BOARD ACTION MEMORANDUM

TO:	NCUA Board	**DATE:**	September 9, 2009
FROM:	President J. Owen Cole, Jr. Central Liquidity Facility	**SUBJ:**	CLF Investment and Earnings Retention Policies

ACTION ITEM: Board approval of changes to Central Liquidity Facility (CLF) investment and earnings retention policies.

ACTION DATE: September 24, 2009.

OTHER OFFICES CONSULTED: Office of General Counsel.

VIEWS OF OTHER OFFICES CONSULTED: Concur.

SUBMITTED TO THE INSPECTOR GENERAL FOR REVIEW: Yes.

BUDGET IMPACT, IF ANY: Not applicable.

RESPONSIBLE STAFF MEMBERS: President J. Owen Cole, Jr., Central Liquidity Facility.

SUMMARY: The actions requested are: 1) the revision of the CLF investment policy to incorporate the recent change in how the Facility invests its subscribed capital stock proceeds and retained earnings from deposit accounts at US Central Federal Credit Union (USC) to U.S. Treasury securities held at the Department of Treasury; and, 2) a change in CLF's earnings retention policy to resume the building of its capital through an ongoing quarterly retention of earnings. The first change is in response to an accounting standard that adversely impacts the presentation of CLF's member equity and the second is in response to a recent increase in expenses due to higher planned staff levels.

BACKGROUND:

CLF has two sources of funds. It has paid-in capital stock subscriptions from Regular and Agent members and it has retained earnings.

In order to be a CLF member, a credit union must subscribe to CLF capital stock in an amount equal to 0.5 percent of its paid-in and unimpaired capital and surplus (this means shares plus unimpaired capital) or belong to an Agent member that has purchased the stock on the credit union's behalf. One-half of the stock subscription must be paid directly to CLF while the remaining one-half must be held by the member on call of the NCUA Board. USC currently funds the capital stock for all agent members as the Agent Group Representative.

As of July 31, 2009, the total amount of paid-in capital stock and retained earnings was approximately $1.83 billion. This is comprised of $68 million in Regular member capital stock, $1.75 billion in Agent member capital stock (USC), and $11.4 million in retained earnings.

DISCUSSION:

The following discussion addresses:

1. Accounting issue impacting financial presentation of investments;
2. Investment of Facility funds; and
3. CLF retained earnings policy.

Accounting Issue Impacting Financial Presentation of Investments:

CLF funds on deposit with USC in 2007 were presented as an investment asset on CLF's balance sheet. Beginning December 31, 2008, CLF changed the accounting for its agent member share capital invested in USC accounts as a shareholder loan. Under Generally Accepted Accounting Principles (GAAP), transactions with equity owners (USC owns the majority of CLF capital stock) need to be evaluated to determine their substance and the appropriate reporting in the financial statements based on the terms of the transaction, including interest rates, payment terms and maturities, evidence of ability and intent of repayment, nature and sufficiency of collateral.

In consultation with its auditor, CLF took into account the complex interrelationship between its stock ownership arrangement and its lending activities during the final months of 2008 and subsequent actions taken in 2009 as detailed below. The existing inter-relationships include USC's majority ownership stake in CLF, the conservatorship of USC by NCUA, the corresponding National Credit Union Share Insurance Fund (NCUSIF) assistance extended to USC, and the CLF liquidity advance made to the NCUSIF which then advanced the funds to USC. These factors raise reasonable doubt as to the ability and intent of USC to repay CLF's invested funds upon demand as of December 31, 2008. This in turn led to a determination that the amount of the investment (funds held on deposit) should instead be reported within the equity section of the balance sheet as a receivable from shareholder (a contra equity account).

Since the total investment in USC was equal to the sum of CLF's paid-in capital stock and retained earnings, this contra equity treatment effectively resulted in total member equity of zero as of December 31, 2008. This accounting treatment led to an untenable situation because of its corresponding impact upon CLF's borrowing capacity under its arrangement with the Treasury Department's Federal Financing Bank (FFB). CLF discussions with representatives at FFB and Treasury confirmed that the zeroing out of total member equity was not acceptable with respect to CLF borrowing from FFB.

CLF's borrowing capacity is based upon its total subscribed stock and surplus (i.e., total capital).

Thus, CLF transferred most of its deposits at USC to U.S. Treasury securities on August 3, 2009. By transferring its investable funds from the current USC accounts into Treasury securities, the unfavorable accounting treatment was rectified because these funds were immediately recorded as an investment asset (Treasuries) on the balance sheet. This in turn means CLF's equity will not have to include a contra equity account and thus restores its borrowing capacity with Treasury to the full amount as provided under the terms of the Note Purchase Agreement between CLF and FFB.

Investment of Facility Funds/Investment Policy:

As permitted by statute, CLF investments are restricted to obligations of the U. S. Government and its agencies, deposits in federally insured financial institutions, and shares and deposits in credit unions. Prior to August 3, 2009, the CLF policy was to deposit nearly all of its available funds in USC at market rates of interest.

Because of the accounting issue discussed previously in this BAM, on August 3, 2009, CLF redeemed its deposits with USC, except for approximately $640 thousand it retained for daily operational purposes, and transferred the proceeds to a FedInvest account with the Department of Treasury, as was discussed with the Board. The funds were invested on that date in a short-term ladder of U.S. Treasury securities with final maturities ranging from overnight to slightly less than two years. The weighted average maturity of all Treasuries is currently 1.3 years.

The CLF Investment Committee recommends CLF Board ratification of the recent investment actions and approval of the proposed CLF Investment Policy as attached.

CLF Retained Earnings Policy:

CLF seeks a change in its earnings retention policy to resume the building of its capital through an ongoing quarterly retention of earnings. This request is in response to a recent increase in expenses due to higher planned staff levels and to maintain appropriate contingency reserves.

In an action dated May 16, 1996, the CLF Board approved a change to the CLF's reserving policy so that no additional reserves will be added, indefinitely provided that CLF continues to periodically reevaluate its reserve needs. At that time, CLF had accumulated retained earnings of $11.5 million. Currently, CLF has accumulated retained earnings of $11.4 million[1]. Until the events of the past year, CLF had little or no lending activity since the action date with the exception of some anticipatory borrowing at the time of the century date conversion (Y2K).

Since 1995, the CLF has not increased its retained earnings and instead elected to pay out all earnings in excess of its expenses. As a general rule, CLF has sought to maintain a level of retained earnings upon which it can earn a sufficient return to cover Facility expenses. This approach has permitted the Facility in most years to then pay out all earnings on the funds from its capital stock (the funds other than retained earnings) in the form of stock dividends. Of course, the primary purpose of retained

[1] The difference is due to the cost of borrowed funds for CLF to preposition funds over Y2K. The cost of this transaction was approximately $109,000. (Reference CLF Report to the Board for January 2000.)

earnings is to serve as an adequate reserve of funds available to absorb the risks of the Facility. With increases in its lending activities to all-time levels, an increase in CLF's retained earnings is both a prudent and timely measure.

While CLF expenses have increased due to the Congressional increase to CLF's budget to a maximum of $1.25 million in 2008 and the increase in CLF's resources from 1.5 full-time equivalent employees (FTEs) to 3.5 FTEs by the NCUA Board in April 2009, there has not yet been a corresponding increase in the level of retained earnings .

CLF proposes a new Earnings Retention policy that establishes target retained earnings sufficient to cover operating costs and maintain an adequate contingency reserve. The functions of retained earnings for CLF are:

1. To maintain a reserve of capital sufficient to support the risk inherent in the operations; and
2. To the extent that the first function is satisfied, to further be able to support the cost of operations through the management of retained earnings.

CLF's objective is to return the subscribed stockholders a fair dividend. That can be better achieved if CLF's retained earnings are sufficient to cover both operating costs and absorb any losses from its lending/investing functions.

RECOMMENDED ACTIONS: CLF recommends the Board approve the following:

1. Ratify the recent change in investment strategy whereby CLF moved $1.8 billion from U.S. Central Federal Credit Union share accounts and certificates to the U.S. Treasury's FedInvest program with placement of funds into a ladder of short-term Treasury securities;

2. Approve the revised CLF Investment Policy as attached; and,

3. Approve an Earnings Retention Policy stating:

   The objective of CLF retained earnings is:

   a. To maintain a reserve of retained earnings sufficient to support the risks of the Facility; and
   b. To the extent that the first function is satisfied, to further be able to support the cost of operations through the management of income generated from the investment of retained earnings.
   c. At least annually, review the level of retained earnings to determine its adequacy.

CLF will retain sufficient earnings on an annual basis to reach the stated objectives within a reasonable period of time and report to the Board at least annually on the status of reaching the targeted goal.

Attachment

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