Missouri Corporate Credit Union

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Secretary of the Board
National Credit Union Administration
1775 Duke Street
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Dear Members of the Board,

We are pleased to comment on behalf of the Board of Directors of Missouri Corporate Credit Union (MCCU) on the proposed revisions to Part 704. Our comments reflect our combined 32 years of experience in managing a corporate credit union.

We offer the following thoughts and observations on the proposed revisions:

Preamble

Section I.A. – It is stated, "NCUA's intention in allowing national FOMs (Fields of Memberships) was to provide NPCUs (Natural Person Credit Unions) with the ability to select membership in a corporate that best met the needs of each NPCU in serving its members. *The anticipated level of competition was expected to spur consolidation within the industry to build scale and improve efficiencies. In turn, this would build capital through increased earnings.* (emphasis added). While a few mergers occurred, one of the primary consequences of competition was to reduce margins on services and put pressure on the corporates to seek greater yields on their investments."

MCCU Comments

We fail to see why NCUA is seeking consolidation in the marketplace. We have already witnessed how consolidation in both the banking industry and credit union world helped fuel the current crisis, as NCUA has acknowledged.
The first corporate that began to compete nationally was CapCorp, which failed in the early 90's, due in part to increasing risk incurred to pay higher rates to compete nationally. The current economic crisis caused, at least in part, by national banks that were "too big to fail" is well documented. Despite these lessons, the new regulation encourages "consolidation within the industry to build scale and improve efficiencies." If the NCUA encourages fewer, larger corporate credit unions to make the system more efficient, then history will repeat itself.
We will have created a system of corporate credit unions that are "too big to fail."

Evidence of a system that is too big to fail is the effort to shield “legacy assets” at the large corporates. We cannot allow corporates to fail. If they are allowed to fail, the remaining corporates could not handle the influx of credit unions that still want and need a corporate relationship.

In May 2009, FDIC Chairman Sheila Bair testified before Congress on the issue of banks that are “too big to fail.” In that testimony, Bair stated, “A financial system characterized by a handful of giant institutions with global reach and a single regulator is making a huge bet that those few banks and their regulator over a long period of time will always make the right decision.” If the corporate system consolidates to a few, large institutions under the control of the NCUA, the NCUA is repeating the same mistake that Chairman Bair cautions against.

If the system consolidates to a few, large corporate credit unions, the ability to provide high levels of local service will be impaired – especially for small and medium-sized credit unions. We have seen this in action. As corporate mergers occurred over the past several years, a number of small and medium-size credit unions joined MCCU because they saw their service diminish locally when their “home” corporate merged to “build scale.” We believe the same thing will happen again as corporates struggle to survive under the stringent requirements of the proposed regulation. We recommend NCUA craft a rule that gives each corporate credit union a reasonable chance for success. Otherwise, only a few “too big to fail” mega-corporates will survive.

<u>Proposed Section 704.3 -- Corporate Credit Union Capital</u>

The proposed regulation moves corporate credit union capital requirements to a partial risk-based capital system. Retained earnings are also emphasized.

Corporates must meet these new capital requirements beginning with the first anniversary of the final rule publication, or will be placed under Prompt Corrective Action (PCA). The NCUA understands that most corporate credit unions have little capital and will not meet the first year requirements and have built in a period of time to achieve the required capital ratios. Additional time has been built in for retained earnings requirements as well.

<u>MCCU Comments</u>

The capital requirements under the new regulation are not realistic. The “sample corporate portfolio with one possible investment mix” is flawed.

Table 1			
Investments			
Sector	**Portfolio Percentage**	**Total Weighted Average Life (years)**	**LIBOR/EDSF Spread**
FFELP Student Loan ABS	20%	1.000	25
Private Student Loan ABS	10%	0.500	200
Auto ABS	20%	0.600	25
Credit Card ABS	10%	1.000	30
Other ABS	10%	0.300	10
Overnight Investments	30%	0.003	0
Total	**100%**	**0.501**	**34**
Liabilities			
Overnight Shares	30%	0.003	0
Term Certificates	70%	0.500	0
Total	**100%**	**0.351**	**0**

As noted in Table 1, the sample mix yields a net interest income of 34 basis points, and net income of 21 basis points (Table 2). The problem with the portfolio lies with the use of private-label student loans and the 30%/70% proportion of overnight to term deposits. There are several problems associated with private-label student loans. Today, private-label student loans are yielding approximately 30 basis points over LIBOR, not 200. Also, private-label student loans are very illiquid and rather difficult to obtain. Finally, private-label student loans are "under scrutiny" as noted in the December 16, 2009 edition of the *Credit Union Times*. To make matters worse, the private-student loans in the sample portfolio provide almost 60% of the 34 basis points in net interest income!

On the liability side, the mix of 30% overnight and 70% term is problematic. Over the past several years, MCCU has averaged about 40% overnight and 60% term. The variation between overnight and term has an enormous bearing on net income. Most corporates take much more spread on overnight deposits than on term deposits. So the larger the percentage of overnight deposits, the more net income is generated.

The sample portfolio concludes that a corporate could achieve a net income position of 21 basis points and meet the net earnings requirement of the proposed rule (see Table 2). *We strongly believe the sample portfolio exercise is unrealistic because it is not based on current or projected returns, relies on a preponderance of income from a thinly traded, risky sector of the securities* *market, and contains a dubious mix of overnight versus term funding. Consequently, the conclusion that a corporate can earn 34 basis points in net interest income is unrealistic.*

Using the sample investment mix, NCUA projects the following pro-forma income statement. Next to the pro-forma numbers are year-to-date numbers for MCCU for the same period.

Table 2		
Year-To-Date Numbers for Period Ending 06-30-09		
	Pro-Forma NCUA Numbers	**Actual MCCU Numbers****
Averages		
Net Interest Income	0.34%	0.25%
Other Income	0.17%	0.10%**
Total Operating Income	**0.51%**	**0.35%**
Total Operating Expenses	**0.30%**	**0.28%**
Net Income From Operations	**0.21%**	**0.07%**

*Source: Callahan & Associates
**The correct number is <1.28%> which includes partial U.S. Central capital losses. Typically, MCCU earns about 10 basis points of Other Income

As you can see, the yield on MCCU's investment portfolio (primarily U.S. Central overnight and term deposits) falls short by nine basis points and Other Income is short by seven basis points.

As the Fed pushed the Fed Funds Target Rate down in 2008, the rate received by corporates on overnight earnings began to diminish, and corporates reduced their spreads in order to pay members *something*. It appears we will be in the current "low rate" environment for awhile longer, so the reduced spread will continue. Consequently, the "low rate" environment will make it even more difficult to meet the third year anniversary earnings required by the new rule.

The other option available to corporates is to reduce assets. But even increasing capital by as much as $23 million, which will be difficult, and reducing assets by one-third will not enable MCCU to meet the regulation's third year requirements. And reducing assets means credit unions will have to move outside the corporate system. As a result, many credit unions may have to:

- Move their business outside the cooperative network
- Assume more risk as they invest outside the corporate system
- Begin to mark their investments to market
- Manage their overnight account on a daily basis
- Wire funds in and out of the corporate to cover settlement

    - Forego a Franchise Tax deduction (Missouri credit unions)

The proposed capital standards are based on a faulty model containing unrealistic data. As a result, the proposed capital standards are much too stringent for most corporates to meet within the required time frames. In order to meet the new standards:

- Most corporates will have to reduce their balance sheets, which means many credit unions may have to leave the corporate system

- Most corporates will have to increase earnings, which means many credit unions may have to:
    - Pay higher fees for day-to-day services
    - Accept less yield on investments
    - Pay more to borrow

- Most corporates will have to reduce or maintain very low operating expenses, which means many credit unions may receive:
    - Limited new services
    - A reduction in service delivery
    - A reduction in educational sessions
    - A reduction in credit union sponsorships

- Some corporates will have to consolidate, which means credit unions may suffer from:
    - Reduced local control
    - Reduced access to corporate decision makers
    - Reduced level of personal service
    - Increased emphasis on sales rather than service resulting in a focus on large credit unions

<u>Proposed Section 704.4 -- Prompt Corrective Action</u>

The proposed revisions appear reasonable.

<u>Proposed Section 704.5 -- Investments</u>

The proposed revisions appear reasonable.

<u>Proposed Section 704.6 – Credit Risk Management</u>

The sector limits *seem* reasonable but pose a problem when combined with the tighter single obligor limit and the other limits noted in the ALM section. Excluding certain assets from the sector and obligor limits, like government agency securities, makes sense.

Proposed Section 704.8 – Asset and Liability Management

Several dramatic changes are proposed in this section. Among them are:

A. New limit on average life mismatch and two year limit on the weighted average life of assets
B. New penalties for early certificate redemption
C. New per-member limit on deposits from any one member. Under the proposed regulation, a corporate cannot accept any investment, including shares, loans, PCC, or NCAs, if, following that investment, the aggregate of all investments from that member would exceed ten percent of the corporate's moving daily average net assets.

Below are our comments on items A through C listed previously:

A. As a "pass through" corporate, MCCU has always closely matched assets and liabilities. In fact, using September 2009 data (the most recent available), the weighted average life of assets was 0.511 years and the weighted average life of liabilities was 0.463 years, a mismatch of only .048 years. In addition, MCCU's base case weighted average life of assets was 0.4903 years, much less than the two year limit proposed in the rule. It appears MCCU could increase its mismatch risk and weighted average life and still remain in compliance with the proposed regulation.

   As a result of taking such little mismatch risk, earnings have suffered. In order for MCCU to achieve the new earnings requirements proposed in Section 704.3, it appears we will have to take more mismatch risk but the proposed mismatch limits are too low to enable MCCU or any other corporate to achieve the earnings requirements set forth in Section 704.3 regarding capital.

   Furthermore, the rule does not take into account core deposits. We have measured core deposits for years and have concluded about $200 million of overnight deposits are "core." That makes sense because credit unions must leave funds on deposit to cover settlement. We have safely invested a portion of these core deposits in longer-term instruments to pick up yield. *The new rule does not acknowledge core deposits and severely restricts the mismatch in maturities. As a result, we cannot generate sufficient earnings to comply with the rule, nor deliver value to our members.*

B. At the present time, MCCU's policies allow for market-based early redemption pricing. The proposed rule does not allow a corporate to redeem a CD at a gain. This new rule is designed to provide more stability for a corporate's balance sheet. The reality is that it makes corporate CDs less competitive against marketable securities. No such rule applies to marketable securities and brokers will be quick to point that out.

This is another example of NCUA-forced “downsizing” of corporate balance sheets. As mentioned previously, in order to meet the new earnings requirements, MCCU will have to take more spread, much more spread, on CDs. It likely will force credit unions to move their term deposits outside the corporate network to bank CDs or marketable securities. In turn, that will cause Missouri credit unions to lose a Franchise Tax deduction and require them to mark-to-market if they choose to invest in marketable securities. We assume this will cause the most harm to small and medium-size credit unions.

C. The proposed per-member limit on deposits could be problematic. At the present time, draws on lines of credit occur overnight and automatically to cover deficit settlement positions. If a large depositor miscalculates their settlement position and a line of credit loan is triggered to cover the settlement and, at the same time the depositor invests in an overnight CD, it could cause MCCU to violate the proposed per-member limit. Systems would have to be developed to monitor such events and/or MCCU would have to place a much lower limit on deposits (8% perhaps) from large depositors in order to provide a cushion to avoid violating the rule. Perhaps the burden should be placed on natural person credit unions to monitor their activity with corporate credit unions?

One additional note -- At the Dallas Town Hall meeting it was announced the NCUA had engaged an independent consultant to develop a model of the proposed regulation to answer two questions:

1. If the proposed regulation was in place in 2006 would it have prevented the losses? And,
2. Will the proposed regulation allow a corporate to earn enough net income to comply with the requirements?

We have not seen this model. However, the model may have a substantial impact on the need for ALM changes. We recommend this subpart of the Regulation be held open for further comment after the model is made available.

<u>Proposed Section 704.9 – Liquidity Management</u>

The proposed revisions appear reasonable.

Proposed Section 704.11 – Corporate Credit Union Service Organizations (CUSOs)

The proposed rule establishes limits on the amount a corporate can invest in and loan to a corporate CUSO. The rule also limits the activities of such CUSOs to:

- Brokerage services
- Investment advisory services, and
- Other categories of services as permitted by the NCUA

MCCU Comments

MCCU owns a portion of three CUSOs, one for brokered CDs (Primary Financial), one for commercial business loans (Heartland Business Services) and one for data processing (CNP). It appears MCCU will have to request permission of the NCUA to continue ownership in these three CUSOs. All three of the CUSOs are successful and MCCU's capital in them appears to be safe.

The CUSO section of the rule seems to be reasonable. However, there is speculation that some US Central functions may be placed in a CUSO(s). If that happens, the proposed rules may present a problem.

Proposed Section 704.14 – Corporate Governance

The proposed rule limits corporate board eligibility to member CEOs, CFOs or COOs for a maximum six-year period. The new rule establishes limits on paying legal or other professional costs of IAPs incurred in proceedings instituted by the NCUA or state regulator(s).

MCCU Comments

We believe the term limit time frame should be extended from six years to nine years. Corporate credit unions are dramatically different from natural person credit unions. Our experience has shown that it takes a new director at least two years to become informed and familiar with a corporate's business. Extending the term limit to nine years allows directors to grow in knowledge and expertise and enhances organizational wisdom.

With respect to limits on legal fees, it is our understanding the language limiting the payment of legal and other costs incurred in proceedings instituted by regulators comes from similar bank regulations. The difference is that bank directors are paid – handsomely. Corporate Board members are not paid. To place the same burden on corporate management and volunteers is unrealistic and unfair and the requirement should be removed.

This new requirement will also make it very difficult to find volunteers willing to serve. If the language is kept in the final regulation, we believe the restrictions should not be retroactive but should be effective upon the effective date of the proposed rule.

Thank you for the opportunity to comment on these critical issues facing the entire credit union movement.

Respectfully submitted on behalf of the MCCU Board of Directors by,

Dennis J. DeGroodt

Dennis J. DeGroodt, CCUE, CUDE
President/CEO

The following credit union CEOs support the positions outlined in Missouri Corporate Credit Union's comment letter:

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Chris McCreary, CEO/President
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MCCU ALCO Committee - member
United Consumers Credit Union – Independence, MO

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Ronald Miller, President
MCCU Board of Directors – Treasurer/Secretary
MCCU ALCO Committee - Chairperson
Edison Credit Union – Kansas City, MO

Susan Venable

Susan Venable, President
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Saint Luke's Credit Union – Kansas City, MO

Carol White, President/CEO
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Central Missouri Community Credit Union – Warrensburg, MO

Philip M. Weber, President/CEO
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Central Communications Credit Union – Independence, MO

Glenna Osborn, President/CEO
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Missouri Central Credit Union – Lee's Summit, MO

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Leadco Community Credit Union – Park Hills, MO

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