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The Corporate System is Stable and on the Mend: Let's Not Create a New Crisis

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At the end of March 2010, the latest corporate data NCUA has released shows the 26 retail corporates have total assets of $80.6 billion, using March's average daily asset balances. U.S. Central's balance sheet adds another $37.7 billion.

An important factor in the financial healing is the cash flows from so-called legacy assets. These securities are especially vital to the largest corporates. Removing these higher yielding assets could cripple their recovery. Moreover any transfer at their current market value, versus the securities' long-term economic value, would create potentially billions more in realized losses for credit unions.

What is the state of the corporate system today? How best can credit unions and NCUA resolve the lingering issues of investment valuation?

The State of the Corporates

The improving financial trends, the continued support of natural person credit unions, and the day-to-day performance of the corporates all suggest the crisis is over. Some important indicators of this are:

- Shares and membership continue to grow. Two corporates have increased share balances more than 20%, and two more than 60%, in the past year. Members continue to increase total investments in their corporates. The NCUSIF guarantee of all corporate shares is certainly an important factor; however the differential in growth rates shows credit unions are still aware of the value of individual corporate credit unions.
- Corporates continue to loan. At March 31 they had a total of $2.5 billion oustanding and more than $29 billion in unused, advised lines of credit, still available. The system is the largest source of standby credit for member credit unions.
- The corporate system processes millions of member transactions daily through auto settlement. These transactions involve hundreds of millions of dollars from ATM, debit, and credit networks. The corporates have never failed to complete this daily settlement activity at any time.
- The corporate's financial position, individually and collectively, has stabilized. The operating income (before OTTI) year to date averages

36 basis points, one of the highest levels of earnings ever. All corporates report positive capital at March 31, except WesCorp (negative $5.0 billion) and Constitution State (negative $24.4 million). U.S. Central's $350 million capital is positive because of the $1 billion capital note from the NCUSIF.

- Virtually every corporate has lowered its operating expenses compared to one year ago.
- The OTTI adjustments, for the seven corporates that have reported such losses, have become less material to their operating performance. In several situations the current earnings of the corporate might be sufficient to offset additional write-downs. Moreover, some securities that have been written down now exceed their reduced OTTI value, although accounting policy prohibits these improvements from being recognized except over the remaining life of the security.

The net capital in the 24 retail corporates that show positive capital is $1.225 billion, mostly in the form of membership shares.

In addition to the improving financial stability, corporates continue to provide valuable correspondent services and member education. Several have even employed new CEOs.

Resolving the Investment Valuation Deficiency

The best performing assets now held on the corporate books are the so-called legacy assets. These are investments in private-label mortgage and asset-backed securities that today NCUA prohibits corporates from acquiring. They are mostly at floating rates with a spread over LIBOR, repricing monthly or quarterly. The minor amount in fixed rate investments are at attractive yields compared to current options.

Over the past year, all of these securities have been under constant review and analysis. These valuations have been certified by audited financial statements. Most corporates publish their portfolios monthly, so members can look at investment detail and current valuations.

It is highly probable the majority of all OTTI losses have already been incurred because these estimates are forward-looking projections over the life of the security. These judgments, mostly made at the height of the crisis, cannot be reversed even though changes in prepayment assumptions and loss severity continue to improve because of positive economic and housing trends.

Cash is Still Flowing

Not all of the write-downs have yet resulted in actual payment defaults. In other words, these securities are still sending monthly principal and interest payments even though the securities in question have been written down in value.

As an example, WesCorp has taken $6.8 billion in OTTI write-downs over the past 18 months. However, according to its April 2010 statements, only $362 million of actual losses, or less than 5%,

have been realized. WesCorp is receiving the cash on these investments and uses this to pay competitive rates on overnight and term shares. Similarly these investments continue to provide cash flow for other corporates with some defaults projected years into the future.

The Critical Role of the Legacy Assets

The legacy assets are the best performers, in terms of yield, on corporate books today. No comparable investments are available should these be taken away. Even if there were a way to value fairly and reimburse the corporates for these assets, in every situation the corporate would almost immediately be put into a worse operating situation. Under current limits corporates are able to invest only in very short, liquid alternatives with yields of approximately 25 basis points. For these corporates, that yield would not cover their operating expenses, let alone pay a return to members. Operating losses would ensue quickly and, in several instances, eliminate any chance of the corporate working its way to survival.

Percipitating a New Crisis

NCUA's proposed plan to "remove $50 billion" of legacy assets would accelerate a crisis in every corporate that transferred a material amount of these assets. During this entire financial crisis, no individual or institution – private or public – has been able to develop a way to fairly price such assets. This is the reason there were no TARP purchases and no private-public investment partnerships except with loan assets from failed institutions acquired by the FDIC. In transferring the assets, someone will take a loss. Each corporate would likely receive less than the current carrying value and be given cash, for which no comparable return is available.

Every legacy asset today is being funded by the corporate credit unions, most likely at the lowest possible cost. Each corporate has the maximum incentive to pay a fair return, but also build retained earnings. ***It is the spread earned on these assets over their full economic lives, not just future principal payments, that will minimize the ultimate costs of resolution.***

Trying to find alternative funding for such assets would be more costly for two reasons. The transaction costs using outside funding options would run in the tens of millions of dollars. For example, when U.S. Central/NCUA borrowed in the open market using J.P.Morgan, Bank of America, Merrill Lynch, and four additional banks as co-managers, the $4.0 billion funding cost $11 million.

U.S. Central's two-year fixed rate note was priced at 1.25%; the three-year note portion at 1.9% - even though these funds were raised with the full faith guarantee of NCUA and the United States government. Today the average corporate cost of funds year-to-date is 73 basis points for all 26 corporates, with March showing a decline to 65 basis points. There is no public funding that would provide a lower cost of funds than corporates are able to achieve.

This loss on the funding spread would continue year after year until the securities pay down or default. For example, if the difference is 100 basis points on $50 billion, that would reduce the net income from securities by $500 million in the first year and by additional millions in years to come — this lost revenue will add to the costs to be paid in NCUSIF premiums.

The Solutions are in Place

Some people might still maintain transferring these investments is the only way to resolve the situation. That is not the case. Right now all of the elements of a solution are in place and working. Each corporate has the maximum incentive to reform its operations in light of new rules, to reestablish member confidence, and to seek the best possible business model to succeed in the future.

When the actual cash defaults on a corporate's securities prevent it from achieving a positive operating income, then NCUA can, on a case-by-case basis, decide the best course of action for the remaining securities and the future of the corporate. Presumably all member capital would be gone, NCUA would honor its guarantee of shares, and the corporate would be given a specific time to raise new member capital or to pay out the membership who could then join another corporate or not.

Co-operatives and Fixing Problems

There is no corporate problem that has a single solution. There are 26 corporates plus U.S. Central, all of which have different business models, market operations, and degrees of exposure to further loss. Some corporate boards will want to merge, some may choose to liquidate, and most will want to adapt and continue to serve members.

Just as in natural person credit unions, capital is raised via future earnings. Low or high capital levels do not prevent or produce a high level of service. WesCorp has been operating with a negative capital ratio of 23% for more than a year and a half, yet no one disputes its continued service or competitiveness.

The worst outcome for the legacy assets would be to impose a solution that might be relevant to a single corporate's circumstance but harmful to every other corporate and costly for natural person credit unions._

Every credit union, regardless of whether its leadership believes in the corporate system, has a stake in seeing the least costly resolution implemented. If the best course is not followed, then everyone will pay via NCUSIF premiums. The solution of time and cooperation is working. Do we have the skill and patience to stay the course — or do we waste resources on plans that would be counterproductive to the least-cost solution?