First Carolina
CORPORATE CREDIT UNION

March 30, 2009

The Honorable Michael E. Fryzel
Chairman, National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

The Honorable Rodney E. Hood
Vice Chairman, National Credit Union Administration

The Honorable Gigi Hyland
Board Member, National Credit Union Administration

Re: Comments on Advanced Notice of Proposed Rulemaking for Part 704

Sent via Email to: regcomments@ncua.gov

Chairman Fryzel, Vice Chairman Hood, and Board Member Hyland:

On behalf of its member credit unions, First Carolina Corporate Credit Union (FCCCU) appreciates the opportunity to comment on the ANPR for Corporate Credit Unions. FCCCU is a retail corporate credit union primarily owned by and serving credit unions in North and South Carolina.

Our comments reflect views of FCCCU with input from its member credit unions. The ANPR process is coming at a time of great uncertainty in the financial markets and the impairments at Wescorp and US Central and corresponding impairments of corporate and credit union capital have shaken the entire credit union community. It is critical for the credit union system to be transparent in its dialogue regarding any re-structuring of the corporate network as well as in the analysis of ongoing balance sheet problems in the corporate system so that the most cost effective solutions for minimizing losses and providing continued services to the credit unions can be achieved.

FCCCU continues to believe that our member credit unions should ultimately decide the correct number and structure of corporate credit unions. Any plan put forth should respect the individual ownership of each corporate and focus on appropriate regulatory guidelines that will help improve the safety of the system going forward.

1. The Role of the Corporates in the Credit Union System

Payment Systems. *The NCUA requested comments on ways to "isolate" payment system service risks by separating it from other businesses (legally or operationally) or establishing capital requirements specifically for payment system operations. Comments on the earnings potential of a payment systems only business were also requested.*

Most corporates have offered payment services and liquidity/investment options for their entire history and have done it extremely well within established guidelines. Separating these functions would become difficult, as funds needed for settlement would need to be invested to allow interest to be earned, as settlement services typically is not an income producing function. Payment services along with liquidity options offered by corporates work hand in hand as the corporate provides these liquidity services to its members. This is the primary role of the corporates.

Payment systems at a corporate can typically be divided into two key functional areas:

1. The facilitation of settlement and funds transfer activities (e.g. wire transfers, ACH) and,

2. Payment processing activities (e.g. share draft processing).

One of the historic core roles of a corporate credit union is to provide short-term liquidity products – overnight deposits and loans. The settlement and funds transfer activities are integrated in these core offerings. It would be difficult and cost prohibitive to separate these functions without destroying the value a corporate provides.

Payment processing activities are distinct operations separate from settlement services. Although all corporates interact with a payment processor, not all provide this service in-house. Those corporates providing share draft processing services use the income earned from these activities to cover direct costs and offset overhead costs. In the Carolinas, payment processing is performed by Palmetto Cooperative Services (PCS) and First Carolina works very closely with PCS as all actual dollar settlement activity flows through our Fed account.

NCUA's concerns seem to involve the actual settlement of transactions rather than the processing of payments. This relates to reducing the risks of short-term funds being tied up in investments that cannot be liquidated. This is more a question of proper liquidity management than isolating payments processing. In our case, the payments processing is already an isolated business as it is done by PCS.

As with other managed risks within an organization, operational risk should be supported by adequate capital. The question is how best to quantify the risks associated with payment systems. To date, financial institution regulators have not developed a common methodology or a definitive conclusion on this issue. The Basel capital standards ultimately estimated the capital needed for operational risks should be based on a percentage of gross income or an acceptable internal model created by the institution (capital needed for specific payment services wasn't defined). We believe a risk-based capital system would more directly address the types and degrees of operational and investment risks rather than specific business line structure changes.

FCCCU has successfully managed its members' settlement and funds transfer needs without issue since its inception. FCCCU does not process payments internally but utilizes its partnership with Palmetto Cooperative Services to facilitate this function while FCCCU handles the funds settlement side of the transaction.

In summary, FCCCU believes that the risks associated with NCUA's concerns are more related to proper liquidity management of member monthly cash flow needs rather than the combined operations of payments and settlement. Forcing the separation of payment systems from funds management is not necessarily the most effective solution. As a system we should continue to work on increasing payment system efficiencies, however, member credit unions should ultimately determine which business lines a corporate provides.

Liquidity and Liquidity Management. *The NCUA requested comments on ways to preserve or strengthen a Corporate's ability to provide liquidity. This includes product limitations or cash flow duration limits.*

Liquidity management has been one of the core functions provided by corporates and a primary reason for the creation of the corporate network. Historically, corporates have managed their liquidity extremely well and have always provided their credit union members with attractive and efficient overnight investment options in combination with settlement services. The stresses created by the current global financial crisis do not mean corporates did not manage this function well.

Limiting the corporates ability to offer other products and services would be detrimental to our credit union members and their ability to manage their own balance sheets. Credit unions have come to trust and rely on the variety of liquidity, investment and correspondent services provided by their corporate and many credit unions see their corporate as an extension of their own staff and rely on the corporates for this liquidity source.

Liquidity management at the corporate level should be determined by analyzing historical and seasonal deposit and settlement activity over a defined period of time (i.e. 5years) as well as other extreme liquidity cycles. Corporates should also project their members liquidity needs for 90 days and shorter and ensure the corporate manages a portfolio which can provide this short-term liquidity to their credit unions. Adequate funds management policies and procedures should be in place to ensure sufficient liquidity levels are reached in a variety of liquidity buckets, such as overnight, up to 90 days, etc. Also, member borrowing should be based on the corporate's capital levels as well as looking at the corporate's historical loan levels during various cycles.

The CLF has proven to be an invaluable, yet under-utilized, tool for the NCUA throughout the credit and liquidity crisis. The NCUA should take all necessary actions to assure that the CLF can take full advantage of its statutory authorities to provide funding directly to corporates. The CLF needs to have the authority to provide funding directly to corporates, including the ability, in certain circumstances, to provide secured amortizing notes payable; the ability to enter into repurchase agreements and conduct repurchase transactions with corporates using investment securities; and the ability to make direct deposits, investments, and/or capital infusions into corporates. The CLF as an ongoing tool for managing liquidity within the corporate and credit union systems would greatly improve the future liquidity condition of the corporate system.

Finally, the corporate network should be set up to work cooperatively to participate in loans to credit unions to provide greater access to funding without taking on excessive risks. Given current balance sheet and capital issues at most corporates today, the ability of the corporate system to access credit externally has certainly become more limited. Therefore, funding mechanisms and resources such as the CLF will need to play a much bigger role in funding credit union liquidity needs going forward. It will take considerable time for corporates to restore their strong credit ratings so that access to external liquidity sources is not cost prohibitive.

For credit unions looking to expand their balance sheets and/or manage additional interest rate risk from mortgage loans held on their balance sheets, it may be difficult for corporates to compete effectively with term borrowings offered through the FHLB system given their government sponsored enterprise (GSE) status.

Field of Membership Issues. *The NCUA notes that national fields of membership for Corporates and the resulting competition may have resulted in significant risk taking. It requests comment on narrowing the fields of membership.*

First Carolina has had a national field of membership since 1995, however, it has always focused its efforts on serving members in its traditional core membership base of North and South Carolina. FCCCU has also always required at least membership capital shares be purchased by any credit union interested in joining FCCCU.

No additional risks were taken to serve non-core members. However, some corporates expanded their balance sheets by requiring minimal capital from new credit unions that brought in deposits, thereby shifting the risk of non-core members to the core group of members who capitalized the organization.

Although the current situation the corporate system finds itself in was not directly caused by granting corporates national fields of membership, it did add to the risk-taking some corporates employed. Under the original system design, each corporate was designed to essentially offer a similar menu of investment and correspondent products/services at somewhat similar pricing.

Fields of membership were limited so there were not the same incentives for taking on more risks on one's balance sheet. With the opening of all FOMs, the competitive environment slowly evolved and over the years increased the need to compress pricing and enhance yield as this was the primary way to differentiate between corporates and attract new credit union members (outside of one's "core" membership). This created more inefficiency within the system through duplications of infrastructures and led some corporates to take on additional risks without necessarily requiring additional capital. Plus, spending hundreds of thousands in advertising does not seem to be an appropriate use of member funds. Given the fact that state-chartered corporate credit unions can have national fields-of-membership, it would appear to be difficult for the NCUA to disband national fields of membership at the federal level.

Therefore, one option for addressing the issue of reducing competitive strains would be to require permanent capital at any corporate in which a credit union conducts investment/deposit business. This would help control the number of corporates a credit union would be willing to join and let the market decide the actual number of corporates. Credit unions may not see the need to have membership in multiple corporates, but if so, they would need to provide capital to any additional corporate they would join. The capital requirement should be uniform across all corporates as to minimize risk to the system while building Tier 1 capital.

We believe that this would be the most effective way of addressing competition in the system -- to require permanent capital investments at any corporate with which a credit union elects to do deposit business under one common capitalization formula.

Another option would be to have regional fields-of- membership that allow corporates within those distinct regions to choose to either remain independent or merge with other corporates within that region based on the needs and input of their members. Similar to the FHLB system, credit unions could only join corporates within their designated region. This would serve to reduce competition amongst corporates by encouraging consolidation along efficiency lines rather than dictating consolidation to the system and would allow corporates to serve their membership while cooperating across regional lines.

<u>Expanded Investment Authority.</u> *The existing NCUA regulations give Corporates the option to exercise additional investment authorities. The NCUA requests comments on modifying these requirements.*

Expanded investment authority provisions are set forth in the Appendix section of NCUA Regulation, Part 704, and outline the specific requirements for corporates to engage in investment activities beyond those available to all corporates under the main section of the regulation. First Carolina has elected not to engage in expanded investment authorities as set forth primarily because we did not believe that the additional returns available were sufficient to justify the additional infrastructure costs and additional risks assumed to take on expanded authorities.

The granting of expanded authority other than US Central created a competitive environment and probably encouraged risk-taking in a system where there were insufficient levels of retained earnings. In addition, concentration limits within the Corporate Regulation were generally based on total capital which allowed corporates to put member contributed capital at equal levels of risk as retained earnings. Although asset classes invested in were believed to be safe, high concentration in various asset classes have put significant strain on the entire credit union system. It also created an environment where competition was not only between corporates, but at times between corporates and US Central. While arguably providing higher yields to credit unions, these system strains hurt cooperation and the accumulation of retained earnings.

Given the fact we believe the re-structure/re-capitalization of the corporate network will be based on credit unions putting up additional permanent core capital, we are not convinced that credit unions will want a corporate to take additional credit risk afforded by the expanded authorities. In addition, it is clear that even greater oversight and stricter regulations did not prevent risk in the network.

Expanded authorities at US Central and corporates did allow the corporate system to offer its member credit unions extremely competitive term rate products and structured certificates such as callables. Most corporates operated under the Base or Base Plus authority and utilized US Central's expanded authorities to their own benefit while some corporates used US Central and their own expanded authorities to provide term investments to their members. It is the fixed rate term products offered within the corporate system that generally require additional investment authorities to provide. The question for credit unions is whether this is a worthwhile trade-off, to capitalize additional risk taking as opposed to buying direct into the securities market. Many larger credit unions already purchase fixed rate products (primarily government agencies) directly in the securities markets for diversification and liquidity purposes rather than rate. Rate is how the corporate network competed for this business, most probably at the expense of lower earnings and higher risk taking.

Corporates have traditionally been one of the safest places a credit union could have its money. FCCCU believes that the great majority of business and balance sheet products provided to credit unions do not require expanded authorities. All appropriate authorities should be contained within the base corporate regulation. If the credit union system desires an entity to provide a sophisticated line of fixed rate term and/or derivative products, a separate corporate or CUSO structure should be created to provide these balance sheet products.

Structure: Two-tiered System. *The NCUA seeks comment on whether the two-tier Corporate system structure (US Central and individual Corporates) is appropriate. Further, the NCUA requests comments on powers, authorities, and capital in the future.*

The primary purpose/benefit of the two-tier corporate structure was to centralize resources and expertise and take advantage of economies of scale. There remains an advantage to member credit unions for the corporate system to continue centralizing functions and aggregating balances. And, as originally conceived, one of its greatest strengths was distributing short-term liquidity within the credit union system. The greatest weakness of the corporate two-tier system was the need to capitalize two levels. Plus, the wholesale corporate was put in a position of assuming the greatest amount of balance sheet risk while having the least amount of capital.

Credit unions built a very efficient system and centralized many operations at US Central. Many corporates, to this day, still utilize US Central as intended to reduce redundancies and inefficiencies as recreating this infrastructure was not in the best interest of the credit unions or their capital. Many corporates chose to work within the original system as designed and provided their members with a variety of products and services at very competitive prices. All the while trying to minimize expenses and risk to the members.

Although as we evaluate current corporate system problems at the only wholesale corporate, US Central FCU, discussion leads to eliminating one tier, specifically the wholesale corporate/US Central. It appears US Central's balance sheet problems will require it to be an on-going entity for some time as it will need to manage down its investment portfolio over an extended period of time to minimize losses. Given this and the fact US Central does provide some aggregate value to corporates and thereby the credit union system, it could be used for a variety of functions going forward. Rather than tear down the wholesale corporate and build something in its place to handle overnight funds or automated national settlements, the system can utilize parts of this entity as it moves forward with a different overall structure. For example, it could continue to offer back-office payment products such as ACH as well as provide limited overnight investment products to maintain adequate liquidity levels to manage down its balance sheet. Of course, this could also be accomplished by moving these products to a separate CUSO entity. In whatever form a wholesale corporate exists, it should not be taking risk onto its own balance sheet but passing it down to the individual corporates who can then better determine their true risk tolerance levels. Capitalizing a two-tier corporate system is inefficient use of capital and allows for outsourcing of risk management which should not be allowed.

A wholesale corporate should not need additional expanded powers or authorities to manage overnight investments. Given the desire to minimize the need to capitalize two tiers, a wholesale corporate should not be adding risk to its own balance sheet which would necessitate more capital. A wholesale corporate's role should be clearly defined in the system to avoid the duplication of systems and infrastructure at the retail corporate level so the future corporate system is as efficient as possible. Capital requirements and investment authorities are addressed in other sections of this document.

2. Corporate Capital.

Core Capital. *The NCUA requests comment on establishing a minimum "Tier 1 Capital" ratio. Tier 1 capital at Corporates currently is retained earnings and, if issued by the Corporate, certain paid-in capital. Commenters are asked to offer their view on an appropriate capital ratio, as well as a time frame to attain the capital level. Comments are requested on the related issues that impact the capital ratio, such as seasonal fluctuations in corporate assets, retained earnings vs. contributed capital growth, and limiting services to members that contribute capital.*

First Carolina believes that the corporate system should transition to a more recognized and accepted financial institution standard for capital and follow the Basel capital standards. These standards currently include a minimum 4% Tier 1 capital ratio along with minimum risk-based capital ratios. The only variation to standard Basel guidelines would be the basis for calculating assets. Currently, corporates use a 12-month rolling average daily net assets to calculate capital ratios due to the seasonal fluctuations common to a corporate balance sheet. This would continue to seem more appropriate for corporates than month-end assets. Given current capital issues within the financial markets, existing Basel capital standards may change which would require a review of this regulatory standard for corporates.

To increase capital ratios by any considerable amount, a corporate will need to do a combination of strategies including reducing on-balance sheet assets, increasing retained earnings accumulation, and raising additional qualifying capital from its members. Given the illiquid markets, a sale of certain securities and/or US Central investments to reduce assets is not a feasible option. We would recommend a period of at least one year to allow corporates to execute their new capital plans upon the approval of new corporate regulatory capital guidelines.

Current loss exposures within the corporate network may also have a negative impact on the percentage of retained earnings to member contributed capital that a corporate may have. Given current extensive impairments to retained earnings across the corporate system, the focus for capital adequacy will need to be member contributed paid-in capital. It does not appear realistic to think that retained earnings can equal and/or exceed member contributed capital in the near term. We would recommend not restricting the amount of member paid-in capital to retained earnings. We also believe that a corporate should have the ability to pay back member contributed capital as they grow their retained earnings as long as all minimum capital ratios are exceeded.

Membership Capital. *The NCUA requests comment on membership capital restrictions. This includes (1) changes in terms/conditions to meet the definition of "Tier 2 Capital" under banking regulations, (2) the mechanics involved in adjusting member capital balances,(3) the delayed payout of downward membership capital adjustments for three years, and (4) restrictions on member withdrawals if the Corporate falls below its capital requirements.*

As stated previously, moving to Basel capital standards would require that all forms of corporate capital conform to Tier 1 or Tier 2 qualifying standards. This would require current membership capital to have a 5-year notice period for withdrawal similar to stock at the Federal Home Loan Bank (FHLB). Given the higher priority and focus going forward on Tier 1 capital, secondary capital/membership capital would probably play a lesser role in corporate capital ratios in the future. That said, membership capital/secondary capital would be used to augment a corporate's capital but would not represent the core of its capital base. Similar to today's practice, we believe an annual adjustment based on a common formula for all corporates that is based on a member's asset size and/or deposits at a Corporate is adequate and appropriate. Assuming a corporate meets its minimum capital requirements, we don't believe delayed payout of capital is warranted for secondary capital. Similar to the FHLB system, we believe capital adjustments on secondary capital should happen on a quarterly or semi-annual basis as long as all minimum capital levels are exceeded after any withdrawal adjustment. Withdrawals should be restricted if a corporate were to fall below its minimum capital requirements.

Risk-based Capital and Contributed Capital Requirements. *The NCUA requests comment on risk-based capital requirements for Corporates, a requirement for credit unions to contribute capital before receiving services, and the basis (share balances or asset size) for the calculation of contributed capital required from members.*

If corporates follow Basel capital standards then they would be subject to a risk-based capital standard as well as a minimum Tier 1 capital level. We believe these risk-based capital standards would be appropriate.

To properly capitalize risks pertaining to funds management, FCCCU believes corporate deposit services should be limited to members that contribute capital. We also believe the calculation for determining a credit union's required capital contribution should be standardized across corporates.

In summary, we believe that corporates should have risk-based capital standards, member contributed capital should be required for membership at any corporate, and minimum Tier 1 capital standards should follow the Basel capital standards.

3. Permissible Investments. - *The NCUA requests comment on limiting permissible investments at Corporates to those that exist for federally-chartered natural-person credit unions (NPCUs). Comments on specific investments examples (CDOs, NIMs, etc.) were also requested.*

Corporate balance sheets have required a wider range of investment alternatives along with more extensive investment and risk management infrastructure and expertise. Going forward, it appears appropriate that risk parameters be tightened and capital within the corporate system be increased to be more appropriately aligned with liquidity, structure, obligor/counter-party, and other investment risks. The cooperative concept of aggregating investment authorities and risk still holds merit and that can be improved upon by aligning capital and risk at the same level. Implementing risk-based capital standards will match appropriate investment risk levels to corporates' capital levels and therefore act as a self-regulating force in the process.

For years, corporates have invested in agency mortgage securities and less-risky asset-backed securities (ABS) structures which provided sufficient cashflow characteristics along with yield in order to pass along attractive rates to their members, all with minimal risks. Many corporates proved their ability to manage a portfolio of such products, along with a mix of products created by US Central. Guidelines need to be put in place to tightly control concentration risks in a variety of assets classes and an appropriate mix of fixed and floating rate instruments, cap risks, and extension risks. Even though expanded investment authorities were allowed for some corporates, we do not believe that more complicated structures such as CDOs and Net Interest Margin (NIM) bonds should have been allowed under corporate investment policies. New subprime and/or Alt-A mortgage structures will be difficult to find going forward, but should also be severely limited by concentration thresholds and types. Examples of other investment types that we would recommend be prohibited include long-term interest-only strips, long-term principal-only strips, and inverse floaters. Investments that are generally considered to be "limited liquidity instruments" are probably not appropriate for corporates if liquidity remains one of their core services.

We believe credit unions may have a difficult time re-capitalizing the corporate system without significant limitations with regard to investment authority and risk controls. Considering that corporates hold a large share of natural person credit union investable funds, permissible investments should be conservative and should be liquid (have an active secondary market). In general, corporate credit union investment authorities should be greater than most natural person credit unions due to its role in providing these services to credit unions which allows credit unions to operate with less investment infrastructure. A majority of credit unions don't have the internal resources to invest in a wide variety of investment options and look to the corporate to provide these products with minimal risks. However, allowing natural person credit unions to gain similar investment authorities given appropriate expertise also seems appropriate.

The world of investment products is always evolving and new products are always being introduced into the market. Going forward it is imperative that the corporates work closely with NCUA to fully understand new investment vehicles that will no doubt be entering the marketplace and permit only those that would benefit the credit union system without taking on undue risks. The new regulation will need to be open to these options as they develop.

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4. Credit Risk Management.

The NCUA requests comments on revising the reliance on credit ratings from Nationally Recognized Statistical Rating Organizations (NRSROs). Comments are requested on setting concentration or sector limits and the independent evaluation of credit risk within regulation.

FCCCU agrees with NCUA's concerns regarding the reliability and value of credit ratings in light of recent events. Prior to current environment troubles, the NRSROs have historically performed well in their roles of evaluating and identifying credit risk. FCCCU continues to believe that rating agencies have value in the pre-purchase analysis that goes into any prospective bond purchase. FCCCU believes that within the credit risk management area, two ratings from NRSROs need to be required on any investment and both ratings need to meet regulatory guidelines. In the event of a downgrade below acceptable levels with one rating, the investment would be considered out of compliance.

In addition, risk taking should be modeled off Tier 1 capital. FCCCU does not believe that secondary or membership capital was ever meant to be a risk asset. There should be different risk tolerances set based on RUDE capital, Tier 1 capital, and total capital.

There also needs to be specific guidelines in regard to concentration limits, which are excessive in the current environment. Concentration limits should be set on a variety of areas, such as investment classes, issuers/obligors, geographic distribution, etc.

5. Asset Liability Management.

The NCUA requests comments on requiring net interest income or spread widening modeling in regulation.

Net income simulation was always a worthwhile process and should be reinstated.

Modeling spread widening is also a worthwhile process, however, given recent spread widening trends we question what assumptions should be used. It may not be possible to manage a balance sheet using catastrophic spread scenarios based on current spread increases/widening over the last 24 months of market dislocation.

There are tools in place for modeling a variety of risk measures, they just need to be used and reviewed on an on-going basis with assumptions validated at least annually.

If expanded authorities remain, additional modeling and validation should be required.

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6. Corporate Governance.

The NCUA requests comments on minimum qualifications, training requirements, term limits, and compensation of corporate directors. Comments on Corporate Board structure (requiring outside directors or natural-person credit union representation at US Central) and disclosure of executive compensation were also requested.

Retail corporate level: FCCCU believes that the current process of the membership electing non-compensated representatives of the members is appropriate for the credit union system. We would suggest that perhaps ALCO committees have representation from staff, board, and 1-2 non-directors from within the credit union system who have expertise with ALM (CFOs or Investment Officers).

Wholesale corporate level: FCCCU believes that if there is a wholesale level organization it should have directors from both corporates and natural person credit unions. The NPCU representatives would essentially serve as "outside directors" and could be elected from credit unions that have capital in the corporate network.

Compensation of directors seems to be related to the use of outside directors as it might be difficult to get someone from outside the credit union system to serve on a board without compensation. If the so-called "outside directors" come from within the credit union system, compensation would not be appropriate. Based on our member input, most believe that directors should come from within the credit union system.

There have always been pros and cons to term limits of directors. On the one hand it takes time to properly train directors and there is the desire to retain strong directors. On the other hand, a regular rotation of new directors can be very healthy for a corporate credit union. FCCCU does not currently have term limits however does regularly rotate its board officers.

All corporates should set minimum qualifications for directors based on the overall complexity of its operation and investment authorities.

Transparency of executive compensation should be similar to what is appropriate for natural person credit unions. Compensation policies should be in place and require periodic/regular reviews to insure the process is legitimate. Executive compensation is an employment issue between the board and management that is already addressed in the regulation. State chartered credit union executive compensation is already public record through IRS records.