southwest corporate
FEDERAL CREDIT UNION

6801 Parkwood Boulevard
Plano, TX 75024-7198
800-442-5763
214-703-7500

www.swcorp.org

Via email to regcomments@ncua.gov

February 17, 2010

The Honorable Debbie Matz
Chairman, National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

The Honorable Gigi Hyland
Board Member, National Credit Union Administration

The Honorable Michael E. Fryzel
Board Member, National Credit Union Administration

Re: Comments on the Proposed Revision of Part 704

To Chairman Matz, Board Member Hyland, and Board Member Fryzel:

Southwest Corporate Federal Credit Union (Southwest Corporate) appreciates the opportunity to submit its comments on NCUA's Proposed Rule for Corporate Credit Unions.

Chartered in 1975, Southwest Corporate has always served credit unions in multiple states. Headquartered in Plano, Texas, with an office in Portland, Oregon, Southwest Corporate serves nearly 1,500 member credit unions, located in 44 states. Credit unions in 7 core states – Arkansas, Louisiana, New Mexico, Oklahoma, Oregon, Texas, and Washington – comprise a large majority of the corporate's membership. Southwest Corporate's products and services include investments, liquidity solutions, advisory services, settlement, imaged item processing, remote deposit services, and a variety of funds transfer and payment services. These products and services provide reduced expenses and increased earnings for the corporate's member credit unions.

Southwest Corporate supports revisions to the current requirements of Part 704, in order to strengthen corporate credit union operations and to ensure the long-term safety and soundness of the credit union industry. A large number of the revisions set forth in the

Proposed Rule are consistent with recommendations made by Southwest Corporate in its April 3, 2009 response to NCUA's ANPR, 74 FR 6004 (2009).

The Proposed Rule contains material regulatory changes that are designed to mitigate risk and apply lessons learned from the recent events that have impacted the corporate credit union system. 74 Fed. Reg. 65210 (2009). Positive changes in the Proposed Rule include the following: (i) stronger capital requirements; (ii) concentration limits by investment sector; (iii) tighter limits on single obligors; (iv) limited subordinated securities restrictions; (v) enhanced liquidity requirements; and (vi) prohibition on certain higher risk securities.

However, the Proposed Rule also contains several new requirements that, if not modified, would severely limit a corporate credit union's ability to provide valuable products and services to its member credit unions. Southwest Corporate believes that the two provisions of the Proposed Rule that are the most likely to have unnecessarily severe negative impacts on corporate credit unions, and thus on the credit union industry, are the following:

1. The proposed new cash flow mismatch limitations; and

2. The proposed 1-year transition period to meet new risk-based capital ratios.

The new cash flow mismatch limitations (i.e., the new credit spread shock test) would severely limit a corporate credit union's ability to generate and build retained earnings. Southwest Corporate believes that although the regulatory framework applicable to corporate credit unions needs to be tightened, more flexibility in certain provisions of the Proposed Rule is necessary in order to give corporate credit unions the ability to generate sufficient operating net income, to build retained earnings, to reduce reliance on member-contributed capital, and to meet the future retained earnings requirements of the Proposed Rule.

This letter will address the proposed new cash flow mismatch limitations in more detail below, in our Comment No. 1 and Comment No. 2, pertaining to paragraphs 704.8(e) and 704.8(f) of the Proposed Rule.

The proposed 1-year transition period to meet new risk-based capital ratios could require corporate credit unions to recapitalize at a time when the potential of additional losses on a corporate credit union's legacy assets (i.e., non-agency mortgage-backed securities) still remained uncertain. Southwest Corporate believes that successful recapitalization efforts will require newly-contributed capital to be isolated from further potential losses on legacy assets.

NCUA recently addressed this concern by directing credit unions submitting comments on the Proposed Rule to assume that a corporate credit union's balance sheet does not include any assets that are likely to take additional significant losses. Southwest

Corporate is concerned, however, that the timeframe may be inadequate between the still uncertain implementation of a legacy asset solution and corporate recapitalization.

This letter will address the proposed 1-year transition period in more detail below, in our Comment No. 3, pertaining to paragraph 704.3 of the Proposed Rule.

Because of the significance of the two issues that are highlighted above, this letter will present Southwest Corporate's recommendations about these issues as the first three of our Comments. For ease of reference, our Comments about the other provisions of the Proposed Rule are set forth in the sequence in which they appear in the Proposed Rule. In total, this letter sets forth Southwest Corporate's Comments and recommendations for fourteen (14) provisions of the Proposed Rule.

Comment 1: 704.8(e) – Cash Flow Mismatch Sensitivity Analysis.

Comment 1.A – Overview of 704.8(e) and of Southwest Corporate's Primary Concerns.

The Proposed Rule would impose a restriction on the mismatch between the principal cash flows of a corporate credit union's assets and liabilities, in order to limit the corporate's exposure to credit spread duration. Proposed paragraph 704.8(e) would require an average life NEV stress test that would measure the economic impact on capital resulting from a credit spread widening of 300 basis points. A corporate credit union would be required to limit its risk exposure so that when the spread widening shock was applied, the corporate's NEV ratio did not decline below 2 percent and the NEV itself did not decline more than 15 percent.

Applying the average life test of proposed paragraph 704.8(e) would permit a corporate credit union with a 4 percent base case NEV to operate with an average life mismatch of up to 0.20 years or approximately 2.4 months.

The Preamble to the Proposed Rule, 74 FR at 65245-47, presents a sample corporate portfolio (the "Sample Portfolio") that purports to demonstrate that a corporate credit union would be capable of growing its retained earnings under the proposed new investment and ALM limitations. The Preamble states that the Sample Portfolio would generate net income from operations of 21 basis points. The pro forma income projections set forth in the Preamble state that a corporate credit union could grow retained earnings to achieve income from operations sufficient to build 100 basis points of retained earnings in 6 years.

Southwest Corporate has significant reservations regarding the Sample Portfolio that was used to support NCUA's conclusion that the investment and ALM limitations set forth in the Proposed Rule are not so restrictive as to prevent corporate credit unions from growing retained earnings.

Southwest Corporate has identified the following four major issues that are associated with the Sample Portfolio used in the Proposed Rule:

1. The 10 percent investment portfolio allocation to private student loan asset-backed securities (ABS);

2. The Sample Portfolio fails to account for the cost of member-contributed capital;

3. The funding mix (i.e., the percentage allocation between overnight shares and term certificates); and

4. Selection of a single date in order to derive the investment spreads used in the Sample Portfolio.

First, the Sample Portfolio allocates 10 percent of the model investment portfolio to private student loan ABS. This asset type generates a market spread of 200 basis points over LIBOR. This investment alone accounts for nearly 60 percent of the model's total income. Private student loan ABS is a fairly risky, extremely illiquid investment type with a very limited market supply – certainly not enough of a supply to account for 10 percent of each corporate credit union's investment portfolio.

Additionally, there are only one or two active originators of private student loan ABS, which means that the Proposed Rule's obligor concentration limits would significantly reduce a corporate credit union's ability to invest in this asset type. Replacing this LIBOR plus 200 basis point investment (i.e., private student loan ABS) with a more appropriate non-mortgage related ABS at LIBOR plus 25 basis points would reduce the Sample Portfolio's net income from operations from 21 basis points to 3½ basis points (i.e., a reduction of 17½ basis points).

Second, the Sample Portfolio does not account for the cost of new member-contributed capital. Adjusting the Sample Portfolio in order to include an assumed cost of new member-contributed capital at LIBOR plus 150 basis points would reduce the Sample Portfolio's net income from operations by an additional 6 basis points, based on a 4 percent leverage ratio.

Third, the Sample Portfolio's funding mix includes 30 percent overnight shares and 70 percent term certificates. Southwest Corporate's traditional funding mix, like that of most other corporates, is closer to 60 percent overnight shares and 40 percent term certificates. Adjusting the Sample Portfolio's funding mix in order to include a higher percentage of overnight shares (i.e., a shorter total weighted average life) would cause the Sample Portfolio to fail the Proposed Rule's cash flow NEV volatility limit of 15 percent.

Fourth, the selection of a single date in order to derive the Sample Portfolio's investment spreads fails to identify the potential risk to a corporate credit union's future earnings if investment spreads tighten.

In the aggregate, adjusting for the private student loan ABS, and for the cost of funds for new member-contributed capital, the Sample Portfolio's net income from operations would be reduced from 21 basis points to a negative 3 basis points. Based on reasonable adjustments to the Sample Portfolio, the Proposed Rule's cash flow NEV volatility limit (i.e., the requirement that NEV cannot decline more than 15 percent in an instantaneous 300 basis point credit spread widening) is so restrictive that it would prevent a corporate credit union from generating sufficient net income from operations to comply with the Proposed Rule's retained earnings requirements.

Annex A attached to this letter (as page 22) sets forth a summary of the appropriate adjustments (as discussed above) that Southwest Corporate made to the Sample Portfolio.

Annex B attached to this letter (as page 23) sets forth a summary of Southwest Corporate's expected net income from operations under the cash flow mismatch limitations of the Proposed Rule, using Southwest Corporate's expected investment allocations, funding costs, fee income, and operating expenses. In Annex B, Southwest Corporate's net income from operations is projected to be 2.3 basis points, based on a $7 billion balance sheet. This improvement in the corporate's operating results (compared to Annex A) is caused by Southwest Corporate's lower net operating expenses (i.e., operating expenses less fee income) and lower average cost of funds on overnight shares. The amount of the projected net income from operations (2.3 basis points) indicates that the Proposed Rule would prevent Southwest Corporate from growing retained earnings at or above the 17 basis points a year needed to accumulate 100 basis points of retained earnings in 6 years.

In conclusion, Southwest Corporate does not believe that an investment portfolio can be created that would comply with the Proposed Rule's investment and ALM limitations and would also allow the corporate credit union to generate sufficient net income to meet the new retained earnings requirements over the 10-year phase-in period (i.e., 45 basis points after 3 years, 100 basis points after 6 years, and 200 basis points after 10 years) that is proposed in the Preamble.

704.8(e) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.8(e)(1)(i) of the Proposed Rule in order to require a corporate credit union to evaluate the risk in its balance sheet by measuring the impact of an instantaneous spread widening of both assets and liabilities by 100 basis points (i.e., rather than by 300 basis points) on its NEV and NEV ratio. Additionally, that NCUA require a more limited shock test (perhaps 50 basis points; i.e., 50 percent of the standard test) for government-sponsored entity debt.

That NCUA amend paragraph 704.8(e)(1)(iii) of the Proposed Rule in order to limit a corporate credit union's risk exposure to levels that do not result in a decline in NEV of more than 35 percent (i.e., rather than 15 percent).

As an alternative, NCUA might consider a tiered approach to the setting of shock test parameters, based on individual investment sectors (i.e., types of investments), as described in paragraph 704.6(d) of the Proposed Rule. Those investment sectors that have recently demonstrated the most severe and protracted credit spread widening (i.e., non-agency residential mortgage-backed securities and private student loan asset-backed securities [ABS]) should require a 300 basis point shock test. Those investment sectors that have recently experienced less spread widening and for a shorter period of time (i.e., commercial mortgage-backed securities, auto loan ABS, credit card ABS, other ABS, corporate debt, and municipal securities) should require a lower shock test of 100 basis points. The two remaining investment sectors – Federal Family Education Loan Program (FFELP) student loan ABS, and agency securities – should each require a shock test of 50 basis points.

Comment 1.B – Additional Modeling Results and Commentary Regarding Prompt Corrective Action Discretionary Authority.

Annex C attached to this letter (as page 24) sets forth Southwest Corporate's expectations as to what its net income from operations would be if the corporate utilized its recommendations – as set forth hereinabove – for revisions of the cash flow mismatch limitations that are set forth in paragraph 704.8(e) of the Proposed Rule. The analysis is based on Southwest Corporate's expected investment allocations, funding costs, fee income, and operating expenses. The model that is set forth in Annex C generates net income from operations of nearly 19 basis points, based on a $7 billion balance sheet. Additionally, the model allows Southwest Corporate to maintain sufficient liquidity to meet member payment and settlement needs, because 25 percent of the investment portfolio's assets are maintained in cash and cash-equivalent investments (i.e., overnight investments). The 25 percent of assets held in short-term investments represents 39 percent of total member overnight deposits.

Southwest Corporate believes it is also important to stress that under the Proposed Rule, a corporate credit union's ability to generate retained earnings would be very sensitive to variations in market credit spreads on investment securities. The modeling results that are presented in Annexes A, B and C attached to this letter (as pages 22 - 24) are based on credit spreads that existed when the models were prepared by NCUA and Southwest Corporate. However, Southwest Corporate's ability to generate sufficient earnings, even when using its recommended changes to the Proposed Rule's cash flow mismatch requirement (i.e., even as set forth in Annex C attached to this letter), would be significantly reduced in an operating environment with tighter credit spreads.

In that regard, Southwest Corporate believes it would be valuable to illustrate the expected net income from operations that would be projected by use of long-term average spreads (rather than by use of current market spreads), in order to identify the potential risk to a corporate credit union's future income if market credit spreads tightened.

Accordingly, Annex D attached to this letter (as page 25) sets forth Southwest Corporate's expectations as to what its net income from operations would be if the corporate utilized its recommendations – as set forth hereinabove – for revisions of the cash flow mismatch limitations that are set forth in paragraph 704.8(e) of the Proposed Rule (i.e., a shock test of 100 basis points rather than 300 basis points, and a maximum decline in NEV of 35 percent rather than 15 percent). The analysis set forth in Annex D is based on Southwest Corporate's expected investment allocations, funding costs, fee income, operating expenses, and investment spreads. The investment spreads are based on each investment's average spread during the 9-year period prior to August 2007 (i.e., prior to the recent credit spread widening). The average investment spreads for that 9-year period were significantly lower than current market spreads.

The model set forth in Annex D (on page 25) generates net income from operations of only 3 basis points, based on a $7 billion balance sheet. The low level of this projected net income from operations indicates that tighter credit spreads (based on historical averages) would have a material impact on Southwest Corporate's ability to grow retained earnings at or above 17 basis points a year in order to accumulate 100 basis points of retained earnings in 6 years.

The historical market credit spreads that Southwest Corporate used in the model set forth in Annex D are not likely to reemerge in the foreseeable future. However, NCUA needs to be aware that periods of tighter credit spreads are possible and could prevent an otherwise fully compliant corporate credit union from building retained earnings at the rate required by the Proposed Rule. If such an interest rate environment did emerge, NCUA would need to be prepared to authorize a longer period for corporate credit unions to build retained earnings.

A related issue is that the Preamble to the Proposed Rule states that the NCUA Board's intent is that "if a corporate is subject to a REAP [retained earnings accumulation plan] and fails to meet any of the established retained earnings milestones, NCUA will take decisive action under the prompt corrective action authorities of 704.4". 74 FR at 65223. The Preamble requests comment on whether any of those actions – which would be discretionary on NCUA's part under paragraph 704.4 of the Proposed Rule – should instead be mandatory for a corporate that fails to meet its REAP requirements.

<u>704.4 - Southwest Corporate's Recommendations</u>:

That NCUA retain the discretionary authority under paragraph 704.4 to accommodate scenarios where temporary market conditions may restrict a corporate credit union's ability to meet its REAP requirements. Southwest Corporate has illustrated one such potential scenario in Annex D attached to this letter (as page 25), in which tighter credit spreads could substantially reduce a corporate credit union's net interest and net income. In the illustration set forth in Annex D, an otherwise well-managed corporate credit union has failed to meet its REAP requirements, but prompt corrective action need not be mandatory.

Comment 1.C – Ability to Raise Prices for Products and Services.

In the Preamble to the Proposed Rule, 74 FR at 65247, and during recent Town Hall meetings, NCUA has suggested that there are other factors that can positively affect a corporate credit union's ability to build retained earnings. Specifically, NCUA has stated that corporates have some degree of pricing power in setting the prices for products and services provided to member credit unions (referred to as "right pricing" during the Town Hall meetings).

Southwest Corporate does not agree with this conclusion. The corporate believes that its pricing is heavily influenced by market factors, and that any attempt to raise its prices would conflict with its recapitalization efforts.

Southwest Corporate's product sales practices regularly include pricing comparisons with other service providers, often embedded in the competitive bidding process for the corporate's complex services. Our experience has been that natural-person credit unions are very cognizant of market prices, and also that cost is a key consideration in natural-person credit union purchasing decisions. This conclusion is to be expected because of the increasingly tighter margins under which natural-person credit unions (and similar financial institutions) have been operating during the past decade. Therefore, Southwest Corporate believes that it can exert little, if any, pricing power, because its pricing is largely determined by market factors.

The final step in the corporate stabilization process will be recapitalization. Part of a corporate credit union's recapitalization effort will be to convey clearly its value proposition to its members, and clearly explain why its value proposition merits recapitalization. Raising fees as part of a revised business model would conflict with any such recapitalization efforts.

Comment 2: 704.8(f) – Cash Flow Mismatch Sensitivity Analysis With 50% Slowdown in Prepayment Speeds.

The Proposed Rule includes a new paragraph 704.8(f) with a spread widening test that assumes a 50 percent slowdown in prepayment speeds. A corporate credit union would be required to limit the structure of its assets and liabilities so that its NEV ratio did not decline below 1 percent and the NEV itself did not decline more than 25 percent. This new test is designed to determine whether a corporate's cash flow extension risk is within acceptable limits.

Southwest Corporate supports regulatory limits on the potential extension of a corporate credit union's average life mismatch based on a slowdown in prepayment speeds. However, the corporate believes that for non mortgage-backed securities, the assumption that prepayment speeds will slow by 50 percent is not supported by historical events.

Southwest Corporate also believes that the 25 percent limit on the decline in NEV, as set forth in the Proposed Rule, needs to be adjusted, for the reasons that support the corporate's recommendations – which are set forth in Comment No. 1 above – that proposed paragraph 704.8(e) be revised in order to allow a modest amount of cash flow extension related to slower prepayment speeds on mortgage-backed securities.

704.8(f) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.8(f)(1)(i) of the Proposed Rule in order to exclude non mortgage-backed securities from the prepayment slowdown test, and apply the 50 percent slowdown test only to mortgage-backed securities.

That NCUA amend paragraph 704.8(f)(1)(iii) of the Proposed Rule in order to limit a corporate credit union's risk exposure to levels that do not result in a decline in NEV of more than 45 percent (i.e., rather than 25 percent).

Comment 3: 704.3 – Corporate Credit Union Capital.

The Proposed Rule would establish three minimum capital requirements that a corporate credit union must maintain: (i) a minimum leverage ratio; (ii) a Tier 1 risk-based capital ratio; and (iii) a total risk-based capital ratio. The Preamble to the Proposed Rule proposes the phase-in of these new capital requirements over a 10-year period.

The effective date for the two new risk-based capital requirements could be 1 year after the publication of Part 704 in Final Rule form. That date would require corporate credit unions to recapitalize before the potential for additional losses on corporate credit union legacy assets (e.g., on the corporate's non-agency mortgage-backed securities) was known. Southwest Corporate believes that successful recapitalization efforts will require that newly-contributed capital not be exposed to potential losses from legacy assets. Southwest Corporate acknowledges and appreciates recent public comments indicating that NCUA is working on a solution to the legacy assets problem, and that credit unions should assume that future contributed capital will not be exposed to potential legacy asset losses. However, Southwest Corporate is still concerned about the timing between the yet unknown implementation of a legacy asset solution and corporate recapitalization.

The Preamble to the Proposed Rule states that the transition period to meet the new minimum leverage ratio requirement would be 3 years after the effective date of the Final Rule. 74 FR at 65244-45. However, there is some confusion about this transition period, because the interplay of various capital definitions embedded within the Proposed Rule indicates that the transition to the new leverage ratio must occur within 1 year after the Final Rule is published.

704.3 - Southwest Corporate's Recommendations:

Southwest Corporate assumes that NCUA will implement a legacy asset solution in order to legally isolate all new member-contributed capital from potential future impairment losses caused by currently-existing non-agency RMBS (i.e., caused by a corporate credit union's legacy assets), thereby significantly reducing the risk-weighting of the legacy assets and greatly facilitating the corporates' recapitalization efforts.

In light of that assumption, Southwest Corporate recommends that the transition period required to meet the Proposed Rule's minimum risk-based capital requirements be specified as the later of two time periods: (i) 1 year after the effective date of the publication of revised Part 704 in Final Rule form; or (ii) 1 year after the implementation of a legacy asset solution. Such a transition period would provide all credit union industry participants with sufficient time to communicate, to implement a recapitalization plan, and to revise their respective business models.

Additionally, that NCUA clarify the Proposed Rule so that the transition period to meet the new minimum leverage ratio requirement is 3 years after the effective date of the Final Rule (as is stated in the Preamble, 74 FR at 65244-45).

Comment 4: 704.2 (Definitions) – "Available to cover losses that exceed retained earnings".

Comment 4.A – Depletion and Replenishment of Member-Contributed Capital.

The definitions set forth in the Proposed Rule include a new term: "Available to cover losses that exceed retained earnings". The proposed application of this newly-defined term would mean that member-contributed capital must be exhausted in order to cover operating losses realized by a corporate credit union if those losses exceeded the corporate's retained earnings. To the extent that any member-contributed capital was used to cover losses, the corporate credit union would not be allowed to restore or replenish the impacted capital accounts under any circumstances.

This new definition incorporates within the Proposed Rule the depletion guidance that NCUA provided in Letter No. 09-CU-10. Southwest Corporate continues to advocate that depletion should not be required in the event a corporate credit union realizes a retained deficit. As an alternative, if depletion remains a requirement, member-contributed capital accounts that have been depleted because of a corporate's estimated losses should be replenished in the future to the extent that the corporate's actual losses are less than the losses that were projected.

Southwest Corporate is concerned that the addition of this proposed new definition could present an obstacle for corporate credit unions' recapitalization initiatives. Premature depletion of member-contributed capital based on future estimated losses, together with the restrictions on a corporate credit union's ability to restore or replenish the impacted capital accounts under any circumstances, would cause a corporate credit union's member-contributed capital to appear to natural-person credit unions to be a less desirable investment than the forms of capital that are offered by other credit union industry service providers (e.g., the Federal Home Loan Banks).

The new capital requirements in the Proposed Rule should eliminate the need to deplete member-contributed capital based on expected losses. Corporate credit unions would be required to maintain a minimum leverage ratio of 4 percent. The proposed leverage ratio would include only <u>permanent</u> forms of capital, including perpetual contributed capital and retained earnings. The permanent nature (i.e., the lack of a withdrawal feature) of a corporate credit union's future capital structure would ensure that capital would be available to absorb actual dollar losses in the future, without the need to resort to depletion.

Based on the capital requirements that are set forth in the Proposed Rule, Southwest Corporate expects that a very large percentage of member-contributed capital will be perpetual contributed capital. However, in the Proposed Rule, another component of member-contributed capital is nonperpetual capital. This type of capital is comprised of share certificates that have minimum terms of 5 years, or that have indefinite terms (i.e., no maturity dates) and minimum withdrawal notices of 5 years. Southwest Corporate believes that the Final Rule could include language that would allow NCUA to restrict withdrawals of existing nonperpetual capital accounts if a corporate credit union's leverage ratio declined below the regulatory minimum of 4 percent.

<u>***704.2 - Southwest Corporate's Recommendations (Depletion/Replenishment)***</u>***:***

That NCUA not require depletion, and instead allow a corporate credit union to maintain a retained earnings deficit. In addition, that NCUA prohibit nonperpetual contributed capital withdrawals if a corporate credit union's leverage ratio fell below 4 percent.

If depletion remains a requirement of the Final Rule, that a corporate credit union be allowed to restore depleted funds if and when projected losses are known to have overstated actual losses, provided that the corporate credit union would continue to meet minimum regulatory capital requirements after restoring the depleted funds.

<u>**Comment 4.B – Non-Extinguishment of Member-Contributed Capital**</u>**.**

In paragraph 704.2 of the Proposed Rule, the new definition of "Available to cover losses that exceed retained earnings" includes the following language as its final sentence: "In addition, contributed capital that is used to cover losses in a fiscal year previous to the year of liquidation has <u>no claim</u> against the liquidation estate" (emphasis added). With reference to the entire definition, the Preamble to the Proposed Rule states that "[t]his language is similar to that used to define the phrase *available to cover losses* as it relates to secondary capital in NCUA's low income credit union rule". 74 FR at 65221, *citing* §701.34(b)(7).

Southwest Corporate notes that although much of the proposed new definition is similar to the definition of "Availability to cover losses" that is set forth in Section 701.34(b)(7), the above-quoted sentence – that the contributed capital "has no claim against the liquidation estate" – is absent from that definition. Instead, Section 701.34(b)(9) (Merger or dissolution) clearly indicates that holders of secondary capital accounts in a low-income credit union (LICU) would have claims if the LICU was voluntarily dissolved: "the secondary capital accounts will be closed and paid out to the account investor to the extent they are not needed to cover losses at the time of . . . dissolution".

Further, if the LICU was the subject of an <u>involuntary</u> liquidation, Section 709.5(b)(8) explicitly references claims that can be made by the holders of any secondary capital accounts that are outstanding at the time of the LICU's liquidation.

It is also worth noting that Sections 709.5(b)(8) and 709.5(e) anticipate that after payment in full of all allowed claims against an involuntarily-liquidated LICU – including claims against the LICU by holders of its secondary capital accounts – a surplus could remain.

When Section 709.5 was revised in order to add these provisions about an involuntarily-liquidated LICU's secondary capital accounts, the Preamble to the Interim Final Rule stated that "in the unlikely event of a liquidation surplus, <u>secondary capital holders would be repaid</u> before payment of a liquidation dividend" (emphasis added). NCUA, Interim Final Rule [Parts 701, 709 and 741], 61 Fed. Reg. 3788, 3789 (1996).

<u>704.2 - Southwest Corporate's Recommendations (Non-Extinguishment)</u>:

That NCUA remove the final sentence of the proposed definition of "Available to cover losses that exceed retained earnings", in order to remove the implication that if a corporate credit union used contributed capital in order to cover losses, that use of the funds would extinguish the corporate's liability for those funds.

Additionally, that NCUA add a provision to the Proposed Rule that specifies that if a credit union or other entity contributed capital to a corporate credit union, and the corporate subsequently was placed into liquidation, the entity that had contributed capital would have a claim against the liquidation estate.

<u>Comment 5: 704.6(c)(1) – Issuer Concentration Limits</u>.

Paragraph 704.6(c)(1) of the Proposed Rule would limit the aggregate of all of a corporate credit union's investments in any single obligor to 25 percent of the corporate's capital or $5 million, whichever is greater. Southwest Corporate generally supports the

25 percent of capital concentration limit in this paragraph of the Proposed Rule. However, the corporate is concerned that if this limit is applied to certain high-quality short-term investment types (e.g., federal funds transactions, and deposits in other depository institutions), the proposed limit would severely restrict a corporate credit union's ability to effectively manage its short-term liquidity position. For example, the single obligor limit for short-term federal funds transactions or deposits in other depository institutions of 1 percent of assets (based on a 4 percent capital ratio), when combined with the limited number of high-quality counterparties (obligors) available in today's financial marketplace, would significantly limit a corporate credit union's access to short-term investment alternatives.

Paragraph 704.6(c)(2) of the Proposed Rule would allow exceptions to the 25 percent of capital limit, by allowing larger issuer concentration limits (50 percent of capital, 100 percent of capital, or 200 percent of capital) for certain investment types. Southwest Corporate believes that additional short-term investment types (e.g., federal funds transactions, and deposits in other depository institutions) should be included as additional exceptions in paragraph 704.6(c)(2) of the Proposed Rule, in order to facilitate a corporate credit union's investment of its short-term liquidity at reasonable rates of return.

704.6(c)(1) - Southwest Corporate's Recommendations:

That NCUA include federal funds sold and deposits in other depository institutions in paragraph 704.6(c)(2) of the Proposed Rule, as additional exceptions from the issuer concentration limits that are set forth in paragraph 704.6(c)(1). For federal funds sold, and for deposits in other depository institutions, that a corporate credit union's aggregate investments with any one counterparty be limited to 200 percent of capital (i.e., rather than 25 percent of capital), with a maximum maturity of 90 days or less.

Comment 6: 704.6(d) and (e) – Sector Concentration Limits.

Paragraph 704.6(d) of the Proposed Rule would establish aggregate concentration limits for individual asset classes. The maximum amount of a corporate credit union's investment in each of the asset classes would be limited to a certain multiple of capital or a certain percentage of assets.

In other paragraphs of the Proposed Rule, NCUA recognizes the unique role that corporate credit unions play as liquidity providers in the credit union system. For example, paragraph 704.2 of the Proposed Rule employs moving daily average net assets (DANA), rather than assets, as the denominator for the computation of a corporate's core capital ratio. By contrast, the use of period-end assets in the denominator in order to calculate sector concentration limits could cause short-term violations due to seasonal and cyclical fluctuations in corporate credit union share balances.

Additionally, paragraph 704.6(e) of the Proposed Rule would limit a corporate credit union's aggregate investment in subordinated securities to the lower of 400 percent of the corporate's capital, or 20 percent of the corporate's assets. Southwest Corporate believes this concentration limit is too high. Recent loss experiences and price volatility in subordinated debt securities would support lower aggregate investment limits.

704.6(d)and (e) - Southwest Corporate's Recommendations:

That NCUA use moving DANA, rather than period-end assets, as the denominator in the computation of capital ratios for sector concentration limits.

Additionally, that NCUA amend paragraph 704.6(e) of the Proposed Rule in order to reduce the aggregate investment limit applicable to subordinated securities, from the lower of 400 percent of a corporate's capital or 20 percent of the corporate's assets, to the lower of 200 percent of the corporate's capital or 10 percent of the corporate's DANA (i.e., rather than 10 percent of the corporate's assets).

Comment 7: 704.6(d)(3)-(4) – Sector Concentration Limits.

Paragraph 704.6(d)(3) of the Proposed Rule would establish sector concentration limits that would restrict a corporate credit union's aggregate investment in federal funds transactions to the lower of 100 percent of the corporate's capital or 5 percent of the corporate's assets. These limits would severely impede a corporate credit union's access to the federal funds market as a means to manage the corporate's short-term liquidity. Here, Southwest Corporate notes that paragraph 704.6(d)(4) of the Proposed Rule would exclude certain investment types from these sector concentration limits, and that one of the investment types thus excluded is deposits in other depository institutions. Federal funds transactions have investment characteristics that are similar to large wholesale deposits in depository institutions, but they are not listed as an exclusion under paragraph 704.6(d)(4).

704.6(d)(3)-(4) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.6(d)(4) of the Proposed Rule in order to specify that federal funds sold to other depository institutions are an additional exemption from the Proposed Rule's sector concentration limits.

Comment 8: 704.8(c) – Penalty For Early Withdrawals.

Paragraph 704.8(c) of the Proposed Rule would establish a maximum redemption value for share certificates. The Proposed Rule would permit redemption only at the lesser of (i) the share certificate's book value plus accrued dividends, or (ii) the share certificate's "value based on a market-based penalty sufficient to cover the estimated replacement cost of the certificate redeemed". The Preamble to the Proposed Rule states that the potential liquidity drains that are faced by corporate credit unions could be exacerbated if a corporate's members were permitted to redeem share certificates at a premium (i.e., at a price that is higher than the share certificate's book value). 74 FR at 65240. This comment in the Preamble implies that the Proposed Rule would provide corporates with more stability within the liabilities on their balance sheets.

Southwest Corporate is concerned that paragraph 704.8(c) of the Proposed Rule would have exactly the <u>opposite</u> effect on a corporate credit union's overall liquidity position. Eliminating a corporate's ability to pay early-withdrawal premiums would place the corporate's share certificates at a significant disadvantage when compared to the other term investments (e.g., agency securities) that are available to the corporate's member credit unions. This would have negative implications on the corporate's ability to attract more stable term funding (specifically, member share certificates), and thus would impact the corporate's funding strategies.

In short, Southwest Corporate believes that the unintended consequences of paragraph 704.8(c) of the Proposed Rule would be as follows: (i) to push term certificates off a corporate's balance sheet; (ii) to reduce the corporate's access to a more stable term funding source (member share certificates); and (iii) to reduce the corporate's ability to provide lines of credit to its members.

<u>***704.8(c) - Southwest Corporate's Recommendations***</u>***:***

That NCUA retain the current rule for share certificate redemptions that requires corporates to assess a market-based penalty sufficient to cover the estimated replacement cost of the share certificate that is being redeemed, and thereby permit the redemption of certain share certificates at a premium.

<u>**Comment 9: 704.8(h) – Weighted Average Asset Life**</u>**.**

Paragraph 704.8(h) of the Proposed Rule would require that the weighted average life of a corporate credit union's investment portfolio, excluding derivative contracts and equity investments, not exceed 2 years. Southwest Corporate notes that paragraph 704.8(e) of the Proposed Rule already imposes a limit on the maximum weighted average life of a corporate's investment portfolio. Specifically, under paragraph 704.8(e), the weighted average life of a corporate credit union's investment portfolio is limited by the aggregate cash flow mismatch between the corporate's assets and liabilities.

Southwest Corporate believes that paragraph 704.8(h)'s 2-year weighted average life limit may restrict a corporate credit union's ability to make full use of the Proposed Rule's permissible cash flow mismatch limitations, specifically in a future business environment in which a corporate credit union's liabilities (e.g., its member shares) may lengthen significantly.

704.8(h) - Southwest Corporate's Recommendations:

That NCUA eliminate the 2-year weighted average asset life requirement from paragraph 704.8(h) of the Proposed Rule, because paragraph 704.8(e) of the Proposed Rule already limits the weighted average life of a corporate credit union's assets, based on the weighted average life of the corporate's liabilities.

Comment 10: 704.8(k) – Overall Limit On Business Generated From Individual Credit Unions.

Paragraph 704.8(k) of the Proposed Rule would prohibit a corporate credit union, after a 30-month phase-in period, from accepting from a member or other entity any investment (e.g., shares, loans, perpetual contributed capital, or nonperpetual capital accounts) if the aggregate of all investments from that member or entity would exceed 10 percent of the corporate's moving daily average net assets.

Southwest Corporate believes that sound liquidity management requires diversification among sources of member shares, and also requires access to multiple external liquidity providers. However, Southwest Corporate is concerned that the 10 percent limit on the amount that a corporate credit union can borrow from any one entity (e.g., from a Federal Home Loan Bank) could unnecessarily restrict the corporate from having full access to all available external liquidity sources, and could also limit the corporate's ability to effectively manage its liquidity. Additionally, the proposed restriction on the amount that a corporate credit union can borrow from an external entity could unnecessarily limit the corporate's ability to gain access to reliable and stable liquidity sources in order to manage seasonal and intra-month fluctuations in member share balances.

704.8(k) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.8(k) of the Proposed Rule in order to remove the paragraph's limit on a corporate credit union's ability to access external liquidity sources when funds are needed to meet liquidity shortfalls that result from seasonal and intra-month fluctuations in member share balances.

Comment 11: 704.11(e) – Corporate Credit Union Service Organizations (Corporate CUSOs) – Permissible Activities.

Paragraph 704.11(e) of the Proposed Rule would require a corporate CUSO to limit its activities to the following: (i) brokerage services; (ii) investment advisory services; and (iii) other categories of services as approved in writing by NCUA and published on NCUA's website.

The list of permissible activities that is set forth in paragraph 704.11(e) of the Proposed Rule does not include several activities that corporate credit unions currently provide to their member credit unions through corporate CUSOs. As examples, the list does not include business lending services, ALM services, card services, and programs for the purchase of certificates of deposit from other depository institutions. If the list of permissible activities in paragraph 704.11(e) of the Proposed Rule is not expanded to include all of the services that are currently provided by corporate CUSOs, natural-person credit unions will be required to transition key services from corporate CUSOs to alternative service providers. Such a transition, in all likelihood, would result in serious service disruptions, and in higher costs to be paid by natural-person credit unions.

704.11 (e) - Southwest Corporate's Recommendations:

That NCUA expand the list of permissible activities set forth in paragraph 704.11(e) of the Proposed Rule in order to include all services that corporate credit unions currently provide to credit unions through corporate CUSOs.

Comment 12: 704.14(a)(2) – Representation.

Paragraph 704.14(a)(2) of the Proposed Rule would require, as a qualification for service on a corporate credit union's Board of Directors, that each candidate currently hold the position of CEO, CFO, or chief operating officer (COO) at a member institution.

Southwest Corporate believes that limiting access to service on a corporate credit union's Board of Directors, based solely on an individual candidate's current job title, would unnecessarily prevent certain otherwise highly-qualified candidates from serving as directors. As examples, individual candidates may have previously held one of the three designated job titles, or may currently have similar responsibilities at their respective credit unions but under different job titles. Consideration should be given to an individual candidate's overall knowledge and expertise, rather than simply to the candidate's current job title.

704.14(a)(2) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.14(a)(2) of the Proposed Rule in order to eliminate the requirement that would limit board candidates to those currently holding the position of CEO, CFO, or COO at a member institution.

Comment 13: 704.14(a)(3) – Representation.

Paragraph 704.14(a)(3) of the Proposed Rule would require that members of a corporate credit union's Board of Directors be limited to service of no more than 6 consecutive years. Southwest Corporate believes that although there is good reason for the introduction of term limits, the proposed 6-year term limit is too short.

As stated in the Preamble to the Proposed Rule, corporate credit unions are complex entities that have a significant impact on the functioning of the entire credit union system. 74 FR at 65250. In light of the underlying complexity and significance of corporate credit union operations, Southwest Corporate recommends that NCUA strive for more balance between the experience of established directors and the fresh approach that new directors would bring. Also, a longer term limit would enable a less disruptive transition to the new restriction over the next several years.

Southwest Corporate also believes that an unintended consequence of the proposed adoption of a term limit would be to further restrict the term of any individual who is appointed to the uncompleted term of a departing member of a corporate credit union's Board of Directors. In such a scenario, the newly-appointed director would have to stand for re-election at the corporate's next annual election. If the normal term of office for the corporate's directors was 3 years, the result would be that even if the newly-appointed individual was re-elected at the next annual election, the individual would be eligible to serve for only a single 3-year term in addition to the partial term to which the individual had been appointed.

704.14(a)(3) - Southwest Corporate's Recommendations:

That NCUA amend paragraph 704.14(a)(3) of the Proposed Rule in order to change the term limit for positions on a corporate credit union's Board of Directors, to 9 consecutive years (i.e., rather than 6 consecutive years), and that for an appointed board member, any partial year of service not be considered when computing the number of consecutive years the individual has served.

Comment 14: Appendix B (Expanded Authorities and Requirements) – Part III.

In the Proposed Rule, Part III of Appendix B to Part 704 would allow corporate credit unions that have met the requirements established by NCUA to enter into derivative transactions that are specifically approved by NCUA. Part III(b)(1)(i) would limit the permissible credit rating of a domestic counterparty in a corporate credit union's derivative transaction to the minimum permissible rating for a permissible investment with a comparable term. The application of paragraph 704.6(f)(2) of the Proposed Rule would restrict a corporate credit union's derivative transactions to transactions with domestic counterparties that had long-term credit ratings of no lower than AA- (or equivalent) or short-term credit ratings of no lower than A-1 (or equivalent).

Based on market research, using the lowest available ratings from a nationally recognized statistical rating organization (NRSRO), Southwest Corporate has determined that currently there are only 4 large domestic derivative counterparties with credit ratings of

AA- or higher. Southwest Corporate believes that limiting the number of a corporate credit union's permissible derivative counterparties to four would create an undue level of obligor concentration risk.

By contrast, expanding the derivative counterparty's permissible minimum credit rating to A- would give corporate credit unions access to a wider range – currently, approximately 8 – of highly-rated, well-capitalized derivative counterparties. This would limit a corporate's exposure to any single obligor.

Southwest Corporate also notes that International Swaps and Derivatives Association, Inc. (ISDA) agreements include bilateral offset procedures and bilateral collateral pledging agreements that can allow a corporate credit union to make a material reduction in the credit risk to which the corporate would be exposed if its derivative counterparty experienced deteriorating financial conditions or committed an event of default. In order to lessen the credit risk represented by any single derivative counterparty, NCUA could establish a limit of 5 percent of capital as the maximum threshold credit exposure allowed to be included in the ISDA Credit Support Annex entered into by the corporate credit union and its derivative counterparty.

Appendix B to Part 704 - Southwest Corporate's Recommendations:

That NCUA amend Part III of Appendix B of the Proposed Rule in order to include domestic counterparties with long-term credit ratings of no lower than A- (or equivalent) or short-term credit ratings of no lower than A-1 (or equivalent).

Summary.

The combination of a revised Part 704, and NCUA's continued effective supervision of the nation's corporate credit unions, enhanced by global regulatory and market reforms, will ensure that corporate credit unions will continue to provide the products and services needed by natural-person credit unions, while also ensuring that corporate credit unions operate in a safe and sound manner.

Southwest Corporate agrees that revisions to the current language of Part 704 are necessary in order to strengthen corporate credit union balance sheets and operations, and to contribute to the long-term safety and soundness of the credit union industry. In this letter and in its 14 Comments on NCUA's Proposed Rule, Southwest Corporate has recommended several modifications to the Proposed Rule that Southwest Corporate believes are necessary in order to ensure that corporate credit unions are able to continue to offer value-added products and services, and to present sustainable business models that include successful recapitalization initiatives.

Southwest Corporate looks forward to further dialogue and collaboration with NCUA throughout this rulemaking process.

Very truly yours,

Brent Taylor
Chairman of the Board

John Cassidy
President/CEO

<u>Attachments</u>:

Annex A: Pro Forma Income Using the Preamble to the Proposed Rule with Adjustments to Key Assumptions – Page 22.

Annex B: Pro Forma Income Using the Preamble to the Proposed Rule and Southwest Corporate's Current Business Model – Page 23.

Annex C: Pro Forma Income Using Southwest Corporate's Recommendations and Current Business Model – Page 24.

Annex D: Pro Forma Income Using Southwest Corporate's Recommendations, Current Business Model, and Historical Average Investment Spreads – Page 25.

Annex A – Pro Forma Income Using the Preamble to the Proposed Rule With Adjustments to Key Assumptions.

	NCUA Model		Adjusted for Investment Spread		Adjusted for Capital	
Assets	Percent of Balance Sheet	Spread to LIBOR	Percent of Balance Sheet	Spread to LIBOR	Percent of Balance Sheet	Spread to LIBOR
FFELP Student Loans ABS	20%	25	20%	25	20%	25
Private Student Loans ABS	10%	200	10%	25	10%	25
Auto ABS	20%	25	20%	25	20%	25
Credit Cards ABS	10%	30	10%	30	10%	30
Other ABS	10%	10	10%	10	10%	10
Overnight	30%	0	30%	0	30%	0
Total	100%	34.0	100%	16.5	100%	16.5

	Liabilities		Liabilities		Liabilities	
Shares & Equity	Percent of Balance Sheet	Spread to LIBOR	Percent of Balance Sheet	Spread to LIBOR	Percent of Balance Sheet	Spread to LIBOR
Overnight Shares	30%	0	30%	0	30%	0
Certificates	70%	0	70%	0	66%	0
Member Capital	0%	0	0%	0	4%	150
Total	100%	0	100%	0	100%	6

Net Interest Margin		0.34%		0.17%		0.11%
Fee Income		0.17%		0.17%		0.17%
Total Operating Income		0.51%		0.34%		0.28%
Operating Expenses		0.30%		0.30%		0.30%
Net Income from Operations		0.21%		0.04%		-0.03%

Note: Based on a $10 billion balance sheet.

Annex B - Pro Forma Income Using the Preamble to the Proposed Rule and Southwest Corporate's Current Business Model.

Investments			
Assets	Percent of Balance Sheet	Spread to LIBOR	Maturity (Years)
Loans	7%	25	1.0
ABS - Autos	15%	15	0.5
ABS - Credit Cards	15%	25	1.0
FFELP Student Loans	12%	25	1.0
Agency	0%	0	1.0
Bank Floaters	0%	0	0.5
Other	0%	0	0.0
MBS - CMBS	0%	0	0.0
Overnight	51%	-12	0.0
Total	100%	4.6	0.42

Liabilities			
Shares & Equity	Percent of Balance Sheet	Spread to LIBOR	Maturity (Years)
Overnight Shares	65%	-18	0.0
Certificates	31%	0	0.7
Member Capital	4%	150	0.0
RUDE	0%	0	0.0
Total	100%	-5.7	0.22

A/L Mismatch (years)			0.20
Net Interest Margin (bps)		10.3	
Net Fee Income (bps)		37.3	
Operating Expenses (bps)		45.3	
Net Income from Operations (bps)		2.3	

Credit Risk (Shock)	**Actual Risk**	**Proposed Limit**
A/L Shock (300 bps)	14.85%	15.00%

Retained Earnings Test	**Year 3**	**Year 6**
Projected RE (bps)	7	14
Regulatory Requirement (bps)	45	100

Note: Based on a $7 billion balance sheet.

Annex C - Pro Forma Income Using Southwest Corporate's Recommendations and Current Business Model.

Investments			
Assets	Percent of Balance Sheet	Spread to LIBOR	Maturity (Years)
Loans	7%	40	2.0
ABS - Autos	20%	35	2.0
ABS - Credit Cards	20%	38	2.0
FFELP Student Loans	18%	32	2.0
Agency	10%	10	1.0
Bank Floaters	0%	5	2.0
Other	0%	0	0.0
MBS - CMBS	0%	0	0.0
Overnight	25%	-12	0.0
Total	100%	21.2	1.40

Liabilities			
Shares & Equity	Percent of Balance Sheet	Spread to LIBOR	Maturity (Years)
Overnight Shares	65%	-18	0.0
Certificates	31%	0	0.7
Member Capital	4%	150	0.0
RUDE	0%	0	0.0
Total	100%	-5.7	0.22

A/L Mismatch (years)			1.18
Net Interest Margin (bps)		26.9	
Net Fee Income (bps)		37.3	
Operating Expenses (bps)		45.3	
Net Income from Operations (bps)		18.9	

Credit Risk (Shock)	**Actual Risk**	**Recommended Limit**
A/L Shock (100 bps)	29.58%	35.00%

Retained Earnings Test	**Year 3**	**Year 6**
Projected RE (bps)	57	113
Regulatory Requirement (bps)	45	100

Note: Based on a $7 billion balance sheet.

Annex D - Pro Forma Income Using Southwest Corporate's Recommendations, Current Business Model and Historical Average Investment Spreads.

Investments			
Assets	Percent of Balance Sheet	Spread to LIBOR	Maturity (Years)
Loans	7%	40	2.0
ABS - Autos	20%	10	2.0
ABS - Credit Cards	20%	7	2.0
FFELP Student Loans	18%	8	2.0
Agency	10%	6	1.0
Bank Floaters	0%	0	2.0
Other	0%	0	0.0
MBS - CMBS	0%	0	0.0
Overnight	25%	-12	0.0
Total	100%	5.2	1.40

Liabilities			
Shares & Equity	Percent of Balance Sheet	Spread to LIBOR	Maturity (Years)
Overnight Shares	65%	-18	0.0
Certificates	31%	0	0.7
Member Capital	4%	150	0.0
RUDE	0%	0	0.0
Total	100%	-5.7	0.22

A/L Mismatch (years)			1.18
Net Interest Margin (bps)		10.9	
Net Fee Income (bps)		37.3	
Operating Expenses (bps)		45.3	
Net Income from Operations (bps)		3.0	

Credit Risk (Shock)	**Actual Risk**	**Recommended Limit**
A/L Shock (100 bps)	29.58%	35.00%

Retained Earnings Test	**Year 3**	**Year 6**
Projected RE (bps)	9	18
Regulatory Requirement (bps)	45	100

Note: Based on a $7 billion balance sheet.