PIEDMONT ADVANTAGE CREDIT UNION

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

Dear Ms. Rupp:

Please see below the comments representing our credit union concerning the NCUA's proposed rule to part 704 of the Rules and Regulations.

Legacy Assets

The proposed rule is silent concerning the issue of legacy assets – or primarily the private label mortgage backed securities. There are two issues of concern regarding these assets which aren't specifically addressed in the proposed regulation.

1. Can former corporate capital holders, whose capital has been depleted, have their capital restored in the future if the ultimate losses on the legacy assets are less than expected?
2. Will new capital deposited be at risk if losses are worse than expected on the legacy assets?

We believe that once a corporate met all applicable regulatory mandates, the corporate's board should be able to determine that any portion of the paid in kind PIC balance be redeemed in cash. The corporate credit union would thus possess the right, but not the obligation, to pay recovery dividends.

We recommend that the NCUA establish a bad bank which would house all the legacy assets from the corporate credit unions. This would enable credit unions to reinvest in the corporate credit unions without risk of loss from the private label investments that are currently impaired.

NCUA's model for growth of retained earnings of Corporate Credit Unions

The proposed rule establishes 3 standards that a corporate credit union must satisfy in order to meet its capital requirement: a leverage ratio, tier 1 risk-based capital ratio, and total risk-based capital. The NCUA intends the leverage ratio requirement to ensure that the corporate credit union's maintain a minimum amount of capital measured in terms of its total assets as protection against risks other than credit risk.

At least 4% of the capital ratio must be Tier I with a total capital ratio of 8%. Of the 4% Tier I, at least 1% must be Retained Earnings at the 6-year mark.

According to NCUA calculations, this would require earnings in the range of 0.15 - 0.20% of DANA (depending upon asset growth). This requirement will seriously limit the ability of these corporates to grow, and if unable to meet the required earnings, they could be forced to shrink assets.

The NCUA model in the preamble reflects a corporate credit union with a questionable concentration in investments (some at unusually high spreads) and doesn't even show the corporate credit union paying dividends on new capital. When you adjust their models to correct for those two flaws, the projection for net income is negative.

Also impacting earnings in the model is the recommended liability mix of 70% in term deposits, and 30% in overnight deposits. Reasonable enough, except for the fact the proposal also calls for eliminating a corporate's ability to pay a market-based premium if a CD is cashed in. With that provision gone, why would we invest in a CD rather than a bullet agency that could recognize a gain at sale?

What is the likelihood a corporate credit union could earn enough to grow retained earnings at this pace? Given the current economic environment and the proposed limitation on weighted average life of assets not to exceed two years, not very likely. While the new capital requirements are equal to banks, the investment restrictions are tighter than banks, which means the time frames to reach them are almost impossible.

What does it mean to natural person credit unions if investment spreads are too thin to meet the earnings range required? The two year average life requirement means your corporate could only issue short term loans. Spreads will decline forcing the corporate to reduce deposit rates substantially. Significantly higher fees associated with payment systems, potential changes in product offerings, and fewer competitive investing options. In essence, we could lose the very thing corporates were founded for: A low cost alternative for liquidity from the credit union system to the credit union system.

NEV sensitivity analysis / credit risk shock and prepayment speed slowdown test

There are two additional financial stress tests included in this proposal that Corporate Credit Unions would be required to perform and determine its impact to their NEV and NEV ratio.

If a corporate credit union fails the test it would be considered a regulatory violation. The repercussions could be very serious. As outlined in 704.8 (e) in the existing regulation – If a corporate credit union's decline in NEV, base case NEV ratio, or any NEV ratio resulting from the tests set forth in paragraph (d)(1) (i)violates the limits established this rule and is not brought into compliance within 10 calendar days, operating management of the corporate credit union must immediately report the information to the board of directors, supervisory committee, and the OCCU Director. If any violation persists for 30 calendar days, the corporate credit union

must immediately restructure the balance sheet to bring the exposure back within compliance or adhere to an alternative course of action determined by the OCCU Director.

These NEV test requirements are too restrictive for the corporate credit unions to take the appropriate level of interest rate risk and liquidity risk in order to attain sufficient earnings to meet their retained earnings goals.

Weighted average asset life

The NCUA Board is proposing a new section in 704.8(h) that will limit the weighted average asset life of a corporate's assets to two years. A corporate must test its assets at least once a month for compliance with this limitation and immediately report failures to NCUA.

Several major impacts to natural person credit unions may occur if this proposal is approved.

1. Less Liquidity – natural person credit union ability to borrow funds beyond two years will be adversely affected. Most loans will need to be made at a shorter maturity. The corporate will need to maintain the average weighted life of its loan portfolio with in the two year limit.
2. Higher Loan Rates – If a longer term loan is granted, a significantly higher rate and fees will be charged to compensate for the negative impact on the weighted average life test.
3. Higher Fees for Products and Services - To meet natural person credit union loan demand, the corporate will have to keep securities well under the two year limit. Reduced investment income for the corporate will result in higher fees to their members for all other services.
4. Lower Rates on Corporate Certificates - The two year WAL will drastically affect the corporate investment portfolio by reducing yield, investing in investments that provide cash flow, and diversification of the securities in the portfolio.

Constraining the weighted average life to two years may cause a lack of diversification in the investment portfolio and lower investment yield. Measuring concentration risk may be another tool to assist in evaluating the investment portfolio. In addition, placing more weight on a dollars at risk to capital approach than other testing may produce a more appropriate assessment in different economic environments.

Natural person credit unions have many choices outside of the credit union industry for products and services. Constraining the corporates and forcing them to charge non-competitive pricing to their members may result in decreased participation. Natural person credit unions want to support their corporate credit unions that share the same philosophy.

Corporate credit union business model and the consolidation of corporate credit unions

All of the items proposed by the NCUA and discussed above reshape the corporate credit union business model to the point that they won't be sufficiently profitable to serve their natural person credit unions. One of the most essential services provided by corporate credit unions is

liquidity for natural person credit unions. The NCUA, by severely limiting the amount of risk corporate credit unions can take on their balance sheet will drive most corporate credit unions out of business. By removing natural person credit union's primary source of liquidity, the NCUA will create a higher level of systemic risk in the industry than the intended risk mitigation their proposed rule will create.

Another solution would be to consolidate and merge all the corporate credit unions into one national corporate entity. The NCUA could better regulate the national corporate credit union to the point that its level of interest rate risk and liquidity risk would justify the growth earnings to reach prudent retained earnings.

The NCUA would have to make changes to its proposed rule as described in this letter for the national corporate credit union, but the trade-off would be improved regulation resulting from overseeing a single corporate credit union rather than the 26 existing corporates.

The existing 26 corporate credit unions could change their organizations to act as regional offices and retail outlets for the national corporate credit union.

Sincerely,

John Jameson
Chief Financial Officer