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February 24, 2010

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

Re: Comments of Part 704 Corporate Credit Unions

Dear Ms. Rupp:

We appreciate the opportunity to comment on NCUA's proposed amendments to Part 704, which would make major revisions regarding corporate credit union capital, investments, asset-liability management, governance, and credit union service organization (CUSO) activities. Our credit union is based in Los Angeles and serves close to 52,000 members.

We have evaluated NCUA proposal and recognize that the NCUA Board and staff have spent a significant amount of resources researching, discussing, soliciting and evaluating input, and creating the Advanced Notice of Proposed Rulemaking and this proposed rule. Your desire to improve and strengthen the corporate system is evident in the scope and breadth of this proposal. We do find several difficulties with the proposal as it stands and, if enacted as proposed, will place onerous conditions on corporate credit unions to operate.

Critical Issues

We are deeply concerned that if the following issues are left unchanged, there will be severe, and possibly unrecoverable, repercussions to corporate credit unions, which in turn would have harmful effects on our credit union that relies upon them.

1. Present day sub-standard Assets in Corporate Credit Unions
   Although the subject is not discussed in the proposal, addressing the issue of what should be done with sub-standard assets current on the balance sheets of corporate credit unions is vital to there being a viable regulatory and operating environment. Investment securities remaining on corporates' books continue to create instability in

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the network, and serve as a major disincentive to credit unions providing any future capital contributions. We strongly urge NCUA to cooperatively and transparently address the business and regulatory issues associated with these assets. We believe that failure to do so invites the weakening of even currently stable corporates, and would serve to negate the positive changes that NCUA and credit unions would like to see in the corporate system.

2. <u>Time Period for Capital Ratio Attainment</u>

The one year window required by the proposal to attain the risk-based capital ratios (i.e., the 4% Leverage Ratio) will require corporates to bring in new capital or, at a minimum, convert existing MCA to the new PCC during a time when significant issues remain unresolved regarding legacy assets. Due to a lack of sufficient retained earnings at most corporates, and an inability to grow retained earnings at a rate required by the proposed rule, member credit unions will likely be asked to contribute approximately 4% of the corporate credit union deposits as perpetual capital within 12 months of the publication date of the final rule.

We are certain that most credit unions will be extremely reticent to contribute additional capital in such a short time frame, and in such an uncertain environment. Indeed, some credit unions may decide to pull their deposits from the corporate system as the result of such a precipitous move to achieving a 4% Leverage Ratio via PCC. This, in turn, would lead to liquidity concerns for corporates. Given the unavoidable reality that credit unions will need longer than one year before they will feel comfortable recapitalizing, we encourage NCUA to recognize that: (a) some kind of interim financing or capital note (equivalent to as much as 4% of a corporate's balance sheet) will be required to meet corporates' operational needs; and (b) the proposal's time period for attaining the risk-based capital ratios must be extended to at least three years.

3. <u>Retained Earnings Growth Model</u>

We take issue with NCUA's assumptions regarding a corporate's ability to grow retained earnings under the proposed investment and ALM limitations and believe that it does not represent a reasonable or attainable mix. For example, NCUA's model appears to work because it allocates 10% of the investment portfolio to a fairly high risk, extremely illiquid sector – private label student loans. This is on top of a 20% allocation in government guaranteed student loans. It is unrealistic and unsound to allocate 30% of a portfolio to the student loan sector. This single sector of NCUA's model accounts for an astonishing 75% of the interest income. The principle of concentration risk is violated and too much exposure is presented.

We believe the adjusted model below created by the Association of Corporate Credit Unions (ACCU), illustrates a more realistic outcome—suggesting the need to make necessary revisions to the proposed assumptions and limitations. This model is based on a $10 billion dollar balance sheet for example purposes and assumes no growth in assets or asset mix. Spreads are adjusted downward by 2 or 3 bps over the 7-year time horizon to reflect industry expectations. Funding has been modified to include a capital

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note of $400 million (4% capital assuming a $10 billion balance sheet) issued on day one, priced as floating at a spread of 200 bps to LIBOR. The adjusted model also assumes that fees and operating expense will increase in line with inflation at an assumed rate of 2% per annum.

With an investment mix that includes loans, ABS-Autos, ABS-Credit Cards, FFELP Student Loans, Structured Agency, Bank Floaters, Other Short-term, MBS-CMBS, and Overnight, it is projected that net income of 14 bps can be realized. However, we must point out that even this would be insufficient to meet the proposed capital targets. Even at 14 bps, a corporate would be short 7 bps of NCUA's model scenario in which projected net income of 21 bps would hypothetically allow for adequate building of retained earnings.

4. Average-Life NEV Testing

The proposal requires average-life mismatch net economic value (NEV) modeling/stress testing, in addition to existing interest rate risk (IRR) NEV modeling, to include:

- A 300 basis point credit spread widening, coupled with a NEV ratio decline limited to 15 percent;
- A 50 percent slowdown in prepayment speeds to determine if the corporate has excessive extension risk; combined with
- A portfolio/asset limit of two years in average weighted life.

We are uneasy with an analysis which indicates that there is no combination of assets—with a two-year average life and limited extension risk—that could generate sufficient margin to attract funding *and* pass a 300 basis point credit shock test. Further, the proposed limitations placed upon a corporate by these tests would not allow corporates to generate sufficient interest margin to build retained earnings to meet the new capital requirements contained in the proposal. The 2 year average weighted life limitation will make holding Agency and Private Label Mortgage Backed Securities—the largest sector of potential investments—a difficult feat for corporates. Any ability to generate a reasonable interest margin in order to build retained earnings will become very dependent upon a lower cost of funds for corporates, which means a lower yield paid to members.

In our view, the proposed spread widening of 300 bps appears to be an over-reaction by NCUA to a once-in-a-lifetime, completely unique event. Historical analysis indicates that, over the past 15 years, excluding recent events, credit card and auto ABS credit spreads to LIBOR widened to a maximum of approximately 50 bps, and generated a standard deviation of spread volatility of approximately 10 bps.

We believe it would be more realistic to set the credit shock test at 100 bps widening – double the historical average. Even at 100 bps credit shock, a NEV volatility limit of 35 percent decline is needed to accommodate the impact of floating-rate investments carrying the loss to maturity. We would recommend that NCUA to amend this test to a 100 bps credit spread widening and a 35 percent NEV volatility tolerance limit.

5. Weighted Average Asset Life

This provision limits the weighted average life (WAL) of a corporate credit union's aggregate assets to two years, and includes loans to members. Such a requirement will have adverse implications for natural person credit unions seeking to fill liquidity needs with term loans from corporates. In order to keep the overall WAL of its portfolio within the two year limit, most of the loans made by a corporate will be limited to shorter-term maturities. For longer-term loans, a corporate will have to substantially increase the rate offered in order to compensate for the impact the longer term will have on its two year WAL test.

Although we do not seek out long-term financing for our credit union, if we did, it would have to be priced with much higher borrowing cost. The two year proposed limitation will force many credit unions to seek less beneficial, or more expensive, funding from other sources. It would make sense to exclude loans from the calculation of weighted average life of the investment portfolio. After all, the original purpose of corporate credit unions was to enable financial intermediation between credit unions—not only their short term needs but also medium and long term needs.

6. Penalty for Early Withdrawals on Corporate Certificates

This proposed provision limits a corporate credit union's ability to pay a market-based redemption price to no more than par, thus eliminating the ability to pay a premium on early withdrawals. Such a change will pose a significant disincentive for member credit unions seeking liquidity, and will likely lead them to seek more competitive investing options than corporates. As a result, corporates' institutional funding market for term certificates will be severely impaired which will lead to a significant reduction in overall liquidity in the corporate credit union system. We urge the Board to strike this proposed requirement from the final rule, as it is not only counterproductive to maintaining corporate liquidity and natural credit union investment options, but would likely have long-lasting and harmful effects to the system.

7. Perpetual Contributed Capital

We applaud the proposal to eliminate the current prohibition on corporates requiring credit unions to contribute capital to obtain membership or receive services. Removing this decision from the regulator and moving it to the board and management of a corporate credit union is desirable.

Other Areas

8. Payment of Dividends

The proposal will prohibit a corporate from paying dividends on capital accounts, unless it obtains NCUA's prior written approval. This is a regimented approach that may pose problems for the future re-capitalization of the corporate credit union system. Capital accounts, as natural person credit unions have painfully learned, are riskier than insured deposits. Accordingly, corporates may need to put a price on this risk. While we understand the operational questionability of paying dividends on paid-in capital when an undercapitalized financial institution needs to maximize retained earnings to build capital, we see this as a case-by-case decision properly made by the board and management of a corporate credit union in the context of the interest rate environment. NCUA should be able to exercise sufficient oversight through its authority to approve or not approve a corporate's net worth restoration plan.

9. Concentration Limits
As written, Federal Funds transactions are not specifically excluded from the sector concentration limits. As a result, corporates would have severely limited access to the federal funds market. This will have the harmful effect of reducing the overnight rates that member credit unions receive from their corporate. We recommend that the definition of deposits in 704.6 (d) be amended to include Federal Funds or, alternatively, that the exemptions from sector concentration limits include Federal Funds transactions. You may also want to amend 704.6(c) to allow a larger single obligor limit of 200% of capital on money market transactions with a term of 90-days or less. An alternative solution might be to specifically allow a single obligor limit of 200% of capital for Federal Funds transactions sold to other depository institutions.

10. Corporate Credit Union Service Organizations
The section of the proposal adds a very short list of permissible corporate CUSO activities (consisting of brokerage services, investment advisory services, and other categories as approved by NCUA). Can you provide clarity in the form of definitions or additional information regarding permissible activities? There is vagueness in the definitions that stand now. Additionally, it is unclear what would happen regarding corporate CUSOs which currently engage in activities not listed in the proposal. Would these activities be grandfathered? Would the NCUA subject them to an approval process? We believe these issues must be addressed in order to avoid credit union uncertainty or concern regarding services provided by these CUSOs.

This section of the proposal also provides for expanded access by NCUA to a corporate CUSO books, records, and facilities. The Leagues respectfully disagree with this proposed expansion. While NCUA has unparalleled skill and knowledge in examining credit unions, this expertise would not necessarily translate into efficient and effective examination of other business entities, and other business products. Indeed, some CUSOs and their activities are already examined by state regulatory agencies, so NCUA oversight would be a redundant and inefficient use of the Agency's resources. In the case of a CUSO with both state and federal credit unions owners, NCUA has access to the CUSO's books and records through the federal credit union owner(s). If NCUA intends to pursue this provision, a better approach would be for the Board to provide for access in situations where the corporate has the controlling interest in the CUSO.

11. Overall Limit on Business Generated from Individual Credit Unions
This provision prohibits a corporate from accepting from a member credit union *or other entity* any investment in excess of 10 percent of the corporate's daily average

net assets, with the objective of reducing risks that could arise from placing undue reliance on a single entity. We believe that such a limitation—from an individual credit union standpoint—is prudent and reasonable from a liquidity management standpoint. However, many corporates avail themselves of inter-month funding when needed to address short-term liquidity volatility. Typical sources of these funds include the Federal Reserve Bank and the Federal Home Loan Bank. Therefore, including "or other entities" in the 10 percent limit may force corporates into short-term borrowing with less favorable terms. It would force corporates to maintain larger cash balances, which would likely be detrimental to earnings. As written, this may limit corporates' ability to provide their credit unions with reasonably priced short-term liquidity.

We suggest that NCUA consider allowing borrowings with a maturity of 30 days or less from either the Federal Reserve Bank, a Federal Home Loan Bank, a Repurchase Agreement counterpart or a Federal Funds counterpart, in excess of 10% of the corporate credit union's moving daily average net assets. Alternatively, this issue could be addressed by eliminating the "or other entity" language of the proposed limitation.

12. Qualifications of Directors
The proposal requires, as qualification for directorship, that all candidates must currently hold the equivalent of a CEO, CFO, or chief operating officer (COO) position at the member institution (typically, though not always, a natural person credit union). We do not agree that a particular job title necessarily makes for a better board member, and instead suggest that NCUA consider that directors of corporates that may not have full experience or training needed in a particular area be required to obtain training on an annual or other periodic basis as a condition of service on a corporate board. There are a variety of credit union training programs, schools, online resources for board members which the NCUA could evaluate (possible every one to two years) and approve for use to meet such a standard. You may also consider a "soft" criterion for board candidates that have professional credentials such as securities licenses, certified financial analyst, certified internal auditors, and certified public accountants. The goal should be that directors serving on a corporate credit union board have professional experience and credentials, ongoing professional development, and analytical ability to effectively look after member credit unions' interests.

Issues Not Addressed in the Proposal

13. Consolidation of Corporate Credit Unions
It is our view that corporate consolidation would be beneficial to the system, and that NCUA should be more open, responsive, and supportive of such consolidation by removing unreasonable impediments and/or resistance to corporate credit union mergers. We recognize that the current number of corporates is less than ideal with respect to efficiency and effectiveness (e.g., potentially redundant member capital

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requirements). While we appreciate NCUA's avoidance in dictating the number of corporates in the system, we would like to see more open dialogue between NCUA, corporates, and credit unions regarding consolidation scenarios including the effect it would have on the viability of the entire credit union system. On the other hand, we do not believe that corporate system made up of two or three would serve the needs of the industry. A system that fosters competition while promoting efficiency should govern this issue.

14. <u>An Extra Line of Defense between Corporates and Natural Person Credit Unions</u>
We suggest that NCUA might consider the creation of a separate insurance fund or separate insurance "system" for corporate credit unions in the future. The logic here is to clarify to corporates and their boards that the primary safety net under a corporate failure is a specific corporate funded share insurance fund as well as mutual support amongst the corporates. We believe that NCUA should explore other options for creating a line of defense between corporates and NPCUs.

Our League informs us that although a number of Federal Home Loan Banks are known to have invested in similarly toxic securities and have found themselves in highly weakened capital positions, no credit unions or their bank counterparts have lost capital held in FHLBs as was lost in the credit union corporate system. Admittedly, FHLBs are a different breed in that they are government-sponsored entities; however, like corporate credit unions, FHLBs are privately capitalized. Under FHLBanks' newly formed regulator, the Federal Housing Finance Agency (FHFA), capital adequacy in this period of financial sector and economic stress has been measured by "regulatory capital" instead of GAAP-based capital. "Regulatory capital," according to SubsidyScope, does not count the losses that an FHLBank suffered on its mortgage-backed securities. Thus, the FHLB of Seattle, for example was allowed to state a capital position of nearly $3 billion with only $960 million in GAAP-based capital. This critical tool of "regulatory capital" that was employed by the FHFA created an effective "line of defense" between investors (i.e., investing credit unions and banks) and those FHLBanks that held problem assets.

There are 90 million credit union members that rely, indirectly, on the corporate system to provide trading, payments, clearing, and settlement services for their local credit unions. Given this *systemically* important role that the corporate credit union network plays in our nation's financial system, NCUA should enact a progressive policy to protect this plurality by utilizing more of the regulatory tools at its disposal to create an added buffer between corporate credit unions and natural person credit unions and assure that the credit union system as a whole is better able to withstand future shocks.

15. <u>Risk-Based Net Worth for Natural Person Credit Unions</u>
We strongly support adoption of risk-based capital among corporate credit unions. Corporate credit unions and natural person credit unions, alike, have been operating in an outdated capital framework that is out-of-step with the broader financial sector and worldwide financial regulatory regimes. While it is beyond the scope of Section

704, we take this opportunity to ask that risk-based capital be extended to natural person credit unions. As the corporate credit union meltdown clearly reminded the entire credit union system, not all assets are created equal and NCUA should take a more granular and specific approach in its measurement of capital adequacy to reflect the degree of risk associated with different assets.

Thank you for the opportunity to provide our concerns and recommendations regarding this very important rulemaking. We urge the Board to strike an effective and fair balance between preventing a repeat of past corporate failures and allowing a viable corporate system to thrive. We ask NCUA to seriously consider another round of proposed rule-making and comment by the credit union system before issuing final rules. The gravity of possibly losing the corporate credit union system as an option for natural person credit unions justifies a thorough and comprehensive evaluation on what NCUA proposes for the future of corporate credit unions and, ultimately, natural person credit unions.

Sincerely,

Michele Wilson

Michele Wilson
Chair, Board of Directors