

From: Wendy Zanotelli [wzanotelli@unclecu.org]
Sent: Monday, April 06, 2009 3:33 PM
To: _Regulatory Comments
Subject: Wendy Zanotelli - Comments on Advanced Notice of Proposed Rulemaking for Part 704

April 6, 2009

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

RE: Comments on the Corporate Credit Union System Strategy

Dear Ms. Rupp:

On behalf of the California and Nevada Credit Union Leagues, I appreciate the opportunity to comment on the NCUA Board's recent actions designed to stabilize the corporate credit union system. The program, as initially outlined in *NCUA Letter to Credit Unions No. 09-CU-02*, and as further reflected in *NCUA Letter to Credit Unions No. 09-CU-06*, included three primary objectives regarding the corporate system: 1) maintaining liquidity; 2) strengthening capital; and 3) evaluating the existing structure of the corporate system via an Advanced Notice of Proposed Rulemaking (ANPR). Our comments will address the actions the Board has taken towards accomplishing these objectives, and reflect California and Nevada credit union input obtained through a series of meetings specifically designed to obtain input regarding the ANPR. By way of background, the California and Nevada Credit Union Leagues (Leagues) are the largest state trade associations for credit unions in the United States, representing the interests of more than 400 natural person credit unions and their 10 million members.

Maintaining Liquidity and Strengthening Capital

The Leagues have significant concerns that the Board's strategy, as crafted and implemented to date, does not fully take into account the serious repercussions to the natural person credit union system and, as a result, to consumers and credit union members. This concern has been further sharpened by NCUA's unexpected actions on March 20, 2009, involving U.S. Central FCU and Western Corporate FCU (WesCorp), which will have an especially pronounced effect on credit unions in the Western states. Further, we believe that the strategy is too narrowly-focused and inflexible in its approach in that it fails to take advantage of several other options and tools available to the Agency that could reduce the costs and impact of the program to credit unions. Our fear is that unless alternative methods and tools are used to soften the staggering financial blow of NCUA's actions, some credit unions may never fully recover from its impact. As a result, we believe there is a real risk that public confidence in credit unions and in the NCUSIF will be negatively affected. However, we are encouraged and cautiously optimistic that the Board's action on March 26, 2009, to ask Congress to form a Corporate Credit Union Stabilization Fund takes an important step towards addressing this concern. By spreading the cost of the stabilization action over as much as seven years, federally-insured credit unions are given the breathing room and flexibility they desperately need.

Impact on California and Nevada Credit Unions

As a result of the 69 percent NCUSIF write off, the accompanying premium assessment to return the NCUSIF capitalization ratio to 1.30 percent, and the write-off of PIC and MCA shares at WesCorp, the Leagues estimate that 478 federally-insured credit unions in California and Nevada—representing 97 percent of all federally-insured credit unions in both states—will experience negative ROA for 2009. Further, both states will see a 360 percent increase in the number of credit unions that will fall under Prompt Correction Action (PCA) requirements, as the number of credit unions in the “adequately capitalized” category or below skyrockets from 22 to 80.

While most credit unions will be able to absorb such losses and eventually recover (the average net worth ratio for California and Nevada credit unions is estimated to fall to approximately 9.2 percent, which is still well above the level to be considered “well-capitalized”), and all member deposits remain insured up to \$250,000, it's clear that in both states—where fallout from the housing crisis has already taken a toll on the financial health of some credit unions—such an

unexpected jolt could have a debilitating, long-lasting, and systemic effect on many credit unions, as well as the communities they serve. Ultimately, this will cause many credit unions to pull back from providing loans and other financial products and services to working families just when the national and states' economies need them the most. This has already started happening in some areas and, as credit unions assess the impact the Agency's actions will have on their operations, will surely accelerate. Some examples that have already been brought to the Leagues' attention:

- Branch closings. California credit unions made up approximately six percent of the 1,032 credit union branches closed in the U.S. in 2008. Reports from several of our member credit unions indicate that this trend has increased in the first quarter of 2009, and will no doubt soar as all federally-insured credit unions—but especially those in the Western states—reconsider their ability to maintain or open branches under the unplanned-for burden of the Agency's corporate strategy.
- Fear of long-term interest rate risk keeping credit unions from committing to low loan rates now. This problem compounds the already existing problem faced by many credit unions of already-depressed lending activity. For example, we have heard from a credit union in Nevada that their loan volume has already been virtually shut down; they are funding only 10 percent of applications submitted to them, and have experienced a reduction of 45 percent of funded loans from 2007 to 2008, as well as a reduction of 56 percent in the first two months of 2009. Like many other credit unions, the impact of the write-off, assessment, and corporate capital write-offs will heap even more harmful effects on this credit union and, ultimately, the members it serves.
- Credit unions critically close to seven percent PCA threshold for "well capitalized" turning away deposits in an effort to "manage capital" by not growing. A telling example representative of many other credit unions: a credit union in California's Central Valley is currently experiencing a loss of \$300,000 per month from loan losses caused by 15 percent unemployment and a 50 percent drop in housing values. In order to maintain a healthy net worth under current PCA requirements, the credit union has to force a two to three million dollar reduction in share balances each month. The effect of the Agency's actions on this credit union—and many more that are similarly positioned—will be to worsen a situation which is already extremely challenging, and to cause reductions in credit union membership and loan growth.

In addition, we are greatly concerned that the reduction in capital levels that credit unions will experience as a result of NCUA's actions will lead to a marked contraction in their lending activity. If, indeed, as Executive Director Marquis stated in NCUA's webinar on March 23, 2009, there is a correlation of 10:1 between capital dollars and lending dollars (i.e., a one dollar reduction in credit union's capital will lead to a \$10 reduction in loan dollars available to members), then we estimate that NCUA's actions—including the write off of PIC and MCA shares at WesCorp—will lead to a reduction in credit union lending *in California and Nevada alone* of approximately **15 billion dollars**.

Finally, the Leagues fear that—in spite of credit unions' healthy net worth levels—the combined effect of 1) a significantly reduced credit union presence in the consumer financial services market, and 2) previously unheard-of levels of credit union negative earnings could have a potentially damaging effect on the well-earned confidence that members and the public have in the safety and soundness of credit unions. Such an undermining of confidence in the credit union system is unwelcome at any time, but it could be particularly detrimental during such turbulent economic times, and could eventually lead to an increased risk to the NCUSIF. The Leagues are extremely concerned that NCUA has not explored and utilized other options to lessen these obviously deleterious effects. Our recommendations as to those legal, responsible, and reasonable options follow.

Immediate Actions NCUA Should Take

First, the Leagues urge NCUA to consider permitting credit unions to charge the insurance costs of the stabilization plan directly to Undivided Earnings rather than reflecting it on the Income Statement. We understand that NCUA has stated that Generally Accepted Accounting Principles (GAAP) dictates that credit unions following GAAP book the premium as an expense in the reporting period incurred, and that the Federal Credit Union Act (Act) requires credit unions to file their Call Reports in accordance with GAAP. However, we would like to point out that §202(a)(6)(C)(ii) of the Act further states:

Board determination.—*If the Board determines that the application of any generally accepted accounting principle to any insured credit union is **not appropriate**, the Board may prescribe an accounting principle for application to the credit union that is **no less stringent** than generally accepted accounting principles. (emphasis added for discussion)*

Clearly, the Act permits NCUA to substitute its own accounting principles for GAAP when necessary. As the Agency states—accurately—in *Letter to Credit Unions No. 09-CU-02*: "Current financial market conditions...are like nothing experienced since the Great Depression." Given this stark truth and the effect such conditions will have on credit unions—as well as actions such as the call to temporarily suspend mark-to-market accounting—we submit to the Board that dire economic times require bold action. Indeed, while some at the Agency may view permitting the expense to be booked in

this manner to be overly zealous, we are of the opinion that it falls soundly and reasonably within a fair reading of §202(a)(6)(C)(ii).

Namely, we believe that the application of GAAP in this situation would not be “appropriate,” since such an application would lead to a variety of negative consequences (e.g., previously unseen levels of negative earnings having a damaging effect on the confidence that members and the public have in the safety and soundness of credit unions) that could ultimately involve risk to the NCUSIF. Further, if the application of GAAP is deemed not appropriate, we believe that permitting the charging of these costs to Undivided Earnings would be “no less stringent” than GAAP, as the ultimate effect on credit unions’ balance sheets would be the same—namely, net worth would be reduced on the balance sheet by the same amount that it would have been had the charge been expensed through the income statement. In other words, the financial statements (certainly the balance sheet and footnotes) would still present accurately and fairly the overall financial condition of the credit union. Also, such a deviation from GAAP would not compromise the safety and soundness of the Fund. Therefore, we suggest NCUA seriously consider this avenue, and challenge the Agency to provide its reasoning as to why this authority granted to it by the Act is being left unutilized during such a critical time.

Next, the Leagues believe that the NCUA should utilize its regulatory authority to redefine the definition of “total assets” under §702.2(g) of the Prompt Corrective Action rule to exclude guaranteed or low/no-risk assets from net worth ratio calculations. This action would provide immediate relief in the following ways:

- It would allow credit unions to invest in no-risk assets and/or take certain assistance (e.g., loans from the CLF, asset purchase, guarantees, etc.), if necessary, without harming or diluting their net worth ratio.
- It would give many credit unions time to manage the multitude of challenging issues they currently face due to this once-in-a-lifetime economic crisis—which now includes the costs of the stabilization plan—without running afoul of PCA requirements.
- It would encourage additional credit union participation in the CU SIP program, therefore generating additional liquidity for the corporate system.

We applaud the NCUA for issuing guidance to examiners which includes instructions to recognize and allow for temporary reductions in ROA and net worth that result from credit union participation in the CU SIP program, and for recently taking action to amend its rule on the assessment of the federal credit union operating fee to exclude investments made under the CU SIP and CU HARP programs from the calculation of total assets. However, we believe it would provide more uniformity and reliability to formally make this redefinition via an amendment to the PCA regulation. If NCUA does take this reasonable and much needed step, the Leagues recommend that the following assets be excluded from “total assets” for the calculation of net worth:

- Cash
- Overnight investments in corporate credit unions
- CU SIP deposits in corporate
- Corporate CU CDs
- Insured institutional certificates of deposit
- Guaranteed student loans
- Share secured loans
- Guaranteed portion of SBA loans
- Shares and loans guaranteed by the government
- Other government/recourse loans
- Accrued interest of non-risk investments
- Loans purchased from liquidating credit unions
- Assets held with options to sell to government
- Loans under Corporate CU Loan Guarantee Program
- GNMA/FNMA/FHLMC (GSE) securities/bonds
- U.S. Treasuries
- Furniture, fixtures, and equipment
- Land and buildings

The Leagues performed a sample analysis of 9 credit unions as of December 31, 2008, which includes the impact of excluding these assets. This analysis also includes the impact of NCUA’s corporate stabilization actions, including the 100% write-down of credit unions’ PIC and MCA investments in WesCorp.

Credit Union	PCA Net Worth Ratio					Effect
	12/31/2008 as reported	12/31/08 with Risk-Adjusted Assets	Effect	12/31/08 Pro-Form with Corp Stabilization and Risk-Adjusted Assets	12/31/08 Pro-Form with Corp Stabilization and Reported Assets	
CU 1	7.64%	8.76%	1.12%	7.45%	6.50%	0.95%
CU 2	11.18%	13.80%	2.41%	11.74%	9.88%	2.08%
CU 3	7.85%	9.24%	1.38%	6.95%	5.91%	1.04%
CU 4	8.04%	9.13%	1.09%	7.61%	6.71%	0.91%
CU 5	7.05%	7.73%	0.68%	6.59%	6.01%	0.58%
CU 6	7.87%	7.97%	0.32%	6.87%	6.42%	0.27%
CU 7	7.77%	10.34%	2.57%	8.00%	6.01%	1.99%
CU 8	9.84%	14.41%	4.58%	11.88%	8.08%	3.77%
CU 9	7.81%	8.29%	0.48%	7.26%	6.84%	0.42%

Our calculations indicate that such a redefinition of “total assets” can positively impact credit unions’ net worth ratios in the range of 27 to 458 basis points. In the case of the stabilization effect, this change would have a dramatic and much-needed effect on some credit unions’ net worth classification. In our opinion, no/low-risk assets represent less risk to a credit union and should not require the same level of reserves as riskier assets. In the absence of a risk-weighted system for calculating credit union net worth (proposed and supported by NCUA in 2005) credit unions are unfairly and misleadingly penalized for holding assets that are of lower risk. Consumers, in short, are not being provided with an apples-to-apples comparison when a credit union’s net worth is calculated under NCUA’s PCA framework and current definition of “total assets”. Indeed, to ignore this option is to invite unnecessary instability into the credit union system when NCUA’s top priority should be to take steps towards system stabilization.

Tools Available to NCUA Through Congress

In addition to the immediate steps described above, the Leagues, CUNA, NAFCU, and other state leagues are continuing to work with Congress to obtain the following tools to help NCUA address current liquidity and capital issues:

- TARP or other government funds as a backstop to NCUSIF - Credit unions have been working with members of Congress to urge the Treasury to set aside at least \$20 billion of TARP funds to be accessed should corporate or natural person credit union losses covered by the NCUSIF exceed \$500 million. By allowing NCUA to reduce the current cost to credit unions of the corporate stabilization plan, this action would greatly mitigate the negative impact on credit unions’ ROA and net worth and would bolster both credit union system confidence and public confidence.
- Corporate access to the Central Liquidity Facility (CLF) - As recommended in the January 2009 report from PricewaterhouseCoopers LLC to the NCUA Board, the CLF should be used to infuse liquidity and capital into the corporates. A change to the Federal Credit Union Act would expand authority of the CLF beyond its current authority to make liquidity loans only to natural person credit unions to permit direct investment in corporates.
- Replenishment of the NCUSIF over multiple years - FDIC is currently permitted five years to replenish their insurance fund. Section 2 of H.R. 786 (which makes permanent the \$250,000 deposit insurance coverage for federally-insured financial institutions) would extend this period of time to eight years. In the interest of greater regulatory coordination within the financial services sector, we believe the replenishment period for credit unions should mirror that of banks, and are pursuing an amendment to this legislation to provide a similar restoration period for the NCUSIF.
- Risk-based net worth standards – Efforts to modernize the PCA system may also include urging Congress to consider the removal of all of the PCA stipulations from the statute and leave it to regulatory determination, similar to the system under which the banking industry operates. This would provide for greater flexibility and responsiveness, especially during times of crisis. Credit unions, which have proven to be less risky financial intermediaries than banks and thrifts, should be subject to a PCA framework that provides, at minimum, as much flexibility as the FDIC, the OTS, and the OCC utilize for bank PCA standards.
 - The Leagues also encourage the NCUA Board to support changes to the definition of net worth that would allow government assistance in the form of loans to credit unions to be included in a credit unions net worth ratio. Such loans, in the form of “Section 208” assistance, were use effectively in the 1980’s to help a number of credit unions through a severe economic crisis. These credit unions are now healthy, and are providing valuable services to hundreds of thousands of members. The loans that were used to help these credit unions were repaid, with interest.

- Credit union access to alternative capital – In order to effectively compete, to have a sufficient financial base to effectively serve their members, and to adjust to fluctuating economic conditions, credit unions must have the ability to build additional capital. Structured properly, giving credit unions this ability will provide an additional buffer to the NCUSIF, and make the fund stronger. We will work with Congress as needed towards this end.

The Leagues urge the Board to actively support the ongoing efforts to secure these tools for NCUA, and further recommend that the Agency assertively pursue the recently announced Treasury initiative designed to deal with troubled assets (i.e, the 'Public-Private Investment Program').

Other Possible NCUA Actions in View of Credit Union Ownership Interests

The Leagues would like to comment regarding NCUA's use of and reliance on Pacific Investment Management Company (PIMCO) and its analysis of the residential mortgage backed securities (RMBS) held by corporates. Before committing almost \$6 billion to replenish the share insurance fund, not to mention impairments of credit union capital deposits in corporate credit unions, credit union owners of WesCorp and US Central deserve very detailed information on the assumptions, methodology, and results of the PIMCO study in order to better understand the calculation of the cost estimates, and to determine whether the agency's cost estimates of the losses for the corporates are reasonable and justified. To date NCUA has provided credit unions little information about the PIMCO report, and absolutely no details from it. Further, we are gravely concerned about the apparent conflict of interest between PIMCO's role as analyst of corporates' portfolios and their publicly stated intention to purchase legacy/toxic assets under the Treasury's Public-Private Investment Program. If true, we believe that NCUA should lead the Agency to reevaluate PIMCO's current loss estimates for the corporates, as well as discontinue any further reliance on the company's analysis regarding this issue. At that point, the NCUA Board should work on devising a plan for credit unions to pay for the actual losses that may result from corporate investments as they occur, rather than requiring credit unions to pay up-front based on a theoretical estimate of the costs.

Finally, the Leagues propose that the Agency determine a regulatory or legislative solution to restore some or all of the member equity at WesCorp. Credit union members of the corporate deserve to have a degree of membership/ownership interest, and should have provided to them by NCUA the Agency's planned path to WesCorp's recovery and return to member ownership and control. AIG, BAC, Citigroup and others were technically insolvent and bailed out by the government, yet their shareholders were left with some, albeit significantly impaired, equity. The Leagues believe that a similar type of solution for credit unions should be explored. Such a move would go a long way towards restoring credit unions' sense of ownership, responsibility, and having a voice in WesCorp's future.

On an important related note: while we have strong disagreements with and concerns about much of the Agency's corporate stabilization actions to date, we would like reassure NCUA that the Leagues support the new CEO of WesCorp, and continue to communicate actively with our members the need to support the corporate and leave liquidity in the system.

Evaluating the Structure of the Corporate Credit Union System

NCUA's ANPR seeks input from all stakeholders in the credit union industry regarding reforms to the regulatory and functional structure of the corporate system. It is a sweeping reconsideration of the current role corporate credit unions play in the credit union system, including their charters, powers, investment authority, capital requirements, fields of membership, risk management and governance. In the Leagues' view, the ANPR takes an unnecessarily broad approach in that it assumes the current corporate system is flawed in virtually every respect, and therefore requires a complete retooling. While we fully acknowledge the serious stress that has been placed on the corporate system due to a variety of factors—some possibly foreseeable and preventable, some not—we do not agree that the current situation warrants what would amount to a wholesale remaking of corporates as they are known and used today. Therefore, rather than addressing the multitude of detailed questions in the ANPR, we would prefer to provide our views on the role of corporates in the credit union system, including our opinion of some of the key issues presented in the proposal.

The Role of Corporates

The Leagues believe that corporates serve a vital role for credit unions. By serving as a central point for credit union investment and payment system services and aggregation, they provide many services that typically would be economically available only to the largest financial institutions (e.g., share draft processing, wire transfers, ACH services, cash orders, etc.). By managing liquidity within the credit union industry, corporates are able to effectively and efficiently move excess liquidity to the areas of greatest need. In addition, they provide the wherewithal to help credit unions

manage risk, and are uniquely positioned to facilitate participation lending. Operational efficiencies and cost considerations prohibit many credit unions from obtaining these services directly from the Federal Reserve.

Without corporates, many credit unions would be largely dependent on more than one bank or bank-affiliated institution for these services, which would no doubt add significant additional costs and due diligence burdens to credit unions' operations, which would ultimately be passed on to members in the form of lower dividends or higher loan rates. We are reminded of the processing relationship (i.e., item processing, shared branching, and ATMs) that California credit unions had with Security Pacific Bank several years ago. When Security Pacific was merged with Bank of America, that relationship was severed by the bank over a six month period, which would have led to widespread dislocation and service collapse for California credit unions if WesCorp had not stepped in to pick up the item processing business and been instrumental in creating the business plan for Financial Service Centers Cooperatives (FSCC). Corporates have long maintained a necessary and trusted relationship with credit unions. Therefore, we strongly disagree with any action which would substantially alter the fundamental role and functions of the current corporate system.

Key Areas of Disagreement

Our disagreement with the ANPR includes NCUA's contemplation to establish separate charters for payment system services and investments, as well as a return to defined fields of membership. We believe such a move would be anti-competitive and would hamstring the viability of the corporate system, likely leading to future problems requiring intervention by NCUA and/or natural person credit unions. Furthermore, not every corporate offers a full array of services (e.g., item-processing for imaged items). Restricting corporate usage to geographic fields of membership would unfairly and unsafely restrict credit unions from accessing critical corporate services. Along the same lines, the Leagues feel that a requirement that an "outside director" be from entirely outside the credit union industry would be potentially damaging, and could serve to weaken the unique nature and philosophy of credit unions (and, frankly, we believe that such a requirement would not have prevented current circumstances).

Areas Where Improvements are Needed

While the Leagues staunchly support the continuation of the corporate system, we feel there is room for greater efficiencies, more effective risk management in the system, and governance enhancements.

Greater Efficiencies. We believe that corporate consolidation would be beneficial to the system, and that NCUA should be more open, responsive, and supportive of such consolidation by removing unreasonable impediments and/or resistance to corporate credit union mergers. We realize that each tier of the corporate network takes its own share of income, adds another layer of cost, each has its own capital requirements, all of which reduces efficiency and effectiveness.

More Effective Risk Management. Recent events indicate that corporates require a larger capital cushion, a greater diversification of investment to include more restrictions on concentration risk, and more—or at least better—risk management tools. In addition, to provide an even more robust "firewall" between corporate credit union risk and natural person credit union safety, NCUA might consider the creation of a separate insurance fund or separate insurance "system" for corporate credit unions in the future. As the Federal Reserve and Treasury contemplate measures for reducing systemic risk, it will be important to recognize the *systemically important* role the corporate system plays in the nation's "financial plumbing." Ultimately, 90 million credit union members rely on the corporate system to provide trading, payments, clearing, and settlement services for their local credit unions. NCUA's aim should be to assure that the credit union system as a whole is better able to withstand future shocks.

Enhanced Governance. Finally, the Leagues are of the opinion that term limits for directors would be reasonable, as would minimum standards for experience, knowledge, and training.

To summarize: the Leagues believe that while the corporate system is in need of some key adjustments, it is not broken. External factors are what caused the current crisis, not the corporate system structure. Going forward, our credit unions would like to be reassured that NCUA will maintain an ongoing evaluation as to the possible need to continue the corporate deposit guarantee past 2010, and that the Agency is prepared to address the concurrent maturities of CU SIP investments.

In closing, the Leagues thank the NCUA Board for the opportunity to provide the views, concerns, and recommendations of natural person credit unions on the Agency's unprecedented action. I cannot emphasize enough how critical it is that the Board seriously consider these views, which come from many of the credit unions hardest-hit by NCUA's actions. We urge the Board to act to strike an effective and fair balance between the current needs of the corporate system and the very real, long-term, substantial needs of the entire credit union movement, and to strive for cooperation and transparency

with credit unions in the process. We believe that to not do so will ultimately hurt public confidence in credit unions and the NCUA, and will be financially detrimental to American consumers.

Sincerely,

Wendy Zanotelli
COO, UNCLE Credit Union
Board Member, California Credit Union League