FIRST CITIZENS' FEDERAL CREDIT UNION
Think First.

Thursday, March 2, 2010

Mary Rupp
Secretary of the Board
National Credit Union Administration
Alexandria, Virginia 22314-3428

Dear Secretary Rupp:

This letter constitutes our response to the NCUA's proposed changes in 12 CFR Parts 702, 703, 704, 709 and 747 the "so called" "Corporate Credit Union Regulatory Reform Proposal". This Rulemaking proposes changes in Investment Limitations, Asset and Liability Managerial Requirements, Capital Standards, Prompt Corrective Action Requirements, Corporate Governance Requirements and CUSO Operations. Our comments will generally follow these major functional classifications, serially.

To begin with, the major objection we have with the proposed regulatory overhaul is that it presupposes the continued existence of the Corporate Credit Union System. Yet, the opacity of deliberations around the actual financial condition of the system precludes the Natural Person Credit Unions from making a rational choice as to what to do with the system. For example, if the losses in the system outweigh the aggregate capital held by all 27 of the Corporate Credit Unions what exactly are we discussing? They need to be liquidated, accounts settled and alternatives found.

If there is residual and sufficient capital, why has there not been a consolidation of these entities from what most credit unions believe to be a system with too many Corporate Credit Unions? Knowing that there is sufficient capital for the corporate mission, however defined, would allow an orderly consolidation of the system. This should result in considerable savings to member institutions and permit a sequestering of bad assets to be managed separately by the NCUA, or its designees. With these actions taken, Natural Person Credit Union Boards could at least make a rational choice based upon price, value and perceived risk.

Before addressing the changes to the Corporate Regulatory framework we feel it necessary to frame the risk of loss to the actions of particular corporate credit unions, now and going forward. Virtually no one at the present time will contribute further capital to the Corporate Credit Union System not knowing the final price tag of the current crisis. So mandatory contributions of capital linked to the purchase of services, will be viewed as unjust and imprudent, and drive Natural Person Credit Unions out of the system.

Indeed, since most, larger credit union have identified and used alternative sources of liquidity and services for some time, an unusual sort of Gresham's Law will prevail. The good and well managed credit unions and those possessing economies of scale will exit the system stopping their losses at the elevated Deposit Insurance Assessments likely to materialize as OTTI Losses become realized in the future. No prudent Board of Directors would permit further, direct investments of "at risk" capital without first knowing the full financial status of these entities.

Four things need to happen before any serious consideration of further investments can be contemplated.

- First, separate the liquidity and investment functions from the payment, settlement and operations functions of the Corporate System.

- Second, find ways to privatize the payment, settlement and operations portions of the Corporate Credit Unions through capital contributions of credit unions in known operations. Alternatively, sell these functions off to private organizations.
  - Under this "operations" sale scenario we would include the brokerage and investment advisory functions of the Corporates.
- Third, make investments, if required, in the operating-system entities true equity investments and thereby limit the potential future losses of invested sums. Notice capital and linked corporate credit union hierarchies constituted a "systemic" problem to those Credit Unions that have had nothing to do with them.
  - This "at risk" approach to investment and services will be the single most compelling Governance enhancement to ensure market discipline and associated risk mitigation.

- Fourth, ascertain how best to meet the liquidity and investment needs of the NPCU's.

  - There is always the Federal Home Loan Bank System, which is used by many credit unions already.
  - Or perhaps, reconstruct the CLF for direct access by NPCU's to manage liquid balances.
    - Indeed, given the specialization of most credit unions in consumer lending, an entity that would do collateralized lending based upon pledged consumer loans would serve a real industry purpose.

The current use of time-restricted "capital", compounded by a dual-institutional, layering of investment risk clearly has hurt the Credit Union industry. Imposing three year notice capital in a market that settles daily, and in institutions potentially restricted to two-year-duration investments, is a riddle we can't figure out. All of the Governance requirements in world will do no good if capital cannot be freely transferred or sold to impose market discipline on the actions of management. The current framework is like steering a super tanker from the fantail; by the time problems are noted it is too late.

The present two-tier system is unworkable and financially impenetrable from the perspective of the Natural Person Credit Unions. This coupled with the proposed requirement of eliminating the national field of membership seems maximally inefficient without the NCUA stepping in and requiring some form of systemic consolidation. It is perplexing that the NCUA does this routinely for Natural Person Credit Unions but is seemingly awestruck by the necessity to consolidate the corporate credit unions?

We would propose an alternative funding and liquidity entity with access to the broader market, not unlike the Home Loan Bank System, where credit unions could access term liquidity. The clearing and ancillary payment services functions can be done by private entities without recourse to NCUA and member resources. Entities of this type are already prevalent in other parts of the financial services industry and examined by the FFIEC to ensure the safe and sound operation of mission critical services. We are of the belief that there is value in the separation of these entities from the impaired portfolios that could be realized from a market sale. Extracting the capital from the privatization of these operations will provide tangible capital to offset present and future losses to the system.

Investment Limitations

The Corporate Credit Unions were the victim of systemic events that materialized from possibly taking on too much credit risk consistent with their business operations. That this credit risk was insufficiently identified at the time of purchase has turned out to be an international market issue. There are manifest players in the market to blame for these events, not the least of which are the National Rating Organization that reviewed and rated these investments. Some Corporate Credit Unions took on more risk than others and the entire industry has paid a considerable price for these decisions. We need to explore the root cause of why these credit unions sought higher yields by taking on greater credit risk.

That inquiry will lead to the determination that there was too much scale in the corporate credit union industry and too little in the Natural Person Credit Union Industry. Competing on price nationally to serve the captive NPCU industry required the excess earning on corporate portfolios to fund overall operations.

Given that most financial institutions in the US made the same or similar mistakes based upon all of the evidence available at the time, it is difficult to fault the Corporate Credit Union for falling into the same trap. We are of the belief that the dual structure of the corporate network and the resulting double-gearing of risk made this a much more profound problem for the industry than it needed to be. The most vexing part of the equation is that the management and governance layers of these operations remain intact despite having presided over institutions with such importance to the industry.

The narrowness of the investment powers suggested in the Advance Notice of Proposed Rule Making is concerning due to both the proposed maximum duration of investments and due also to the scope. Remember at some level the losses we are suffering under today are a function of undue concentration in a particular market segment. If the continued operation of the Corporate Credit Unions is a given, and as most believe, the investment portfolios of these institutions serve to provide offsetting income to discounted pricing for services, then the model will not work. Their investment authority will be defined too thinly to support overall operations, the corporates will need to raise prices, and with compelling alternatives for most of the services they provide to their members, ultimately fail.

Asset and Liability Management Requirements

We support any and all prudent enhancements to ALCO practices consistent with the mission of the organizations being managed. However, the detailed nature of the prescribed practices would cause one to pause and wonder whether these financial institutions will be chained in their vulnerability to the next major economic event. ALCO deliberations of financial institutions are prescribed by best practices, risk appetites, personnel, information and technology capabilities, governance and oversight and the flexibility to react to changing economic and market circumstances. One might question the highly prescriptive approach to ALCO in the context of the proposals to change the governance structure of the corporate credit unions. Would not a governance framework, populated by the right directors, ensure that all necessary, prudent and adaptable Asset and Liability regimens are adopted?

Capital Standards

Currently there is only one 4 percent capital requirement for corporates. We support the use of a two-tier Basel I-like capital structure for the corporate credit unions, and concur with the decision to opt-out of the more onerous Basel II framework contemplated for significant banking organizations. These did not work in detecting or preventing the current market collapse and would do no better at a specialized credit union. Incorporating a leverage ratio as well as a risk weighted capital measure too, will improve the monitoring of corporate capital levels.

Given their currently deteriorated condition it is more than prudent to allow these institutions to “phase-in” to the final capital requirement. Paid in capital the so called “non-perpetual contributed accounts” having a fixed five year term of five years is a problem. Once again, unless we allow credit unions to purchase certain forms of equity that is immediately transferable/ saleable, it will no doubt result in another “slow motion” train wreck as the next asset bubble takes its course. Governance is both hard work and dedication to the preservation and growth of the institution, as well as exercising your rights as an investor to provide market discipline.

Prompt Corrective Action Requirements

Prompt corrective action, what a fascinating idea; where was this idea two to three years ago? Indeed, since there was an entire corporate-examination team, many of whom were on-station at the corporate credit union offices, prompts one to ask how much closer do regulators need to be? It is clear that the NCUA is looking for bright red lines of authority to intervene in corporate credit union affairs, early rather than later, to avoid the necessity for using judgment, analysis and best practices. Prompt corrective action is a prudent course of action by the NCUA, if and only if the corporate credit unions can be reconstituted in a healthy and competitive manner. This would run counter to the approach taken toward the corporates over the past year. Indeed, prompt corrective action might have mitigated losses had they been implemented in early 2007.

We underscore again, the corporate credit unions must consolidate and streamline their operations and shed those functions that are not sustainable. *It appears unlikely that this consolidation will take place voluntarily given the disparate distribution of remaining capital and the competing objectives of present management.* Indeed, we are hearing quite often the cry for a means of isolating "legacy" assets a concept we object to because carrying these legacy assets will have a cost that the entire industry will have to bear, unless they are offset against the equity base of the corporate.

Credit unions having no relationship with a corporate should not have to shoulder the carrying costs and associated losses of a failed corporate. Let them fail, or capture the economic value in the operations of the corporate credit unions, maximized through consolidation, and net this value against the accumulated losses. There is no easy way to do this, but the most inequitable of all approaches is to do nothing and make selected catastrophic losses everyone's responsibility. These credit unions were organized to serve the natural person credit unions not drag them into oblivion with investment losses.

Corporate Governance

Focusing on the governance framework is in the best spirit of the Sarbanes-Oxley movement if it entails a serious effort to promote a risk management culture at the board level. Limitations on terms is democratic but could be impractical, ensuring that the board is representative of the institutions it serves is good but potentially a political nightmare. Let's find the best directors from within the industry to reboot the governance of these institutions and let them establish a succession plan that ensures continuity and fairness, while remaining open to the constituent credit unions. As to board fees, by all means, this is serious work and deserves compensation. The work is no less serious at the Natural Person Credit Unions, nor is the dedication of the directors, so let's also make provisions to compensate the directors of these organizations as well.

CUSO Requirements

As to the CUSO regulatory amendments to promote more openness and visibility into the CUSO operations of the corporate credit unions we are in full agreement. The NCUA might even consider a reporting framework to provide visibility into the consolidated operations of the corporate empire. If we had these requirements presently, we would have a better opinion of their consolidated value, not just individual credit unions, but also the associated lines of business they were engaged in. This would be an essential element in calculating the future of these operations.

Concluding Comments

The corporate credit unions in many instances provide useful services to many credit unions, essential services to some, and irreplaceable services to none. They have served as the "big brother" to a large number of credit unions that lack the scale or sophistication to survive in a market where services are provided on a competitive basis. They have been given powers that exceed those of the industry they serve as a means of preserving the essential mission of cooperative finance. Unfortunately, it also concentrated risk in a relatively few organizations with balance sheets that linked these risk to the broader industry. It is not uncommon to ladder powers and surveillance over institutions based upon their size and mission, and this is something that the NCUA needs to begin considering.

By now it must be apparent that the proposed regulation of the corporate credit unions is tortured at best, and seeks to preserve a function that is perhaps best managed at the natural person credit unions level. Adding a corporate credit union level to support inefficiency at the NPCU level must by now seen to be folly by all who have witnessed the failure of the system in recent months. We have set them up to fail in a brutally competitive market environment, and it is now time to set the NPCU's up to succeed.

Let's consider expanding the credit union operating charter, reducing geographic restrictions, allowing compensation for directors and providing controlled access to capital markets. And finally, let's give the smaller credit unions with a well defined mission a chance to survive through a reasonable affiliation framework like the Mutual Holding Company. Many of the economies of scale that the corporates had hoped to provide for smaller credit unions could be achieved through affiliation.

Sincerely,

Chief Operating Officer
First Citizens' Federal Credit union