

S O U T H E A S T  C O R P O R A T E

**Response to  
NCUA's Advance Notice of Proposed Rulemaking  
April 3, 2009**

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

Re: Advanced Notice of Proposed Rulemaking to 12 CFR Part 704

Dear Ms. Rupp:

Over the last eighteen months, the corporate credit union network has experienced dramatic reductions in the value of its aggregate investment portfolio. These reductions, coupled with the dislocation of the credit markets, have undermined the network's stability. The NCUA Board recently took several actions to provide an immediate remedial impact. These actions include:

- A capital infusion of \$1 billion into U.S. Central Federal Credit Union, the corporate system's wholesale credit union, by the National Credit Union Share Insurance Fund (NCUSIF); and
- A temporary NCUSIF guarantee of all member shares, for any corporate credit union that participates in a voluntary program offered by NCUA.

These extraordinary measures have helped stabilize the network and enabled credit unions to return to their primary mandate, which is to provide affordable financial services to their members.

The Board recently issued an Advance Notice of Proposed Rulemaking designed to identify issues within the corporate network that may have contributed to the current state of affairs and to solicit comment on how to improve the corporate network going forward. Southeast Corporate believes that properly addressing the issues identified in the ANPR will further instill stability and confidence in the corporate credit union network and are grateful for the opportunity to contribute to this process.

### **Payment Systems**

It is the position of Southeast Corporate that it is not necessary to isolate payment system services from other services in order to separate risks. Separating payment services from other corporate services may add additional costs and inefficiencies to a corporate and its members without a commensurate reduction in risk. Southeast supports a review of payment services with the goal of generating efficiencies through further consolidation.

Payment system services are comprised of two related functions: processing and settlement. Southeast believes that the risks associated with payment processing have been and continue to be effectively managed, and the focus of the Board's risk management efforts should be on the liquidity risk associated with settlement. Southeast supports additional controls and risk mitigation efforts designed to ensure sufficient liquidity is maintained for settlement, and believes those controls can be effected without isolating the service. Southeast believes consolidating payment processing into several regional corporate-owned payment service centers would reap cost savings while providing systemic liquidity risk mitigation.

### **Liquidity and Liquidity Management**

Southeast Corporate recognizes that providing liquidity for the credit union system has been and continues to be one of the principal purposes of the corporate credit union network. Historically, corporates have effectively managed investments and ensured funds were available to meet members' short-term liquidity needs. Recent events underscore the need for corporates to reevaluate their investment positions relative to their cash flow needs. To this end, it would be beneficial for the NCUA to consider the risks presented by corporates' practice of matching liability maturities with the reset dates of floating rate assets ("short funding.") The liquidity risks that are inherent in this activity are generally not exposed during the Asset/Liability Management process as the modeling is generally confined to interest rate changes. Employing a cash flow duration limitation would not succeed in measuring or managing this risk. Southeast believes that adding a spread duration requirement to the ALM process, in conjunction with the current use of effective duration measures, would provide a more accurate vehicle for the measurement of this risk. The combined use of both of these shocks to a corporate's net economic value ("NEV") would be the best alternative. Although corporates are currently required to address different spread scenarios, the amount of change is not specified as it is in the case of interest rate changes (up and down 300 bps). The specified increase in spreads should be sufficient to encompass the amount of increase in spreads that have been witnessed during the most recent two-year period. Southeast also believes that incorporating spread widening into the NEV process will permit the measurement of this risk to be considered within the context of the entire balance sheet as opposed to the individual security. As is the case in measuring the level of a corporate's interest rate risk, the extent of a corporate's spread risk should consider the liability portion of a corporate's balance sheet as well by considering the amount of risk that is offset by the corporate's liabilities. An effective mechanism to achieve this is to mandate a maximum net economic value decline given a certain level of spread widening. Given the recent level of spread widening witnessed in the fixed income markets; it would be beneficial to mandate a severe widening simulation of several hundred basis points.

Southeast concurs that activities that may harm a corporate's ability to act as an effective liquidity provider should be restricted. The primary activity that could impair a corporate's ability to function in this capacity would be the excessive use of leverage in order to arbitrage. Southeast believes that although these activities should be

restricted, they should not be eliminated completely. For example, a commercial paper provides an ancillary source of liquidity to a corporate. However, a commercial paper program requires regular issuance (regardless of liquidity needs) in order to achieve placement during periods of market stress. Finally, a key shortcoming in the corporates' role as liquidity providers to natural person credit unions during the current economic turmoil has been the lack of a "backstop" during periods of unusually constrained liquidity. In order to continue to effectively engage in their function as liquidity providers, Southeast believes corporates should be provided direct access to the Central Liquidity Facility.

### **Field of Membership**

Southeast Corporate believes corporates should return to well-defined fields of membership. It can be argued that competition among corporates has resulted in improved products and services; however, it has also resulted in unacceptable levels of capital accumulation and risk. Free-market competition from outside the network is sufficient to drive efficiencies and product development.

A cooperative network of corporates with defined fields of membership could bring the sharing of best practices without associated pressures to assume unnecessary risks or accept unprofitable pricing. Such a relationship among the corporates proved to be very beneficial in the past for both the network and natural person credit unions.

### **Expanded Investment Authority**

Southeast Corporate believes a review of investment authorities is appropriate while still affording corporates adequate investment and ALM capabilities (for example hedging and loan participations) in order to manage risks and generate value for natural person credit unions. Within the context of a regional corporate network comprised of four to eight corporates, and improved risk management techniques evolving from today's economic crisis, Southeast believes investment authorities should be standard across the network, and supports regular validation of each corporate's risk management and investment expertise.

### **Structure: Two Tiered System**

Southeast Corporate feels that the current two-tiered corporate network is inefficient and concentrates too much risk at U.S. Central. Southeast believes a network of four to eight regional corporates would achieve additional economies of scale, the size necessary to support the needed infrastructure and expertise, yet be diversified enough to mitigate concentration risk.

### **Corporate Capital**

Southeast Corporate believes that NCUA should return to a risk-weighted methodology similar to that established by the Federal Banking Regulators under the Basel accords, taking into account the unique and purpose and structure of the corporate network.

Basel sets forth two separate capital measurements: Tier 1 (core capital) and Tier 2 (secondary capital) which are measured as a percent of risk-weighted assets. U.S. regulators have also added a leverage ratio, which is the ratio of Tier 1 capital to un-weighted assets. Southeast supports similar capital measurements for corporate credit unions, including a minimum core ratio requirement.

Based on the corporates' exposure to the current market turmoil, and the uncertain timeline of an economic recovery, it is difficult to assert a specific time for corporates to achieve capital ratio targets. Southeast Corporate supports the establishment of targeted capital ratios once the full impact of the current economic disorder can be measured.

Because of the sometimes significant seasonal fluctuation in a corporate credit unions' assets, Southeast Corporate supports the continued use of the moving 12-month, (risk-weighted) daily average net assets as the denominator for capital ratios.

Regardless of the final capital methodology adopted by NCUA, Southeast believes it is important that capital structures be uniform across the network. If not, an individual corporate may be tempted to weaken its capital position for competitive reasons.

### **Core Capital**

As is the case with natural person credit unions, corporate credit unions are owned by the members they serve and exist solely for the benefit of those members. Part of this service entails a transfer of risk from the members' balance sheets to their corporate credit union. Southeast Corporate believes members must take an active roll in capitalizing their corporate and, therefore, corporates should be limited to offering services only to those credit unions that contribute core capital.

### **Membership Capital**

Southeast Corporate believes that, to the extent that regulatory capital requirements are based on the asset size of the corporate (whether or not risk-weighted), member capital share requirements should be based on member balance sheet factors such as total shares, total investments or total assets at the corporate to mitigate the introduction of 'basis risk' into the capital formula. Also, capital adjustment periods should be contingent on basis used for capital ratios. (For example, if capital requirements continue to be based on a rolling 12-month denominator, an annual adjustment period should provide the corporates sufficient ability to adjust capital as needed. A more frequent adjustment period could be necessary if capital sufficiency calculations are based on spot numbers.)

Withdrawal of member capital shares should be permitted only if the corporate's minimum capital requirements are met.

### **Credit Risk Management**

The current crisis has exposed flaws in the rating methodology used by the nationally recognized statistical rating organizations (NRSRO). The use of NRSRO ratings in credit valuation will have significantly reduced value going forward unless regulatory oversight is extended to this industry. Corporate management must identify and obtain the necessary tools and resources to analyze potential and existing credit risk inherent in their individual investment portfolios.

Regulators should continue their oversight of policies, procedures, staffing and tools used to manage the level and types of credit risk presented by a corporate's investment activities.

Rather than requiring specific tests, regulations should require management to determine and perform additional tests based on the known and anticipated risks to their individual portfolios. New credit risk matrices must be established using the lessons learned from the current crisis, and should likely include risk factors such as sector, obligor, geographic concentration, broad NRSRO ratings, etc. These matrices should be incorporated into a risk-based capital calculation that would limit the degree of risk a corporate can take.

### **Asset Liability Management**

Southeast Corporate believes that net interest income stress testing is part of a comprehensive Risk Management process and should be reinstated as a regulatory required risk measurement. Net Interest Income simulation gives insight into the short run risk factors that can be missed by measuring NEV volatility alone.

Regulatory NII exposure limits have historically been linear as rates move away from a base case scenario. Limits are usually directed towards restricting exposure to certain changes in interest rates. As different tests are appropriate for different situations, Southeast does not believe that requiring a specific set of tests is the best solution. However, Southeast supports regulation requiring corporates to have the necessary expertise to identify risks and perform an array of tests as circumstances dictate.

### **Corporate Governance**

Southeast Corporate believes that an experienced and diversified board of directors is vital to a corporate credit union. A corporate's board is generally comprised of CEO's and other high-ranking officials of natural person credit unions fully experienced in matters affecting financial institutions and markets. Accordingly, Southeast believes allowing the members of the corporates to elect their directors without mandated regulatory qualifications remains the preferable method for selecting the board.

Southeast supports the current make-up of directors with direct ties to the credit union movement, while acknowledging that an outside director(s) can provide leadership from a different perspective and new ideas that may benefit a corporate. Similarly, Southeast recognizes there are both potential benefits and weaknesses in establishing term limits

for directors. Accordingly, Southeast supports the members' preferences regarding outside directors and term limits.

As to the disclosure of senior management salaries, such disclosure should be at the discretion of the board of directors of each corporate and should not be mandated by regulation.

Thank you for the opportunity to comment on this advance notice of proposed rulemaking.

Sincerely,



William G. Michael  
President and Chief Executive Officer