

Corporate Credit Unions in Crisis

The financial crisis has highlighted a weakness in the credit union system – the interrelatedness of the credit union structure. In a prescient speech in 1998, then Treasury Assistant Secretary Richard Carnell said the following:

I want to turn now to the fourth topic from the study: credit unions' access to emergency liquidity. This topic came to our attention as we reviewed corporate credit unions. Corporates provide their member credit unions with a safe place to invest unloaned funds. And one way they can invest those funds is by lending them to other credit unions. The corporate system does a fine job of reallocating excess liquidity.

But what would happen if we had a systemic crisis, whether in the financial system generally or in the credit union system specifically. What if, in the midst of that crisis, there were no excess liquidity?¹

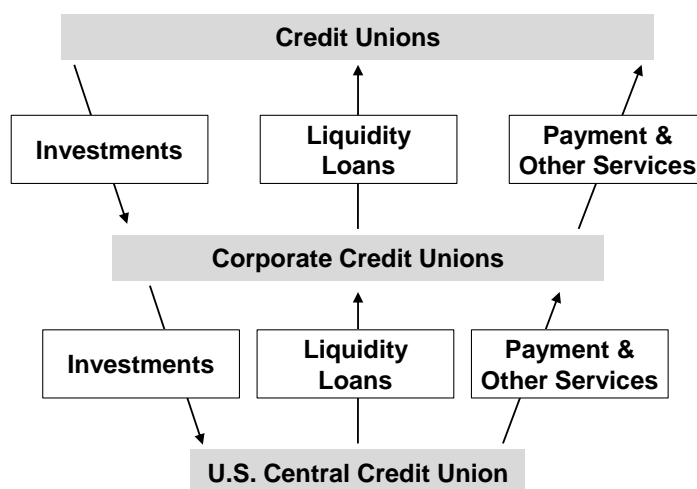
As the financial crisis enters its 19th month, those words spoken more than a decade ago are ringing true today. The corporate credit union system is experiencing a strain on liquidity and capital due to approximately \$64 billion held in mortgage and asset-backed securities for which, as banks are well aware, there is currently a limited active trading market. The recent conservatorship of two corporate credit unions is imposing a huge financial burden on the credit union system.

This backgrounder provides information on corporate credit union structure and history, as well as details on the impact of the financial crisis on corporate credit unions. This is helpful in understanding and responding to a recent request by the National Credit Union Association (NCUA) for legislative changes that would ameliorate the cost of the bailout of the corporate credit union system.

Corporate Credit Union Structure

The first corporate credit unions started operations in 1968, and were created to provide lending, investment, liquidity, and other financial services to the nation's 7,900 natural person credit unions (see figure below). Corporate credit unions are nonprofit financial cooperatives that are owned by natural person credit unions (that is, credit unions whose members are individuals).

Credit unions operate in a three-tier structure. U.S. Central Federal



¹ <http://www.treas.gov/press/releases/rr2237.htm>

Credit Union (FCU) operates in a similar manner to a bankers' bank, and invests the excess deposits of member corporate credit unions and provides liquidity and payment services to its member corporate credit unions. Corporate credit unions, in turn, offer other products and investment advice to natural person credit unions, such as, automated settlement, securities safekeeping, data processing, accounting, and electronic payment services, which are similar to the correspondent services that large commercial banks have traditionally provided to community banks.

Corporate credit unions are not the only financial institutions that provide products and services to credit unions. For example, some credit unions may also obtain loans from Federal Reserve Banks or Federal Home Loan Banks. Credit unions also obtain services related to securities from broker-dealers or investment firms, and they arrange for correspondent services from large commercial banks.

Corporate credit union's fields initially served credit unions located in single states or regions. Over time, corporate credit unions were granted national fields of membership, which increased competition – and risk – among corporate credit unions. This competition has fueled consolidation within the corporate credit union system. By the end of 2008, there were 28 corporate credit unions including U.S. Central FCU. With membership no longer chained to its local corporate credit union, the historically close bond between members and their corporate credit union has weakened. Therefore, a corporate credit union may be less able to rely on members' support, if needed.

Another risk is the three-tier structure. As the Treasury Department noted in 1997, “the three-tier cooperative structure of the credit union system – regular credit unions, corporate credit unions, and U.S. Central – creates an interdependence risk among and within the various levels... [I]f U.S. Central were to fail, its member corporate credit unions could face losses on their deposits – reducing their own net worth. Similarly, if a corporate credit union were to fail, its member credit unions could face losses on their deposits – reducing their own net worth.”²

As a general rule, corporate credit unions operate with very thin margins. This constrains their ability to build a financial cushion against adverse financial conditions or unexpected losses. In addition, corporate credit unions act as a “liquidity sponge” for the underlying natural person credit unions. The cyclical rise and fall of their assets and deposits are tied to the deposit flows of the natural person credit unions and these inflows and outflows of deposits, which are beyond their control, affect the financial strength of corporate credit unions.

In recent years, corporate credit unions have faced an increasingly challenging business environment that has created potential stresses on their financial condition. To generate earnings, corporate credit unions have targeted more sophisticated and potentially riskier investments, such as privately issued, mortgage-related and asset-backed securities. National Credit Union Administration has also permitted corporate credit unions to invest in lower-rated securities.

Corporate Credit Unions in the Financial Crisis

The financial crisis has hit hardest those institutions who invested in higher-risk securities. According to Standard & Poor's (S&P), “[t]he credit crisis has had only minimal impact on corporates that have stuck closest to the original model, taken very little incremental risk (and

² *Credit Unions*. The Department of the Treasury, December 1997, p. 9.

therefore little to no exposure to securities write-downs), and husbanded their franchise. However, several other rated corporates have heightened risk profiles arising from their holdings of more at-risk securities, specifically 2005-2007 vintage subprime, Alt-A, and home equity-backed structured securities.”³

As of November 30, 2008, corporate credit unions reported approximately \$18 billion in unrealized losses on securities. Concerns that some of these unrealized losses will be treated as other-than-temporarily-impaired (OTTI) have caused rating agencies to downgrade the debt ratings of some corporate credit unions.

As information about the financial conditions of corporate credit unions became public, natural person credit unions have reduced their exposure to corporate credit unions. Since the end of 2007, investments in corporate credit unions by natural person credit unions have declined by almost 17.7 percent to \$28.7 billion. Between March 31, 2008 and September 30, 2008, natural person credit unions deposits in corporate credit unions contracted by nearly 49 percent from \$44.7 billion to \$22.9 billion.

Corporate credit unions can only meet this demand for liquidity by (1) selling securities, (2) drawing down their deposits at U.S. Central, or (3) increasing their borrowings.⁴ Given the dislocation in the credit markets, should a corporate sell its securities at this time such transactions will likely occur at “fire sale prices” resulting in losses that may far exceed the current unrealized losses and the \$8.7 billion in corporate credit union capital. Therefore, selling investments are not a feasible option to meet the demand for liquidity of natural person credit unions.

Additionally, as of last November 2008, several corporate credit unions were approaching their borrowing limit from the Federal Home Loan Banks, including Western Corporate (WesCorp), Members United, Corporate America, and Corporate One. Therefore, to meet natural person credit unions demand for funds, corporate credit unions were drawing down their deposits at U.S. Central. U.S. Central FCU reported that members’ shares and certificate accounts fell 53 percent from \$36.8 billion as of January 2008 to \$17.3 billion as of January 2009.^{5,6}

NCUA Actions to Support Corporate Credit Unions

NCUA has taken a number of initiatives to shore up the corporate credit union system, since mid-October 2008.

- On October 16, 2008, NCUA approved a Temporary Corporate Credit Union Liquidity Guarantee Program (TCCULGP) that will operate from October 16, 2008, through June 30, 2009. The National Credit Union Share Insurance Fund (NCUSIF) provided a 100 percent guarantee on new unsecured debt obligations issued by eligible corporate credit unions on or before June 30, 2009, and maturing on or before June 30, 2012. This included promissory

³ Standard & Poor's, Corporate Credit Union Rating Review Leads To Several Rating Actions, January 8, 2009.

⁴ Under NCUA's current regulations, corporate credit unions may borrow up to 10 times capital or 50 percent of shares and capital, whichever is greater. In the failure of Capital Corporate FCU in 1995, this borrowing limitation was a severe and binding constraint.

⁵ <http://www.uscentral.org/uploadedFiles/USC%20January%202009%20financials.pdf>

⁶ As of November 2008, U.S. Central had borrowed \$3.5 billion of its \$3.76 billion line from the Federal Home Loan Banks.

notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt. Twenty-six corporate credit unions, including U.S. Central are participating in the program.

- On December 9, 2008, NCUA unveiled its Credit Union System Investment Program (CU SIP) to provide contingent liquidity to corporate credit unions. The Federal Reserve was supportive of this initiative. Under the CU SIP, participating creditworthy credit unions would borrow from the CLF and invest in a SIP Note. The CLF will designate which corporate will issue SIP Notes to which credit unions. Each SIP Note will be fully guaranteed by the NCUSIF, pursuant to the TCCULGP. The corporate credit union that receives the funds will be required to use it to retire external debt to free up collateral. So far, the CLF has advanced almost \$8 billion through the CU SIP.
- On December 12, the Board approved a regulatory change that enables U.S. Central to convert its membership capital accounts (MCA) to a new paid-in-capital instrument (PIC2), which is considered Tier 1 capital by debt ratings agencies.
- On January 28, 2009, U.S. Central FCU informed the NCUA that it would be taking an OTTI charge of \$1.2 billion for 2008, creating a loss of \$1.1 billion. As a result NCUA issued a \$1 billion note to U.S. Central Federal Credit Union – which has 26 corporate credit union members – to offset the expected losses and guaranteed uninsured shares at all corporate credit unions through February 2009 and established a voluntary guarantee program for uninsured shares of all corporate credit unions through Dec. 31, 2010. Twenty-three corporate credit unions have subsequently opted for the voluntary guarantee.⁷
- On March 20, NCUA placed both U.S. Central FCU and WesCorp FCU into conservatorship. U.S. Central has approximately \$34 billion in assets and WesCorp has \$23 billion in assets and 1,100 natural person credit union members. NCUA found that the potential credit losses at the two corporate credit unions presented an immediate capital concern necessitating NCUA assuming control of the two institutions.

The impact of NCUA's action to stabilize the corporate credit union system is that all federally-insured credit unions will be required to partially write down their one percent NCUSIF deposit and will be assessed a premium to restore the NCUSIF ratio to 1.30 percent of insured deposits. With the conservatorship of the two corporate credit unions, NCUA has revised upward its estimate of the losses to the NCUSIF. The NCUSIF required reserves for potential losses jumped from \$4.7 billion to \$5.9 billion. This will result in an impairment charge of 69 percent of the credit unions' one percent NCUSIF deposit. NCUA has also estimated that this impairment of credit unions' one percent deposit in the NCUSIF will lower the net worth ratio of credit unions by 65 basis points. Additionally, credit unions will be subjected to a premium assessment of 30 basis points in 2009 to restore the NCUSIF to its designated level of 1.30 percent.

⁷ John Kutchev, acting director for NCUA's Office of Examination and Insurance, commented during a National Association of Federal Credit Unions' webinar that if NCUA had not acted on January 28 to stabilize the corporate credit union system, there may have been costs of \$40 billion to \$50 billion from the sale of corporate credit unions' underwater securities, with the impact felt throughout the credit union industry.

However, the cost of the corporate credit union could go higher. NCUA estimates that the cost of the corporate credit union stabilization program could ultimately increase to as much as \$10.8 billion in losses; but under a worse-case scenario, those losses could be as much as \$16 billion.⁸

Furthermore, with the conservatorships of U.S. Central and WesCorp, the losses at these corporate credit unions are cascading down through the tiered structure of the credit union industry. Corporate credit unions will have to expense their equity investments (membership capital accounts and paid-in capital) in U.S. Central and natural person credit unions that are members of WesCorp will have to write down their equity positions in WesCorp, thus adversely impacting the net worth of corporate credit unions and natural person credit unions, respectively.

Due to the cost associated with the corporate credit union bailout, NCUA is requesting that Congress:

- raise the borrowing limit for the NCUSIF from \$100 million to \$6 billion;
- grant NCUSIF emergency borrowing authority up to \$30 billion;
- stretch out the assessment to pay for the corporate bailout to as long as eight years; and
- give the agency broad new "systemic risk" powers to deal with extraordinary failures.

⁸ <http://www.ncua.gov/letters/2009/CU/09-CU-06.pdf>