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January 12, 2010

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

Re: Marvin Umholtz Comments on Part 704 Corporate Credit Unions

Dear Ms. Rupp:

I appreciate having the opportunity to present these comments about proposed corporate credit union regulations to the members of the NCUA Board. The views expressed here represent my own professional opinion and do not necessarily reflect the opinions of any client or organization with which I am affiliated. I also urge the NCUA Board to review my March 6, 2009 comments on the *Advanced Notice of Proposed Rulemaking for Part 704 Regarding Corporate Credit Unions* since the remarks expressed in that letter still apply.

Comment Letter Contents:

Key Points From Umholtz Comments on Corporate Credit Union Regulations

- **No Capital Left.** For all practical purposes, there is no capital left in the corporate credit union network and corporate credit unions exist today only due to NCUA's regulatory forbearance and conservatorships. Even the handful of individual corporate credit unions that claim to have some capital left are woefully undercapitalized in relation to the risks represented by their untenable business plans.
- **Legacy Assets Problem.** In order to keep the NCUA Board's proposed corporate credit union regulations in the proper context, it is also important to recognize that adoption of these new rules in any form does nothing to address the legacy assets problem that weighs heavily on the corporate credit union network and the industry in general.
- **Political Solution Probable.** Without an effective solution to the legacy assets problem, the proposed corporate credit union regulations are essentially moot. In the long run a political solution potentially including a financial bailout in which the U.S. Treasury, the Federal Reserve, and the NCUA all play a role is a highly probable scenario.

- **Comprehensive Solutions Needed.** In the meantime, the credit union industry will have to (1.) work through its pain (and denial) about the probable end of the corporate credit union network as they have known it, (2.) come to terms with who – the marketplace or the regulators – decides which credit unions will be winners and which will be losers, and (3.) continue to pay high deposit insurance premiums to buy the needed time to come up with the broader and more comprehensive solutions to the huge toxic asset problem.
- **Fragile CU Capital.** Unfortunately, in retrospect the 1997 U.S. Treasury study appears to have been correct about the fragility of credit union capital arrangements. The current writedowns of corporate credit union contributed capital investments by the retail credit unions and the cascading effect of the corporate credit unions' losses validates that the "double-counted" capital doesn't hold up well during a huge systemic problem.
- **Firewall Corporates Mistakes.** The NCUA contends that had these newly proposed corporate credit union regulations been in effect, much of the current problems would not have occurred. While recognizing that the agency did lots of modeling to come up with that conclusion, I remain unconvinced that under the proposed regulatory regime retail credit unions would be sufficiently firewalled from corporate credit unions' potential mistakes.
- **Undercapitalized for a Decade.** The timetable for corporate credit unions to rebuild capital under the proposed NCUA regulations, both through contributed capital and retained earnings, is ten years. That suggests that any corporate credit union going forward would likely be undercapitalized for those same ten years. That's a long time to leave the NCUSIF and the TCCUSF exposed – and via those funds the retail credit unions would also remain exposed.
- **Regulatory High Bar.** The proposed corporate credit union regulations are most notable for what they do not do. They don't outline a viable corporate credit union business plan going forward under the new limitations. Not that they should, but the proposed regulations become a mere academic exercise if the bar gets raised so high (although probably necessarily high) that no corporate credit union can leap it.
- **Alternatives Must Make Business Sense.** If an alternative structure can be designed, it would still have to be sold to the credit union industry one credit union at a time before any retail credit union could justify to its board and membership the capital investments required to launch the substitute ventures. So far no one has publicly unveiled any approaches that make business sense.
- **Upgrade Problem Resolution.** The bottom line is that in order to manage the next several years, the NCUA will need to seriously upgrade its problem resolution capabilities, including those dealing with corporate credit unions. The failure to upgrade could impede the agency's ability to provide timely least cost solutions for the NCUSIF and TCCUSF.
- **NCUA Adopt FDIC Best Practices.** The NCUA Board should adopt all of the FDIC's problem resolution best practices in an effort to mitigate the costs to the NCUSIF. Keeping the NCUSIF costs down keeps the deposit insurance premium assessments down as well. Additionally, the perception that any corporate credit union is too big to fail must end and every corporate should have a credible plan for its rapid resolution in the event of distress – a living will. NCUA's resolution process must ensure that closing any corporate credit union will not lead to a systemic collapse.
- **Reform Deposit Insurance.** Although the NCUA Board's proposed regulations do not address the structure of deposit insurance, the credit union deposit insurance flaws were fundamental to the current problem and should be corrected. Whatever statutory or regulatory changes are needed to fix the situation should be made at the earliest opportunity.
- **Unlimited Claim on Capital.** In addition to the potential risks to the NCUSIF associated with the corporate credit union legacy assets, credit unions are also exposed to systemic risks from their involvement in the interconnected credit union industry. Essentially, the NCUA has an unlimited claim on all the capital at every federally insured credit union if

needed to fund resolution of problem credit unions, including the troubled corporate credit union network.

- **CU Industry Overhaul Process.** In addition to everything that they addressed in the proposed regulations, the NCUA Board needs to purge the dangerously interconnected regulatory and deposit insurance infrastructures of their inherent risks. Deposit insurance reforms, capital reforms, and access to additional income sources for retail credit unions top the list of needed actions. The proposed corporate credit union regulations are the beginning of, not the end of, the credit union industry overhaul process.

General Comments on Part 704 – Corporate Credit Unions

As described in the *NCUA Board Action Bulletin* posted following its November 19, 2009 meeting, the NCUA Board…"issued a proposed rule to reform the corporate credit union system by establishing a comprehensive new framework for safety and soundness. The proposed reforms are intended to enhance NCUA regulatory oversight and address deficiencies in the current rule…Each reform would directly improve an aspect of current oversight critical to the proper functioning of the corporate system. Lack of adequate capital standards, insufficient asset/liability management tools, and unacceptably high risk concentrations were problems identified by NCUA and stakeholders during development of the proposal."

The proposed rule for corporate credit unions revises 12 CFR Parts 702 – Prompt Corrective Action, 703 – Investments and Deposit Activities (for federal credit unions), 704 – governing Corporate Credit Unions, 709 – Involuntary Liquidation of Federal Credit Unions and Adjudication of Creditor Claims Involving Federal Credit Unions, and 747 – Administrative Actions, Adjudicative Hearings, Rules of Practice and Procedure, and Investigations. In the format as adopted by the NCUA Board, the corporate rule ran over 250 pages.

Although the NCUA Board's proposed regulations addressed many issues upon which to comment, the public comment process also allows for, even encourages, the commenter to address just about anything that he or she considers to be relevant to the central issues surrounding the corporate credit union network. In addition to risk concentration, capital expectations, asset/liability management, and governance, a wide range of related issues are germane. Credit union deposit insurance funding reform, problem credit union (including corporate credit union) resolution practices, ownership of the Central Liquidity Facility (CLF) and determining its future role, retail credit union capital and income reforms, etc. – all stand out among many other legitimate issues that have become exacerbated by the corporate credit union dysfunction.

The NCUA Board's proposed corporate credit union regulations also assume that there will still be corporate credit unions left to operate under these regulations, potentially including the two conserved corporates – Western Corporate Federal Credit Union (WesCorp) and U.S. Central Federal Credit Union – despite the legacy (formerly known as toxic) assets hanging precariously over the industry like the foreboding sword of Damocles. There is of course no explanation as to how this would be accomplished. For all practical purposes, there is no capital left in the corporate credit union network and corporate credit unions exist today only due to NCUA's regulatory forbearance and conservatorships. Even the handful of individual corporate credit unions that claim to have some capital left are woefully undercapitalized in relation to the risks represented by their untenable business plans.

It is difficult to believe that retail credit unions would recapitalize the corporates, especially WesCorp and U.S. Central. Perhaps NCUA is afraid to believe otherwise because the house of cards would tumble leaving the agency with no palatable solution. It is much more likely that NCUA will have to run those corporate credit unions (and perhaps more of them) as public utilities until the legacy MBS assets are all resolved. That could certainly take ten years to accomplish – and would likely be costly since a profit making business model for these negatively capitalized corporate credit unions has to date been both illusive and elusive.

Legacy Assets Hang Like the Sword of Damocles Over the CU Industry
In order to keep the NCUA Board's proposed corporate credit union regulations in the proper context, it is also important to recognize that adoption of these new rules in any form does nothing to address the legacy assets problem that weighs heavily on the corporate credit union network and the industry in general. Credible industry analysts believe these legacy assets represent as much as $20 to $30 billion in eventual losses potentially costing each credit union 300 to 500 basis points in deposit insurance premiums. Every federally insured retail credit union is also on the hook for these legacy assets via the National Credit Union Share Insurance Fund (NCUSIF), the Temporary Corporate Credit Union Stabilization Fund (TCCUSF), and the Central Liquidity Facility's (CLF) U.S. Treasury borrowings that have been used to provide the corporate credit union network with emergency liquidity.

As stated by NCUA Board Chairman Deborah Matz in her December 9, 2009 speech to the Credit Union Executives Society (CUES) Directors Conference, "The first priority must be to remove what we call 'legacy assets' from corporate balance sheets. Several corporates, including U.S. Central, are still holding high concentrations of downgraded securities backed in large part by non-performing mortgages with terms of up to 20 years. These investments will likely continue to cause losses and further deplete corporates' capital until the legacy assets can be repackaged and sold. We are evaluating all possible options to alleviate the problem. Removing large impairments from corporate balance sheets will be pivotal to allow corporates to rebuild capital through retained earnings. The rate at which safe capital levels return will also depend on the willingness of retail credit unions to provide additional contributed capital."

Without an effective solution to the legacy assets problem, the proposed corporate credit union regulations are essentially moot. In the long run a political solution potentially including a financial bailout in which the U.S. Treasury, the Federal Reserve, and the NCUA all play a role is a highly probable scenario.

The NCUA-managed CLF has already borrowed tens of billions of dollars from the U.S. Treasury's Federal Financing Bank to provide the liquidity need to forestall the forced sale of corporate credit unions' underwater securities (which would lock in huge losses), inject capital into the conserved U.S. Central, and to fund the TCCUSF. Under existing statutes – 12 USC 1795f (b)(1) and (2), and 1795j – the CLF can also serve as an agent for the Federal Reserve. If necessary, the NCUA via the CLF could take over the entire liquidity and payment systems role of the corporate credit union network and at the same time manage the wind down of the legacy assets with the help and guidance of the Treasury and Fed.

In the meantime, the credit union industry will have to (1.) work through its pain (and denial) about the probable end of the corporate credit union network as they have known it, (2.) come to terms with who – the marketplace or the regulators – decides which credit unions will be winners and which will be losers, and (3.) continue to pay high deposit insurance premiums to buy the needed time to come up with the broader and more comprehensive solutions to the huge toxic asset problem.

Proposed Corporate Credit Union Regulations Well Intended, But Tardy
The work that NCUA Board and staff put into the proposed corporate credit union regulations was impressive, both in quantity and substance. As far as they go, there are lots of appropriate ideas in the key reform areas of capital, asset/liability management, investment concentration, and governance that deserve widespread support.

One could only wish that the NCUA Board's corporate credit union regulations had been enacted as far back as 1994 when the Government Accountability Office (GAO) recommended major changes – (T-GGD-95-15 October 6, 1994 *Corporate Credit Unions: Condition, Issues, and Concerns*; T-GGD-95-107 February 28, 1995 *Credit Unions: The Failure of Capital Corporate Credit Union*; T-GGD-115 March 8, 1995 *Proposed Reform for Corporate Credit Union*

Regulation; GAO-04-977 September 10, 2004 *Corporate Credit Unions: Competitive Environment May Stress Financial Condition, Posing Challenges for NCUA*).

Also, a 1997 U.S. Treasury Department study actually forecast some of the problems that the corporate credit unions, the NCUSIF, the TCCUSF, and the CLF are experiencing today. The U.S. Treasury's study of the credit union industry recommended significant changes to the corporate credit union capital structure, the dissolution of the CLF, and the overhaul of the NCUSIF. Unfortunately, the NCUA Board and the credit union lobby chose to largely ignore these warnings.

In the proposed regulations, the NCUA Board now calls for a system of Prompt Corrective Action (PCA) for corporate credit unions. PCA for retail credit unions actually started with the failure of and NCUA's conservation of Capital Corporate Federal Credit Union (CapCorp) back in the mid-1990s. CapCorp had big losses on underwater CBOs (collateral backed securities) that eventually led to its closing. It was a big deal at the time and got lots of attention from Congress, the GAO, and the U.S. Treasury.

Based upon the U.S. Treasury recommendations, PCA for retail credit unions (but not corporate credit unions) was born in 1998 legislation with a 2% higher capital expectation than for banks (which translates into about 40% more capital required). The U.S. Treasury and Congress said that the "well capitalized" 5% for banks and the 7% for credit unions were essentially equal due to the unusual accounting treatment that credit unions used – credit unions counted about 2% net worth that to non-believers wasn't really net worth. Rather than force credit unions to adopt bank capital and accounting standards for the corporate credit unions and the NCUSIF back then, the Congress chose to increase the retail credit union PCA targets to compensate.

The GAO and U.S. Treasury were both very critical of the corporate credit union capital structure and also had concerns about the retail credit union capital structure (no absolute capital levels, just annual transfers to reserves until 6% was reached), and the funding structure of the NCUSIF. One U.S. Treasury conclusion in its 1997 study was that the credit union system's cooperative capital structure was not as strong as the more traditional banking industry capital because the capital was both counted by the retail credit union and the corporate credit union. In addition credit union's "double-counted" the one percent investment in the NCUSIF in terms of its ability to stop-gap deposit insurance fund losses. The NCUA Board now proposes that the entire corporate credit union capital structure be upgraded to more resemble what is required of other financial institutions.

Unfortunately, in retrospect the 1997 U.S. Treasury study appears to have been correct about the fragility of credit union capital arrangements. The current writedowns of corporate credit union contributed capital investments by the retail credit unions and the cascading effect of the corporate credit unions' losses validates that the "double-counted" capital doesn't hold up well during a huge systemic problem. The same thing happen with the NCUSIF one percent writedown until the TCCUSF was enacted so the losses could be spread out over several years.

Retail Credit Unions Should Be Firewalled from Corporate Credit Union Risks

The NCUA contends that had these newly proposed corporate credit union regulations been in effect, much of the current problems would not have occurred. While recognizing that the agency did lots of modeling to come up with that conclusion, I remain unconvinced that under the proposed regulatory regime retail credit unions would be sufficiently firewalled from corporate credit unions' potential mistakes.

The only way that retail credit unions could be effectively insolated would be to completely phase out the corporate credit union network and the systemic risk that it represents. Barring that, all capital investments and deposits in corporate credit unions should be uninsured. That would put all corporate credit union customers on notice that corporate credit unions were no longer too big to fail. It would also send the message that in the future the NCUSIF won't be stepping in to protect them from the moral hazard whereby the corporates gamble with retail credit unions' money.

The absence of deposit insurance and its implied 100% systemic risk guarantees would shift the burden to retail credit unions that use the corporate credit unions to impose market discipline on their service providers. That would also mean that retail credit unions that choose not to use the corporate credit unions would not be subsidizing the risks via the NCUSIF, TCCUSF, and CLF.

The timetable for corporate credit unions to rebuild capital under the proposed NCUA regulations, both through contributed capital and retained earnings, is ten years. That suggests that any corporate credit union going forward would likely be undercapitalized for those same ten years. That's a long time to leave the NCUSIF and the TCCUSF exposed – and via those funds the retail credit unions would also remain exposed. That of course assumes that a corporate credit union business model is developed that is both price competitive and that achieves a net spread much larger than has been the historical corporate credit union margins.

Workable Corporate Credit Union Business Plan Elusive

The proposed corporate credit union regulations are most notable for what they do not do. They don't outline a viable corporate credit union business plan going forward under the new limitations. Not that they should, but the proposed regulations become a mere academic exercise if the bar gets raised so high (although probably necessarily high) that no corporate credit union can leap it.

Some within the industry have criticized the NCUA for not maxing out the Central Liquidity Facility's (CLF) U.S. Treasury borrowings to prop up the corporate credit union network and otherwise enabling corporate credit unions to earn their way out of the problem. However, these pundits have yet to explain how corporates with infinitesimal operating margins are going to earn their way out of so large a financial hole. Also, the CLF was never designed as a bailout tool and all of that borrowing has to be paid back with interest. The corporate credit unions would never have been able to pay back these CLF loans by themselves.

Those who claim that the credit union industry dodged the bullet and has not required a government bailout are way off the mark. If the U.S. Treasury loans to cover the huge corporate credit union unrealized and realized MBS losses via the CLF, NCUSIF, and TCCUSF (not to mention NCUA's regulatory forbearance with the negatively capitalized corporate network) isn't a taxpayer bailout, one can only wonder what is. Without this government intervention, the corporate credit union network, as well as the retail credit union industry, would have seized up in 2009. As a practical reality, the U.S. Treasury currently "owns" the NCUA and by extension the credit union industry.

Although it might prove to be a hopeless exercise, at least some of the corporate credit union executives and officials are thinking outside the box with things like buying banks, converting to a mutual savings bank charter, or constructing CUSOs to step in and fill the liquidity and payment services gap. There is, of course, no guarantee that any of these alternative approaches would be successful for a variety of regulatory and competitive reasons. Prudence would advise every credit union to responsibly explore alternative service providers, even if they would prefer to remain with their corporate credit union going forward.

If an alternative structure can be designed, it would still have to be sold to the credit union industry one credit union at a time before any retail credit union could justify to its board and membership the capital investments required to launch the substitute ventures. So far no one has publicly unveiled any approaches that make business sense. Most alternatives postulated to date have relied more on voodoo economics, questionable socio-political ideology, clannish cooperative philosophy, or other esoteric concepts that require huge leaps of potentially misplaced faith bolstered by naked hubris.

The credit union industry must avoid making wrong moves for the wrong reasons and try not to compound the problems it already faces from its interconnectedness and the confiscatory what's yours is really mine "cooperative movement" infrastructure. Only those within the industry who choose to ignore the facts believe that what worked in the past will suffice moving forward. Those who fear real change are anxious – with good reason.

Resolving Troubled Credit Unions Growing Challenge for NCUA

On October 26th the NCUA sent letter No. 09-CU-20 to all federally insured credit unions on the subject of deposit insurance premium assessments. The letter explained that the 15 basis points of insured shares invoice would be sent in the fourth quarter of 2009 with payment due within 30 days of the invoice date. As attachments the letter also included explanations of and the sobering results from stress testing done on the corporate credit union stabilization fund and on the NCUSIF from troubled institutions. In a worst case adverse scenario, including two more years of a poor economic conditions, the result was the allocation of $56.4 billion in losses resulting in 519 credit union failures at a maximum exposure of $15.5 billion to the NCUSIF.

The anticipated increased NCUA activity dealing with troubled retail credit unions coupled with the corporate credit union conservatorships have put exponentially more stress on the NCUA's problem resolution infrastructure, skill set, staff expertise, and financial resources. Throughout most of its history, NCUA had very few problem situations to resolve at any one time. Many were handled through quick mergers or purchase and assumptions, and occasionally through liquidations. These easy fixes are much less likely to be successful in the current economic environment where there are fewer healthy qualified merger partners and where the assets of the troubled institutions are extremely difficult to fully evaluate. Even if a potential merger partner had the wherewithal to merge in the troubled credit union, it would often be impossible to know exactly what it was getting.

The bottom line is that in order to manage the next several years, the NCUA will need to seriously upgrade its problem resolution capabilities, including those dealing with corporate credit unions. The failure to upgrade could impede the agency's ability to provide timely least cost solutions for the NCUSIF and TCCUSF. The agency will also need to think outside the ideological box and consider mergers and P&As involving banks and other financial entities – not just credit unions.

NCUA Should Adopt FDIC Problem Resolution Best Practices

Resolution tactics used by the Federal Deposit Insurance Corporation (FDIC) should be studied for application to the credit union situation and for ways to help grease resolution deals. Additionally, the NCUA should be much more accountable and transparent concerning the costs of each credit union problem that gets resolved. Anything less would doom the NCUA to stumble embarrassingly through the next few years' problems – and that could be extremely expensive for the industry.

For example, FDIC Board Chairman Bair recapped what that agency was doing when she testified alongside NCUA Chairman Matz on October 14th in the Senate subcommittee hearing. "The FDIC has made several changes to its resolution strategies in response to this crisis, and we will continue to re-evaluate our methods going forward. The most important change is an increased use of partnership arrangements. The FDIC and RTC [Resolution Trust Corporation] used partnership arrangements in the past – specifically loss sharing and structured transactions."

Bair continued, "In the early 1990s, the FDIC introduced and used loss sharing. During the same time period, the RTC introduced and used structured transactions as a significant part of their strategy. As in the past, the FDIC has begun using these types of structures in order to lower resolution costs and simplify the FDIC's resolution workload. Also, the loss share agreements reduce the FDIC's liquidity needs, further enhancing the FDIC's ability to meet the statutory least cost test."

“The loss share arrangements enable banks to acquire an entire failed bank franchise without taking on too much risk, while structured transactions allow the FDIC to market and sell assets to both banks and non-banks without undertaking the tasks and responsibilities of managing those assets. Both types of agreements are partnerships where the private sector partner manages the assets and the FDIC monitors the partner. An important characteristic of these agreements is the alignment of interests: both parties benefit financially when the value of the assets is maximized.”

The NCUA Board should adopt all of the FDIC's problem resolution best practices in an effort to mitigate the costs to the NCUSIF. Keeping the NCUSIF costs down keeps the deposit insurance premium assessments down as well. Additionally, the perception that any corporate credit union is too big to fail must end and every corporate should have a credible plan for its rapid resolution in the event of distress – a living will. NCUA's resolution process must ensure that closing any corporate credit union will not lead to a systemic collapse.

In a properly functioning market economy there will be winners and losers, and some credit unions (including corporate credit unions) will become insolvent and should fail. Actions that prevent credit unions from failing ultimately distort market mechanisms. The NCUA Board's actions during the corporate credit union crisis have reinforced the idea that some credit unions are too big to fail. Going forward, it should not be the NCUA Board's purpose to prop up a failed retail credit union or a failed corporate credit union indefinitely, but instead to permit its swift and orderly dissolution. NCUA must have the ability to manage the unprecedented scale, scope, and complexity of today's corporate credit union and retail credit union failures.

Reform NCUSIF Funding, Accounting Treatment, Risk-Based Premiums

Among the hard lessons of the corporate credit union situation is that the NCUSIF/TCCUSF needs a radical overhaul. NCUA assessed a 15 basis points of insured shares premium for 2009 and is expected to annually assess between 15 and 40 bps (or more) in subsequent years. Although the NCUA Board's proposed regulations do not address the structure of deposit insurance, the credit union deposit insurance flaws were fundamental to the current problem and should be corrected. Whatever statutory or regulatory changes are needed to fix the situation should be made at the earliest opportunity.

Although banks expense their premium contributions to the FDIC, credit unions are allowed to treat their 1% NCUSIF contribution as an investment. Essentially the same funds are counted twice as assets, once on the books of the credit unions and again by the NCUSIF. Another key difference between the funding structures of the NCUSIF and the FDIC is the timing of losses. FDIC insured banks pre-pay for losses through premiums that they expense, while credit unions recognize the impairment to their 1% NCUSIF investment at the time of the loss.

In a worst-case scenario where the credit union industry experiences losses that exceed the NCUSIF's resources, including retail credit unions' NCUSIF investments, then in addition to high premiums the NCUA could require that the entire one percent investment be replenished following a writedown – perhaps even repeatedly replenished. Some industry analysts believe that the credit union industry is already facing that worst-case scenario due to the corporate credit union legacy assets.

In addition to the potential risks to the NCUSIF associated with the corporate credit union legacy assets, credit unions are also exposed to systemic risks from their involvement in the interconnected credit union industry. Essentially, the NCUSIF has an unlimited claim on all the capital at every federally insured credit union if needed to fund resolution of problem credit unions, including the troubled corporate credit union network.

Unlike the FDIC, credit union's contributions to the NCUSIF are not risk-based and all credit unions regardless of their risk profile have the same capital requirement. A credit union that keeps all of its funds in cash and government insured investments is treated exactly the same as a credit union that makes commercial business loans and exotic mortgages. Bank premium rates are adjusted for unsecured debt, secured liabilities, and brokered deposits yielding an adjusted premium range of 7 to 77.5 bp. FDIC risk categories go from I to IV. Credit unions should be similarly risk-rated.

For both FDIC insured banks and NCUSIF insured credit unions there remains much that is unknown and uncontrollable. The FDIC losses could really grow if commercial real estate problems are exacerbated by the troubled economy. The NCUSIF/TCCUSF could face the worst-case loss scenario from the corporate credit union mess and have to cover tens of billions of dollars in losses. Both charter types would suffer if their underwater securities sink deeper in value due to a worsening economy. Regardless of charter, all financial institutions would need to earn their way out of any bad situation created by deposit insurance fund losses.

Retail Credit Union Charter and Business Model Overhaul Required

In addition to everything that has been addressed in the proposed regulations, the NCUA Board needs to purge the dangerously interconnected regulatory and deposit insurance infrastructures of their inherent risks. Deposit insurance reforms, capital reforms, and access to additional income sources for retail credit unions top the list of needed actions. The proposed corporate credit union regulations are the beginning of, not the end of, the credit union industry overhaul process.

The housing meltdown, prolonged recession, and rising unemployment have indeed tested the credit union business model (including the corporate credit union business model) and identifying how it needs to evolve is necessary. Some analysts have already predicted that without major changes the credit union industry might contract, but that it would be unlikely that all credit unions disappeared. The key question remains, however, concerning how the remaining healthy ones would be able to carry the new financial, regulatory, and marketplace burdens placed on the credit union charter.

In the early days of the credit union charter in the U.S., it's biggest strength was that it required merely seven organizers with $5 apiece to capitalize a new credit union. Anyone with the motivation to do it could start a credit union. It grew its capital – and its ability to serve members – slowly over time through successful lending and retained earnings.

Yet today, the credit union charter's biggest shortcomings are its lack of access to large influxes of capital and its restricted income sources with which to add to retained earnings. Both capital and net income are essential to the long-term viability of the charter. The current capital-depleting economic cycle and the corporate credit union meltdown have brutally demonstrated that not changing the statutory and regulatory model is a certain road to the credit union charter's eventual extinction.

Here is a list of ways the credit union charter needs to be fixed:

- More organizational and ownership structure choices
- More governance structure choices – board composition, bylaws, proxies
- Increase choices for strategic mission and business model
- Streamline charter conversions to other financial institution charters
- Streamline merger procedures to encourage consolidation
- Streamline voluntary liquidation - equity distribution
- Access to Tier 1 equity capital - beyond retained earnings
- Access to Tier 2 regulatory capital - subordinated debt
- Expand lending, investment, and fee income authorities
- Self-define FOM, common bond, and own market niche
- More flexibility with subsidiaries, CUSOs, 3rd party partners
- Premium-based, risk-based deposit insurance structure
- Redefine regulatory structure and deposit insurance role
- Remove regulatory interference - *in loco parentis*

- Mitigate systemic risk and too big or too interconnected to fail
- Preserve the financial integrity of each independent CU
- Defend against politically-directed lending or investing
- Incorporate sense of urgency into evolutionary change

Gaining access to capital and expanding income producing opportunities are the two priority fixes for the credit union charter. In what looks like a once in a hundred years flood, the costs of operating under the credit union charter have gone up exponentially. Capital and income are the keys to revitalization.

The credit union charter's restricted access to capital only through retained earnings and the tight limits on sources of income are huge weights dragging it down. With their current charter, credit unions would experience an uphill climb to earn their way out of these extraordinary costs even in a good economy. Unless the charter receives major capital access and income reforms – and receives them soon, the industry is in danger of stagnating.

Summary Statement About Proposed Corporate Credit Union Regulations

The NCUA Board's proposed corporate credit union regulations are a worthy effort that merits support. The proposed regulations outline a disciplined operating environment for corporate credit unions that many within the industry now wish had been in place over a decade ago as the GAO and U.S. Treasury had advised. The proposed regulations establish a risk-managed expectation for which there is unlikely to be a workable corporate credit union business plan going forward – signaling the probable retirement of the corporate credit union charter and its associated systemic risk.

Despite the adoption of these proposed regulations, significant problems caused by the corporate credit union legacy assets still remain awaiting resolution. The legacy asset resolution process will be lengthy and with much cost for retail credit unions. There exist strong arguments for additional government intervention in such a solution, especially from the U.S. Treasury and the Federal Reserve. For its part, the NCUA Board must also press forward with reforms to remove the interconnectivity and systemic risks inherent in the credit union industry's deposit insurance structure, capital structure, and antiquated business model.

If the NCUA Board Members have questions concerning these comments, please feel free to have them contact me for clarification or elaboration.

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Marvin Umholtz is President & CEO of Umholtz Strategic Planning & Consulting Services based in Olympia, Washington south of Seattle. He is a 34-year credit union industry veteran who has held many leadership positions with credit union organizations and financial services industry vendors during those years. An accomplished speaker and former association executive, he candidly shares his credit union industry knowledge and insight with public policy makers, financial industry executives, and vendor companies. Umholtz also helps credit union boards and CEOs with strategic issues like growth, board governance, charter conversions, proactive mergers, voluntary liquidations, regulatory advocacy, and the growing conflict about the future role of credit unions in the financial services industry.