The Next Shoe Falls: CLF becomes the latest example of Humpty Dumpty

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EDUCATE

There is a lot of information floating around, reflecting a variety of different objectives and agendas. It's easy to get confused – especially if others' agendas do not line up with what your organization needs to address an issue. This site will help you get the facts on the Corporate network and educate yourself about the options for alternative capital. Then, raise your voice about other issues you want the community to address.

ACT NOW

The key success factor is to do what credit unions have always done: join together, learn from each other, speak with common purpose, and take timely actions to influence events.

PLEDGE

Now is the time to join in the reshaping of the credit union movement to not only address current issues, but other concerns that will arise in the future. Natural person credit unions are the bedrock of the movement. Every other organization in the movement depends on you for their continued well being, indeed survival.

In reading the NCUA's July 31 press release, listening to the their August 11th webinar, and talking with Corporates about NCUA's unilateral change to the CLF's twenty-five year funding structure, an age old nursery rhyme came to mind:

Humpty Dumpty sat on a wall. Humpty Dumpty had a great fall.

And all the king's horses and all the king's men couldn't put Humpty together again.

Every credit union is a member of the CLF. This collective funding provides the maximum capital base for CLF borrowing. However the overwhelming majority have no contact or even knowledge about what this means. NCUA's most recent actions would appear to have no immediate financial implications for them.

Yet, this decision to re-open the way CLF membership is conferred could accelerate the dissolution of the unitary credit union system. The outcome would then be the exact opposite of what NCUA said its intentions were, that is to bring greater stability to the industry.

The Context for this Decision

Before reviewing this latest action imposed without discussion on the Corporates and all credit unions, it is helpful to look at the NCUA record since the beginning of the year. These prior actions—accompanied by incomplete statements, lack of factual data, and shifting responsibility to other parties—continue in the case of the CLF.

Moreover it is important to note that never in the history of the Agency have the outside audits of the CLF, NCUSIF or the Agency ever been delayed this late past year end. Late audits are a warning. Something in management's presentations are not passing muster. As we will see in the CLF's case, the auditors are obviously not in agreement with the Agency's presentations. For an organization that raised the charge of "honest numbers," its own actions are sorely delinquent.

The First Eight Months of 2009: NCUA's Track Record

Let's review the major events of this year:

1. In January the NCUA said the NCUSIF was bankrupt and that member capital was impaired. Credit unions would have to recapitalize the Fund. The Agency put a $1 billion capital note in US Central. NCUA said the estimated losses to the NCUSIF from the corporate network's investment problems would be $3.7 billion. But they would not disclose how that number was calculated.

2. The Agency stated that credit unions could account for this initial deposit write down and potential premium in any manner consistent with accounting practice. This could include re-filing 2008 results, taking the losses in the first quarter of 2009 or waiting until the premium assessment was announced later in the year.

The result: the quarterly 5300 financial reporting system has been compromised so

that it will be impossible to compare current period results with prior periods until the year 2011. The restatements for 2008 year-end alone amount to over $ 2.2 billion in lower net income and a decline of net worth of more than $2.5 billion. **(See before and after financial statement comparisons.)** So when year-end 2009 arrives, which financial statements are used? For example, the 2009 income statements will include reversals of the 2008 re-filings which will result in a doubling of the adjustments on the bottom line! This difficulty will continue through every quarter including year-end 2010.

3. In March the NCUA declared that WesCorp and US Central were bankrupt and that all membership capital shares would have to be written off. NCUA said the PIMCO analysis contracted for in January justified this assessment. But the numbers were never shown to the boards, management, or apparently the auditors at that time so that this information could be verified. The estimated expense to the NCUSIF was now $6 billion, resulting in a complete write-down of the 1% deposit, completing the NCUSIF's bankruptcy.

The eventual "release" of PIMCO's report lacked any meaningful information due to numerous redactions. The Agency's stated intention to have two or three additional assessments over a period of time to establish a trend line was never done. PIMCO was dropped from the picture without explanation and Clayton was brought in to re-do estimates of PIMCO and NCUA's own modeling.

4. The Agency announced legislation, passed by Congress and signed into law, which allowed the NCUA to borrow up to $30 billion dollars to inject in the corporate system as capital. All borrowings were to be repaid, over seven years, by the natural person credit unions through NCUSIF assessments. Credit unions were given no say in how this new fund would be used or expensed. Credit unions had already written off as of March 31, 2009 over $6 billion of the corporate losses; over $20 billion of CLF liquidity was available when the bill was passed. No information was provided why the $6 billion March estimate needed to be raised to a potential expense of $30 billion.

5. WesCorp, now under NCUA management, issued its December 2008 financial statements showing operating losses of $7.6 billion. Of this amount, $7.7 was from estimated losses on investments and securities. These losses, according to the audited statement, were based on estimates provided by the NCUA as the conservator (referred throughout the report as "WesCorp"). The report continues in footnote 4, "Estimates of future impairment are highly dependent on the validity of these (management's) assumptions used in the models, and actual losses incurred could be materially higher or lower than those projected." (Page 33)

After delay, NCUA agreed to release Clayton's estimates for US Central and WesCorp, but did not show the CUSIP numbers with the bond values so that no independent review of the assumptions was possible. Over 15 Corporates use Clayton to value their direct investments and routinely make these valuations, including CUSIPs, available to their members. The two Corporates managed by NCUA do not release the full details of their investment valuation.

The CLF Changes-The Latest Shoe

In late July, the NCUA, in its management role at US Central, announced in a phone call with their corporate members that the Agency is breaking the collective funding solution for CLF capitalization. No explanation was initially provided for why the Agency was withdrawing CLF's $1.8 billion U.S. Central deposit in a time of seasonal outflows and while the Agency was urging credit unions to continue to support the system.

Subsequently on July 31, and in a webinar on August 8, the Agency provided its explanation. The pattern of partial information, ex post rationalizations and inconsistent logic of prior actions continues in these communications.

But piecing together the incomplete explanations, it now appears that because the CLF, US Central and NCUSIF are under the common management of the NCUA, the accounting for the CLF's funding deposit is no longer considered an arm's length transaction. As such it has to be characterized as a contra account thus negating US Central's contribution of CLF capital.

This is not how the Agency stated its actions, but obviously this is just one of the issues holding up all the Agency's audits. This is another unintended consequence of NCUA's conservatorship US Central. In its press release, NCUA would not even state this fact outright, but said the accounting rules may require; in fact the rules would require, a clarification made in the Q & A during the webinar.

Why this Action Matters

So what will be the consequences of the change and why is this another "Humpty Dumpty?"

The deposit draws $1.8 billion out of the credit union

network and puts it in treasury bills—so then the CLF can go to the Treasury and borrow money if the system needs liquidity! Talk about circular reasoning. The CLF has broad investment authority and placing the money in Treasuries is the lowest possible yield available. This change will entail both a loss of liquidity and of earnings for US Central and the corporate network.

The Agency stated that this was not due to any lack of confidence in US Central. Since NCUA itself manages US Central and has guaranteed all of its shares and borrowings, this statement is at best gratuitous and at worse, meaningless.

But the most important aspect is that NCUA is clear in its intention to change the CLF's funding solution. "It does not make economic sense for US C[entral] to hold the vast majority of stock on behalf of credit unions. Thus it is necessary for the CLF to consider ways for the orderly exchange of CLF stock ownership from US C[entral] to other credit union owners in a manner that fully preserves the CLF's role as a stabilizing agent . . ." (NCUA press release of July 31).

The CLF funding done by US Central was the least expensive funding solution, covering virtually all credit unions. The Corporates are the delivery and underwriting arm for the CLF. Before this solution in 1983 only a few Corporates had joined the CLF and coverage was limited to 20-30% of the industry's assets. Through US Central and the membership share requirements at each corporate, all credit unions gained access to the CLF. This funding approach was consistent with not only the CLF statute but also was affirmed by CLF and US Central auditors for 25 years.

The Agency stated that it wants to maintain as much CLF capital as possible to retain the CLF's maximum borrowing limit of 12 times capital and retained earnings (subject to Congressional authorization). However, by changing the membership structure there is only one way to go from the 100% capital contribution, and thus maximum borrowing capability, that exists today.

NCUA can try to make CLF membership mandatory, but it has neither the statutory authority nor the credibility with the industry to require capital contributions. The CLF has been used by less than 1% of credit unions in its history. Most credit unions are unaware of their potential CLF access or what it could do for them. If NCUA attempts to require CLF membership via corporate membership shares (many which have been partially written down) then it will just precipitate a further search for alternatives to the Corporates.

The CLF's Response to the Credit Crisis

During the past year of the greatest credit crisis in a generation, the CLF has been unresponsive to repeated industry requests from both natural person and corporate credit unions. Both the HARP and SIP programs were agency-designed, unilateral efforts that were not only ineffective, but in the case of SIP with its 25 and 75 basis point charges, more expensive than alternate financing for the Corporates.

When the Corporates requested direct CLF loans in 2008, citing both historical precedent and legal justification, the Agency turned a deaf ear. Only in March 2009 did it grant $10 billion of CLF loans to US Central and WesCorp, anticipating potential funding problems when the conservatorships were announced later that month.

Instead of being a collective resource used for the benefit of the credit unions helping their members, the CLF has been turned into another form of regulatory control by the Agency. That is not a function or practice that credit unions will be anxious to support with future voluntary CLF capital funding.

The New Bottom Line

So in the first eight months of 2009, NCUA has taken actions that made NCUSIF bankrupt, WesCorp and US Central bankrupt, and the 5300 reporting system unreliable. It has also broken the CLF membership process and done all of this while the external audits of its own activities continue to be delayed.

In all of these actions the Agency has used rationales that include references to GAAP, Agency interpretation of rules, external reviews such as PIMCO, Clayton or PricewaterhouseCoopers, and even more vague "conversations with Treasury" as justifications for the choices being made.

That is the critical point. Every one of the steps above was a choice, from multiple options, not inevitability. The Agency, at the highest levels, has either misunderstood or not assessed the impact of its actions on the industry. Never, in all of the explanations, has the justification that this decision is being made to help credit unions better serve their members ever been used.

The unintended consequences of NCUA's actions continue to mount. The corporate system has been "locked down" in a critical period when credit unions need to be assured of credit lines, loan participations and other balance sheet

support. The CLF has been unavailable as credit unions have reached out to help members in difficulty with home mortgages. The capital injection capability of the NCUSIF, which resulted in a $1 billion note in US Central, has not been used to help credit unions maintain capital levels so they can continue to serve members' urgent borrowing needs. For example, one credit union said they have run off over $400 million in assets just to stay within the 7% well-capitalized PCA "trip wire" in the first seven months of 2009.

Instead of using the collective resources of the system to help credit unions, these funds have been withheld sometimes, as in the corporate situation, waiting for credit unions to get into an impaired status so they could take them over.

Cooperatives are different from for-profit financial institutions. Assets are held in common to promote the common good. NCUA is part of the credit union system. All of its funding is from credit unions; any outside borrowings are repaid only from their earnings capability. Each of the sudden announcements of losses, takeovers and regulatory action by the Agency has led to more confusion and future uncertainty. Problems, as well as solutions for a stronger system, have only been pushed into the future. No audit reports of the Agency's actions are available. The primary solution appears to just keep spending more money.

All the king's horses and all the king's men, could not put Humpty together again. Well hopefully a new chair, who is not a king, can at least take a second look at the value of CLF's collective funding. Credit union's market-facing member benefits are achieved by collaboration. The CLF's use in a liquidity crisis gives credit unions the ability to help members when they are most in need.

And rather than using all the king's horses and men, she might want to go to credit unions directly and ask for their solutions, not just their checkbooks.