

Executive intelligence on credit union exams, enforcement and risk management

Popular 'Pre-Funded' Benefits Plans May Be Riskier Than Many CUs Realize

For many credit unions, the growing cost of health care and employee benefits has been a challenge, compounded by slower earnings growth from the economic slump. Slashing benefits is a tough alternative since it makes your CU seem like a less attractive place to work at a time when competition for the best and brightest is intense.

But a growing number of vendors have a solution: investment programs that allow you to "pre-fund" the cost of benefits and earn higher yields on your money.

The idea exploits a little-known exception to the NCUA rule on impermissible investments. With credit

unions flush with cash, and with margins slashed to the bone, more and more institutions are giving the idea a look.

At the same time, the programs present potential new risks for credit unions, since some of them are tied to equities and other investments that can rise or fall depending on interest rates or the economy.

The array of vendors offering the programs include CUNA Mutual Group and a host of smaller firms, which are touting the programs as a new and relatively easy way for credit unions to close the benefits gap, and gain an edge on the competition.

"Planning and accumulating general assets or 'pre-funding' for employee

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NCUA Approves Hefty Assessment as Corporate Loss Estimates Decline

There is good news and bad news about the costs of the corporate CU bailout.

First, the bad news: the NCUA has approved a record assessment of \$1.96 billion or 25 basis points for 2011 to cover the corporate "stabilization" fund. The assessment – the largest in the three years that CUs have been forced to help shore up the fund – will drive hundreds of CUs into the red this year.

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Should You Hire a CRO?

The risks associated with running a credit union are certainly not what they used to be. Gone are the days when your only worries were the direction of interest rates or the credit-worthiness of borrowers. Today you have a smorgasbord of risks to consider – from security concerns relating to new technology to complying with the seemingly ever-increasing demands of regulators.

More and more financial institutions are formalizing and centralizing risk management by hiring a single risk manager.

That raises some questions: Can you afford to have a Chief Risk Officer? Can you afford not to?

SSR spoke with three experienced risk-managers to get their views on how CUs should be stepping up their efforts in a risky world. The informal roundtable included:

Jeannie DeCarlo, senior vice president, operations, and chief risk officer, USE Credit Union (\$718 million), San Diego, Calif.; Jenny Morrison, vice president and senior risk manager, Corporate One FCU, Columbus, Ohio.; and Steve Ruwe, senior vice president, and chief risk officer, PCSU Financial Inc., a St. Petersburg, Fl.-based credit union service organization that serves 600 credit unions.

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benefits,” CUNA Mutual said in a recent ad, “is one way credit unions can position themselves for a competitive advantage as other employers continue to ask employees for deeper benefits sacrifices”

While there is no official count of credit unions that are participating in pre-funding programs, interest is apparently rising, and boosters are in growing attendance at industry trade shows and other events.

“Credit unions are really coming to understand how they can make or use pre-funding as one of their investment tools,” says Joe Tripalin, marketing director for O.M. Financial Group, a Madison, Wis., firm, which has done hundreds of benefit-related plans for credit unions around the country.

“For credit unions that have a significant amount of excessive liquidity using a program like this benefits them. They can enjoy some additional yields that they cannot normally get in their regular portfolios,” says Tripalin, who formerly headed CUNA Mutual’s executive-benefits program.

NCUA rules permit CUs to invest in “otherwise impermissible” investments so long as the investments relate to their employee benefits obligations. A series of NCUA legal opinions since 2004 have continued to expand the field. The rising cost of health-care, and moribund lending conditions have credit unions increasingly seeking out options.

The NCUA regulations do not detail what investments are permissible to fund the benefit plans. “Rather than regulate it via the rulemaking, the takeaway is that diversification of the portfolio is critical and that the FCU/NCUA must approach the matter through safety and soundness considerations,” said NCUA spokes-

man David Small.

The credit union must determine whether the benefit plan is “reasonable” given its size, financial condition, and duties to covered employees, Small said. Among the factors that are to be taken into consideration: employee benefit plan documents; date or dates of investment purchases consistent with assumption of the employee benefit obligation; anticipated maturity of the investment and evidence that the credit union has calculated the amount of the investment and the anticipated return on investment to match the benefit obligation.

Pre-funding packages have sprung up with an array of investment plans, such as insurance-based products, annuities and mutual funds, including ones that invest in stocks. The amount that credit unions are allowed to invest in the vehicles is limited by the estimated future costs of their benefit program obligations. Proponents say most credit unions choose not to invest that much money, although in some cases they may invest in sums that approach or exceed their equity.

Some benefit experts are skeptical about the trends, however, and are concerned that credit unions, starved for growth and earnings, are essentially gambling with member funds. In essence, they are saying the benefits promised are too good to be true.

“We think these credit unions out there are taking undue risk,” said Keith Mahan, a principal with Executive Compensation Solutions, Covina, Calif.

Mahan says some credit unions may be taking riskier positions than banks in their pre-funding of employee and officer benefit costs. Banks must fund their programs with investment-grade instruments, he says, while credit unions involved in some pre-funding

programs appear to be moving far afield from that standard.

“The use of equity securities, in either mutual funds, or annuity and insurance products, is widespread. The authority to invest in such investments is blurry, at best and non-existent at worst,” Mahan contends.

He advises using fixed accounts and investment grade bond accounts to fund benefit obligations. He says they offer good returns without the worry of fluctuating and volatile markets.

Mahan adds that credit union executives should be asking these questions before pursuing pre-funding programs:

- Do we understand the risks we are taking with the investment vehicle chosen?
- Does the investment vehicle chosen create any safety and soundness issues for the credit union?
- Have we looked at not only the “projected” investment performance, but also the worst-case scenario?
- Are we prepared to deal with an underwater investment in the event the credit union incurs a payment event when the underlying investment is not performing as anticipated?
- Do we understand how the performance on this small piece of your balance sheet might impact the rest of the balance sheet?
- Are we prepared to explain to our members the process we went through in making long-term decisions about their money?


Accounting rules could also come into play, requiring that some of the pre-funding investments reflect their current market value, which could help or hurt earnings, depending on how markets and interest rates have been moving. Thus the programs

could affect your bottom line.

Tripalin says, in the case of O.M. Financial, potential credit union customers are fully apprised of the risks as well as the benefits of the various alternative investment choices the firm offers, and that efforts are made to tailor the products to the particular risk appetite of institutions.

“As you consider a program, you really need to understand the accounting impact,” he said. “Depending on the type of investment utilized, there

could be some real negative impacts that you have to realize, which could impact the credit union’s financial standing.”

“I think regulators understand the program, and what credit unions are trying to achieve,” Tripalin says. “I don’t think they endorse it or not endorse it. I think they are taking a look to understand how big an investment this is, and what does it look like in terms of the credit union’s other investments.” 

(Chief Risk Officer continued from p. 1)

DeCarlo assumed the title of Chief Risk Officer about four years ago. She had taken a leave from the CU to get a master’s degree in security administration. Upon her return, it was decided that she should be taking on added risk-management duties in addition to her operations role.

She spends about half her time on security-related issues. And along with the rest of the USE executive team, she sits on an enterprise-risk management committee.

She acknowledges that the CU has done “some pretty risky things” but it has also set up the processes to manage them.

The CU has ratcheted up its risk profile, with a focus on electronic financial services, rolling out smart phone applications for mobile banking, and a remote deposit capture program. Those are things that could keep any self-respecting risk manager up at night.

But USE also goes through an extensive and robust business case process when it is looking at improving or introducing new products that examines ten different risk factors.

She offers a rule of thumb: being the first to embrace the latest trends and always choosing the best-known vendors can mean lots of heartache and headaches.

For example, mobile banking applications, while popular, are not all that secure, at least in some early versions. A risk-savvy position would be to wait until the bugs are worked out – and losses incurred by early adopters – to enter the market.

The notion that “Everybody is doing mobile banking, let’s do it, too,” and “We will go with a reputable company and we will be fine,” DeCarlo says, is “not necessarily true.”

While the size of a credit union is a factor in deciding how to structure a risk-management function, more important, DeCarlo says, is its risk appetite.

“If you are a risk-averse organization, someone who does not take a lot of risk, it is probably not necessary” to have a separate, centralized risk-managing function, she says.

Some organizations, she observes, cope by breaking up the various func-

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tions, having the IT department ride herd on membership security issues, for example.

“For a small credit union, it is risk awareness more than anything else,” DeCarlo says. “Just knowing what your risk is and the levels of risk are really helpful in making decisions,” she says.

That should lead to a fairly straightforward analysis: “As with any kind of risk, you either mitigate it, and you don’t do what you are proposing to do because you don’t want to take on that risk, or you accept that risk but share it.”

“Your regulators are going to be a lot happier if they know you have done the analysis,” she says.

Corporate One has one of the most

extensive and elaborate risk-management programs. Morrison was hired about 10 years ago to do traditional interest and credit risk analysis. Her own career shows how the field has grown. Corporate One’s risk-management function originally consisted of just her and an analyst. It’s now a full-time staff of eight.

“It definitely moved beyond what I was hired to do,” she says. “The fact that I spend time in operational risk assessment is completely different than what I was initially hired to do.”

“I can’t imagine having more than a billion on your balance sheet, and not really being where we are” in terms of having an extensive risk-management program, she says. “I cannot say everybody has to have one. But I think

given the complexity of risk management and the complexity of the regulatory environment, just managing the exam and the regulatory expectations mean you have to have a full-time department with more than just someone like me.”

“The board has to set the tone,” she says, by first clearly establishing the level of risk the CU is willing to take, and then by being informed on a consistent basis what risks management is proposing to take.

“The risk-taking versus the risk-management side ... has to be separated,” she says, “and housing risk management under a CFO may not provide you the separation of duties and responsibilities that you need.”

“I think it really comes down to

New CUSO Rules Won’t Limit CU Leasing Options

The NCUA is proposing to tighten regulation of Credit Union Service Organizations. But in a key area, the area has decided to give CUSOs and their member CUs a break: owning and managing real estate.

An FCU that owns and occupies a building can sell it to its CUSO and lease it back so long as the lease agreement covers at least half the building, the agency’s Office of General Counsel held in an August 3 letter.

Because CUs are normally subject to stricter occupancy requirements, the ruling gives CUs more flexibility in managing their real estate holdings.

It also has at least the incidental benefit of helping some CUs conform to NCUA limits on fixed assets, which have recently been

tightened, although the agency said such deals cannot be used to circumvent the fixed-asset rules.

The NCUA has long permitted CUSOs to manage and develop fixed assets including real estate. If a CUSO chooses to lease property, however, it must lease it “primarily” to credit unions, members or affiliates. The definition of “primarily” for purposes of the CUSO rule has been unclear until now.

The issue arose in the case of an FCU that owned a two-story, 11,300 square foot office building. The FCU occupied the 5800-foot first floor. A non-CU tenant occupied the smaller second floor.

“The credit union owned the property and wanted to remain in that place for a period of time,” said Guy Messick, of Media, Pa.-based Messick & Weber, P.C. “It

also had a good tenant.”

But under NCUA rules that presented a dilemma.

“Credit unions can have tenants in their buildings but they are really supposed to be placeholders while the credit union expands in the space,” Messick explained. “CUSOs have more flexibility to use the space and have (non-CU) tenants over a longer period of time.”

The NCUA Office of General Counsel told Messick in a written legal opinion that the sale-lease-back was permissible so long as a majority of the building was leased out to a CU or affiliates. Since the FCU would be leasing more than half the space, the agency cleared the proposal.

“In this case, we believe the ‘primarily’ serves requirement is

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corporate governance. If you are taking a very, very low level of risk ... then you are probably OK throwing risk-management under the CFO and compliance folks,” she says. “But I think once you get to a certain level ... corporate governance requires a division of duties.”

For smaller natural person credit unions, she says, it is a more difficult call. “There is no way they are ever going to have a staff that can separate out risk management. They have people who wear so many different hats,” Morrison says. “It is really difficult to say there is a magic size, and this is the size, and there is a magic product mix and this is it, in making a decision to add this functional area.”

Ruwe acknowledges the difficult cost-benefit dilemma that many CUS face in deciding whether to enhance risk management.

“The practical side of me says it is probably not realistic for every credit union to be able to support a unique resource dedicated to risk manage-

ment,” he says. “However, I think there’s going to have to be someone inside of every credit union that wears that hat,” whether it be the CU president or chief operations officer.

“There are just too many things that can affect a credit union if someone is not keeping an eye on enterprise risk.”

“Someone needs to be focused on that at some level. There are just too many things that can affect a credit union if someone is not keeping an eye on enterprise risk,” Ruwe says.

Credit unions look to the CUSO for certain aspects of their risk exposure: Ruwe oversees a major unit that focuses on fraud protection, for

instance.

“We take that clearly on our shoulders,” he says. “But I am not looking at things in their organizations that cover risk categories like financial risk or compliance risk or operational risk or risk to their strategic plan. I am addressing one aspect of their risk, which is both financial and reputational. I am trying to prevent fraud on their behalf.”

“Somebody at the credit union better be focused on these things, and it really depends on the size of the organization,” Ruwe says. “There is a lot of risk out there that a lot of people don’t even think about. It is not enough to be just aware of the fact. Identifying those things is half the battle. The other part of the battle is taking those elements you have identified as potential risk and making sure all the parts of your credit union are on the same page as to how those things are going to be managed. 🧑‍💻

(NCUA *continued from p. 1*)

The good news: the total projected losses from the corporate mess appear to be declining, and perhaps significantly. A new analysis for the NCUA predicts that it could cost \$1 billion less than previously forecast, and raises the possibility of even greater savings.

The new analysis, conducted for the agency by Blackrock Inc, was the third since 2009, and the most optimistic yet. Blackrock, based in New York, is one of the world’s largest investment firms, with some \$3.66 trillion (CQ) under management.

NCUA said the firm had been engaged to conduct quarterly mod-

eling of losses and cash flows from the assets backing up the guaranteed investment notes that NCUA has sold to help fund the corporate costs.

Based on that analysis, and other factors, the NCUA said future costs to the industry of paying off the corporate debts would range between \$1.9 billion and \$6.2 billion.

That compares with assessments of between \$5.0 billion to \$7.2 billion that NCUA projected last September, when it announced plans for selling notes backed by the so-called legacy assets once held by the defunct corporate CUs

NCUA said the latest analysis,

besides Blackrock’s estimates, also reflects “actual performance of the legacy assets, and updated projections in monetizing the other assets in the asset management estates.”

The agency also cautioned that recent economic volatility in the markets made it difficult to make precise judgments. “Blackrock’s new estimates forecast a wider range than previous projections given the ongoing economic volatility,” the agency said.

The range means that the total cost could still end up approximating pre-

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vious estimates. But it also raises the prospect that it could cost many billions less. And it puts an outer limit on the cost that is at least \$1 billion than earlier predicted.

The Blackrock estimates would put the total costs of the bailout – including billions in previous assessments and billions in capital losses that the corporates sustained directly – in the range of \$10.8 billion and \$15.1 billion. That compares with a previous range of between \$13.9 billion and \$16.1 billion.

The corporate meltdown stemmed from the failure of five large corporate CUs. The five went belly-up because of huge investments in mortgage-backed securities, which collapsed in value in the 2008 financial crisis.

The NCUA has filed four lawsuits against securities firms that packaged and sold the investments, claiming

billions in damages. But the new cost estimates do not include any provision for recovering any money from the suits, because they are considered overly speculative.

The \$2 billion assessment comes on top of \$1.3 billion in assessments in 2009 and 2010. NCUA said it would begin distributing the invoices with the assessment due by September 27.

The latest assessment, the agency said, would drive as many as 1,648 credit unions into the red for the third quarter. Some 811 credit unions, including a disproportionate number of smaller institutions, would have losses for the year because of the charges, officials said.

The handling of the corporate meltdown and the huge attendant costs have left many in the industry unhappy with the NCUA. An agency

proposal that would have enabled credit unions to pre-pay some of the corporate costs recently failed for a lack of industry interest. Some of the corporate CUs that have been conserved by the agency are also having trouble raising new capital that they need to survive, and they may fail again.

NCUA said that 2012 assessments for corporate stabilization fund would be 9 basis points, based upon June 2011 insured shares. That would raise about \$700 million.

The agency said there were no plans to charge a premium this year on the National CU Share Insurance Fund. The agency said the fund's reserve ratio remains stable, between 1.26% and 1.28% of insured deposits, within its desired range. It charged premiums totaling \$2 billion over the past two years as CU failures drained the fund. 📌

(CUSO *continued from p. 4*)

met because the CUSO will lease the majority of the building (5800 of the total 11300 square feet) to the FCU," Hattie M. Ulan, associate general counsel, wrote to Messick. "You should note, however, that a majority is not the only definition of "primarily" and will not be sufficient to meet the "primarily" serves requirement in all circumstances."

"We further caution that a leasing arrangement with a CUSO should not be used as a means for an FCU to circumvent the fixed assets rule," Ulan added.

Messick said the FCU was also con-

cerned about bumping up against the NCUA fixed-asset rule, under which an FCU with \$1 million or more in assets cannot invest in fixed assets if the investment would cause total fixed assets to exceed five per cent of shares and retained earnings.

Assets held by CUSOs have not been subject to the NCUA rule since 2004. Lease payments made to a CUSO would be considered within the definition of fixed assets for a CU – although those sums would presumably be much less.

The NCUA board is seeking comment on a proposal to expand its

reach over CUSOs, requiring all CUSOs to file financial reports directly with the agency for the first time. The agency says the proposal is necessary because of the lack of accurate and complete financial information about CUSOs and because the agency worries about undercapitalized CUs investing in them.

Industry observers say the proposal over-reaches, would be burdensome financially to the industry, and fails to acknowledge the benefits that CUSOs provide credit unions. NCUA is seeking comment until Sept. 26. 📌

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