# Memo

**To:** National Credit Union Administration

**From**: Terry Belcoe, President/CEO, North Coast Credit Union

**Date:** 3/5/2010

**Re**: Comment on Proposed Regulation 704

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I am President/CEO of North Coast Credit Union in Bellingham, Washington. I have degrees in finance and account, am a CPA, and hold and MBA. I've been in the credit union movement for over 20 years, with 11 of those as a CFO and the past nine as CEO. I point that out to highlight the fact that with that background, I was largely lost in details of the proposed new regulations. They were clearly developed by individuals with a vast knowledge of the underlying theoretical concepts, but without much of an eye for what those of us in natural person credit unions must do: build financial institutions with both short-term positive results and long-term viability.

As financial institutions, our primary function is as a "risk intermediary." We get paid to take calculated risks. Our entire success is not based upon our ability to *eliminate* risk, but rather to *mitigate* and *manage* risk. If, as credit unions, we were to totally eliminate credit risk, interest rate risk, and liquidity risk, for example, we would serve not purpose in our members' lives or in the economy. We would bring no value that would warrant consumers doing business with us, as our terms and pricing would be vastly inferior to those which could be obtained from any bank.

This is where, from the highest level, I believe that the proposed regulations are fundamentally flawed. They seek to impose a series of controls aimed at ensuring that the corporate system is never again in a position to fail as it did over the past couple of years. And in so doing, I believe that they create an business model that is "dead on arrival." I can't create a scenario wherein any financial institution could meet all of the conflicting constraints imposed by the proposed new regulations. In explaining them to my senior management team, I likened them to a quadratic equation:

$X^2 + XY + 1 = 0$

When you've solved all of the variables, the end result is zero. Nothing. That is what I believe the proposed regulations would create; a very complex operating model which, after all of that effort, results in nothing. If you create a game plan that prevents errors, but also prevents scoring, it doesn't matter how well you execute the plan. You will still lose.

At the end of all of this, there is the intention that the natural person credit unions will recapitalize the corporate credit union system. Standing in the way of this, however, are two provision that make this highly unlikely. First, we, like so many other credit unions, took a huge hit to earnings when our stock in WesCorp was wiped out when the write-downs on its portfolio of investments. The proposed regulations do not provide for natural person credit unions to recover any those losses should the actual losses on those investments prove to be less than the OTTI adjustments that precipitated the extinguishment of our stock. How can we be expected to invest in the corporates credit unions again when we lost our first investments and now precluded from any future recoveries on those?

Second, if asking us to invest more of our members' money into a business that has already failed once isn't enough, now we would be asked to do that when these proposed regulations would create an operating structure in which any financial institution would fail, regardless of how well managed or capitalized it might be. Who of us would invest our own money a second time in any company where we lost our all of our initial investment and when the odds of that business being able to survive under the regulatory requirements were slim to none? While such a leap of faith might represent a noble show of support and solidarity for the credit union system, at the end of the day it is still our members' money that we would be gambling with. Personally, I believe, were the proposed regulations enacted as written, I would do better by my members to take that money to Las Vegas and bet it on the roulette wheel. At least there would be a chance that the money would not be lost.

Moving backward through that "quadratic equation," from the answer of zero to the variables that add up to that, here are a couple of my concerns that lead me to my conclusion articulated above.

1. Legacy Assets
As stated previously, we lost a significant amount when our shares in WesCorp were wiped out. To seek my support for recapitalizing the corporate system while barring me from any potential recovery of my initial investment is simply asking too much. Fool me once, shame on you. Fool me twice, shame on me.

2. Net Economic Value Tests and Weighted Average Asset Life constraints
The intent here is clearly to *eliminate* interest rate and liquidity risk completely. While I applaud the minimum NEV ratio requirement of 2%, limiting the changed in shocked NEV to 15% virtually precludes the opportunity to manage the balance sheet in a manner that can generate net interest income. Without that spread, and the ability to rebuild Tier 1 capital, the whole model fails right out of the gate. The corporates will be unable to provide competitive pricing on borrowings, deposits or services. Without those, there is no purpose for the corporate credit unions.

There are clearly many other constraints in the proposed regulations that, in my mind, also contribute to my conclusion that any new corporate system, so tightly limited in their ability to manage and mitigate risk, would be doomed to failure. I present these as an example of why I feel that way.

My recommendations for giving the corporate credit union system a chance at survival would include the following:

Regulatory Oversight

There was no lack of NCUA presence in any of the corporate credit unions that got themselves into trouble. Why, in all of the proposals, is it not mentioned that those regulators should have done a better job of monitoring what was going on, reporting it, and interceding to head it off? Shouldn't part of the solution be to implement a regulatory and oversight structure that would keep the corporates from getting into the situations in which they found themselves? With all of the resources the NCUA is adding, why would this be so hard?

Consolidation

If the proposed regulations take effect in anything like their present form, many of the corporates have no chance of success. The proposed regulations, in effect, dictate that the corporates operate on the very minimum of net earnings. With their individual opportunities for generating net income significantly reduced, their only hope will be economies of scale. This will mean consolidation.

In light of the current and future realities, is there any need for more than one corporate credit union? Why aren't the corporate credit unions themselves already stepping up to recognize this reality? With the NCUA already prescribing the rules of the game, why aren't they focusing their energies on building a genuinely new consolidated model for the corporates "collectively" rather than focusing on promulgating rules for individual credit unions that they as much as acknowledge will not produce the desired outcome of multiple strong, sustainable corporate credit unions.

In referring to the proposed capital requirements, the NCUA states "only two of the 28 corporates would be considered well capitalized or adequately capitalized today, with 16 of 28… would be considered critically undercapitalized (the lowest net worth category). Only two of the corporates would meet the proposed minimum 4% leverage ratio requirements." They go on to state that "the 18 retail corporates that have zero retained earnings will face a significant challenge in meeting the 4% leverage ratio requirement" and at the end of year six, they would have to have retained earnings of 1% of their net assets. "This will require earnings growth in the range of .15 - .2% of net assets, depending on asset growth."

With the vast majority of corporate credit unions already virtually insolvent, it is indeed difficult to envision a scenario where, under the very restrictive operating requirements set forth in the proposed rules, they could survive. Even for those handful of corporates currently adequately capitalized or better, these new constraints could quickly change that picture for the worse, driving them into insolvency as well.

Given the distinct possibility that most or all of the individual corporate credit unions would fail under the proposed rules, why isn't the focus of the NCUA and the corporates themselves on developing an entirely new, consolidated model for the system that actually has a chance of success?

Conclusion

I keep coming back to my analogy of the quadratic equation. Arguing the respective merits of the individual variables of the 252 pages of the proposed rules is, in my opinion, a waste of time and energy if the end result is still going to be zero. It is a total redesign of the corporate credit union system that is required at this time, not a rehashing of the rules as they pertain to the existing structure.

Again, at the end of all of this exercise, the NCUA will once again turn to the natural person credit unions to recapitalize the corporate credit union system. If the best that they can offer us is the opportunity to invest more of our members money in a “dead horse,” no thank you. I think I’ll pass.