



March 5, 2010

Ms. Mary Rupp  
Secretary to the Board  
National Credit Union Administration  
1775 Duke Street  
Alexandria, VA 22314

Re: Comments on Proposed Rulemaking for Part 704, Corporate Credit Unions

Dear Ms. Rupp:

The National Association of State Credit Union Supervisors (NASCUS)<sup>1</sup> appreciates the opportunity to provide comments to the National Credit Union Administration (NCUA) concerning NCUA's proposed changes to the corporate credit union rule, Part 704, with conforming amendments to Part 702, Part 703, Part 709 and Part 747.

Stabilizing the corporate credit union (CCU) system, resolving the question of the corporate legacy assets and promulgating new rules for CCUs, all while balancing operational needs with safety and soundness, are not easy tasks. Reasonable minds will likely disagree on the best path forward, and NASCUS anticipates this process will undergo several revisions before final rules are promulgated. NCUA is to be commended for putting forth a comprehensive proposal for comment.

After reviewing NCUA's proposal, NASCUS recommends NCUA:

- Restore diversity to the corporate system by allowing state regulations to vary from NCUA's §704.
- Provide state regulators access to federal corporate credit union books and records.
- Amend the proposed Prompt Corrective Action provisions to mirror the natural person credit union Prompt Corrective Action provisions with respect to consultation and cooperation with state regulators.
- Limit governance provisions to federal corporate credit unions.
- Promulgate the stress testing and asset liability management provisions as thresholds rather than inflexible limits.

NCUA's proposal represents a substantial change to the current regulation of the corporate credit union network. Although the changes are predicated on the existing corporate credit unions

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<sup>1</sup> NASCUS is the professional association of the 47 state and territorial credit union regulatory agencies that charter and supervise the nation's 3,100 state-chartered credit unions.

beginning with “clean balance sheets,” to date the credit union system has not been presented with NCUA’s proposed resolution for the legacy assets. How the legacy asset situation is resolved is an essential element to evaluating the practical workability of the re-capitalization of CCUs and NCUA’s proposed rule changes.

In addition, NCUA announced the retention of an independent consultant to evaluate the proposed rules to determine: 1) what effect the proposed rules would have had if they had been in place prior to the economic downturn; and 2) the accuracy of NCUA’s modeling.

NASCUS appreciates the urgency felt by many to move forward in the rulemaking process. However, NASCUS anticipates that NCUA will provide for an additional comment period once it discloses the proposal for resolving the legacy assets and has received the report of the independent consultant. NASCUS reserves the right to elaborate on, or amend, the comments contained herein.

During the past year, weaknesses in both the CCU and the natural person credit union (NPCU) systems have become evident. A number of corporate credit unions have experienced a dramatic reduction in the value of their investment portfolios, resulting in startling losses. These losses have undermined the stability of some CCUs. NCUA placed both the wholesale corporate credit union, US Central Federal, and one of the largest retail corporate credit unions, WesCorp Federal, into conservatorship. Further, NCUA acted to guarantee deposits in the corporate system, and with Congressional approval created a \$6 billion corporate stabilization fund with a line of credit from the Treasury Department. But for these extraordinary steps, the losses within the corporate system and to the corporates’ natural person credit union members might have been catastrophic.

Given the tenuous condition of some corporates, it is necessary for regulators to reconsider how the CCU system is structured; what proper functions CCUs should perform; and how CCUs are regulated. NASCUS supports NCUA’s efforts to enact remedial measures to correct identified deficiencies within the CCU system. Those deficiencies include acute concentration risk and systemic risk; insufficient capital; and insufficient investor discipline.<sup>2</sup> These concerns notwithstanding, state regulators believe the events of the past year also demonstrate that the risk in the corporate system was not uniform. In fact, several CCUs remain well capitalized and are able to absorb the loss of their member capital accounts (MCA) and paid in capital (PIC) at the wholesale corporate without causing a loss to their natural person credit union members. **If** the credit union movement desires a corporate system to serve its liquidity needs, payment services and investment services, the proposed rule should provide a reasonable operating environment where well managed corporate credit unions can be successful. NASCUS cautions against a reaction to the corporate situation that results in regulation to the lowest common denominator.

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<sup>2</sup> In addition to these deficiencies, NASCUS has noted previously that the culpability for the failings of the corporate system is widespread. In addition to the obvious responsibility borne by many of the corporates, natural person credit unions in many cases failed to exercise prudent due diligence with respect to their corporate relationships. From a supervisory perspective, regulators may have failed to exercise existing authority to curb unsafe and unsound practices within the corporate system as well as with respect to natural person credit union investment in the CCU system.

Such a reaction would ultimately prove counter-productive. State regulators believe that responsible corporate credit unions, like responsible natural person credit unions, should be provided the regulatory flexibility to operate to the maximum benefit of their members within safe and sound parameters.

### **1. Homogenization of the Corporate Credit Union System**

NASCUS remains concerned that the corporate credit union system lacks meaningful dual chartering. Dual chartering strengthens the credit union system by fostering innovation and by providing institutional and regulatory diversity. It also improves the system's ability to withstand cyclical downturns and to more effectively identify safety and soundness concerns.

NCUA's Part 704 should allow state laws to establish governance standards, additional investment authorities, credit union service organization (CUSO) activities, obligor limits and other powers. Returning diversity to the corporate system would promote a rejuvenation of the business model and help foster a balance between oversight and needed business flexibility. In some cases, NCUA's proposed rules address matters that are only indirectly related to safety and soundness concerns and which in fact should be under the purview of state authority for state-chartered corporate credit unions. As discussed in more detail below, proposed §704.11 related to CUSO services, §704.14 board representation and §704.19 disclosure of director compensation should be left entirely to the determination of state law.<sup>3</sup>

Other provisions in the proposed rule address legitimate safety and soundness concerns, but establish limits upon which reasonable minds could disagree. For example, proposed §704.8 would limit shares, loans and contributed capital from any one member to 10% to the corporate's moving daily average net assets. In this case, however, 15% or 20% could be equally prudent limits. As long as the issue of "capture" by one member is addressed, state law and regulations should be allowed to set reasonable safety and soundness limits for state-chartered corporate credit unions that recognize individual market variations. This model would be similar to that of the NPCU system where states have established member business lending (MBL) rules that are different from NCUA's rules but provide the same protection to the National Credit Union Share Insurance Fund (NCUSIF). **See §723.20.**

Under both the existing §704 and the proposed changes, NCUA would retain ample authority to mitigate material risk to the NCUSIF, the corporate system and NPCUs even with a restoration of state authority. NCUA would have the ability to consult with state regulators regarding establishment of corporate specific capital standards pursuant to proposed §704.3(d). With respect to provisions where a state specific waiver could be obtained, NCUA would retain approval authority ensuring material risk was properly mitigated.

#### **NASCUS Recommendation**

Proposed §704 should be amended to restore meaningful dual chartering to the corporate system. Provisions concerning governance, compensation and CUSOs for state-chartered

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<sup>3</sup> While existing §704.11 addresses CUSO services, NASCUS has long held that the current corporate credit union rule is overly broad. Further, proposed §704.11 narrows the approved services to an extent to be an entirely different rule.

corporates should be governed by state regulation. Investment thresholds and limitations should be subject to waivers for state specific rules in a manner consistent with the NPCU regulatory structure for §723.20.

## **2. Joint Examinations**

In addition to reconsidering the authorized products, services and powers of corporate credit unions, regulators must reconsider how oversight of the CCU system is conducted. All credit union regulators, regardless of whether they have direct supervisory responsibility for a corporate credit union, need to understand the risk profiles of the corporates.

In whatever form the corporate system takes in the future, NCUA should require federally chartered corporate credit unions to make their books and records accessible to state regulators with vested natural person credit unions.<sup>4</sup> As the regulator of the federal corporate credit unions, NCUA could coordinate joint examinations as needed. The precedent for this approach is found in NCUA's regulations regarding natural person CUSOs and the requirement for NCUA and state regulator access to books and records. **See NCUA §712.3(d)(3).**

Not only would providing this access allow for all regulators to conduct their due diligence with respect to their natural person credit unions' risk exposure, the conducting of joint examinations would materially improve oversight of the corporate system. Conducting joint examinations would be an important step to safeguarding against regulatory complacency. By drawing on the expertise of many regulatory agencies, state and federal regulators could improve their ability to detect and address troubling trends before those trends achieve critical mass. This could help restore confidence in the corporate system, which would present the credit union movement with an opportunity to remain a cooperative system that can develop, provide and access its own services while maintaining economies of scale that make those services available to credit unions of all sizes and means.

## **3. Role of the State Regulator**

Comments in this section pertain specifically to NCUA's consultation and cooperation with state regulators.

When Congress mandated Prompt Corrective Action (PCA) for federally insured credit unions, it made its intent clear: NCUA was to consult and cooperate with state regulators throughout rule drafting, implementation and enforcement. **See 12 USC 1790d(1).** In some provisions, NCUA's proposed Part 704 lacks sufficient consultation with state regulators.

### **i) Proposed §704.3(a)(3)**

This provision would require CCUs, beginning with the call report three years after publication of the final rule, to report the ratio of their retained earnings. If the ratio is less than .45%, the CCU must submit a retained earnings accumulation plan for NCUA's approval or be subject to PCA pursuant to §704.4. There is no reference to state regulator participation in this provision.

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<sup>4</sup> NASCUS will be making the same recommendation to state regulators with state-chartered corporate credit unions.

NASCUS Recommendation:

Section 704.3(a)(3) should be amended to provide for state regulator participation. A state-chartered corporate credit union's retained earnings accumulation plan should be submitted to both NCUA and the state regulator. NCUA should consult with the state regulator in the evaluation of the submitted plan. This would be consistent with NCUA's evaluation of a net worth restoration plan for a federally insured state-chartered natural person credit union. **See §702.206(f)(3).**

In addition, proposed §704.3(a)(3) should be amended to provide state regulators the opportunity to take the enforcement action NCUA may deem necessary if a retained earnings plan is rejected. **See Consultation on proposed discretionary action §702.205(c).**

ii) **Proposed §704.4**

NASCUS commends NCUA for the consultation and cooperation with state regulators provided for in §704.3(d)(4) with respect to individual capital standards; §704.3(e) reservation of authority to disregard transactions and reclassify capital components; and §704.4 with respect to any discretionary actions under PCA. However, with respect to proposed §704.4, the CCU PCA framework is missing an important element from the NPCU PCA framework. While proposed §704.4 properly provides for cooperation and consultation, the section lacks a specific provision for the state regulator to have an opportunity to take the NCUA determined discretionary PCA enforcement action.

NASCUS Recommendation:

As discussed above with respect to §704.3(a)(3), NCUA should amend the proposal consistent with existing PCA for NPCUs: §702.205(c) which provides that if NCUA deems discretionary action necessary, the state regulator has the opportunity to take the action individually or jointly with NCUA.

**4. Corporate CUSOs**

Proposed section 704.11(e) limits the permissible activities of a CCU CUSO to 1) brokerage services; 2) investment advisory services; and 3) other services as approved by NCUA and published on the agency's website. This provision is unnecessarily limiting. With respect to state-chartered corporate credit union CUSOs, state law should determine the products and services that may be offered. Unnecessary limitation to the state system may result in loss of innovation and growth for state corporate credit unions. As the insurer, NCUA could retain the authority to restrict an activity that is determined to present an undue material risk to the insurance fund.

NASCUS Recommendation

Proposed §704.11(e) should be modeled after §712 and §712.5. Currently CUSO rules for

NPCUs generally apply only to federal credit union CUSOs.<sup>5</sup> NCUA should allow state law, or regulation, to establish the powers and authorities of state corporate credit union CUSOs, while reserving the right to prohibit activities by publication on the NCUA website. In addition, §704.11(g)(5), the provision requiring NCUA access to the books and records of the CUSO, should be amended to provide an exception for state-chartered corporate credit unions in states where the regulator already has access to the books and records. **See §712.10.**

## **5. Governance**

The proposed governance provisions concern NASCUS both from a state authority perspective as well as from a practical operational perspective.

### **i) Proposed §704.14**

Proposed §704.14 would mandate, among other things, term limits for directors and qualifications for directors based on job title. The composition of the board and the qualifications of individual board members are properly the province of state law and regulation. The direct connection to safety and soundness of these specific provisions is too tenuous to justify federal preemption of state authority. As NASCUS has stated in the past, well established law supports state law in issues pertaining to governance.<sup>6</sup>

NASCUS also questions the utility of the proposed regulations. There is no evidence that mandating a director be a CEO, CFO or COO will result in enhanced board competence or function. Further, many highly talented potential directors from member entities may not hold the prescribed titles. For example, an economist or an attorney employed by a member entity could enhance the leadership of a particular corporate. While an individual corporate may decide to establish such criteria for its directors, that is a business decision for the individual corporate which should be guided by the institution's own corporate governance framework.

Proposed §704.14(a)(3) is unclear as to how long the term limit prohibitions would last. Is a term-limited director prohibited from serving at the same corporate into perpetuity? May they seek re-election after one year or after one full term off the board? NCUA should clarify the proposed term limit prohibition and clearly articulate what risks the proposed limitations are intended to mitigate.

### **ii) Proposed §704.19**

Proposed §704.19 would require disclosure of executive and director compensation. State regulators concur that transparency is beneficial to the credit union system. However, the benefit of transparency must be balanced with the respective appropriate roles of state and federal regulators.

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<sup>5</sup> CUSO rule requirements regarding access to books and records and corporate separateness do apply to SCU CUSOs.

<sup>6</sup> See <http://www.ncua.gov/Resources/RegulationsOpinionsLaws/Comments/CreditUnionCharter/2008/5-1-08-BrianKnight-NASCUS.pdf> (p. 4).

NASCUS sees no relation between compensation and the weaknesses revealed at some of the corporate credit unions. From a chartering perspective, if NCUA believes the philosophy of the federal charter would be better served by compensation disclosure, the agency should mandate such disclosure for federal corporate credit unions. However, mandating such disclosure by rule for a state-chartered corporate is unsupported by safety and soundness concerns.

In addition to being an unsupported encroachment on state authority, proposed §704.19 is mostly unnecessary with respect to state-chartered corporate credit unions. Unlike their federal counterparts, state-chartered credit unions are required to file an Internal Revenue Service (IRS) Form 990 which itself contains elements of compensation disclosure as required by the IRS. Duplicating that disclosure through regulation is an unnecessary regulatory burden that disadvantages state-chartered corporate credit unions.

#### NASCUS Recommendation

The proposed regulations concerning governance should be limited to federal corporate credit unions.

### **6. Capital Standards and Balance Sheet Management**

NASCUS supports establishing increased capital standards for the corporate system. Instituting PCA for corporate credit unions is a reasonable regulatory framework to address safety and soundness concerns going forward. In addition, NASCUS believes revisiting corporate investment authority is also prudent. We do, however, note the following concerns.

- i) Realistic ability of the corporate system to re-capitalize within the specified timeline

In the preamble to the proposal, NCUA references its internal modeling of the corporate system going forward under the proposed regulations. NCUA's conclusion is that prudently managed CCUs would be able to meet the capital benchmarks established by the proposal. In its discussions with various sources, NASCUS has learned that there are serious concerns about the practical application of NCUA's modeling as well as doubts regarding several of the presumptions underlying the modeling. Specifically, CCUs themselves contend that the modeling is based upon overly optimistic assumptions unsupported by actual historical operational data.

While reasonable minds can disagree on the parameters of modeling, NASCUS would like NCUA to specifically address concerns that have been raised regarding the modeling.

#### NASCUS Recommendation

Before a final rule is published, NCUA should release the results of the independent consultant review of the proposed rule and address the concerns of the corporate system with respect to the modeling.

ii) Investment limitations

Many of NCUA's proposals, when viewed solely from a regulatory perspective make sense. However, NASCUS generally favors a regulatory approach that seeks to offset risk while permitting flexibility over a prescriptive approach that overly constricts prospective yield. The fact that several CCUs have managed to maintain strong balance sheets indicates that a regulatory focus on risk management could produce the desired risk mitigation in the system.

There is no substitute for sound risk management and vigorous supervisory oversight. For CCUs with adequate safeguards in place, a range of investment authority would allow them to make investment opportunities available to credit unions lacking the resources to manage their portfolios day-to-day. However, it is expected that regulators would require the natural person credit unions engaging a corporate credit union for investment purposes to have sufficient expertise to manage the third-party relationship, understand the associated risks and mitigate those risks consistent with existing regulatory guidance.<sup>7</sup>

iii) Asset liability management

NCUA proposed several new rules regarding asset liability management. NASCUS concurs that the spread testing of proposed §704.8(e)(1)(i); the weighted average life proposals of §704.8(h); and the cash flow mismatch analysis of proposed §704.8(f) are prudent considerations in response to the problems experienced at some CCUs. However, these provisions should be implemented as thresholds rather than firm restrictions. In some cases, sound business reasoning could support operation outside of these parameters. NCUA should consider establishing the parameters as triggering additional oversight rather than as prohibitive limits. NASCUS believes existing supervisory authority provides regulators the tools to implement corrective measures if a particular CCU operates outside the established thresholds with insufficient management expertise, risk mitigation or business continuity planning.

**7. General Comments on the Future of the Corporate System**

Regardless of the rules implemented to address weaknesses in the credit union system, a real question remains whether NPCUs will re-capitalize corporate credit unions. As noted at the beginning of this letter, CCUs have historically provided three primary functions for the credit union system: 1) liquidity; 2) payments systems; and 3) investment services. Ultimately, it will be the credit union system itself which determines if the corporate system continues. If the credit union system desires CCUs to serve those three functions in the future, regulators must ensure that the rules promote mitigation of material risk. NCUA's proposal contains some sound first steps to achieving that end. Concentration in certain sectors has long been a weakness in parts of the CCU system, and the proposed rule addresses some of those concerns. However, the fact remains that individual credit unions seek different products and services from their corporate credit unions. The future rules of the corporate system should be carefully tailored to address risk, while providing credit unions the opportunity to provide their service solutions from within the system – if that is what the credit union system ultimately determine best serves its cooperative model. In addition, NASCUS recommends that at some future point, NCUA address

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<sup>7</sup> LCU 07-CU-13.

the relationship between the National Credit Union Share Insurance Fund (NCUSIF) and the CCUs. Given the implications of either maintaining or severing the nexus between the NCUSIF and the CCUs, this issue should be thoroughly discussed among regulators and NCUSIF stakeholders.

### **Conclusion**

In considering changes to CCU regulation, it is easy to forget that the corporate system is comprised of individual corporate credit unions some of which remain safe, sound and viable. Those corporate credit unions demonstrate that with prudent management, investor discipline and effective supervision, the corporate model can exercise existing authorities to the benefit of their members with minimal risk to the overall system.

NASCUS remains committed to working with NCUA to develop prudent regulation to address any weaknesses in the credit union system while preserving the flexibility for corporate credit unions that are safe, sound and retain the confidence of their membership to continue as ongoing concerns. Specifically, the NASCUS regulator task force that worked with NCUA to provide feedback during NCUA's drafting process reiterates its appreciation for NCUA's good faith efforts to incorporate state regulator suggestions.

NASCUS appreciates the opportunity to comment on NCUA's proposed corporate credit union rule. Please do not hesitate to contact me to discuss our comments further.

Sincerely,

- signature redacted for electronic publication -

Mary Martha Fortney  
NASCUS President and CEO