUNA and the Leagues will continue to develop information to help them do so. The facilities and infrastructure that support the payment and settlement service provided by these corporates, as well as similar operations at WesCorp and U.S. Central, could eventually be taken over and put to good use by other corporates, credit unions, or CUSOs. One option will be for the members of a bridge corporate to charter a new corporate to acquire the assets of the bridge institution.

* The NCUA indicated that Constitution Corporate will not be operated as a bridge corporate – in this case, the agency is looking for a purchase and assumption arrangement or possible merger with one of the other existing corporates.

Over the coming few months, all concerned parties, including the remaining corporates, credit unions and others must develop viable plans so that all credit unions can enjoy uninterrupted payments and settlement services. CUNA has and will continue to take a leadership role in this process, as evidenced by the recently-published report of our Corporate Credit Union Next Steps Working Group - a very valuable report, available on our website here: http://www.cuna.org/download/corp_nextsteps.pdf.

CUNA Chair Harriet May has requested the Next Steps Working Group to remain in action for the coming months to continue its work. The Working Group will soon issue an RFP toolkit to help credit unions select new service providers. The Group will also be following up on other aspects of Friday's announcements, and meeting with NCUA shortly.

II. Legacy Assets

CUNA has frequently urged NCUA over the past year to develop a plan that does not create additional costs due to the legacy assets, on top of the already very large expected credit losses on those assets. After a careful review of the high-level outline of the plan, we believe the NCUA approach will do a very good job of meeting this main objective of minimizing resolution costs to credit unions by avoiding market losses in addition to the credit losses.

The plan involves securitizing the legacy assets by transferring them into a trust, and then selling notes, guaranteed by NCUA. The notes will be collateralized by the bonds in the trust, and will be structured to reflect the expected amortization of the legacy assets. As the legacy assets pay down, the note holders are paid off. When a legacy asset fails, the NCUA covers the loss through the stabilization fund. In this way, the stabilization fund only incurs a loss when an actual credit loss occurs on a legacy asset.

Throughout the whole process, our main concern had been that NCUA would have to sell some or all of the securities before they amortized, locking in market losses which by all accounts would be substantially greater than the likely, and eventual, actual credit losses. It is abundantly clear that selling the assets would have been extremely costly. We were also concerned that wrapping some type of guarantee around the assets might also be very expensive. It appears that NCUA has managed to provide a U.S. government full faith and credit guarantee without incurring any significant guarantee fee. The U.S. Treasury Department is implicitly playing the role of co-signer in the deal by permitting NCUA to describe them as backed by the full faith and credit of the U.S. government. This is a substantial, positive development.

The fact that Treasury has approved this suggests that Treasury officials have a high level of confidence in the likely performance of the bonds (not that there won't be losses, there will be, but that the loss estimates are conservative enough), and in the ability of credit unions to make good on the guarantee if necessary.

It is important to note that the securitization process will not be cheap. The fees and other costs for setting up the deals will likely be in the neighborhood of \$35 million. That's real money - about ten basis points of the deal, but over the ten year life, it's only about one basis point per year. In contrast, having to sell the legacy assets now could have caused additional losses of \$5 to \$10 billion, or even more in today's illiquid market for these securities.

Here are some additional details on the NCUA's legacy assets plan:

First, when NCUA began its action on the corporates last January, the total amount of the legacy assets was around \$65 billion. Legacy assets now total about \$50 billion. With about \$1 billion in actual, realized losses, that means there have been about \$14 billion of principal paydowns from normal amortization and prepayments.

The latest, revised, estimated future losses on the legacy assets are in the range of \$14 to \$16 billion, the mid point being \$15 billion. It is important to remember, **these are still estimates** of the performance of the bonds over the next several years. So far, the actual losses have been a little over \$1 billion, but that doesn't mean there aren't significant losses to come.

The \$14 to \$16 billion updated range of expected losses is much narrower than the \$6 to \$18 billion range that NCUA announced last year, and while it is within NCUA's previous range, the expected losses are on the high side of that former range. The new estimates were produced by Barclay's for purposes of underwriting. Their valuation model is likely not the same one previously used by PIMCO and Clayton to obtain the \$6 to \$18 billion estimate.

We don't know the parameters of the Barclay's analysis, but assume their underlying assumptions are more conservative than those used by PIMCO and Clayton to obtain previous estimates. The apparent conservative approach used by Barclays was likely to ease underwriting concerns and to get Treasury approval of the deal. What we do know is that other information, such as U.S. Central's mid-year financial report and reports in the financial press, suggest that bonds such as those that make up most of the legacy assets have, if anything, improved slightly over that past few quarters.

In other words, there is reason to believe that the actual, realized losses will come in below the \$14 billion to \$16 billion range, but there is no guarantee of this. The losses could even be greater than \$16 billion, although this is unlikely.

In any case, using the \$15 billion midpoint, NCUA reports that \$5.6 billion of the loss has already been covered by the extinguished capital of the conserved corporates.

That leaves \$9.4 billion to be covered by the Stabilization Fund, of which \$1.3 billion has been paid in last year's (\$0.3 billion) and this year's (\$1.0 billion) assessments. The remaining **estimated** balance is therefore \$8.1 billion.

Because the amortization schedules of the legacy assets is nearly ten years, NCUA secured the permission of the Treasury Department to extend the life of the Stabilization Fund until June of 2021. This way, the notes that Barclay's will issue between now and next summer, guaranteed by NCUA, can have maturities of up to ten years, to align with the amortization schedules of the troubled assets.

This extended life of the Stabilization Fund also gives credit unions longer to pay the stabilization assessments. Assuming the \$8.1 midpoint turns out to be accurate, the average cost in basis points of insured shared depends on the growth of those shares over the next 11 years.

- Assuming credit union shares and deposits grow by 5% a year for the next eleven years, the average annual assessment will be about seven basis points (7.3bp). (Starting at around nine basis points (9.2bp) next year, falling to five and one-half (5.5bp) in the last year).
- Again, the future loss estimates are just that, estimates. If savings growth is faster than 5% a year, and/or if the remaining losses to be covered by the stabilization fund are less than \$8.1 billion, the average cost will be less than seven basis points per year. Conversely, if savings growth is slower than 5% a year, and/or if the remaining losses to be covered by the stabilization fund are higher than \$8.1 billion, the average cost will be more than seven basis points per year.
- Some other examples of average annual basis point costs are in the table below.

Annual Stabilization Assessments

Depending on: Total Stabilization Cost and Assumed Insured Share Growth

		Low	Medium	High	
	Total Cost	\$7 B	\$8.1 B	\$9.2 B	
4% Ann Share Growth	First (2011)	8.1 bp	9.3 bp	10.6 bp	Top Average ←
	Last (2021)	5.4 bp	6.3 bp	7.1 bp	
	Average	6.7 bp	7.7 bp	8.8 bp	
	Total Cost	\$7 B	\$8.1 B	\$9.2 B	
5% Ann Share Growth	First (2011)	8.0 bp	9.2 bp	10.5 bp	
	Last (2021)	4.9 bp	5.5 bp	6.4 bp	
	Average	6.3 bp	7.3 bp	8.3 bp	
	Total Cost	\$7 B	\$8.1 B	\$9.2 B	
6% Ann Share Growth	First (2011)	7.9 bp	9.1 bp	10.4 bp	
	Last (2021)	4.4 bp	5.1 bp	5.8 bp	
	Average	6.0 bp	6.9 bp	7.9 bp	
					Low Average ↗

Under the plan, the financial markets will be funding the legacy assets as they wind down, and doing so with a government guarantee. Credit unions will also be allowed to buy the NCUA guaranteed notes if they wish.

For the plan to work there must be sufficient funds (i.e., deposits) in the conserved corporates until the securitization can be set up. **IT IS THEREFORE VITAL FOR CREDIT UNIONS TO CONTINUE TO HOLD SECURED DEPOSITS IN THE CONSERVED CORPORATES IN THE INTERIM.** These deposits are guaranteed under the temporary corporate share guarantee program through December 2012.

Were liquidity issues to arise, the NCUA may need to impose higher assessments in the next two years compared to those outlined above, though assessments in out years would then be lower. CUNA will be discussing the possibility of using short-term bridge loans to side step this possibility.

Again, the most significant point for credit unions is that under the plan, the total remaining costs of the stabilization will be limited to the actual credit losses on the securities as they play out over the next several years. It would be nice if we could tell you what those losses will be, but we can't. No one can. They will be what they will be. The faster the economy and housing markets recover the lower will the losses (and credit union costs) will be.

Finally, under NCUA's plan, in the very remote event the actual losses are very substantially below current estimates, there is a mechanism for those credit unions that have had their capital depleted in one of the conserved corporates to recover that capital. Again, under all but the most very optimistic economic scenarios this will not be an issue, but it is appropriate and fair to the affected credit unions that the possibility at least exists.

III. Final Corporate Rule

We have identified no big surprises in the NCUA's 250-page Final Corporate Rule. The final rule was not substantially changed from the proposed version, but it does include some key changes that CUNA sought.

The rule focuses on four areas, with many provisions phased-in over time:

1. New capital requirements for corporates that will be phased in over ten years – including a 4% minimum leverage ratio, a 4% tier-one risk-based requirement and an 8% total risk-based capital requirement. The final rule requires that retained earnings constitute a certain portion of capital – for example the corporate must have at least 45 basis points of retained earnings after three years, 100 basis points of retained earnings after six years and at least 200 bps after ten years.
2. A new PCA system for corporates. This new system is similar to those currently applicable to banks and natural person credit unions.
3. Limits on investments and ALM. Investment limitations include prohibition of investment in private-label residential MBS and subordinated securities, while the ALM dictates require internal ALM policies and place restrictions on borrowings and on term investing.
4. New regulations on governance – requiring that corporate board members be CEOs, CFOs, or COOs (including equivalents such as managers and treasurers) of natural person credit unions or other member entity. The

majority of a corporate's board members must be comprised of representatives from natural person credit unions.

A detailed summary of will be posted to CUNA's website by the Regulatory Advocacy department within the next week.

The final rule is completely consistent with the future business model that has been described by two CUNA task forces and is available on our website. The latest CUNA Corporate Task Force report, posted just last week, concluded that some elements of the corporate system could become the preferred providers of settlement and clearing services for credit unions in the future provided they make deep and far-reaching changes in their operations. This will require operating with much, smaller balance sheets and acting in many cases as an agent on behalf of member credit unions rather than as a principal.

NCUA has already announced there will be further amendments to the corporate rule. We expect their proposal in November.

Conclusion

Friday was an extremely difficult day for the credit union system, but it could have been a lot worse. (The main point is that credit unions will not have to absorb any significant market value losses in the resolution of the legacy assets). CUNA worked, and is continuing to work, on many fronts to help credit unions deal with these developments, including working with the press and leaders on Capitol Hill. Treasury has asked for our reaction, and CUNA staff plan to meet with Treasury officials soon.

In the meantime, CUNA will continue to monitor NCUA's actions to urge that costs to credit unions are contained. We will also continue to help credit unions in the selection of and transition to new providers of wholesale financial services. The bad news is that this has to be done. The good news is that there will be plenty of time to take on this difficult task.

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