American Bankers Association
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August 16, 2011

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314–3428

re: National Credit Union Administration; Credit Union Service Organizations; 12 C.F.R. Parts 712 and 741; 76 Federal Register 44866, July 27, 2011

Dear Ms. Rupp:

The National Credit Union Administration (NCUA) Board (the Board) issued a proposed rule to amend its credit union service organization (CUSO) regulations. The American Bankers Association (ABA)[1] believes that the proposed rule is an appropriate step; but does not go far enough to mitigate the risk to the National Credit Union Share Insurance Fund (NCUSIF). ABA has concerns about the section of the proposed rule, which allows undercapitalized federally-insured state chartered credit unions (FISCU) to invest in a CUSO to the permissible state limit, does not adequately address safety and soundness concerns and the potential risk to the NCUSIF. Specifically,

- some state laws have significantly higher CUSO investment limits than the Federal Credit Union Act (FCUA), which would cause the CUSO investment to represent a significant contingent claim on the net worth of an undercapitalized FISCU; and
- the proposed rule does not address the degree of risk posed by the activity of the CUSO to an undercapitalized FISCU.

Additionally, ABA believes that NCUA should amend its prompt corrective action (PCA) regulation regarding transactions with and ownership of CUSOs by undercapitalized credit unions so that its regulation more closely tracks the requirements followed by the Federal bank regulators.

Background

Credit unions are increasingly using CUSOs to perform various functions. According to testimony of NCUA Chairman Matz, "credit unions currently have $1.3 billion invested in CUSOs and approximately 33 percent of all credit unions reported using CUSO services."[2]

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[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than $165 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.
[2] http://www.ncua.gov/GenInfo/Members/Matz/speeches/MatzStateOfIndustryDec2010-Final.pdf

However, in recent years several CUSOs have failed, wiping out the investments of their credit union owners. For example, the 2009 failure of Central States Mortgage Co. cost 25 credit union investors more than $8 million.

In addition, activities of several CUSOs have contributed to the failures of several credit unions. According to NCUA's Inspector General, the 2009 failure of Eastern Financial Florida CU was partly attributed to bad loans made by its business loan CUSO. The failures of Norlarco CU and Huron River Area FCU were attributed to speculative Florida real estate loans sold through CUSOs.

Unlike the other federal banking regulators, NCUA does not have oversight authority of third-party vendors. Thus, the risks posed by CUSOs are outside of the agency's direct regulatory and supervisory domain.

The Proposed Rule

The proposed rule seeks to amend NCUA's CUSO regulation. The proposed rule seeks to limit undercapitalized FISCUs' investments in CUSOs. Additionally, the proposed rule will impose accounting and reporting requirements on CUSOs owned by FISCUs.

The Board is proposing to limit an undercapitalized FISCU's aggregate cash outlay to a CUSO, measured on a cumulative basis, to the permissible investment limit in the state in which the FISCU is chartered. The proposed rule does not require an undercapitalized FISCU to divest a CUSO; instead, the FISCU would not be allowed to make additional investments without prior written approval from the appropriate state supervisory authority. The proposal will also require an undercapitalized FISCU to submit its request to the NCUA Regional Office, so that the Regional Office can provide input to the appropriate state credit union regulator. If the state law is silent on CUSO investment limits, then the investment limit of 1 percent of paid-in and unimpaired capital and surplus applicable to FCUs would apply.

The Board believes that the proposed amendments are necessary to protect credit unions and the NCUSIF. In addition, the proposed amendments would help to address NCUA's concern that "FISCUs are exposed to significant potential safety and soundness and reputation risks based on their relationship with their CUSOs."[3]

The proposed rule also adds two new requirements that would apply to both federal credit unions (FCUs) and FISCUs. These new items include a requirement that CUSOs file financial reports directly with NCUA and the appropriate state supervisory authority and a requirement that subsidiary CUSOs follow all applicable laws and regulations. Finally, this proposal makes conforming amendments to NCUA's regulation on the requirements for insurance.

ABA's Position

In lieu of the NCUA having the authority to examine CUSOs, ABA believes the proposed rule is an appropriate step in addressing risk posed by CUSOs to credit unions and the NCUSIF.

[3] 73 Federal Register 23983, May 1, 2008.

However, ABA believes the proposed amendment limiting undercapitalized FISCUs' investments in CUSOs does not do enough to mitigate the risk to credit unions and the NCUSIF.

The Board's justification for the proposed rule is that undercapitalized FISCUs that continue to invest money in a failing CUSO pose serious risks to the NCUSIF. ABA agrees with the Board that such an investment does pose a risk to the NCUSIF that should be mitigated. Unfortunately, ABA believes that this section of the proposed rule **does not** achieve this objective.

According to ABA's analysis of Call Report information, there were 28 undercapitalized FISCUs that had investments in CUSOs at the end of the first quarter of 2011. Some undercapitalized FISCUs reported holding significant aggregate investments in CUSOs as a percent of net worth. For example, Texans Credit Union, which is under conservatorship, reported aggregate CUSO investments as a percent of its net worth of 37.55 percent. Other FISCUs have aggregate CUSO investments that exceed their net worth.

First, some state laws have very high CUSO investments limits. In fact, NCUA acknowledged this point in 2008 when the agency stated that some states do not have the same relatively strict investment limits as the Federal Credit Union Act.[4] For example, the states of Iowa and Texas permit a FISCU to invest up to 5 percent of its assets in a CUSO.[5] This investment in a CUSO by an undercapitalized FISCU could represent 83.3 percent of the FISCU's net worth.

For states with more permissive investment limits, such an investment by a FISCU could represent a significant contingent claim on the net worth of the credit union if the CUSO fails; and thus could pose a significant risk to the credit union and the NCUSIF.

Second, some CUSOs are engaged in activities that are ***not permissible*** under NCUA's regulations. Once again, NCUA acknowledged this in 2008 as a concern; but this section of the proposed rule does nothing to address this issue.[6]

Third, the degree of risk to a FISCU depends on the nature of the services provided by the CUSO. The Board noted that it is more concerned by "a CUSO that originates mortgage and business loans than one that provides backroom management or operational support."[7] Also, a CUSO engaged in "widespread sale of participation interests and providing loan servicing on behalf of a significant number of credit unions present potential systemic risks" warrants direct monitoring.[8]

Rather than following a one-size-fits-all state CUSO investment limit for a specific state where the FISCU is chartered, ***NCUA should set different CUSO investment limits for all undercapitalized credit unions, both federal charters and state charters, based upon the activities of the CUSO.***

[4] *Id.*
[5] Code of Iowa 533.301(5)(f) and Texas Financial Code, Title 3, Subtitle D: Credit Unions, Section 124.352.(b)(1)
[6] 73 Federal Register 23983, May 1, 2008.
[7] 73 Federal Register 23984, May 1, 2008.
[8] *Id.*

Fourth, under NCUA's prompt corrective action (PCA) regulations (12 CFR Section 702), restricting transactions with and ownership of a CUSO is a discretionary supervisory action, ***not a mandatory action***, with respect to a credit union that is undercapitalized with a net worth ratio below 5 percent. ABA believes that discretionary supervisory action is not sufficient. A Government Accountability Office study on bank regulator use of PCA notes that "[w]hen an institution becomes significantly undercapitalized, regulators are required to take more forceful corrective measures, including … restricting otherwise allowable transactions with affiliates."[9] Once a bank becomes critically undercapitalized, it cannot engage in any covered transaction without first receiving the approval of the FDIC.

ABA believes that NCUA should amend its PCA regulations so that once a credit union becomes significantly undercapitalized there is a presumption of a restriction on investments with CUSOs. And a critically undercapitalized credit union should not be able to engage in any transaction with a CUSO without first receiving an approval from the NCUA. This would be consistent with the approach followed by the Federal banking regulators.

If you have any questions, please feel free to contact the undersigned.

Sincerely,

Keith Leggett
Vice President and Senior Economist

[9] "Deposit Insurance: Assessment of Regulators' Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System," U.S. Government Accountability Office (February 2007), p. 23.