Chapter 311

CORPORATE CREDIT UNION SERVICE ORGANIZATIONS

Introduction

A corporate credit union service organization (corporate CUSO) is an entity that:

1. Is at least partly owned by a corporate credit union;
2. Primarily serves credit unions;
3. Restricts services to those related to the normal course of business of credit unions; and
4. Is structured as a corporation, limited liability company, or limited liability partnership under state law.

Corporate CUSOs are proliferating, primarily because these entities a) offer their corporate owners the opportunity to generate significant fee and other revenues without a substantial balance sheet commitment, and b) permit corporate owners to offer selected services to their members which cannot be provided directly by corporates under current statute and regulation. It is not unusual for a corporate to have investments in and/or loans to a number of different corporate CUSOs.

Section 704.11 of NCUA's Rules and Regulations authorizes corporates to invest up to 15 percent of capital in member and non-member corporate CUSOs. The aggregate of all investments in and loans to member and non-member corporate CUSOs must not exceed 30 percent of capital. However, an additional 15 percent of capital can be loaned if the loans are collateralized by assets in which the corporate has perfected a security interest under state law. Note that while Section 704.7(e)(2) of NCUA's Rules and Regulations states corporate CUSOs are not subject to Part 723, this statement is made relative to Part 723 loan limitations, which are superseded by Section 704.11 limits. Loans to corporate CUSOs are still subject to the due diligence requirements imposed on business loans by Section 704.11(c), which incorporate selected subsections of Part 723 by reference.

A corporate CUSO's organizational requirements (i.e., corporation, limited liability company, or limited liability partnership) are designed to limit the risk of loss to the affiliated corporate to the extent of the corporate's loan and/or investment balance. It should be noted, however, that the loss of a service provided by the corporate CUSO could affect the operations, financial condition, and reputation of affiliated corporates beyond the amounts loaned or invested.

Corporate CUSOs are chartered under state law and, therefore, must comply with all state laws, including state licensing and regulated activities' laws. Corporate CUSOs, being separate legal entities neither chartered nor insured by NCUA, are not subject to NCUA regulation. However, under the agreement terms required by Section 704.11(g)(4), NCUA does have the contractual right to "complete access to [corporate CUSO] books, records and any other pertinent documentation." For this reason, the term "corporate CUSO examination" is used throughout this chapter.

NCUA performs corporate CUSO examinations using a risk-based focus. Corporate CUSO examinations are performed in a consensual manner in cooperation with corporate CUSO management. State supervisory authorities (SSAs) may participate in corporate CUSO examinations, as determined by individual circumstances.

In instances when disputes arise between the examiner and a corporate CUSO over access to books and records or problem resolution, the examiner should look to the corporate field supervisor (CFS) and the OCCU office for guidance on resolution. It is important examiners take a professional, reasonable approach with corporate CUSO management and consult their CFS if they encounter circumstances that cannot be cooperatively resolved. Examiners should tailor review procedures according to the size, complexity, and risk activities of the corporate CUSO.

Section 704.11(f) prohibits any official of a corporate, which has an investment or loan to a corporate CUSO, from receiving, either directly or indirectly, any salary, commission, investment income, or other income, compensation, or consideration from the corporate CUSO. This prohibition also extends to immediate family members of officials.

Corporate CUSOs are formed to provide a wide variety of services to both corporates and natural person credit unions. Corporate CUSOs often provide investment and ALM advisory services, broker/dealer services, shared branching networks, operational services such as accounting, EDP, and human resources management services, as well as other services related to corporate and natural person credit union operations. In all cases, the examiner must not only determine the corporate's investment does not pose excessive credit risk, but also the services provided do not pose operational risk to the corporate(s) using the services of the corporate CUSO. Therefore, the examiner should always perform a limited financial and operational review of all corporate CUSO investments and/or loans on the books of a corporate during standard corporate examinations.

When evaluating a corporate's investment or loan to a corporate CUSO, the examiner should use a "two-tiered approach." The first tier evaluation will include a general corporate CUSO review as part of the overall examination scope. This review should determine, for each corporate CUSO the corporate has loaned to or invested in:

1. Compliance with Section 704.11 requirements. This includes a review of the corporate CUSO's current and proposed services to determine they are related to the normal course of credit union business.

2. Whether the corporate can legally be considered a separate entity relative to the corporate CUSO investment. Corporates are required by Section 704.11(d)(2) to obtain a written legal opinion concluding the corporate CUSO is organized and operated in a manner the corporate will not reasonably be held liable for the obligations of the corporate CUSO. These opinion letters can contain disclaimers limiting the circumstances under which the opinion is to be considered valid. The examiner must review the letter during each examination, to ensure current corporate CUSO operations conform to all the requirements and conditions imposed by the opinion letter. If this is determined not to be the case, a new opinion letter will be required which clearly establishes a corporate veil remains present, or operations will have to be modified to

conform with conditions imposed by the existing opinion letter. Additional discussion concerning this issue is provided below.

3. The overall financial condition and operating results of the corporate CUSO, and the extent of any financial risks the investment/loan may pose to the corporate. Corporate CUSOs are required to provide quarterly financial statements to corporates who have loaned to or invested in them. The examiner should determine these financial statements have been regularly received and are being reviewed by the corporate, and a credit analysis of all corporate CUSO loans and/or investments is performed at least annually. Newly formed corporate CUSOs may initially incur operating losses. The corporate CUSO's success in achieving budgeted performance goals during this start-up period should be considered during the evaluation of its of long-term financial prospects and the reasonableness of any corporate CUSO investment's carrying value. The corporate's financial records should accurately reflect any permanent impairments to corporate CUSO investments or to loans extended to corporate CUSOs. The corporate CUSO's annual audit should also be reviewed, to determine that any weaknesses disclosed therein are being adequately addressed.

4. The quality of any services the corporate CUSO may provide to the corporate being examined, and any operational risks that may be incurred by the corporate as a result of those services. Risks may include inadequate establishment of the rights and responsibilities of all parties involved with provision or use of the services, as well as risks posed by the manner in which services are being provided. For example, if the corporate has a website which advertises corporate CUSO services and links to the corporate CUSO, sufficient disclaimers should be in place to ensure members soliciting corporate CUSO services understand the service provider is a separate legal entity. Letter No. CU 2003-08 provides additional information on risks in this area.

Additional examination considerations present themselves when the corporate CUSO being reviewed is majority- or wholly-owned by the corporate being examined:

1. Majority- or wholly-owned corporate CUSOs are not required to obtain a separate annual audit if they are included in the corporate's annual consolidated audit. The corporate's consolidated annual audit will have to be reviewed to determine if comments relative to the corporate CUSO have been provided.

2. Corporates may elect to insure majority- or wholly-owned corporate CUSOs through existing corporate contracts, including bond contracts. These contracts have to be carefully reviewed to determine that the cost of coverage, dollar amount of coverage, and covered events for the corporate CUSO are clearly identified, that the corporate CUSO is the insured entity, and that coverage is sufficient given the nature and volume of the corporate CUSO's activities. The insurance contracts must also establish that, in the event claims relative to the corporate CUSO affect coverage available to the corporate, remaining corporate coverage will meet regulatory requirements. Corporate CUSO insurance coverage obtained through a corporate's insurance contracts could negatively impact the determination that a corporate veil is present, and should be discouraged if a number of other negative factors which could affect this determination are also present.

3. Majority- or wholly owned corporate CUSOs often share space and staff with their corporate owner. Comprehensive, reasonable, and accurate shared services agreements should be in place to ensure the corporate CUSO is being operated as a separate entity. Directors of such corporate CUSOs are often staff members or officials of their owner corporate. The examiner should determine separate meetings of the corporate CUSO board of directors take place, are documented by meeting minutes, and transactions involving both entities are "arm's length" as supported by written documentation.

If the "tier one" reviews discussed above disclose any material weaknesses (financial or operational) regarding the corporate CUSO, the examiner will recommend to the CFS a "tier two" review of the corporate CUSO operation. A tier two review will consist of an on-site corporate CUSO examination. The examination will be coordinated with the management of the corporate CUSO, and will be undertaken in order to gain a more comprehensive understanding as to the financial condition and quality of services provided by the corporate CUSO. The major objective of the examination will be to determine the degree of risk that the corporate CUSO poses to the NCUSIF and the investing corporate(s).

OCCU Instruction No. 15200 (REV), dated May 2, 2006 (CUSO Review Guidance), and attendant Appendices A through F currently provide guidance, checklists, procedures, reporting requirements, and review information concerning corporate CUSO examinations. Selected areas of that instruction are expanded upon below.

When performing an on-site review of the corporate CUSO's operations, the examiner may inquire about its managerial controls and working arrangements with leagues or trade associations, if applicable. The following are guidelines which may assist the examiner in the review of corporate CUSO operations and management:

1. Management - The examiner should arrange to review the corporate CUSO's policies, procedures, budgets, business plan, goals and objectives, reporting processes, articles of incorporation, and bylaws. The examiner should discuss with management the nature and extent of managerial planning, the overall reasonableness of the business plan, and budgetary projections.

2. Business Plan - Good business planning involves management's development of a written business plan before the organization begins doing business. A corporate CUSO's business plan, at a minimum, should include:

    a) A statement of goals (including profitability goals) and objectives;
    b) Policies, procedures, and time frames for achieving the goals and objectives;
    c) Budget projections demonstrating management's efforts to meet profitability and capitalization goals and achieve (and maintain) self-sufficiency; and
    d) Monitoring techniques to inform management of the operation's status.

Management should revise and update the business plan, as necessary, to ensure it is current. A corporate CUSO's well-developed and maintained business plan provides affiliated corporates and credit unions a valuable resource for making decisions about permissible investments and lending.

3. Managerial Personnel - An on-site corporate CUSO review provides the examiner an opportunity to observe and ascertain management's ability to effectively direct and control the corporate CUSO's operations. As part of the key personnel review, the examiner may find it helpful to request employee resumes and evaluations (i.e., depending upon state law, etc.) as well as note, in the work papers, key management background information. The adequacy of key personnel experience and education depends on the types and levels of service offered by the corporate CUSO. Observed managerial weaknesses should be noted in OCCU's CUSO examination report.

4. Minutes - The examiner should review board minutes for content, decisions, and required frequency of meetings according to the corporate CUSO's bylaws. If available, the examiner may also request other minutes, including those of user/client meetings, special meetings, and executive committee meetings.

5. Investment/Loan Documents - The examiner should review investment and loan documents and corporate CUSO agreements of affiliated corporate and natural person credit unions.

Review of Corporate CUSO Services

The examiner should ensure the corporate CUSO is performing permissible services and is primarily serving credit unions or their members as required by regulation.

The corporate CUSO's quality of services provides information about the ongoing feasibility of the corporate CUSO. If available, membership surveys, complaint departments, and third party studies can assist the examiner in assessing the quality of services.

Review of Financial Performance

The examiner should evaluate the corporate CUSO's financial condition to determine its ability to meet its goals, objectives, and financial projections, analyze its prospects for future success, and assess the risk to affiliated corporate and natural person credit unions. Since financial trends for a start-up operation can be uncertain, it is important the examiner differentiate between start-up corporate CUSOs and those that have been in business for some time (e.g., cash flow projections, since start-up costs are expensed as they are incurred). Review of the following areas may assist examiners in performing the financial condition review:

1. Trend Analysis - The financial analysis of a corporate CUSO is similar to that performed during corporate examinations. However, some ratios used to evaluate corporate CUSOs may differ from those used for corporates. To better understand the corporate CUSO's trends and ratios, corporate examiners normally request at least three years' financial data. Comparative ratios (both over the prior three years and versus industry averages) assist the examiner in determining the reasonableness of the corporate CUSO's current financial condition. Both Dunn and Bradstreet and Robert Morris Associates publish industry averages.

2. Profitability - Due to tax consequences, corporate CUSO profitability objectives may differ from those of credit unions. However, corporate CUSOs still require sufficient cash flow to meet their objectives. The examiner should analyze earnings to ensure they are sufficient to pay for services offered, while achieving profitability and capital goals.

3. Cash Flow - Profitable corporations, including corporate CUSOs, do not always have positive cash flow. This is often true in the initial or start-up stages but can also be a result of mismanagement. Conversely, since corporate CUSOs hope to reduce taxes by minimizing net income without affecting cash flow, it is not uncommon for the CUSO to be unprofitable but have positive cash flow.

To analyze cash flow, the examiner may request cash flow statements. If the corporate CUSO does not prepare cash flow statements and cash flow appears to be a problem, the examiner should analyze the cash flow position to ensure the CUSO has sufficient cash flow to maintain normal operations. Depending on its severity, negative cash flow may require the examiner to expand the scope, review the situation with management, and develop (with corporate CUSO management) a plan to reverse the trend.

4. Taxes - As taxable entities, corporate CUSOs should adjust their projections for anticipated tax liabilities. During the review, the examiner may request a copy of the corporate CUSO's IRS filings (and documentation of other local, state, or municipal taxes for which the corporate CUSO is liable) for evaluation of proper payments and inclusion in the supporting work papers.

Review of Accounting and Audit Functions

The examiner should review the independent auditor's report, notes to the audit report, engagement letter, report of reportable conditions (if these letters are available), and other correspondence before determining the scope of the general ledger review. If the CPA's competence and independence are not in question, the examiner may place greater reliance on the CPA's work.

The examiner may determine a comprehensive General Ledger review is not mandatory. In these instances, the examiner may limit the General Ledger review to those areas that may be of concern. For example, the examiner may choose to review only the corporate CUSO's tax filings and aging of receivable and payables, or only the appropriateness of classification of accounting information (e.g., expenses improperly capitalized or income improperly recognized). The examiner may want to pay particular attention to the collectibility of accounts receivable. If uncollectible receivables are material, NCUA may require affiliated corporate and natural person credit unions to reserve for their investments in and loans to the corporate CUSO.

When the examiner believes reviewing the actual audit work papers is necessary, permission should be obtained from the corporate CUSO to review the work papers and management should be requested to make necessary arrangements with the CPA firm. Review of audit work papers often provides meaningful information not evident from a review of the audit report (e.g., the CPA's assessment of the corporate CUSO's internal controls, or a statement regarding its viability as an ongoing concern).

The examiner should also confirm the corporate CUSO is following GAAP, as required by Section 704.11(g)(1).

Internal Control Assessment

The examiner's scope for an on-site corporate CUSO examination may include assessing the adequacy of internal controls necessary for the corporate CUSO's business. Likewise, if the corporate CUSO has an internal audit function, the examiner will arrange to review the internal audit scope and procedures.

Electronic Data Processing

During an on-site review, the examiner may arrange to review the corporate CUSO's information processing system, including related controls and the disaster recovery plan.

Legal Review

Section 704.11(d) requires a corporate investing in or lending to a corporate CUSO take reasonable steps to ensure a court would not "pierce the corporate veil" and hold it liable for the obligations of the corporate CUSO. This can happen when the assets of a corporation (the CUSO) are insufficient to satisfy its debts and there is a parent entity (the corporate) which is so closely identified with the corporation the judicial system requires holding the parent liable for those debts. Section 704.11(d)(2) requires a written attorney's opinion stating the corporate CUSO has been structured as a separate legal entity to limit the corporate's potential exposure to no more than the loss of funds invested in and/or loaned to the corporate CUSO. The legal opinion should address the factors specified in the cited regulation.

The examiner should review the following, evidencing a corporate veil has been established and has not been pierced:

1. Articles of incorporation or partnership agreement filed with the state;

2. Written bylaws;

3. Minutes of the first meeting of shareholders or partners or a unanimous consent of the shareholders or partners electing the board of directors;

4. Minutes of the director's first meeting or a unanimous consent of the directors electing officers and authorizing the issuance of the shares (if applicable) and adoption of the bylaws;

5. Review of stock certificates (if applicable);

6. Proof of capitalization and a determination that capitalization is minimally adequate to support the business plan; and

7. An opinion letter from an attorney, licensed to practice in the state where the corporate CUSO principally operates, stating that the corporate CUSO is structured in such a manner as to limit the liability of the corporate credit union to the investment in and/or loan to the corporate CUSO.

Affiliated corporates should obtain a new legal opinion if the corporate CUSO restructures its organization or if its current or planned operations raise potential liability issues.

There is usually no single controlling component the courts examine in determining whether to pierce the corporate veil thus imposing liability on the parent organization. The factors courts have considered include inadequate capitalization of the corporate CUSO, lack of separate and distinct CUSO identity, common boards of directors, management, or employees, corporate control of the corporate CUSO, the use of the same or similar forms by both entities, the lack of organizational meetings by the corporate CUSO, and lack of separate books and records.

To evidence distinction in identity, the corporate CUSO must demonstrate it operates separately from the corporate. The following questions and their response can aid the examiner in determining whether the corporate CUSO is operating as a separate entity with its own financial resources and necessary distinction in management and operations:

1. Is the corporate CUSO holding shareholder or partner meetings and board of director meetings regularly as required by the bylaws (it should be)?

2. Are payments made by the corporate CUSO to the corporate for rent, shared employee costs, etc., supported by appropriate management agreements, equipment leases, or real estate leases (i.e., office space, mailing addresses, and telephone numbers should be separate, etc.)?

3. Is the corporate providing guarantees to the corporate CUSO which could cause the corporate to incur liability in excess of the permitted investment limitation in the regulation?

4. Is there a good faith attempt to separate the identities of the corporate and corporate CUSO both in operation and management (i.e., corporate CUSO management should be separate from corporate management, red flags may include corporate management personnel holding a majority of corporate CUSO board positions)?

5. Is the capitalization of the corporate CUSO adequate in relation to its business plan?

Additionally, during on-site reviews, the examiner may arrange to review the corporate CUSO's compliance with all other applicable regulations, such as consumer regulations, state laws, and requirements imposed by other regulatory agencies (e.g., the SEC) as dictated by the nature of its business.

Finally, corporate CUSOs are encouraged to maintain appropriate levels of liability insurance and bonding. Management should periodically review coverage to ensure adequate protection. In reviewing the adequacy of bond coverage, examiners should use their professional judgment considering the CUSO's type (e.g., shared branching CUSOs would require similar coverage as credit unions), state law requirements, and insurance company recommendations.

Reserving

In the rare instance an examiner concludes the risk associated with a corporate CUSO's operation necessitates reserving by the affiliated corporates, the examiner will submit, with the concurrence of the CFS, a reserve recommendation with the report but in a separate memorandum to the OCCU Director. Examples of severe unresolved problems that may result in examiners recommending reserving include:

1. Material negative cash flow resulting in an inability to meet obligations;

2. Continual operating losses resulting in, or leading to, a deficit in retained earnings; and/or

3. Piercing of the corporate veil.

Reporting Format

Exceptions taken during the corporate CUSO examination will be communicated to corporate CUSO management as Other Examiner's Findings at an exit conference at the conclusion of the examination field work. Copies of these findings will be sent to the chairman of the board of the affiliated corporate(s).

The examiner will prepare a corporate CUSO examination report that will include, at a minimum, an executive summary as to the state of the corporate CUSO's financial and operational condition. The executive summary will outline strengths and weaknesses within the operation, and will clearly address any risks corporate CUSO operations may pose to the investing or lending corporate. The report may include a confidential section communicating any internal comments to the OCCU (central) office, as well as a summary as to the scope of the corporate CUSO examination. The report will be distributed to the CFS, the OCCU central office, affiliated corporates, state supervisory authorities of affiliated corporates, and to the subject CUSO (i.e., excluding the confidential section, as appropriate).

When the corporate CUSO poses significant risk to the corporate, the examiner will develop plans for action, review them with the CFS and OCCU Director (if necessary), and present them to corporate management. This may include, but is not limited to, reserving requirements. Since corporate CUSOs are not regulated institutions, NCUA does not have the authority to provide corporate CUSOs with a Document of Resolution. However, corrective action can be communicated to the corporate(s) having investments or loans to corporate CUSOs so they can minimize their risk of loss.

Examination Objectives

The examiner will address the following major examination objectives during the review of the corporate's investment in or loan to a corporate CUSO:

1. Determine the corporate is in compliance with the corporate CUSO investment and loan limitations as provided in 704.11(b);

2. Determine the corporate CUSO is structured in a manner consistent with 704.11(a)(4);

3. Determine the corporate CUSO is operated as a separate entity from the corporate. This will include a determination there exists an adequate "corporate veil" between the two entities;

4. Determine the services offered by the corporate CUSO are related to the normal course of business of credit unions;

5. Determine there are no conflicts of interest between an official of the corporate and the corporate CUSO pursuant to 704.11(f);

6. Determine the corporate CUSO has provided, and is in compliance with, the written agreement required by 704.11(g); and

7. Determine if circumstances warrant an independent corporate CUSO review.

Examination Procedures

See Corporate Examination Procedures - Credit Union Service Organizations (OCCU 311P).

Examination Questionnaire

See Corporate Examination Questionnaire - Credit Union Service Organizations (OCCU 311Q).

References

1. Section 704.11 of NCUA's Rules and Regulations

2. Chapter 25 of the NCUA Examiner's Guide, Corporate Credit Union Service Organizations