February 28, 2010

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

Re: Proposed Regulation 12 CFR Part 704

Dear Ms. Rupp,

Thank you for the opportunity to respond to the Proposed Regulation 12 CFR Part 704 that affects the operations and administration of Corporate Credit Unions. The importance of Corporate Credit Unions to natural person credit unions should not be diminished; while the current crisis has weakened the Corporate Credit Union system and severely impaired a number of Corporate Credit Unions thoughtful consideration of how these entities should work and behave can produce a revitalized, functioning system.

Thus, in response to your request for comments regarding the proposed rule governing Corporate Credit Unions, the following is offered.

While it can debated why the Corporate Credit Union debacle occurred, the following appear to be the primary contributors to the calamity natural person credit unions are now paying for:

- Lax regulatory supervision over the types of investments Corporate Credit Unions could purchase; this was made worse by inexperienced and/or untrained regulatory personnel overseeing the Corporate Credit Unions. Regulators allowed Corporate Credit Unions to expand their investment envelope without:
  - Understanding the underlying risks sub-prime and ALT A loans carried: risk was not just from falling home prices but, more importantly, came from resetting interest rates and payments, recasting loan amounts, payment shock, payment affordability, and refinance assumptions that said borrowers with these loans would always be able to refinance—the 1998 sub-prime disaster, when the same refinance claims were made, was overlooked.
  - Comprehending, as those who bought and sold the securities did, the Achilles' heel in the securitization of CDOs, and sub-prime, ALT A, and commercial loans: no one examined underlying loan documentation after a Lender packaged and sold the loans—ratings and Rating Agencies replaced the need to revalidate and require quality control.

- Requiring in-house loan expertise: Corporate Credit Unions employed investment and trading specialists, yet most of the investments Corporate Credit Unions purchased were collateralized by real estate loans that featured negative amortization, interest only payments, recasting of balances, and payment shock—issues and problems lenders, not investment and trading specialists, were familiar with and concerned about.

  Compounding problem: The National Credit Union Administration (NCUA) did not have a staff of investment and lending experts in investment arenas Corporate Credit Unions were permitted to trade in and participate.

- Establishing concentration limits that respected and valued the increasing risk Corporate Credit Unions were taking on: Corporate Credit Unions did not purchase the investments that brought them down over night, they bought them over time—enough time for regulations to be issued that could have controlled and restricted concentration and risk.

- Demanding more net worth as Corporate Credit Unions shifted risk onto their balance sheet: private label securities were significantly more risky than those issued by Fannie Mae or Freddie Mac—if loans defaulted an Agency security, the Agency removed the loans from the security and continued making payments; if loans went bad in higher yielding non-Agency or private label securities (i.e., the type of securities most Corporate Credit Unions purchased), the security owners assumed the risk.

* Corporate Credit Unions countenanced a permissive approach to investment policies, practices, and security purchases as they:

  - Did not hire loan experts to exam the loans collateralizing the CDO, sub-prime, Alt A, or commercial securities they purchased.

  - Relied on security issuers and, more significantly, Rating Agencies (see conflict of interest, next), to define risk in the investments purchased: Corporate Credit Unions did not do loan level due diligence, it was someone else’s responsibility (violating a basic investing principal: know what you are buying).

  - Disregarded conflicts of interest Rating Agencies had regarding the securities they rated: security issuers paid the Rating Agencies to rate their securities (which produced the infamous and well known practice by security issuers of “shopping for a rating”).

  - Ignored warning signs for CDO, sub-prime, Alt A, and commercial loan securities, just like other investment banks and financial institutions.

    Wescorp admits seeing signs of trouble for sub-prime loans; they stopped buying these securities as a result. However, Wescorp did not sell their sub-prime securities when they stopped buying them; they opted to hold them—perhaps for yield purposes or maybe to forestall recognizing losses or possibly both. Additionally, if Wescorp saw signs of trouble for sub-prime loans how did they miss the same signs of trouble for CDOs (which mostly contained sub-prime loans) and Alt A loans (which many considered a higher credit scored sub-prime loan)—was yield the dominant consideration.

* Corporate Credit Unions did not appreciate, grasp and/or understand the trust and reliance natural person credit union place in them:

  - Corporate Credit Unions acted more like Investment Banks or hedge funds than service providers—high yield investments supplanted the import of services.

- Corporate Credit Unions claimed they were:
  - Purchasing higher yielding, low risk investments—an interesting premise since higher yielding investments typically mean more risk, the reason for higher yields.
  - Able to compete with Wall Street firms and large financial institutions—and do so without any additional risk to natural person credit unions.
  - Experts risk managers: they used sophisticated financial models, outside third party investment experts, credit ratings, tranche support, and bond insurance—they did not need to do loan level due diligence.
- Corporate Credit Unions did not recognize (or appreciate) their special position as a natural person credit union's "trusted" institution—instead of purchasing safe, steady paying investments, they reached for yield which came with unrecognized, unquantified, and unknown risk, just the opposite of what natural person credit unions wanted.

Given that the issues, matters, and problems listed above were in fact primary contributors to the current Corporate Credit Union debacle, the changes in Proposed Regulation 12 CFR Part 704 governing Corporate Credit Unions net worth and investments appear to be overly complicated and not nearly as strong or effective as required. The regulation should be simplified, Corporate Credit Unions investment powers should be restricted, and the laddered net worth ratio reduced to a single specific percentage of assets ratio. The following is a starting point for such changes.

Investments

- Corporate Credit Unions should be limited to investments that are:
  - Mortgage backed (i.e., Residential Mortgage Backed Securities or RMBS, including Collateralized Mortgage Obligations or CMOs) with one to four units only as collateral
  - Credit card, auto loan/lease, or student loan asset backed (natural person credit unions are familiar with the type of loans that secure these investments since most natural person credit unions make them on a daily basis)
  - Securities, deposits, and obligations permitted under the Federal Credit Union Act and meets the requirements of this section, including repurchase agreements
  - Deposits in and the sale of federal funds to national and state banks, corporate credit unions trust companies, and mutual savings banks—debt obligations of these institutions should only be allowed if guaranteed by an agency of the Federal government or the National Credit Union Share Insurance Fund (NCUSIF) or NCUA
  - Investment funds maintained by a national bank or mutual savings bank but only if the fund makes investments permissible for Corporate Credit Unions
  - AAA rated securities, super senior tranche of such securities, and provide the owner with the right to the first interest and principal payments from the securities
  - Collateralized geographically with no one state representing more than 15% of the security's total collateral
  - Made in Corporate Credit Union service organizations (CUSOs) that provide services to natural person credit unions (i.e., the CUSOs should not be allowed to function as investment advisors to or to own securities).

- The following should be required for Investments collateralized by:
  - First or second mortgage loans:
    - The Issuer withdraws any loan from the security that goes into default
    - Borrower payments are current at time the investment is purchased
    - The loans do not negatively amortize or have prepayment penalties
    - Borrower income is fully documented based on Fannie Mae or Freddie Mac only guidelines, credit scores are 640 or higher and debt-to-income ratios are 50% or less.
  - Auto loans/leases or credit cards:
    - Borrower payments are current at time the investment is purchased
    - Borrower income is documented (i.e., with at least one full month of current pay stubs), credit scores are 620 or higher, and debt-to-income ratios are 55% or less.

Investment requirements for holding securities (see Two year average life section)

- All securities purchased by a Corporate Credit Union should be rated by two Nationally Recognized Statistically Rating Organization's (NRSRO)—one of the NRSROs should be Standard and Poors, Moody's, or Fitch (the Big Three) and the other NRSRO selected by the Corporate Credit Union (it may be one of the other Big Three NRSROs or another NRSRO).
  - The two NRSRO ratings must be AAA; if not, the investment cannot be purchased.
  - A Corporate Credit Union must have the securities it owns rated quarterly by the two NRSROs that initially rated the investment. A Corporate Credit Union should not be allowed to replace or remove a NRSRO that provides a credit rating other than AAA.
  - A Corporate Credit Union must sell timely (i.e., within 90 days) any security that does not receive a AAA rating from both NRSROs when reviewed (quarterly reviews should ensure that a security can be sold within 90 days without a significant loss).
- Corporate Credit Unions should be required to have a staff of loan specialists with lending expertise in the type of loans that collateralize the investments they purchase.
  - The lending staff should select and evaluate (i.e., validate documentation, including employment, income, assets, credit, appraisal, title, and any information deemed appropriate—loan level due diligence) a select number of loans collateralizing the investment to be purchased.
    - The analysis should be made on a random sample basis (e.g., 10% or 20% of the loans underlying the investment to be purchased).
    - The analysis should include all loans deemed high risk in the investment (e.g., loans with high loan to value and/or high debt-to-income ratios)—these loans are in addition to the random sample.
    - The security cannot be purchased if the issuer does not allow loan level due diligence.
  - The lending staff review determines if the loans meet the proposal's requirements and there are not have other attributes that negatively impact performance—staff judgment should be final and not subject to rejection or change by a Corporate Credit Union.

  - The lending staff should perform an annual loan level due diligence on collateral securing each investment; the analysis should review the performance of the underlying loans, credit attributes (e.g., change in credit scores), and value of the collateral. The analysis determines if the risk from the loans has changed, what new risk factors are present, and what actions should be taken to reduce the increased risk (includes selling the security).
- The Investment purchased by Corporate Credit Union should:
  - Be matched to deposits (i.e., shares and/or certificates) identified at the time the investment is purchased
  - Have a maturity that reasonably coincides with the maturity of the deposits / certificates
  - Provide a yield that exceeds the matched deposits cost by at least 1.00% (exception: US Treasuries, Fed Funds, and deposits in banks or other federally insured institutions).

Investments that should not be allowed and removal of expanded authority
Corporate Credit Unions should not be allowed to engage, invest, purchase, or trade in:

- Commercial mortgage backed securities
- Asset backed securities not listed in Investments section
- Collateralized debt obligations (CDOs), collateralized loan obligations (CLOs) or any type of obligation that mirror or acts like CDOs or CLOs (e.g., a CDO squared)
- Net interest margin securities, stripped mortgage-backed securities, short sales or adjusted trading, and mortgage serving rights
- Corporate debt or marketable debt obligations of US corporations, including small business related securities
- Securities with less than AAA rating and AAA rated securities that are lower than a super senior tranche (this includes subordinated securities and mezzanine financing)
- Derivatives (including the selling of or any expanded authority to use)
- Residual interests in CMOs, real estate mortgage investment conduits, and asset-backed securities
- Securities lending or an investment in investment companies registered with the SEC.

By limiting the type of securities a Corporate Credit Union can own and not allowing purchases of securities with less than AAA rating or ownership of AAA rated securities lower than a super senior tranche, there is no need for expanded authority and thus such authority should be eliminated (expanded authority invites risk and changes what should be a principal Corporate Credit Union objective: risk avoidance).

Investment concentration

- An Investment purchased by a Corporate Credit Unions should be restricted to the lesser of:
  - $10 million per obligor and transaction counterparty
  - No more than 20% of a Corporate Credit Union’s total net worth per obligor and transaction counterparty.

  The following exceptions should be allowed provided the obligor is:

- The United States Government (USG) and the investment backed by an explicit guarantee from the USG: no maximum investment limit.
- A company controlled by the USG: the investment limitation is increased to $20 million but not more than 35% of a Corporate Credit Union's total net worth.

  If control of a company changes from the USG to a non-governmental entity and the USG does not provide an explicit guarantee for the new debt/investments issued by the new company, the initial investment limitation should apply.

  Fannie Mae, Freddie Mac, or Ginnie Mae: the investment limitation is increased to $50 million but not more than 50% of a Corporate Credit Union's total net worth. If control for an entity changes from the USG to a non-governmental entity and the USG does not provide an explicit guarantee for the new debt/investments issued by the new company, the initial investment limitation should apply.

- Corporate Credit Unions should not exceed the following investment sector limits:

– RMBS, first and second mortgages, including HELOCs	35% of total assets
– Auto loan/lease backed securities	25% of total assets
– Student loan asset backed securities	20% of total assets
– Credit card asset backed	20% of total assets
– Credit Union Service Corporation (see CUSO below)	1% of total assets
– Other investments (see Liquidity and Borrowing section)	
– Loan participation interests (from credit unions only)	10% of total assets
▪ Fixed Assets	5% of total assets
▪ Investments guaranteed or issued by the USG (e.g., Treasury Bills or Bonds), insured by the NCUSIF or the Federal Deposit Insurance Corporation, and investment repurchase agreements	No Limit

<u>Reporting</u>
A Corporate Credit Union should report monthly all investments holdings, sales, maturities, and gains or losses from sales, to its Board of Directors along with all credit ratings obtained during the month for a security purchased or held.

Two year average life (see Investment requirements for holding securities section)
While the proposal seeks to reduce "unnecessary risks" for Corporate Credit Unions by establishing a maximum weighted two year average life for investments, this runs counter to matching maturities of investments to deposits. Limiting the average life for investments without establishing a similar requirement for deposits creates a mismatch that can profoundly harm Corporate Credit Unions (see Capital Corporate FCU). The proposal should require Corporate Credit Unions to match investment and deposit maturities as feasible and with flexibility provided for absolute maturity dates and prepayment speeds. Aligning maturity dates improves the ability of Corporate Credit Unions to manage spread between investments and deposits.

Credit Union Service Corporation (CUSO)

The maximum investment allowed by Corporate Credit Unions in a CUSO should be changed from a net worth provision to a percentage of assets (i.e., 1% of assets, see Investment Concentration section above). The net worth provision is affected by a Corporate Credit Union's gains and losses where an asset limitation is a more reliable basis for investment management.

Corporate Credit Unions should be allowed to lend to a CUSO they own. The maximum amount a Corporate Credit Union can lend should not exceed the amount of their investment.

The current proposal calls for Directors of Corporate Credit Unions to have access to a CUSO's facilities, staff, books and records and any documentation deemed pertinent. While such a requirement may be necessary for a Corporate Credit Union's auditors and NCUA examiners, access by Corporate Credit Union Directors to a CUSO could be disruptive to and unmanageable for the CUSO. Also, "any documentation deemed pertinent" may mean different things to Corporate Credit Union Directors; as such, this could subject a CUSO to a constant refrain of questions, analyses, and explanations. Thus, access by Corporate Credit Union Directors should be limited to a delegated Director and to a specific time.

Liquidity and Borrowing

The proposed liquidity and borrowing rules should be revised. Corporate Credit Union liquidity requirements need to be strengthened and borrowing focused on need, not opportunity.

- Corporate Credit Unions should be required to hold 15% of assets in cash or cash equivalent securities for liquidity (assets are defined in the Capital Requirements section). Cash equivalent securities include Treasury bills and bonds, deposits in federally insured institutions, repurchase agreements, and fed funds. The 15% proposal provides "support for the corporate's payment systems obligations" and untimely or unexpected share withdrawals.
- Corporate Credit Unions with liquidity that falls below this minimum as a result of share withdrawals, purchase of facilities or equipment, or funding current operations, should be:
  - Required to notify the NCUA and request approval for borrowing; the NCUA should evaluate a request, establish borrowing limits, and begin monitoring the Corporate Credit Union and its activities to ensure it is being operated in a safe and sound manner.
  - Allowed to borrow funds to meet liquidity requirements and needs until such time as its liquidity is replenished through share deposits or earnings from operations
  - Required to invest (excess) borrowed funds in cash and cash equivalent securities.
- Corporate Credit Unions should not be allowed to borrow funds to purchase investment securities, arbitrage investments, increase lending (this can be done by selling non liquidity securities and redeploying the funds received), or leverage the balance sheet—regardless of the Corporate Credit Union's net worth amount or net worth ratio.
- Corporate Credit Unions should be allowed to borrow, secured or unsecured, based on borrowing requirements (e.g., a borrowing to purchase a building may require the building as collateral while an overnight borrowing to meet liquidity rules may not need any collateral).

  Additionally, the proposal's 30 day limitation on secured borrowings used for liquidity purposes is not appropriate. The 30 day limitation should be replaced with a rule that allows the Corporate Credit Unions to hold borrowed funds related to liquidity until such time as the liquidity is replenished through share deposits or earnings from operations. The 30 day limit exacerbates a Corporate Credit Union's ability to manage its cash and operational needs, focuses the Corporate Credit Union on quick responses versus stable solutions (i.e., as it scrambles for funds it cannot adjust share deposit rates timely or effectively to replenish the funds it needs), and exposes a Corporate Credit Union to potentially higher borrowing costs as it tries to secure funds for a short period of time.

Capital Requirements

A fundamental problem for Corporate Credit Unions is the ability to secure new capital; it can only be obtained from retained earnings or contributions by credit unions (i.e., member capital accounts). Corporate Credit Unions do not have the authority to go to capital markets for new capital. Thus, Corporate Credit Unions must rely on earnings or other credit unions for support.

As a result of this constraint and reining in of Investment authority as provided in the proposal and changes offered herein, the proposal's new capital levels, risk based capital rules, and establishment of a Corporate Credit Union capital structure similar to Banks is overly complex, allows and promotes risk by providing a risk based ratio, and is arguably unattainable (i.e., without NCUA assistance, a swift improvement in the housing market and economy, and/or a significant turnaround in the performance of underlying collateral securing the investments of most Corporate Credit Unions).

To simplify the proposed net worth requirements, promote safe and sound operations, and build a risk adverse culture, Corporate Credit Unions should be required to maintain a "regulatory net worth" equal to 10% of total assets at each month end.

For purposes of this section:

- "regulatory net worth" is defined as Member Capital Accounts (MCAs), Paid in Capital or Perpetual Contributed Capital, and Retained Earnings.
- Assets are defined as set forth in the proposed regulation.
- Regulatory net worth is not GAAP net worth (i.e., GAAP net worth does not include MCAs).

Corporate Credit Unions need regulatory net worth since:

- Corporate Credit Unions cannot obtain funds from the capital markets
- There is an immediate and overriding need to:
  - End the current Corporate Credit Union crisis
  - Recapitalize, reorganize, and stabilize Corporate Credit Unions.
- It allows Corporate Credit Unions to become functional, effective credit union service providers (once again), instead of trying to find ways to reduce costs and eliminate services in an effort to shore up and/or restore net worth.
- Remedies the "time is of the essence" problem Corporate Credit Union face today: Corporate Credit Unions need to viable, operational, and competitive now; their owners (natural person credit unions) should not, cannot, and will not wait years for this to happen.

To ensure Corporate Credit Unions meet the regulatory net worth requirement, natural person credit unions should be required to:

- Belong to a Corporate Credit Union
- Purchase MCAs timely (e.g., 120 days after of passage of the regulation) and equal to:
  - 1.00% of their net assets if they do not use the services of the Corporate Credit Union
  - 1.25% of their net assets if they use the services of the Corporate Credit Union.

Natural person credit unions should be allowed to choose the Corporate Credit Union they join provided the Corporate Credit Union is in their same examination district (helps eliminate some Corporate Credit Union shopping) and supplies the services they require.

To protect natural person credit unions, encourage and reward their participation, and prevent them from abandoning Corporate Credit Unions to institutions that offer similar services:

- NCUA should provide a guarantee for the newly issued MCAs (such a guarantee may require substantive support by the USG)—current MCAs would not be guaranteed by NCUA.
- Corporate Credit Unions should be required to pay interest on newly issued MCAs just as they do for share accounts—the interest should be withdrawable any time.
- Natural person credit unions should be allowed to request withdrawal from a Corporate Credit Union after five consecutive years of membership provided such the request is made one year in advance of the withdrawal and the withdrawal does not take the Corporate Credit Union's regulatory net worth below 10%.

The proposed NCUA guarantee of newly issued MCAs should be for a specific period (e.g., five, six, or more years but not more than ten years—a sunset provision). This allows Corporate Credit Unions time to increase their capital without hampering their primary mission: providing low-cost financial services and competitive lending and investment rates (i.e., without reaching for yield) to their member owners (see Capital Corporate FCU section).

The new MCAs should only be issued to and owned by natural person credit unions. Other Corporate Credit Unions, financial institutions, hedge funds, corporations, and individuals should be prohibited from purchasing or owning Corporate Credit Union MCAs.

The new MCAs should not be used to absorb losses from investments a Corporate Credit Union owns prior to their recapitalization. Any losses from the investment owned prior to the recapitalization should continue to be treated as they are currently (i.e., losses would continue to deplete a Corporate Credit Union's current capital accounts and retained earnings) and natural person credit unions should continue to be assessed for those losses.

The Corporate Credit Unions net worth ratio with the new MCAs would also include a Corporate Credit Union's current or remaining net worth and losses it may record in the future from investments it owns prior to the recapitalization.

The natural person credit union ownership percentage of MCAs (i.e., 1.00% or 1.25%) may be adjusted to ensure that most, but not all, Corporate Credit Unions have the ability reach the 10% regulatory net worth requirement. Corporate Credit Unions that do not achieve this ratio should be given 24 months to reach the goal. If a Corporate Credit Union does not achieve the 10% capital standard within the extended time period, the Corporate Credit Union should be closed or merged (a merger with another Corporate Credit Union should only be allowed if the surviving Corporate Credit Union has a regulatory net worth ratio after combing assets of more than 10%).

Corporate Compensation

The proposal's disclosure of corporate compensation seems arbitrary, capricious, and politically inspired. The rationale presented does not justify the action; and, the proposal does not appear to serve a need or address an issue. The proposal does open Directors to criticism and/or disparagement from those who disagree with the compensation paid and who do not appreciate or understand what executives managing complex financial organizations or operations are paid.

Corporate Governance

The proposal's Corporate Governance section recognizes the need to have experienced directors for Corporate Credit Unions. However, the proposal should:

- Expand the qualified list of directors to include senior lending officers (i.e., by Title and experience) of natural person credit unions

  The investments Corporate Credit Unions purchase are typically collateralized by loans (i.e., home loans, credit card, auto loans, student loans, etc.). However, the current proposal fails to recognize the importance such collateral has in the performance of the security. This is the same failure Corporate Credit Unions made when they purchased the securities that are now causing natural person credit unions large losses. The knowledge lending professionals bring should improve decision making as it adds another dimension of experience and expertise.

- Require that each director have a minimum of five years continuous and uninterrupted natural person credit union experience in the position they hold when elected

  Corporate Credit Union directors should be knowledgeable of NCUA regulations, aware of the current state of credit unions, and well-informed about operational needs of credit unions. The five year period recognizes that there will be some professionals from other industries or financial service companies that become credit unions executives; this time frame allows such individuals time to gain needed experience and expertise while establishing an overall requirement for any credit union professional to serve on a Corporate Credit Union Board.

- Limit the number of directors:
  - From natural person credit unions with assets of:
    - Less than or equal to $100 million to: 10% of the Corporate Credit Union's total number of directors
    - Over $100 million but less than or equal to $500 million to: 25% of the Corporate Credit Union's total number of directors
    - Over $500 million but less than or equal to $1.0 billion: 33% of the Corporate Credit Union's total number of directors
    - Over $1.0 billion but less than or equal to $10.0 billion: 25% of the Corporate Credit Union's total number of directors
    - Over $10.0 billion: 20% of the Corporate Credit Union's total number of directors.
  - Not from a natural person credit union to no more than 15% of a Corporate Credit Union's total number of directors and require these directors to have at least fifteen years experience in financial services, five of which should be as an executive.

– Who are senior lending officers, chief financial officers, and chief operating officers from natural person credit unions to no more than 40% of the total number of directors.

The size of Corporate Credit Unions and the risks they have demand professionals who understand the complexities of large institutions, value management structure and validation processes, and are knowledgeable of and experienced with investment portfolio management.

Capital Corporate FCU

The failure of Capital Corporate Federal Credit Union (Cap Corp) highlights the problems that remain in the Corporate Credit Union system. The causes of Cap Corp's failure, which occurred 15 years ago, and the problems that led to its failure are eerily similar to what led up to and caused today's failure of two major Corporate Credit Unions (i.e., US Central and Wescorp).

Unfortunately, the history and the lessons from Cap Corp's failure were not learned, realized, or accepted by the NCUA or the Corporate Credit Unions. The NCUA, while passing some new rules after the Cap Corp failure, allowed Corporate Credit Unions operate almost unfettered until they nearly bankrupted the Credit Union system. Such limited supervision permitted Corporate Credit Unions to expand investment activities with few new restrictions and let some Corporate Credit Unions become more like investment firms and hedge funds than service providers.

The following is from the Statement of Charles A. Bowsher, United States Comptroller General before the Senate Committee on Banking, Housing, and Urban Affairs, on February 28, 1995:

> "As of December 31, 1994, Cap Corp was one of the largest…corporate credit unions…it's failure resulted from a number of factors, including an inappropriate investment strategy, an inadequate risk management system and insufficient board oversight, lax regulatory supervision and examination, and inadequate capital."
>
> "Over the five year period 1989-1994, Cap Corp invested an increasing portion of its assets in collateralized mortgage obligations (CMOs), a form of mortgage derivative, in an apparent attempt to increase the return paid to its member credit unions…(In) September, 1990…Cap Corp had about $63 million in CMOs. By 1992 (these) holdings were over $500 million (and) by September 1994, (they)…increased to over $1 billion (or) about 68% of its assets."
>
> "The sharp increase in interest rates that began in February 1994 caused…CMOs to lengthen in expected average maturity. Some… substantially, which caused their market values to fall dramatically. What began as a mild mismatch between longer term assets and shorter term liabilities turned into a substantial mismatch…In the fall of 1994…member credit unions began withdrawing shares …To avoid realizing…losses…Cap Corp funded…withdrawals by borrowing…funds (which caused it to exceed) its regulatory borrowing limits. Cap Corp was directed not to borrow any more. Cap Corp (had) to liquidate its investments at substantial losses…On January 31, 1995, (the) NCUA placed Cap Corp in conservatorship."

Additionally, as Barbara A. Good, Federal Reserve Bank of Cleveland, stated on May 15, 1996 in an article titled "The Credit Union Industry—An Overview":

> "Corporate Credit Unions (CCUs) have historically had very low capital/asset ratios, and many have significant investments in financial instruments that are considered to pose a higher-than-standard risk. In April 1995, the NCUA attempted to address this concern by releasing its proposed regulation to strengthen the capital ratios of CCUs, reduce the risk of their investments, and improve asset-liability management. This proposal said that its

provisions "would return corporate credit unions to their primary function of serving as liquidity centers and service providers, and would protect the safety and soundness of the corporate credit union system." [4] "

[4] See "Corporate Credit Unions: Requirements for Insurance," *Federal Register*, vol. 60, no. 80 (April 26, 1996), p. 20,438; and Proposed Rules, 12 C.F.R., pts. 704 and 741.

The Department of the Treasury's report on credit unions stated on December 1, 1997:

"(t)he failure of Cap Corp in January 1995 raised specific concerns about…interest rate risk …corporate credit unions were taking…Congress held hearings in early 1995 to examine these issues. The GAO testified that Cap Corp's failure resulted from "inadequate board oversight of an inappropriate investment strategy." The GAO also criticized the NCUA's supervision of Cap Corp. The GAO outlined five factors…precipitating Cap Corp's failure:

- Cap Corp lacked an effective risk management system and effective board oversight.
- Cap Corp's accounting did not reflect declining market values.
- The NCUA's examination and supervision of Cap Corp were inadequate.
- The NCUA's call report data were too limited and inaccurate.
- The NCUA's capital standards were inadequate and not targeted to corporate credit union risks." [171]

[171] GAO, *Credit Unions: The Failure of Capital Corporate Federal Credit Union*, statement of Charles A.Bowsher, Comptroller General, Feb. 28 (Washington, DC: GAO, 1995), 2-6.

History is a foundation on which rules and regulations can be formulated; however, when history is ignored, it repeats itself—and harshly as the current Corporate Credit Union crisis has shown.

Finally, the Association of Corporate Credit Unions state on their web page:

"A corporate credit union is a not-for-profit financial cooperative that serves retail (natural person) credit unions."

"Corporate credit unions (or "corporates") were organized for the express purpose of providing low-cost financial services and competitive investment and lending rates to their member/ owners, and are guided by volunteer boards of directors."

Corporates are …owned and directed by their member credit unions…(and) exist solely for the benefit of their member credit unions...(they) fulfill their traditional roles while evolving to meet the growing demands for a full range of financial, investment, credit, funds-transfer, settlement and educational services by the credit union industry…(which) achieves collective cost-savings, synergies and competitive advantages."

"Corporates' strength is their ability to leverage economies of scale in the areas of item processing, payment systems, settlement, investments and liquidity for their members' benefit. They serve as an integral link in the chain of financial transactions initiated at the credit union member/consumer level."

The current proposal:

- Allow Corporate Credit Unions to continue investment operations with no redirection to their primary mission: "providing low-cost financial services (i.e., item processing, payment systems, settlement), and competitive investment and lending rates."

- Does not change Corporate Credit Union behavior or the propensity of Corporate Credit Unions to take on risk to generate yield (i.e., there are few penalties for risk taking).

The changes proposed herein are directed at returning Corporate Credit Unions to the initial role and responsibilities, providing low cost financial services to natural person credit unions.

It is hoped the NCUA will find these comments helpful in determining a course of action. Thank you for the opportunity to comment.

Thank you.

Ed Casanova

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Vice President
Aerospace Federal Credit Union

Email comments to regcomments@ncua.gov