Mid-Hudson Valley FCU

As of March 2009

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The Role of Corporates in the System

- ✖ Payment System
- ✖ Liquidity and Liquidity Management
- ✖ Field of Membership
- ✖ Expanded Investment Authority
- ✖ Structure; two tiered system

Corporate Capital

Permissible Investments

Credit Risk Management

Asset Liability Management

Corporate Governance

Payment System

The pressing issue related to payments is a corporate's ability to fund settlement associated with the payments services it provides. This is effectively a subset of the overnight and intra-day settlement and liquidity risks that corporates incur by being in the settlement services business. A corporate settles many classes of transactions including the payments it operates, payments others (e.g. Federal Reserve, banks, League Service Corporations, independent processors) operate deposits and associated dividends, loans and associated payments, etc. The ANPR asks whether the payment services should be isolated from other services to separate the risks. MHV believes that settlement of payments cannot be effectively separated and should be addressed in a broader context than just payments. This issue is addressed further under "Liquidity and Liquidity Management" below.

Corporates have managed other payment risks well – Corporates have offered payment services and managed the associated risks quite well for decades. In fact, part of the value corporates offer is mitigating some of their members' payment risks through corporates' payment offerings and associated settlement services. Assuming the primary issue of liquidity risk is addressed, there is little reason to believe that corporates cannot continue to operate their own, and distribute others', payment services successfully.

Corporates must offer payment and settlement services – The corporates are the primary financial institution (PFI) for most credit unions. To maintain this relationship, corporates must offer full lines of account services, settlement services, payment and correspondent services (regardless of whether they are operated or distributed by corporates), and short-term and intermediate-term investment and lending options. Eliminating any of these offerings reduces the corporate's value as the cash management provider and risks losing the entire relationship to non-corporate providers.

Corporate payment operations should be consolidated – The redundant corporate payment operations limit corporate profitability, slow capital accumulation, and inflate fees to members. The fragmented nature also limits incremental and radical innovation, while the limited (regional) markets often make new products infeasible because required scale cannot be achieved. The industry should consider consolidating corporate payments, and potentially those of some other credit union-owned payment operations, to better serve credit unions. Though this consolidation would require several years and considerable expense to complete, the long-term strategic and financial benefits to the industry would be significant.

Require corporates to isolate certain payment operations from the core corporate and require that the business model be self-sustaining (have sufficient capital and profitability). This will likely encourage consolidation and/or out-sourcing to third parties.

Also if we consolidate from 27 to one corporate, the efficiencies will come with that move.

<u>**Liquidity and Liquidity Management**</u>

Liquidity must continue to be a core service of the corporate system – The corporates are the primary financial institution (PFI) for most credit unions. To maintain this relationship, corporates must offer full lines of account services, settlement services, payment and correspondent services (regardless of whether they are operated or distributed by corporates), and short-term and intermediate-term investment and lending options. Eliminating any of these offerings reduces the corporate's value as the cash management provider and risks losing the entire relationship to non-corporate providers.

Improve liquidity strategies, plans, and modeling – Corporates' liquidity plans have been effective during many difficult economic cycles. The recent crisis has underscored several best practices that should be employed (e.g. multiple borrowing sources, adequate cash reserves to cover unexpected short-term liquidity swings). Require modeling of liquidity plans for typical fluctuations in economic cycles.

Establish best practice of set-aside funding for settlement – Require corporates to set aside a portion of liquidity to specifically fund daily settlement. The set-aside must accommodate the timing of settlement of debits and credits as well as the daily, monthly, and annual cyclical activity levels. The allocation must be clearly identifiable from other activity and reserved for settlement only.

Enhance liquidity contingency plans to accommodate more dramatic scenarios – Stress liquidity plans by modeling performance under more dramatic scenarios and adjust liquidity requirements/sources accordingly. Require provisions to increase existing or add new sources of liquidity if limits are hit. One such tool may be to secure member balances as the primary source of liquidity for settlement services and allow the required level of deposit to be adjusted under extraordinary circumstances (such as what the market is currently experiencing). For example, require members to maintain a settlement account balance equal to 1 to 1.5 times a credit union's average or peak historical settlement activity. This is a common practice by some corporates today. The contingency plan may include triggers that increase this requirement to 1.5 or 2 times the average or peak activity in order to ensure adequate liquidity to continue settlement.

Improve the Central Liquidity Facility (CLF) – The CLF has proven to be an invaluable tool for the NCUA throughout the credit and liquidity crisis. However, the agency has encountered legislative barriers that prohibited or hampered their efforts to effectively address the crisis. Conduct a comprehensive evaluation of the CLF and advocate for changes that improve it as a tool for use by the NCUA and the industry. Allow the CLF to serve the entire credit union industry.

Build corporate capital – Corporate capital has historically been adequate to weather economic cycles. However, this market crisis will redefine capital adequacy for all sectors of the financial services industry. Higher capital levels would provide corporates greater ability to either sell securities at a loss when liquidity is needed, or to hold securities that cannot be sold for a fair value (accommodate "Other Than Temporary Impairment (OTTI)"). Higher capital levels would also help the corporates retain higher ratings, preserving member balances and external sources of liquidity.

Field of Membership Issues

Impact of national fields of membership – Granting of national fields of membership did foster competition as well as increased risk-taking, as cited in the ANPR.

Several options of been recommended as follows;

The "Geographic FOM" alternative – One simple approach is to eliminate national FOMs and return to FOMs for the corporates' "home states" only. Enable corporates to distribute other corporates' investment and lending products, for a fee, to allow credit unions to diversify investments across multiple corporates without fostering the fierce competition that currently exists.

The "Preferred Corporate" alternative – A more practical alternative to the "Geographic FOM" approach is to allow each credit union to pick their primary corporate, regardless of location. This approach would involve the following:

We at MHV recommend one corporate with regional (perhaps mirroring the five NCUA Regions) offices. Why reduce from 27 to something more than one and to get to the economy of scales.

Expanded Investment Authority

Should only be considered outside of the basic corporate structure via the CUSO or separate corporate route.

Structure: Two-Tiered System

The Corporate System should be collapsed into a single tier – Many functions are replicated at the two tiers creating significant inefficiencies. Capital accumulation at both tiers is not feasible given current low margins and ROAs, prospective losses, and anticipated increases in capital requirements across the entire financial services industry. To gain efficiencies, improve margins, and accelerate accumulation of capital, one tier should be eliminated.

CORPORATE CAPITAL

Retain existing membership capital shares (MCS) until core capital is 6% – The existing membership capital shares are needed given the corporates' current capital levels. Once a corporate reaches this capital level, membership capital shares may no longer be needed and might be returned to members (without a notice period). Allow the corporate the option of maintaining this structure to augment core capital in order to fund additional products and services. Govern unforeseen circumstances by requiring NCUA approval of MCS distributions.

Limit services to members with any type of contributed capital – Limit access to the corporate's core services to those members that have contributed membership capital shares, term PIC, and perpetual PIC. As the Corporate Network is able to retire membership capital share and term PIC structures, users of services will all be perpetual PIC holders.

PERMISSABLE INVESTMENTS

MHV is not knowledgeable enough to make comments here.

CREDIT RISK MANAGEMENT

MHV is not knowledgeable enough to make comments here.

ASSET LIABILITY MANAGEMENT

MHV is not knowledgeable enough to make comments here.

CORPORATE GOVERANCE

MHV has no recommendation for changes here. The outside director is a concept that has some merit as long the qualifications were consistent with the charter of corporates and brought in an outside expertise not currently available. This would be a compensated position.

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MHV also strongly suggest term limits be put in place. This is healthy in any organization including the corporates.

SUMMARY

While some individual credit unions might not need the corporate system, the credit union movement certainly does. By making the system more stable, focused, capitalized and more efficient, we produce a more competitive, effective and sound wholesale structure.